INDONESIA

KEY POINTS

- The financial crisis has breached relationships between many Indonesian corporates and their banks. High levels of non performing loans and banks' need to retain capital adequacy and meet new regulatory requirements have prevented most new lending. Many conglomerates' assets are owned by the Government and many other Indonesian corporates are trading whilst technically insolvent.
- The Government now owns the majority of banks, together with a large portfolio of non performing loans. If they proceed with planned public placements of bank and corporate assets and strategic sales to new entrants, including foreigners, the Government will reduce major families' dominance of the corporate sector. This should encourage more unrelated transactions, increasing opportunities for an arm's length business environment to develop.
- Many of the laws and regulations supporting a rules based business environment are in place, though accounting standards are still weak. New prudential laws and regulations passed since the crisis eventually should strengthen corporate governance and market development, but are as yet untested. For example, the Government has passed a new bankruptcy law, set up commercial courts and established an informal debt workout process. The Jakarta Stock Exchange has tightened listing rules, especially on disclosure and liquidity.
- However, generally weak implementation of new laws and regulations undermines their impact. In particular, the court system has yet to implement the new bankruptcy laws. Similarly, accounting and listing rules require better enforcement.
- Efforts to better enforce the bankruptcy laws would help accelerate the corporate restructuring and economic recovery currently underway. A few successful debt actions through the court system would make a significant contribution to encouraging more reasonable settlements through negotiation.
- Since the crisis, Indonesia has increased competition in goods and services markets by dismantling monopolies, reducing trade barriers on imports and relaxing foreign investment restrictions; the new Government also plans to privatise state enterprises. Eventually a more competitive economy should increase discipline on corporates.

Serious structural weaknesses in Indonesia's corporate and financial sectors, including close relationships between firms and their banks, low levels of transparency, inadequate prudential enforcement, weak outside shareholder protection and a dysfunctional insolvency regime contributed significantly to Indonesia's financial crisis and retarded its recovery (PricewaterhouseCoopers, 2001). After 1997, the Government introduced legal and regulatory reforms to improve corporate and financial system operation. If these are rigorously implemented, eventually bank and corporate restructuring, the entry of new players and the enforcement of new corporate laws will create more competitive markets and better corporate governance in Indonesia, aiding economic recovery.

CORPORATE SECTOR STRUCTURE

Powerful families and the state control most of Indonesia's corporate sector (Claessens et al., 1999a). Typically, a few wealthy families own and manage the dominant business groups. These family groups operate across diverse sectors, including banking, and rely on debt to finance their activities (Naughton, 2001). In the past, they used strong political connections to preserve entrenched positions in key markets. Now, many corporates are in government ownership, though some are still operated by their former family owners. Under this business model, minority shareholders, depositors with group banks and small competitors are at risk.

Family Ownership Dominant

In the lead up to the crisis, the top 15 large families controlled 62 per cent of the Indonesian share market's capitalisation (Claessens et al., 1999a). In 67 per cent of cases, owners used pyramid structures to control conglomerates, driving a wedge between voting and cash rights and in over 80 per cent of cases, owners appointed the CEO (Claessens et al., 1999a; Naughton, 2001). Consequently, controlling families could and did expropriate wealth from minority shareholders.

Diverse Conglomerates the Norm

Before the crisis, easy access to finance allowed large conglomerates to grow rapidly, entering many sectors. The top 300 conglomerates owned almost 10 000 business units across all sectors; most were unlisted; together, they accounted for about 13 per cent of GDP (Asian Development Bank, 2001). Firms in non-complementary sectors and complex relationships between listed and unlisted firms in the same group exposed banks and shareholders to considerable risk of loss.

Bank Debt Dominates Financing

Conglomerates often owned a bank that financed most of their needs. All top ten private Indonesian banks had relationships with major business groups, including the largest, Bank Central Asia, owned by the Salim Group (Asian Development Bank, 2001). State owned banks also provided low cost credit to well connected groups. The crisis forced a public bailout of the banking system, raising state ownership from around 33 per cent to close to 50 per cent (Asian Development Bank, 2001). State directed and relationship based lending lowered the banking sector's return on assets to well below the corporate sector's average and reduced corporate incentives to use funds efficiently (Asian Development Bank, 2001).

Family conglomerates typically have higher debt-to-equity ratios than widely held firms. Conglomerates' preference for debt over equity financing and readily available foreign and domestic bank lending raised debt-to-equity ratios in firms with concentrated ownership to 700 per cent by 2000; even in firms with widely dispersed ownership, debt-to-equity reached 350 per cent.[1] High leveraging made investing in and lending to conglomerates, especially family owned ones, highly risky for minority shareholders and banks.

Capital Markets Immature

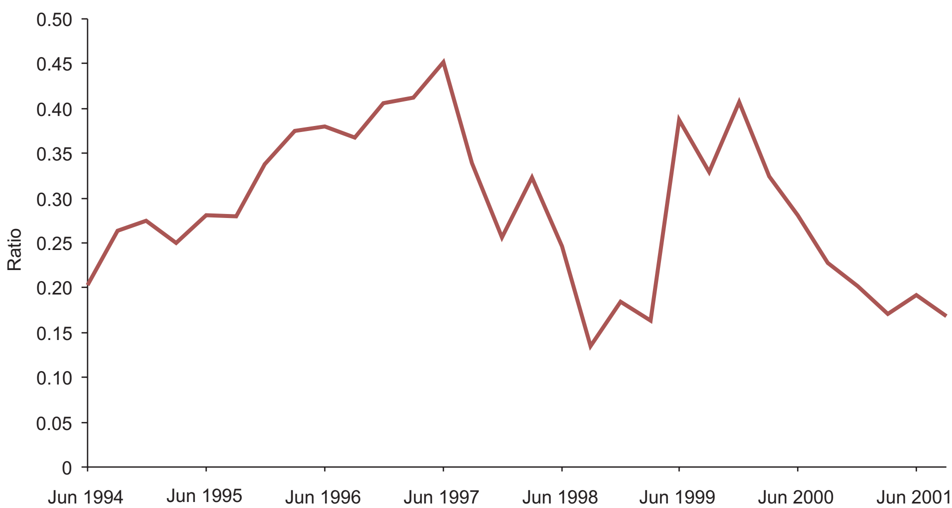
Most conglomerate owners list only a small share of total equity or do not list at all, to protect controlling relationships; this retards stock market development and the stock market's potential role in disciplining corporates. Company insiders also often hold tightly a large part of listed stock. Of the 11 major East Asian economies, only Vietnam's capitalisation is a smaller share of GDP than Indonesia's.

The crisis further undermined the role of the stock market in corporate financing, sending market capitalisation to 13 per cent of GDP at the end of 1998; despite a rally in 1999 and 2000, it was still under 20 per cent by June 2001 (Figure 11.1).

Figure 11.1

Share Market – Little Impact on Corporate Behaviour

Stock Market Capitalisation to GDP, 1994-2001



Source : CEIC, 2002

[1] Loose credit and prudential controls allowed listed companies' average debt ratio to rise from 220 per cent in 1992 to above 300 per cent by mid 1997 (Asian Development Bank, 2001).

Share market liquidity is also low, exceeding only the Philippines in South East Asia (Naughton, 2001). Sales by listed companies are less than 10 per cent of GDP (Asian Development Bank, 2001). Despite a substantial amount of issued public debt, the corporate bond market also is underdeveloped; issues are negligible (Naughton, 2001).

Government Enterprises a Priority

To date, post crisis commitments to privatise the large state owned sector have foundered on concerted vested interest opposition. Although state enterprises generally perform poorly, the state still controls more than 40 per cent of national assets (Jakarta Post, 30 April 2001; Naughton, 2001).[2] Their presence reduces markets' competitiveness and undermines corporate governance standards. Under the Soeharto regime, some ministers controlled state enterprises, using them to create business for connected families and cronies; in many respects they acted like family companies (Herwidayatmo, 2001). By 1995, 165 state owned companies operated in most sectors and accounted for around 8 per cent of GDP (Asian Development Bank, 2001). Despite some holding special monopoly rights and ready access to state bank lending, state enterprises have a much lower return on equity than private companies. Many state enterprise loans are non performing. Since 1998, opposition by state enterprise workers, managers, host provincial governments and the national parliament has prevented most planned state enterprise sales (East Asia Analytical Unit, 2000). Despite the current Government's commitment to an ambitious privatisation program, it has not yet made much progress. Some provincial governments are pressuring the central government to get access to state enterprise assets.

MARKETS PRESSURING RELATIONSHIPS

Importantly, trade and investment liberalisation and dismantling of monopolies increases firms' exposure to competition. Also post crisis bank and corporate restructuring eventually may separate banks from related firms, increase corporate exposure to share markets, dilute company ownership concentration and lower small investors' risks; however, at present, these forces are facing resistance. Several publicly listed companies, including PT Astra and PT Indosat, plan to adopt higher corporate governance standards to protect new investors and attract new funds.[3] Several major corporates also are seeking international business services assistance to review and upgrade their corporate governance regimes (East Asia Analytical Unit, 2000). As bank sales slow, the risk increases of state determined lending policies producing new non performing loans.

2 The majority of those were once private assets nationalised after the crisis.

3 PT Astra is one of Indonesia's biggest conglomerates and PT Indosat is a major telecommunications company.

Banking Reform

Following the crisis, massive state-led bank recapitalisation nationalised over 90 per cent of banks.[4] The state plans to sell most of its recently acquired bank equity over the next five years; if this occurs, new private, including foreign, owners should make banks more independent of corporations. Already, the Government has approved a majority share sale in PT Bank Central Asia and it intends to sell PT Bank Niaga in 2002 (Naughton, 2001). However, the sale of Bank Central Asia continues to generate controversy, with parliamentary intervention aborting the initial sales plan; its sale is expected sometime in 2002 (*Australian Financial Review*, 9 January 2002, p. 16). Analysts and the Indonesian Bank Restructuring Agency are concerned the original owners are seeking to regain control through nominees (Reuters, www.reuters.com, 18 and 20 July 2001). The Government is also concerned; in early 2002, the Minister for State Owned Enterprises, Laksamana Sukardi, stated that the Government would not permit the Salim group to buy back a major share in Bank Central Asia. Complicating the sales process, the Parliament and Government are reluctant to sell assets at what they believe are 'fire sale' prices, increasing market scepticism about the commitment to privatisation.

Bank restructuring means many conglomerates no longer own banks. Furthermore, banks are reluctant to lend, as they need to comply with capital adequacy regulations. Major bank losses, non performing loans, restructuring and the weak corporate sector have slowed the resumption of bank lending. Many conglomerates have been forced to consider raising funds through equity or bonds, exposing them to new listing rules.

Finance Markets Developing Slowly

Indonesian financial markets are developing gradually from a low base. Already, the share market may motivate better governance, granting an average equity premium of 27 per cent for firms practising sound corporate governance (Naughton, 2001).

Although relatively few companies are listed, the eventual sale of government owned bank and corporate equity will expand the supply of equity, boosting market capitalisation. The number of listed firms on the Jakarta Stock Exchange increased gradually from 122 in 1990 to 291 in 2000. In 2001, around 30 new firms listed, 9 more than in 2000. Market turnover remains well below 1997's peak. Foreign investors' total annual trading peaked in 1993 at US$157.5 million or 20.7 per cent of total trading. However, by 2000, it had tumbled to US$9.2 million or 1.3 per cent of the market.

The corporate bond market is underdeveloped and reviving only gradually from the crisis. By December 2000, only Rp92 billion (US$9.52 million) worth of convertible bonds were outstanding. A local ratings agency, Pefindo, with close links to Standard and Poor's, provides local firm ratings, aiding bond market transparency (Institutional Analysis, 2001). Since the crisis, large government debt issues have provided a benchmark yield curve, but could crowd out private sector borrowing as demand grows for funding.

[4] The Government reduced the number of banks from 240 to around 160. Five state owned banks now hold 33 per cent of deposits. The state owns 95 per cent of private commercial banks; these hold around 65 per cent of deposits.

Institutional investors are growing gradually from a low base. The Government is committed to developing the pension fund sector; employer managed funds are growing rapidly; and life and non-life insurance activity surged after the crisis. Foreign insurance companies can enter the Indonesian market without restrictions, boosting insurance sector growth (East Asia Analytical Unit, 2000).

The 1995 Capital Market Law regulates listed securities and market participants. The legislation defines financial reporting, auditing and disclosure requirements, cross shareholding and insider trading regulation and shareholder standards. Indonesia's Capital Market Supervisory Agency, Bapepam, and the Jakarta Stock Exchange gradually are improving their enforcement of this law, exposing non-compliers to tougher penalties and fines (Herwidayatmo, 2001). However, prior to the crisis, enforcement was limited. Delistings for non-compliance remain rare.

Corporate Restructuring

Corporate restructuring eventually should weaken relationships between firms in conglomerates, reducing the dominance of original owners and increasing their exposure to direct financing markets and market regulators. Bank conversion of non performing loans into equity or secured convertible bonds theoretically has transferred ownership from families to the state and banks. Analysts estimate a majority of Indonesia's corporate sector is technically insolvent. Most domestic debts are owed to troubled domestic banks and have been transferred to the Government as part of the bank restructuring program (East Asia Analytical Unit, 2000). If sold, this equity should disperse ownership and reduce dominant shareholders' power.

However, under the Indonesian Bank Restructuring Agency's Master Settlement and Acquisitions Agreement, and many agreed restructuring schemes, original owners can retain operational control and ownership of recapitalised firms (*Far Eastern Economic Review*, 19 October 2000, p. 43). Furthermore, original owners have illegally tried to use front companies to buy back their assets at low prices, at minority shareholders' and taxpayers' expense (Patrick, 2001). Such practices create a moral hazard and limit new investors' scope to dilute family control. The Government is working hard to avoid these actions succeeding. The bulk of debt workouts being undertaken under the Jakarta Initiative largely favour debt rescheduling agreements over more thoroughgoing management and asset restructuring. Hence, many distressed assets are likely to remain in original owners' hands, lessening the long term viability and productivity of these assets, and weakening the potentially positive impact of more thorough restructuring on corporate governance.

PRODUCT MARKETS MORE COMPETITIVE

In the long term, post crisis trade and investment reforms should force conglomerates to adopt international best practice management, technology and corporate governance if they wish to survive international competition and generate high profits. After the onset of the crisis, the Government abolished several private and government monopolies, notably import licensing requirements on commodities that the national logistic agency, BULOG, controlled. Now, imports and distribution of wheat, flour, sugar, soy beans and garlic are competitive (East Asia Analytical Unit, 2000). It also abolished monopolies in the car, plywood and clove industries.

Trade Reforms

After the financial crisis began, the Government accelerated trade reform; Indonesia's trade regime now is moving towards that of Singapore or Hong Kong in the 1960s and 1970s. By mid 2000, 60 per cent of Indonesian tariff lines had duties of 0 to 5 per cent and over 70 per cent had tariffs of 10 per cent or less. The unweighted average tariff rate is below 9 per cent. The Government also removed many non-tariff barriers on agricultural imports.

Investment Reforms

Indonesia's foreign investment regime also is now more open; as economic stability returns, resumed inflows eventually should encourage greater corporate competition. Foreigners now can: own 100 per cent of manufacturing and plantation operations, existing banks and most other financial institutions; operate retail outlets; distribute goods produced locally; and apply to import and distribute other products. Foreign banks can purchase banks or bank equity from the Indonesian Bank Restructuring Agency's sizeable holdings. Foreign investors also can form holding companies to facilitate local business debt restructuring and enter joint ventures for medical services and telecommunications. Only a few sectors restrict foreign investment; foreigners cannot invest in property unrelated to productive investments or own land in Indonesia, although they can take out long term leases.

Despite reforms opening most sectors to foreign investment, due to political uncertainty and cautious government asset sales, foreign direct investment flows have been negative since 1997. Net outflows reached US$4 billion in the first half of 2001, compared to net inflows of US$6 billion in 1996 (CEIC, 2002). If the current administration sells state enterprises and nationalised assets and the weak rupiah keeps export oriented and import substitution sectors competitive, foreign investment inflows should recover. This would not only boost growth but corporate governance prospects.

Government Role to Decline

The Minister for State Owned Enterprises, Laksamana Sukardi, has committed to a vigorous program of privatisation. Selling inefficient state firms should boost economic efficiency and competition and benefit consumers. If this succeeds it will make an important contribution to moving to a rules based business environment. In 1999, sales of three state owned enterprises raised US$850 million and in 2000, the part sale of PT Telkom raised a further US$406 million (World Bank, 2001). However, in 2001, the privatisation process stalled. The thwarted sale of Semen Gresik and its subsidiaries, Semen Padang and Semen Tonasa, to Mexican company Cemex, reflected the competing interests opposing privatisation. The only significant privatisation achievement in 2001 was the 11 per cent sale of shares in PT Telkom, which mostly went to institutional investors. In 2002, the Government aims to accelerate sales, including majority shares in profitable telco Indosat and pharmaceutical firm Indofarma, and a minority share in property firm Wisma Nusantara (*South China Morning Post*, www.scmp.com, 15 January 2002).

Competition Policy Reform

In 1999, the Government passed the *Prohibition of Monopolistic Practices and Unfair Business Competition Law*. Authorities also plan to establish a Fair Competition Commission (Asia Foundation, 1999). However, implementing this legislation is very challenging in the current business and bureaucratic environment.

NEW RULES FOR BUSINESS

Many of the prudential and market reinforcing laws and regulations supporting arm's length business dealings are in place and several have been strengthened since the crisis, but their weak implementation undermines their impact on corporate governance and market development.[5] As market discipline increases, firms should be more motivated to adhere to these regulations. However, regulations still do not protect minority shareholders or require directors to meet fiduciary duties. Further, despite reasonably sound laws, weak enforcement still results in regulatory failure. The major challenges are to improve regulatory implementation and strengthen corporate recognition of the need for good corporate governance for firms' survival and recovery.

TRANSPARENCY

Better and more timely information on companies is needed to make arm's length investing safe; institutional investors and market analysts rate Indonesia's transparency and disclosure as poor and deteriorating. Indonesia is near the bottom of the scale of Transparency International's Corruption Perceptions Index, scoring 2.7 out of 10 in 2000 and only 1.9 in 2001 (Naughton, 2001). The Indonesian accounting standards, the Capital Market Supervisory Agency, Bapepam, rules and the stock exchange, regulate corporate disclosure.[6] Since the crisis, most disclosure requirements are tighter and enforcement is improving, although from a low base.

Corporate Reporting

Since 1999, all companies seeking funds from the public, issuing debt instruments and controlling total or net assets over Rp25 billion must provide annual reports, including audited and annotated financial statements and a company profile. Reports must be available on the Internet and at local registries. Consolidated reporting is mandatory.

---

5 Chris Cooper, Dudi Kurniawan and Michelle Narracott, PricewaterhouseCoopers and PricewaterhouseCoopers Legal, contributed to this section.

6 Bapepam produces a publication 'Presentation and Disclosure of Financial Statements, a Guideline for Publicly Listed Companies'.

NON-GOVERNMENT CORPORATE GOVERNANCE INITIATIVES

Since the crisis, several public and private initiatives have sought to boost corporate governance standards. In October 1999, the National Committee on Corporate Governance, which included eminent official and private sector representatives, presented the Government with a draft Code for Good Governance to guide corporate governance reforms. The committee's recommendations have influenced several new and planned reforms. In June 2001, the National Committee on Corporate Governance set up an Indonesian Institute of Directors and Commissioners to train company directors in good corporate governance.

The Corporate Leadership Development Institute also trains directors. State enterprises allocate 5 per cent of their training budget to fund the Institute. The Institute runs workshops and major conferences on corporate governance; a mid 2001 conference had 500 attendees. At present, professionals from companies like PricewaterhouseCoopers give their time voluntarily to speak at these conferences and run training seminars.

Indonesia's Forum for Corporate Governance initially had five professional associations; this has doubled and includes the Publicly Listed Companies Association, the Indonesian Financial Executives Association, the Indonesian Accountancy Institute and the Transparency Institute of Indonesia. The Forum raises awareness of corporate governance issues among company directors, helps produce position papers for the National Committee on Corporate Governance, provides inputs into the code on corporate governance, runs workshops and conferences, and publishes and distributes corporate governance materials. In cooperation with PricewaterhouseCoopers and the Asian Development Bank, the Forum launched a self-assessment questionnaire for firms regarding their corporate governance standards, available at www.fcgi.or.id.

Since August 1998, the Indonesian Society for Transparency has promoted good governance in the public and private sectors, publishing a newsletter and conducting seminars and research led by prominent private and public sector members, including former Ministers (Asian Corporate Governance Association, 2000).

These initiatives provide an important positive impetus, but all these bodies recognise the existing corporate culture will be slow to change.

Source: Carmody, 2001; Cooper, 2001; Gunadi, 2001.

Accounting Standards

The reform program for Indonesian accounting standards started in the early 1990s, but was given a higher priority as a result of the crisis; it aims for the profession to attain IAS implementation within five years. Indonesian law requires all companies, listed and private, to comply with accounting standards issued by Indonesia's standard setting body, the Committee on Financial Accounting Standards and endorsed by the Indonesian Accountants Institute.[7] The Financial Accounting Standards Advisory Council, representing regulators, public accounting firms, businesses and state owned enterprises, advises the Accounting Standards Board on which standards should be developed or revised.

Listed firms do not have to use international accounting standards, but can employ a mix of international and Indonesian standards. Currently, only about 50 per cent of Indonesian accounting standards refer to international accounting standards with some adjustments for local conditions, laws and regulations. Around a quarter of Indonesian standards are completely local, relating to Indonesian laws or conditions.

Since the crisis, accounting standards have improved, due largely to the efforts of the Indonesian Accountancy Institute, the profession's supervisory body; however, enforcement remains weak and practices could take five to ten years to improve significantly. Education on accounting standards takes place through the institute's continuing professional education program and its journal, *Media Akuntansi* (Kurniawan, 2000). The institute's judiciary process seeks to enforce standards. Since 1998, the Indonesian Accountancy Institute has overseen all accountants' exams and issued licences. In cases of malpractice, it can withdraw an accountant's licence. In the last three years, fewer than ten public accountants have lost their licences, but this is considerably more than before the crisis (Gunadi, 2001). Most major firms only use accountants from the big five accounting firms, which usually have local partners (Gunadi, 2001).

Auditing

Formal auditing standards are good but not properly enforced. Under the 1995 Corporate Law, independent auditors must audit companies' annual accounts. Company shareholders should appoint independent auditors, usually an international audit company. The National Committee on Corporate Governance also recommends the company board of commissioners establish an audit committee, independent of the Board of Directors, with the external auditors solely reporting to the board of commissioners.[8] In mid 2001, the Jakarta Stock Exchange required listed companies to establish audit committees, appoint independent commissioners comprising at least 20 per cent of the board

[7] The Accounting Standards Board, created in 1998 to supersede the Indonesian Accounting Standards Committee develops and maintains accounting standards. The Board has formalised processes for identifying and developing accounting standards and makes draft standards available to ensure informed public comment.

[8] Indonesian companies have a board of directors consisting mainly of executives and company insiders, and a board of commissioners overseeing the board of directors.

of commissioners and strengthen the company secretary's function. In 2000, fewer than 25 per cent of Indonesian companies had audit committees (Asian Development Bank, 2001). In 1999, Bank Indonesia also required commercial banks to appoint a compliance director to audit their activities.[9]

The Indonesian Accountancy Institute's Professional Standards for Public Accountants defines auditing standards based on International Standards of Auditing. Despite this, their implementation has been limited. For instance, during the financial crisis, many auditors failed to warn the public about companies' true financial positions. To improve standards, the Indonesian Accountancy Institute conducts reviews of professional conduct through the Judiciary Council for Public Accountants. The institute has prosecuted several auditors for failing to maintain independence and objectivity, observe ethical conduct or provide sufficient working papers to support an audit (Kurniawan, 2000).

MINORITY SHAREHOLDERS' RIGHTS

In most Indonesian listed companies, the dominance of large shareholders, typically founding family members, weakens outside shareholders' positions and increases their need for protection. Beneficial transactions, expropriation of minority shareholders' wealth and asset stripping are commonplace (Patrick, 2001). Addressing these problems is essential to develop equity markets for arm's length financing of companies.

Listing Rules

Since the crisis, the Jakarta Stock Exchange has tightened listing rules, especially disclosure and liquidity rules (Jakarta Stock Exchange, 2001). For main board listing, companies need a minimum of 200 shareholders, Rp300 billion in assets and two years of making profits. Development board listing conditions are more lenient (Daniri, 2001).[10]

If companies fail to comply with listing rules, the exchange now more often publicly exposes and sanctions them.[11] However, analysts believe the Jakarta and Surabaya stock exchanges often defer difficult decisions, especially delisting insolvent or distressed companies; this may hamper corporate governance improvements (Patrick, 2001).

Since the crisis, Bapepam also has issued numerous rules and regulations to strengthen corporate governance. Bapepam requires public companies to appoint independent directors and commissioners, and imposes sanctions against related party lending. Enforcement is strengthening slowly but major improvements will take a long time (Herwidayatmo, 2001).

---

9 Overlapping corporate governance jurisdictions create confusion. For example, an earlier Bapepam regulation says audit committees are voluntary, while in 1999, Bank Indonesia said audit committees are no longer required.

10 To list on the development board, companies need 500 shareholders, Rp10 billion in assets and to have operated profitably for at least the last 6 months (Jakarta Stock Exchange, 2001). In 2000, 21 new companies listed and, in the 6 months to June 2001, ten new companies listed, most on the development board. The exchange recognises that if it had not eased its listing rules virtually no new companies could have listed as virtually no company has been profitable in the last three years (Daniri, 2001).

11 In 2000, the exchange publicly exposed 40 companies compared to six in 1999.

Representation

The company and capital market laws regulate shareholder meetings, providing most shareholder protection; however, Indonesian minority shareholders are positioned weakly. Corporate law measures to protect minority shareholders include proxy and cumulative voting, the right to call an emergency meeting, mandatory shareholder approval of important transactions and mandatory disclosure of transactions benefiting insiders. Compliance is low, particularly on proxy and cumulative voting (Asian Development Bank, 2001). Under the law, a simple majority vote of shareholders can approve company charter amendments, mergers and acquisitions, and bankruptcy declarations. Mostly this ensures dominant owners' views prevail, providing little effective voice for minority shareholders (Asian Development Bank, 2001).

FORMAL SHAREHOLDER PROTECTION GOOD

Indonesian company law formally protects shareholders' rights including:

- access to reliable information free of charge
- proxy voting, including by mail
- cumulative voting for directors
- pre-emptive rights on new share issues
- one share one vote
- procedures to call emergency shareholders' meetings
- ability to make proposals at shareholders' meetings
- mandatory shareholders' approval of interested transactions and major transactions
- mandatory disclosure of transactions of significant shareholders, connected interests of non-financial information and inter-company affiliation, such as affiliated lending or guarantees
- mechanisms for resolving disputes between the company and shareholders
- severe penalties for insider trading.

However, the Government recognises considerable effort is needed to lift implementation.

Source: PricewaterhouseCoopers, 2001.

From March 2000, Bapepam required public companies to hold special shareholders' meetings to approve all material transactions that could affect the private economic interests or commissions of directors.[12] Company management and boards of directors must release information justifying the transaction, explore alternatives that achieve the same result without a conflict of interest and have an independent expert evaluate the proposal before any meeting. Notwithstanding this provision, controlling shareholder dominance can undermine efforts to improve minority shareholder representation. For example, from 1998 to 2000, shareholders rejected only one management proposal at an annual general meeting (Asian Development Bank, 2001).

Board Structure and Duties

Indonesia's two tier board structure, comprising the Board of Directors and the Board of Commissioners essentially requires directors to represent management, and commissioners to oversee and guide board directors to protect the owners' interests. However, in general this system does not operate well. Boards of Commissioners usually exert limited control over directors and the roles of the two boards are unclear, impairing decision making and good corporate governance (Asian Development Bank, 2001).

The new Corporate Governance code defines board members' fiduciary duties and urges them to conduct their roles faithfully and responsibly in the company's interest; they also should disclose all shareholdings (Forum for Corporate Governance in Indonesia, 2000). Board members may be personally liable for the board's actions with the burden of proof on the board member to address any allegation (Kurniawan, 2000). However, directors who fail to meet their fiduciary duties are not subject to any criminal sanctions, weakening the impact of these requirements (Gunadi, 2001).

In mid 2000, the Jakarta Stock Exchange required companies to appoint independent commissioners in proportion to the shares owned by non-controlling shareholders, and to a minimum of 20 per cent of board positions. However, of 40 recently surveyed companies, 29 did not have independent commissioners and 30 did not have independent directors (Asian Development Bank, 2001).

The Government is trying to improve directors' and commissioners' credentials, who must now undergo 'fit and proper tests'. In one example, 5 per cent of a company's directors failed this test and had to resign (Kurniawan, 2000).

CREDITORS' RIGHTS

Pre-crisis, relationship driven lending and a weak bankruptcy regime resulted in high non performing loan rates. After the financial crisis, the Government raised creditor protection by amending bankruptcy laws, establishing a new Commercial Court and introducing an out-of-court framework for restructuring non performing loans. However, problems with a weak and opaque court system and political resistance to bankrupting well connected debtors thwarts the effectiveness of these new laws.

[12] Material transactions are acquisitions or disposals of assets, or changes in the line of business, of amounts exceeding 10 per cent of company revenues or 20 per cent of the equity.

Bankruptcy Laws

Theoretically, the bankruptcy laws provide good protection but failure to implement them undermines incentives for good corporate governance and risk management. The 1998 bankruptcy law allows unsecured creditors to proceed against defaulting debtors in the commercial courts (Asian Development Bank, 2001). The court can declare a firm bankrupt if at least two creditors request it or if default occurs on a single loan. In 2000, the Government also passed the *Company Bankruptcy and Debt Restructuring and/or Rehabilitation Act*, modelled on US Chapter 11 laws. The Jakarta Initiative complements these legal procedures, providing a voluntary work out facility allowing parties to bypass the courts.[13] In 2000, the Government increased sanctions on uncooperative debtors and empowered the Attorney General to deal directly with cases, improving the incentives for debtor participation (World Bank, 2000).

Since the crisis, commercial courts have declared only a handful of companies bankrupt (Asian Development Bank, 2001). Most distressed companies continue to trade while insolvent, weakening protection for creditors (World Bank, 2000; International Monetary Fund, 2000a). The Habibie and Wahid administrations also drew criticism by refinancing and exempting from bankruptcy proceedings some well connected corporates.

Bank Supervision

Strengthening bank supervision is key to restoring depositors' confidence in the banking system and increasing market discipline. The 1998 *Banking Amendment Law* introduced stricter prudential controls on banks and more liberal foreign ownership rules.[14] The Indonesian Bank Restructuring Agency supervises problem banks and requires external audits by international firms.

COMPLIANCE

Throughout Indonesia, weak regulatory institution capacity and the courts impede the potential of new laws to strengthen corporate governance standards. Better enforcement is essential to increase the credibility of regulations and motivate higher corporate governance standards. The Government openly acknowledges the legal system's shortcomings; the judiciary's skills and independence urgently need improving. The Asian Development Bank is assisting the National Corporate Governance Committee in developing a corporate governance legal reform master plan, proposing changes in listing and company laws, minority shareholders' rights and directors' responsibilities (Carmody, 2001).

[13] In January 2001, companies with a combined debt over US$17 billion were registered with the Jakarta Initiative program.

[14] It also introduced elements of Islamic, *syariah*, law.

IMPLICATIONS

Difficulties in fostering arm's length financing for firms via the largely dysfunctional banking system and the under developed share and bond markets, failure to enforce bankruptcy laws and unwillingness to thoroughly restructure insolvent corporates retards Indonesia's recovery. Since the crisis, the Government has introduced many new laws and regulations, and many committed regulators and non-government organisations have sought to improve corporate governance standards. If these laws are rigorously implemented and responsible agencies adequately resourced, corporate behaviour should improve and levels of economic activity increase.

REFERENCES

Asia Foundation, 1999, Indonesia's Anti-Monopoly Law and its Impact on Small and Medium Enterprises, Jakarta.

Asian Development Bank, 2001, *Corporate Governance and Financing in East Asia*, Volume Two, ADB, Manila, Philippines.

Asian Corporate Governance Association, 2000, 'Building Stronger Boards and Companies in Asia', mimeo, Hong Kong, January.

Basisfield, 1999, 'BA tests Indonesian appetite', www.basisfield.com/bfnews/ infomain.htm, accessed February 2000, Basis Point Publishing Ltd, Hong Kong.

Carmody, B., 2001, Economic Analytical Unit interview with Team Leader, Asian Development Bank Corporate Government Reform project, Jakarta, June.

Claessens, S. and Djankov, S., 1999a, 'Who Controls East Asian Corporations and the Implications for Legal Reform', World Bank, Washington.

Cooper, C., 2001, Economic Analytical Unit interview with Senior Partner, PricewaterhouseCoopers, Jakarta, June.

Daniri, M.A., 2001, Economic Analytical Unit interview with Chairman, Jakarta Stock Exchange, Jakarta, June.

East Asia Analytical Unit, 2000, *Indonesia: Facing the Challenge*, Department of Foreign Affairs and Trade, Canberra.

Forum for Corporate Governance in Indonesia, 2000, 'The Roles of the Board of Commissioners and the Audit Committee in Corporate Governance', Jakarta, June.

Gunadi, E. M., 2001, Economic Analytical Unit interview with Acting Chairman, Forum for Corporate Government in Indonesia, Jakarta, June.

Herwidayatmo, 2001, Economic Analytical Unit interview with Chairman, Capital Market Supervisory Committee, Bapepam, Jakarta, June.

Institutional Analysis, 2001, Consultancy prepared for the Economic Analytical Unit, August.

International Monetary Fund, 2000, 'Selected Issues', Jakarta, August.

Jakarta Stock Exchange, 2001, Listing Rules, www.jsx.co.id, accessed August.

Kurniawan, D. M., 2000, Corporate Governance in Indonesia, Paper presented at 'Second Asian Roundtable on Corporate Governance', OECD, Singapore, June.

Naughton, T., 2001, Consultancy prepared for the Economic Analytical Unit, August.

Patrick, H., 2001, 'Corporate Governance and the Indonesian Financial System: a Comparative Perspective', Paper prepared for the Columbia University CSIS program, Indonesian Economic Institution Building in a Global Economy, New York.

PricewaterhouseCoopers, 2001, Consultancy prepared for the Economic Analytical Unit, August.

World Bank, 2001, 'Indonesia's Road to recovery', http://www.worldbank.org, accessed August.

—— 2000, 'Accelerating Recovery in Uncertain Times: Brief for the Consultative group on Indonesia', Jakarta, October.