

From Recklessness to Prudence

A Study of Regulatory Space Change in Indonesian Banking from 1997 to 2008

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ABSTRACT

This thesis seeks to explore the question of what it is that brings about regulatory change. Traditionally, regulation studies tend to assume that, in circumstances where a regulatory change occurs, a state or governing structure is somehow present and sufficiently powerful to engineer or direct change processes. This thesis will explore the forces that come to bear on regulatory change by examining a case study where one cannot easily make such an assumption. Between 1997 and 2008, banks in Indonesia significantly changed their business practices and behaviour. In 1997, on the eve of the disastrous Asian Financial Crisis, they engaged in banking business in an unrestrained and risk tolerant way in relative disregard of the formal regulatory framework that demanded greater prudence from them. A decade later, however, the banks by and large had taken on a restrained, risk-adverse, and more law-abiding character. Although such prudent behaviour was in line with government policy at the time, one cannot assume that the government had the ability to coerce such a widespread change during that decade, given the massive social and political turmoil that came in the wake of the crisis wiping out the economy and causing President Soeharto's 30-year regime to collapse.

This thesis deploys an adapted version of Hancher and Moran's 'regulatory space' approach to explain how such a dramatic behavioural turnaround could have nevertheless occurred in a context where the government was in a state of relative weakness. The approach will be modified, however, in order to address issues of behavioural change within a context of banking. Specifically, it will turn to notions of aggregation of micro-level actor behaviour across a space to show links between regulatory space change and behavioural change. In so doing, it will argue that the Indonesian case study reveals that regulatory change is the outcome of a space-wide process that results from the aggregated interdependent and interacting relationships of regulatory actors whose behaviour changes as they respond to contextual changes in their circumstances.

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Introduction

Scholarly investigations of regulation typically describe change as originating somehow out of the presence, the initiative, or the driving policy of government or the state. A number of scholars in recent years have challenged many assumptions traditionally held about the role of states in regulatory processes. Most of these challenges have offered counter-narratives to assumptions made about states as articulators of communal goals, the hierarchical nature of the state's authority and power, and the centrality of 'rules' as shapers of social behaviour.¹ In spite of these critiques, though, it is still difficult to conceive of how the nation-state might not always be 'the primary forum for collective decision-making at the macro-political level.'² Even purposefully 'decentered' legal perspectives still require law to consist in some form as 'authoritative rules backed by coercive force, exercised by a legitimately constituted (democratic) nation-state' in order to maintain their coherence.³

Indeed, it is hard to imagine a regulatory framework where the state is not present in some fashion, and this thesis will not challenge that. However, taking the ubiquitous presence of a state in regulation as one's analytical starting point, one can be tempted into making assumptions about that state having a central guiding or determinative role in regulatory change

¹ Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation: Text and Materials* (Cambridge University Press 2007) 4.

² *ibid* 5.

³ *ibid*.

processes. The central aim of this thesis is to draw attention to that assumption by asking what are the forces that bring about regulatory change, where 'regulatory change' is understood in its broadest sense, including both formal actions to change a legislated regulatory framework, as well as changes in the behaviours and relationships of regulatory actors in practice. It will address this question by examining Indonesia's banking sector after the Asian Financial Crisis of 1997-1998 as a case study.

Although Indonesian banking might not seem to be the most obvious case for studying how and why regulatory change happens, in at least two ways it is useful for doing so. First, this is a case where there was an alignment of regulated behaviour outcomes by non-state actors that complimented or were in harmony with government policy, in spite of a background of great social, economic and political turmoil. The 1997-1998 crisis famously wiped out Indonesia's economy, caused massive socio-economic upheaval, and brought down a highly entrenched patrimonial and clientelistic political regime that had held onto power for three decades, leaving in its wake a vacuum of political certainty and years of political turbulence. In other words, a regulatory behavioural change occurred in a context where one cannot assume the government or the state was in a commanding position to coerce those changes.

Secondly, this behavioural alignment represented a real and tangible regulatory change for Indonesia's banking sector. At the onset of the crisis in 1997, Indonesian banking was characterized by uninhibited competition among domestic banks, imprudent business practices, and a casual disregard of the legal authority of state regulators, all operating within an institutionalized environment of entrenched patronage and corruption. Sharma describes

Indonesia as having a ‘weak financial system’ in 1997 that was ‘open to both indirect and direct political influence’, composed of ‘dangerously undercapitalized and poorly supervised banks’ with a regulatory framework whose rules, while ‘modern and fairly comprehensive’ on paper, were ‘hardly enforced.’⁴

Yet, barely a decade after the 1997 crisis and on the eve of the 2008 global financial crisis, outside observers celebrated Indonesia for being blessed with a ‘relatively healthy and sound banking system,’ and despite a few persistent shortcomings in its legal framework for banking, Indonesian banks were praised for having ‘a good framework of internal control and compliance functions’.⁵ It is striking that Indonesia’s banks were able to move from the former to the latter state in such a short amount of time, especially when it occurred amidst considerable socio-political turmoil that swirled in the background. The starting point for this thesis, therefore, is this empirical puzzle: how was it that the behaviour of Indonesian banking actors aligned so dramatically to a more prudent and compliant footing, in line with the regulatory objectives of the government, at a time of considerable political upheaval. In other words, how did the Indonesian banking sector en masse move from recklessness to prudence after the crisis at a time when its government was not in a strong position, when such a change had not been possible before the crisis under a much stronger, albeit nepotistic and corrupt, government?

⁴ Shalendra D. Sharma, *The Asian Financial Crisis - Crisis, Reform and Recovery* (Manchester University Press 2003) 131.

⁵ IMF, *Indonesia: Financial Sector Assessment Program - Basel Core Principles Assessment - Detailed Assessment of Compliance* (IMF Country Report No 12/335, Washington DC, 2012) 7-8, 11, 14.

Methodology⁶

This thesis will explore what factors other than official coercion may account for regulatory change processes by examining a case study of banking reform in Indonesia in the turbulent wake of the devastating Asian Financial Crisis of 1997/98. In order to study a case of regulatory change where, because of profound political instability, one cannot automatically assume that state or government authorities were able to fully determine change outcomes, it will be necessary to apply an analytical approach that fits a scenario where the state or government might not necessarily be the main change agent. In Chapter 1, I will argue that ‘regulatory space’ is an approach that is well suited to such a task. However, it will also argue that the ways that ‘regulatory space’ has typically been employed in the past will need some modification in order to address the kinds of regulatory change questions posed here. In light of this, in Chapter 2 I will propose a modification of ‘regulatory space’ by a) incorporating principles from studies of ‘complex systems’ to better account for change processes in a regulatory space; and b) applying the ‘regulatory space’ approach to a particular context, namely the study of banking. Once done, in Chapter 3 this will be applied to the case study of Indonesia between 1997 and 2007. The case study itself will be informed by secondary macro- and micro-economic data drawn from a variety of sources, contemporary and academic accounts of Indonesia’s recent political, financial and social history, especially as they relate to banking, as well as data drawn from semi-structured elite interviews conducted with Indonesian and non-Indonesian individuals who are or previously worked at middle- to senior-management levels in either Indonesia’s state and private

⁶ Please refer also to Appendix I below.

banks or its central bank. These latter qualitative participant perspectives will be used to corroborate the wealth of secondary data that is publicly available about Indonesia since the 1997-98 crisis, as well as to provide first-hand accounts of and rationales for behavioural change by regulatory actors. The thesis will then conclude with some reflections on the insights that the regulatory space approach offers to the central theoretical and empirical question about regulatory change, but also what the case study has to offer about our understandings and use of the regulatory space approach itself.

Chapter I

REGULATORY SPACES AND COMPLEXITY

Introduction

In this chapter I will argue that ‘regulatory space’ is an approach that is highly malleable and well suited to studying regulatory change in contexts political and social turmoil. ‘Regulatory space’ is an analytical metaphor that has been used to study regulation in ways that highlight how power relations between actors and institutions give shape to regulatory structures or systems. Its suitability for this project derives from its recognition that both state and non-state entities can exercise power and influence in regulation and regulatory systems, and that by studying actor inter-relationships within a regulatory space one can determine how power functions within it. This chapter will briefly describe the regulatory space concept and how it has been regularly modified and adapted by scholars to suit a variety of explanatory processes. It will also demonstrate that, while useful as a tool to map power relations in regulation, it can run into difficulties when used to explain why certain change processes occur within a regulatory space, in particular how behavioural changes at micro levels are linked to middle- or macro-level phenomena of change. The chapter will conclude by proposing that for the current study the metaphor be altered and embellished by principles derived from studies of complex adaptive systems in order to build such a bridge that will allow for a regulatory space explanation for behavioural changes in Indonesian banks.

Hancher and Moran

In 1989, Leigh Hancher and Michael Moran introduced an alternative approach to studying regulation that they called the ‘regulatory space’.⁷ They offered it in an open-ended fashion, saying that it was a ‘metaphor’ that could include anything within ‘the range of regulatory issues subject to public decision’.⁸ It is a ‘delineated space’ or ‘arena’ that is occupied by regulatory actors who act within a contextual cloud of ‘culture’, described as the ‘recurrent tension between the common structural forces shaping regulation in the economies of developed market nations, and the idiosyncrasies introduced by unique, historical, national and industrial settings.’⁹ Power relations run through those structures and idiosyncrasies, such that studying a regulatory space requires investigating competitive struggles over the distribution of resources among institutions along with the manner in which the ‘legal structures of public power’ are driven by the ‘context for power’.¹⁰ The primary methodological premise underlying regulatory space is that the architecture of regulation consists of relationships and relational structures that determine who is included or excluded from the space, the cultural environment in which actors work, the procedural standards and behavioural assumptions that guide their routine operations, and the terms on which they make use of resources that are available to them.¹¹

⁷ This was a re-engineering of Colin Crouch’s earlier concept of the ‘public space’ to suit the study of regulation. Leigh Hancher and Michael Moran, ‘Organizing Regulatory Space’ in Leigh Hancher and Michael Moran (eds), *Capitalism, Culture and Economic Regulation* (Clarendon Press 1989) 272, 277.

⁸ *ibid* 277.

⁹ Leigh Hancher and Michael Moran, ‘Introduction’ in Leigh Hancher and Michael Moran (eds), *Capitalism, Culture and Economic Regulation* (Clarendon Press 1989) 3-4.

¹⁰ Hancher and Moran, ‘Organizing Regulatory Space’ (n 6) 277.

¹¹ *ibid* 278-279.

In short, regulatory space was developed as an alternative way of explaining regulatory phenomena in terms of interactions between regulatory actors, which are driven by competition for resources and structured by power relations within the scope of particular regulatory issues. Its open-endedness makes it a highly flexible tool, which makes it attractive for an explanation of regulatory change within the unstable and rapidly changing regulatory environment of Indonesia in the late 1990s. This flexibility invites one to tailor the metaphor to suit different types of explanations, and several scholars have adapted it to suit a wide range of explanatory purposes. The following section will demonstrate the diversity of ways in which they have done this, after which it will be possible to imagine what modification may be required for the present study.

Uses of Regulatory Space

One of the most common reasons why scholars have used regulatory space as an analytical approach is because it provides a way to challenge dominant paradigms that see regulation as having a hierarchical legal or political nature. Mary Canning and Brendan O'Dwyer, for instance, see it as an alternative 'to views of regulation as being hierarchically exercised by the state or its approved oversight bodies.'¹² Similarly, Colin Scott argues that while society 'may operate under the impression that law is hierarchical and normative, in reality regulation is marked by patterns of negotiated interdependence,' creating a tension between formal legal

¹² Mary Canning and Brendan O'Dwyer, 'The Dynamics of a Regulatory Space Realignment: Strategic Responses in a Local Context' 38 *Accounting, Organizations and Society* 169, 172.

authority and the actual exercise of informal authority.¹³ Joni Young has celebrated the way that it forces one to move beyond mere regulator-regulatee dynamics and to contemplate the relationship of regulatory activities to their external environments.¹⁴

Other scholars have used regulatory space as a means of going beyond questions of regulatory compliance or capture in discussions of power relations in regulation. Tony Prosser argues that regulatory space usefully demonstrates how regulation is an open process without a single, overarching logic, like ‘capture’ or ‘compliance’, and that the latter bilateral accounts in comparison are ‘of limited utility either in predicting regulatory behaviour or in providing normative principles of how regulators should act.’¹⁵ Doreen McBarnet and Christopher Whelan demonstrate this in their regulatory space study of standard setting in European financial markets, where they detected a shift away from concerns over formal compliance and enforcement towards more fragmented decision-making arrangements involving public-private standard setting bodies.¹⁶

Regulatory space has also been adapted to describe regulation in terms of discursive practices that generate regulatory outcomes. Joni Young, for instance, argues that it is within the regulatory space that claims about regulatory ‘problems’ are ‘defended, maintained and promoted’, and that these ‘problems’ are discursive constructs that arise out of the relationships

¹³ Colin Scott, ‘Analysing Regulatory Space: Fragmented Resources and Institutional Design’ Summer Public Law 329, 334-335, 343-344.

¹⁴ Joni J. Young, ‘Outlining Regulatory Space: Agenda Issues and the FASB’ 19 Accounting, Organizations and Society 83, 84.

¹⁵ Tony Prosser, ‘Theorising Utility Regulation’ 62 Modern Law Review 196, 217.

¹⁶ Doreen McBarnet and Christopher Whelan, ‘The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control’ 54 Modern Law Review, 853, 853-854.

between actors.¹⁷ This discourse produces action when actors move to address problems in ways that appear ‘appropriate’.¹⁸ For Alex Nicholls, legal outcomes in a regulatory space emerge out of discourse and that it is ‘the process of the power and discourse dynamics antecede reform and negotiation around regulatory consensus.’¹⁹ Laura MacDonald and Alan Richardson argue that this discursive aspect of a regulatory space implies a reimagining of the role of the regulator, less as an enforcer or implementer of law and more as a participant that must ‘either work within or attempt to influence ... normative discourses in order to establish and maintain the legitimacy of its actions.’²⁰

However, because regulatory space is a site of interaction constituted by discourse, several scholars have looked at structures of interaction to explain patterns of behavioural change. Canning and O’Dwyer, for instance, examine interactions between regulatory actors in search of patterns of resistance and compliance during the formation and creation of regulatory frameworks. Such patterns, they argue, can be explained as strategic responses to a context of interactivity, one that is conditioned and mediated by power distributions within it.²¹ For Colin Scott, the way that power is distributed among state and non-state actors in a regulatory space is the very framework within which regulatory decision-making is made. It is the distribution of power that creates and shapes interdependent relationships, with actor behaviour explained as

¹⁷ Young (n 13) 84.

¹⁸ *ibid.*

¹⁹ Alex Nicholls, ‘Institutionalizing Social Entrepreneurship in Regulatory Space: Reporting and Disclosure by Community Interest Companies’ 35 *Accounting, Organizations and Society* 394, 397.

²⁰ Laura MacDonald and Alan Richardson, ‘Identity, Appropriateness and the Construction of Regulatory Space: the Formation of the Public Accountant’s Council of Ontario’ 29 *Accounting, Organizations and Society* 489, 492.

²¹ Canning and O’Dwyer (n 11) 174-175.

being driven by strategy and negotiation between one another.²² This strategic and competitive explanation contrasts with Laura MacDonald and Alan Richardson, however, who argue that behaviour within a regulatory space is better explained as being driven by a ‘logic of appropriateness,’ where, ‘in order to maintain legitimacy within a regulatory space, the regulator must simultaneously negotiate its identity and engage in actions that other agents in the space will accept as appropriate to that identity.’²³

Finally, scholars have also used regulatory space as a mapping tool. Hancher and Moran felt that by mapping out key actors and their relationships one could explain the competitive dynamics of control over resources within a regulatory space.²⁴ Scott similarly argues that mapping helps establish the framework for actor behaviour because regulatory organizations act strategically within a space limited by ‘institutions of culture and organizational form.’²⁵ Such mapping exercises can be complicated and unwieldy, however. Canning and O’Dwyer, for instance caution that mapping exercises by themselves are often insufficient. This is especially the case for behavioural explanations because drawing behavioural inferences from actor relationships requires a subsequent analysis of different and shifting actor strategies as they respond to and anticipate one another within the regulatory space.²⁶

²² Scott (n 12) 331, 333.

²³ MacDonald and Richardson (n 19) 493; Young (n 12) 86.

²⁴ Hancher and Moran, ‘Organizing Regulatory Space’ (n 6) 287.

²⁵ Scott (n 12) 333.

²⁶ Canning and O’Dwyer (n 11) 170.

Limitations of Regulatory Space Explanations of Change

Despite its merits, regulatory space has received some criticism and scrutiny over the years. One common complaint is that it tries to do too much. Julia Black argues that the social and systemic complexity that regulatory space tries to capture is the very thing that undermines its explanatory power as it ‘bundles together so many variables that may affect the formation and implementation of public policy and in so doing tends to obscure more than it illuminates.’²⁷ Other scholars, in contrast, have argued the opposite, that it does not do enough, Tony Prosser, for instance, has criticized it for being perpetually in need of fleshing out ‘to provide analytical and evaluative purchase and normative principles as a basis for regulatory reform.’²⁸

One thing that regulatory space struggles to explain is change over time. More often than not, regulatory space is spoken of in terms of spatial arrangements of actors, resources and power that together produce outcomes through multilateral interactive processes.²⁹ Regulatory outcomes are often explained in terms of their emerging out of the particular form that a regulatory space’s internal construction or arrangement of actors and relationships takes, whether that be: the fragmentation of power,³⁰ decision-making,³¹ jurisdictional overlap,³² or general complexity.³³ But in so doing, it requires individual actor behaviour to either be conditioned to or produced by

²⁷ Julia Black, ‘Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a ‘Post-Regulatory’ World’ 54 *Current Legal Problems* 103, 109-110.

²⁸ Prosser (n 14) 196, 213.

²⁹ Scott (n 12) 344.

³⁰ *ibid.*

³¹ McBarnet and Whelan (n 15) 853-854.

³² Jody Freeman and Jim Rossi, ‘Agency Coordination in Shared Regulatory Space’ 125 *Harvard Law Review* 1131, 1156-1181.

³³ Prosser (n 14) 217.

these constructs, and says relatively little about how actors themselves contribute to those arrangements. This presents a problem when one tries to conceive of change processes within a regulatory space. If it is the relational arrangements of actors within a regulatory space that produce regulatory outputs, such as desirable changes in actor behaviour patterns, then, logically, observed changes in those outputs must somehow originate from changes to those relational arrangements. However, if it is true that these relational arrangements themselves are subject to change, which they must be, this implies that any discussion about regulatory space change must, at some level, also account for changes in actor behaviour.

This presents a chicken-and-egg problem. For most regulatory space writers, in order for behaviour to change, the space itself needs to change somehow. Joni Young, for instance, explains changes in actor behaviour as being the product of alterations to patterns of discourse or rules in the regulatory space.³⁴ This, of course, begs the question of what brings about discursive change in the first place. Similarly, Hancher and Moran's claim that relationships are what govern the scope of regulatory issues and the terms by which actors participate in them is also ambiguous and seems to imagine regulatory relationships as somehow external to the participants themselves.³⁵ Yet, if one accepts that actor behaviour can be structured, influenced and reinforced by contextual patterns of relationships in a regulatory space, but also that these relationships are themselves the products of actor behaviour, it becomes difficult to point to a starting point for an explanation of how or why a regulatory space changes.

³⁴ Young (n 13) 87.

³⁵ Hancher and Moran, 'Organizing Regulatory Space' (n 6) 278.

This poses a methodological problem for the present case study. As outlined in Chapter 1, its starting point is an empirical observation of a general behavioural in Indonesian banking, summed up as a move from ‘recklessness’ to ‘prudence.’ A regulatory space account would be well-equipped to explain why the Indonesian banking sector exhibited such behaviour at any given time in terms of middle-level explanations of particular arrangements of actor relationships, power and resources. It could also explain behavioural change in terms of changes in the overall structural arrangements of the space. However, such an approach would have difficulty explaining *why* those overall structural arrangements changed in the first place to generate space-wide behavioural changes.

In short, the explanatory power of regulatory space as an approach is limited because it lacks a framework for understanding how actor behaviour is related to change phenomena in a regulatory space. The chicken and egg problem boils down to a lack of clarity about how one can explain behavioural change as being produced from changes to the relationships that compose a regulatory space, while simultaneously understanding that those relationships are themselves rooted in actor behaviour. In order to explain how and why Indonesian banks changed their behaviour between 1997 and 2007, therefore, the regulatory space metaphor will require some modification in a way to clarify how actor behaviour is linked to the regulatory space. Luckily, there is a body of knowledge that is well versed in doing this, specifically in mapping behavioural change from micro to macro levels of explanation. This is the study of ‘complexity’ or ‘complex systems’, and the following section will turn to it for inspiration in search of a way of establishing this bridge for the current study.

*Complex Systems*³⁶

Scholars of ‘complex systems’ are interested in ‘systems’ that produce observable phenomena that are ‘complex’. Such systems tend to be defined broadly as entities that are composed of individual components that interact in networked, organized, non-random fashions, not unlike the way scholars have conceived of the regulatory space. Studies of these systems examine the organization and structure of the interactions of those components in reference to the system as a whole.³⁷ Descriptions of a system at any given moment of time will attempt to describe its large-scale properties in terms of the aggregated behaviours of its individual, interacting components.³⁸ A system is considered ‘complex’ when the interaction of its micro-level components is uncertain and variable, but which, when aggregated, produce large-scale system-wide phenomena that are not observable at the micro-level.³⁹ The behaviours of actors within complex social systems can be described in terms of the continuous adaptation of behaviour and interactions with other actors in response to changes in contextual circumstances, whether brought on by factors endogenous to the system, or from its exogenous environment. Establishing causality within a complex system is achieved by aggregating the effects of this multitude of micro-level adaptive behaviour, which means that causation, and therefore also

³⁶ The current discussion about ‘complex systems’ is quite different from ‘autopoietic’ systems theory that is quite prevalent elsewhere in the social sciences. See Niklas Luhmann, *Social Systems* (John Bednarz and Dirk Baecker trs, Stanford University Press 1995) and Gunther Teubner, ‘Autopoiesis in Law and Society: A Rejoinder to Blakenburg’ (1984) 18 *Law & Society Review* 291. It is beyond the scope of this paper to debate the relative merits of each, other than to say that this study will focus on the former because it is well suited to address the methodological conundrum of regulatory space depicted above.

³⁷ Yasmin Merali and Peter Allen, ‘Complexity and Systems Thinking’ in Peter Allen, Steven Maguire and Bill McKelvey (eds), *SAGE Handbook of Complexity and Management* (SAGE Publications 2011) 32; Thomas C. Schelling, *Micromotives and Macrobehaviour* (Norton 1978) 21.

³⁸ Sunny Y. Auyang, *Foundations of Complex-System Theories: in Economics, Evolutionary Biology, and Statistical Physics* (Cambridge University Press 1998) 61.

³⁹ The internet, ant colonies and ecosystems are a few obvious examples of ‘complex’ systems. Melanie Mitchell, *Complexity: A Guided Tour* (Oxford University Press 2009) 12.

change processes, can only be explained in non-linear, organic and evolutionary terms, rather than mechanistic or deterministic ones.

It is from this multi-layered intricacy that a solution to the methodological problem of regulatory space change can be mined. Descriptions of change in complex systems must account for differences in a system's state or condition between two or more points in time.⁴⁰ Within social systems composed of individual actors or institutions, questions about how or why system change occurs are usually treated as questions about what structures or incentive pressures contextualize actor behaviour, what impact contextual changes may have on actor behaviour, and how sufficient micro-level actor behavioural changes, when aggregated, can cause system-wide 'emergent' effects, which, in turn, can feed back to alter the contexts of further actor behavioural choices.⁴¹ Actors in complex social or economic systems are understood as behaving and acting along the lines of individual rationales formed in their subjective contextual environments. Each employs logics, beliefs, or hypotheses to make decisions in ways that make some subjective sense. Through time, those logics, beliefs or hypotheses are continuously acted upon, tested, altered and/or discarded by actors, and they can be informed by the behaviours and choices of others with whom they interact, in a kind of feedback loop that inspires further change and adaptation into the future.⁴² In this sense, an economy, as a complex system, is a 'vast collection of beliefs or hypotheses... all interacting and competing and evolving and coevolving; forming an ocean of ever-changing, predictive models-of-the-world.'⁴³ This bears an obvious resemblance to discursive studies of regulatory spaces noted above, however, with a key

⁴⁰ Auyang (n 37) 327.

⁴¹ W. Brian Arthur, 'Complexity and the Economy' (1999) 284 *Science* 107, 108.

⁴² Steven N. Durlauf and H. Peyton Young, 'The New Social Economics' in Steven N. Durlauf and H. Peyton Young (eds), *Social Dynamics* (Brookings Institution Press 2001) 1.

⁴³ W. Brian Arthur, 'Complexity in Economic and Financial Markets' (1995) 1 *Complexity* 20, 20.

difference being that here the chickens and eggs of relationship structures and behaviour have been replaced by action-reaction feedback cycles.

If a ‘regulatory space’ is understood as being, or at least similar to, a complex system it then becomes possible to link micro-level actor behaviours with middle- and macro-level phenomena observable in a changing regulatory space.⁴⁴ Change in a regulatory space can be seen as being a product of the variable and adaptive interactions of its composite actors. The aggregate effects of these collective behaviours can produce middle- and macro-level effects that are different from what might be immediately observable at the individual level. The discursive ‘regulatory issues’ that some scholars have said provide shape to regulatory spaces can be understood here as being emergent properties that arise from the aggregate behaviours of actors within the regulatory space. For example, the following chapter will propose that ‘liquidity’ is a regulatory ‘issue’ that is relevant to any discussion about banking regulatory spaces. From a complexity perspective, liquidity can be explained as an emergent property of a banking system, produced by the individual actions and decisions made by its composite banks and financial institutions, among other actors. How liquidity is manifested at any given time and in any given banking system will depend on the internal aggregate dynamics of banking actor actions and interactions, each making choices in ways that make sense to the particular contexts in which they find themselves. While liquidity has no singular essential reality at the individual, micro-level, it can be observed as a middle- or macro-level phenomenon produced by aggregated micro-level individual actions and behaviour. Thus, in such a paradigm, one can say that liquidity in a banking system changes when sufficient banking actor choices at the micro level change such that they produce that aggregated change effect.

⁴⁴ This analytical approach should not be confused with Julia Black’s tri-layered “decentered analysis” of regulatory regimes. Where Black differentiates micro, meso and macro types of governance, here the analytical levels distinguish different degrees of aggregation within a regulatory space. Black (n 26).

The relevance of this example will become more evident in the discussion to come in the following chapter. The purpose of this chapter instead has been to explore the usefulness and limitations of ‘regulatory space’ as an approach for explaining regulatory phenomena. It explored its inherent flexibility as well as the multiple uses to which it has been adapted over the years by scholars seeking explanations that were different from mainstream accounts of hierarchical power, regulator/regulated, capture/compliance narratives. The chapter also observed, however, that the regulatory space metaphor suffers from a logical dilemma when one attempts an explanation of change in or to a regulatory space. The final section above sought to resolve that dilemma by drawing on certain features of complex systems theories, which allow for descriptions of middle- or macro-level phenomena as emerging from aggregated micro-level behaviours of system components and feeding back to further contextualize and inform micro-level actor choices thereafter. In short, the key modification to the regulatory space approach that this thesis offers is to argue that actor behaviour can be linked to descriptions of regulatory space change when attention is placed on the scale effects of their aggregated behaviour, and how such effects inform the space, but also feedback to inform behaviour at the micro-level. This cyclical construct allows one to move beyond the chicken and egg causality problem. The door is now open for the regulatory space approach to be tailored further to suit a discussion about a banking regulatory space for the purposes of answering the central empirical question posed in the Introduction.

Chapter II

BANKING AS A REGULATORY SPACE

Introduction

The overview of regulatory space approaches provided in Chapter I demonstrated that the regulatory space metaphor derives its conceptual shape from the relationships and interactions of regulatory actors within some kind of spatial arrangement. These interactions are structured by power relations that are related to actors' respective abilities to access and exercise control over resources, and whose behaviours give rise to and are themselves structured around regulatory 'issues.' Given these composite factors of the metaphor, and with the assisting device of the complexity modification provided earlier, change in a regulatory space can be explained in terms of alterations to the makeup and arrangements of actors, their relationships, the resources they compete for, and the regulatory issue discourses that they engage in, which, when aggregated, produce a middle- or macro-level aspect of change to the space, which may produce feedback flows that can produce wider change effects on the space. This chapter will use these base parameters to outline what a regulatory space for banking would look like, keeping in mind their interplay between different micro, middle and macro levels of aggregation within the regulatory space.

In short, this chapter will explore separately how 'issues', 'actors', 'relationships' and 'resources' might be conceived of in a banking regulatory space. It will examine three key 'issues' for banking, namely 'risk', 'liquidity' and 'confidence', then will briefly outline which

actors or institutions tend to play key roles in banking regulatory spaces. This will be followed by an exploration of the key attributes relationships between those actors that structure the regulatory space, as well as an account of how ‘resources’ influence those relationships.

ISSUES

Hancher and Moran describe regulatory space as ‘the range of regulatory issues subject to public decision,’⁴⁵ and that the scope of those issues is governed by the relationships of regulatory space actors.⁴⁶ Joni Young equates regulatory issues with discursive concerns that are constructed as ‘problems’ by actors, which generate action when actors move to address them.⁴⁷ Regulatory issues are related to regulatory ‘goals’⁴⁸ in the sense that they are the problems or concerns that regulatory goals target. On their own, they are normatively neutral, but regulatory actors can draw normative interpretations from them when they create set goals or objectives to respond to them. The discourse that evolves around regulatory issues arises out of actor interactions within the regulatory space, and is the conceptual framework that informs and guides their activities.

This paper argues that there are three primary ‘issues’ that underlie all activity within a banking regulatory space, namely: ‘risk’, ‘liquidity’, and ‘confidence’. Although this cannot

⁴⁵ Hancher and Moran, ‘Organizing Regulatory Space’ (n 6) 277.

⁴⁶ *ibid* 278.

⁴⁷ Young (n 13) 86.

⁴⁸ Consider, for instance Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press 1992) 38; or Larry D. Wall and Robert A. Eisenbeis, ‘Financial Regulatory Structure and the Resolution of Conflicting Goals’ (2000) 17 *Journal of Financial Services Research* 223.

claim to be an absolute or complete list of all banking issues, these three underlie and speak to virtually every aspect of actor behaviour within a banking regulatory space.⁴⁹

Risk

‘Risk’ has been recognized as an issue for virtually any regulated sector.⁵⁰ It is especially important for banking, however, because the business of banking is fundamentally based on engaging risk in pursuit of future gains. For Bert Scholtens and Dick Van Wensveen, risk is the ‘root of financial intermediation and ... its main raison d’être.’⁵¹ The essence of traditional banking involves banks managing a risky balancing act between their short-term liabilities of liquid deposit funds with their illiquid long-term loan portfolios.⁵² All financial assets in a banking system are commitments to pay cash at a certain point in the future, yet, each has risk built into it, contingent on the ability and willingness of others to pay at any given time. That willingness and ability to pay is contextual, and because the future is unknown, uncertainty prevails throughout a banking system.

⁴⁹ Mark Brunnermeier and others, ‘The Fundamental Principles of Financial Regulation’ (Geneva Reports on the World Economy, International Center for Monetary and Banking Studies (ICMB) and the Centre for Economic Policy Research (CEPR), Geneva, 24 January 2009) 168.

⁵⁰ Julia Black, ‘The Role of Risk in Regulatory Processes’ in Robert Baldwin, Martin Cave and Martin Lodge (eds), *The Oxford Handbook of Regulation* (Oxford University Press 2010) 304.

⁵¹ Bert Scholtens and Dick Van Wensveen, ‘A Critique on the Theory of Financial Intermediation’ (1999) 24 *Journal of Banking & Finance* 1243, 1247.

⁵² Deposits and loans are, of course, not the only financial instruments that banks deal with. In the banking systems of developed capitalist economies, the number of non-interest income generating financial activities has grown rapidly since the 1980s, including things like issuing guarantees and letters of credit, or securitized debt financing. These new financial instruments have created new types of financial risk. The role they played in Indonesia’s banking system was relatively small, however, and they have received superficial treatment here as a result. See Neil F. Johnson, Paul Jefferies and Pak Ming Hui, *Financial Market Complexity* (Oxford Scholarship Online 2003) 6; Shelagh Heffernan, *Modern Banking* (John Wiley & Sons 2005) 102.

Risk as a regulatory space ‘issue’ is acted upon by banking actors through their choices and their willingness to engage in banking in pursuit of future returns despite that uncertainty. Banks are perpetually exposed to a variety of risks. To name a few: liquidity risk (the risk of having insufficient funds to finance their short-term liabilities); credit risk (the risk that their loan assets will default); operational risk (the risk of their employees behaving improperly); market risk (the risk that the market will go into a downturn and decrease future returns); foreign exchange risk (the risk that the value of foreign currencies will fluctuate to the detriment of assets denominated in those currencies); etc. Banks interpret and act upon risk by calculating their risk exposure at any given moment. How banks choose to act upon the results of these risk calculation processes is variable because the threat that risk poses is relative and subjective, linked to beliefs about potential future gains and their respective willingness to shoulder different amounts of risk to pursue them.⁵³ This trade-off between risk and profit is the principal dilemma of banking, and it manifests itself in a variety of ways. For instance, while a bank can reduce its liquidity risk by retaining liquid assets like cash reserves to guarantee its ability to fulfil all expected or unexpected short-term obligations, the more it retains the fewer assets it will have to leverage out to generate returns.⁵⁴ Similarly, banks can minimize credit risk by choosing loan assets with low default risk, but at the cost of receiving lower returns than those potentially receivable from higher risk assets. How each bank responds to this dilemma will depend on how it chooses to balance the various risk trade-offs that any course of action brings with it.

Banks are, of course, not the only actors in a regulatory space who are concerned about bank risk. Depositors assume the risk of bank failure when they deposit funds in banks in return for small interest returns and to facilitate payments. Borrowers take out loans from banks to fund

⁵³ Heffernan (n 51) 105.

⁵⁴ Hyman Minsky, *Stabilizing an Unstable Economy* (2 edn, McGraw-Hill 2008) 265.

long-term investments or to meet their day-to-day payment obligations, and are subject to risks of being unable to pay back these obligations on time, which may be dependent on levels of market demand for their products or services over which they have little control. Governments are concerned about risk in banking primarily because the intermediary role played by banks in an economy is so important. By leveraging deposits into loans, banks provide an economy with liquidity, facilitate financial transactions and party-to-party payments, and enable investment, without which an economy would grind to a halt. But, when banks lose the gambles that they make, the effects on the wider economy can be disastrous. The political, social and economic ramifications of bank failure can be immense, and governments charge their state regulators with the task of implementing and enforcing policy, legislation, and regulatory measures designed to control bank behaviour to avoid or prevent it.⁵⁵

In recent decades, the normative framework for state intervention in banking has centred around the notion of ‘prudence’ in banking. ‘Prudence’ reflects an idealized balancing of all of these risk-based tensions. The ‘prudent’ banker is one who tempers the drive for profit by accepting ‘just the right amount of risk’ and by balancing all of the uncertain variables and weighing them with past experience.⁵⁶ ‘Prudent’ regulatory tools are instruments that a state can use to remove some of the subjectivity of risk-taking by imposing objective limits. For instance, to prevent banks from over-leveraging their capital bases in pursuit of profit, regulators can impose mandatory minimum levels of held capital at each bank (commonly called ‘Capital Asset Ratios’ or ‘CARs’).⁵⁷ Within an uncertain and competitive marketplace, however, interventions by regulators to constrain the scope of risk-taking can encourage banks to innovate alternative

⁵⁵ ibid 349.

⁵⁶ ibid 267.

⁵⁷ CAR levels vary from country to country, but the international Basel III accord from 2011 sets a base CAR guideline ratio at 4.5%-6%, depending on the type of bank in question, meaning that 94%-95.5% of its capital assets can be out in the market generating profit at any given time.

ways to seek out advantage and earn returns in spite of those restrictions, which may include efforts to circumvent them entirely, if feasible.⁵⁸

Risk has a central importance in any explanation of actor behaviour within a banking regulatory space. While at the micro-level, concerns about risk centre on individual banks, at the middle- or macro-levels, risk concerns focus on ‘common, herd behaviour, and with shifts in generalised attitudes to risk’.⁵⁹ Hyman Minsky argues that risk calculations are usually informed by one’s understanding of one’s local context, socially prescribed behavioural conventions, and history.⁶⁰ Patrick Honohan has noted that when times are good, bankers typically suffer from ‘disaster myopia’, which, when aggregated, can give a financial system an over-inflated sense of immunity to risk by feeding back a general impression of market optimism that induces managers to ignore or neglect risk contingencies.⁶¹

In short, managing risk is a key aspect of all banking activity.⁶² Banks, especially private banks, generate returns relative to their ability to manage the risk imbalance between short-term deposit liabilities and long-term loan assets, or by providing services for fees to clients that absorb risk or help them to manage their own risk.⁶³ In other words, the whole business of banking involves managing risk for profit. The relative willingness of banks to engage in risk, and the manner in which they do so must therefore be central to any analysis of a banking regulatory space because it drives decision-making and action by actors within it.

⁵⁸ Minsky (n 53) 279.

⁵⁹ Brunnermeier and others (n 48) 9.

⁶⁰ Minsky (n 53) 207.

⁶¹ Patrick Honohan, ‘Banking System Failures in Developing and Transition Countries - Diagnosis and Prediction’ (2000) 29 *Economic Notes* 83, 88.

⁶² Scholtens and Van Wensveen (n 50) 1250.

⁶³ Douglas Diamond, ‘Financial Mediation and Delegated Monitoring’ (1984) 51 *Review of Economic Studies* 393.

Liquidity

'Liquidity' is a measure of the ease with which a financial asset can be exchanged for something else without losing much or any of its value in the process. Markets and economies are considered 'liquid' when the aggregate assets that flow within them and through their banks can generally be exchanged quickly and easily. Liquidity is an 'issue' for banking because liquidity is the grease that keeps the wheels of banking, and an economy, turning. It is a primary regulatory concern because the liquidity-providing function that banks provide to an economy is vitally important, but also potentially dangerous. When an economy is generally 'liquid', it is possible for economic actors to make payments and fund investments that enable growth. The interest of public authorities in facilitating economic growth gives them an interest in banks' usage of mechanisms and procedures whose effects, when aggregated, can ensure a sustainable and sufficient level of liquidity for the economy. When liquidity is low, however, payments and transactions are more difficult, which, at the micro level can make banking more costly, and at the macro level can slow an economy down entirely as viable, productive activities are unable to find cost-effective financing. Liquidity is not, however, a universally good thing. An overly liquid economy, for instance, can suffer from the misallocation of available liquid resources to low-quality investments and over-inflation, while banks that hold excessive liquid capital in reserve inefficiently lose out on the revenue potential that they could have earned if that capital had been leveraged out as loans. The primary regulatory concern with liquidity, thus, is to strike the right balance of enough, but not too much, liquidity at both the macro and micro levels in order to ensure that banks can function and that funds flow freely and easily throughout an economy at sustainable and efficient levels.

Banking traditionally consists of using the liquid funds of depositors to finance illiquid loans elsewhere in the economy. Banks hope and take pains to ensure that these loans will

generate returns when they are eventually repaid with interest, while equally hoping and ensuring that they can maintain sufficient internal currency liquidity to pay out any withdrawal demands of their depositors at any time.⁶⁴ In this sense, banks profit by making liquidity available to the market, and are able to do so by balancing the cash flow between long-term, illiquid loan assets and their short-term liabilities of their client deposit accounts. However, as seen in the previous section, given the uncertainty of the market and the future, it is a balance that is inherently prone to risk.

At the micro-level, banks need to ensure their own internal liquidity by keeping enough cash reserves to meet on-demand deposit claims at any given time. Determining how much to hold in reserve is a risk calculation that balances the uncertainty of future depositor withdrawal demands with the long-term revenue-earning potential of lending. Since cash held in reserve is an asset with no future earning potential, banks have an incentive to leverage out as much as possible without excessively endangering their overall position. Banks that cannot honour their obligations, however, are insolvent and liable to be wrapped up. Thus, if a bank lacks sufficient cash on hand to make its obligatory payments, it can sell off some of its assets, or take out short-term loans from other banks, using their loan assets as collateral, to ensure it can do so. Banks run into trouble, however, when demand in the market for such assets is low, rendering them relatively illiquid, and exchangeable only at a loss. A bank essentially fails once it runs out of options to stay solvent.⁶⁵

The traditional source of bank liquidity is deposit accounts, which banks offer to depositors as a financial product in exchange for a commitment to repay them cash upon demand along with a prescribed rate of interest. Banks then create liquidity for a marketplace by pooling depositor

⁶⁴ Heffernan (n 51) 3.

⁶⁵ Brunnermeier and others (n 48) 14.

funds and making them available for investment elsewhere. Deposit accounts also provide a secondary liquidity function by facilitating payments throughout and across an economy. When individuals pay one another through their banks, banks simply credit or debit their respective correspondent deposit accounts that each hold with one another, thereby converting cash-based deposits into a form of easily tradable ‘money’ without requiring any actual exchange of currency.⁶⁶ This payment structure, along with interbank short-term lending, is the primary way in which banks are interrelated and interdependent with one another in a banking system.

Liquidity is a perennial concern in such an interdependent construct because it can be sustained only as long as banks trust that each are sufficient capitalized and that their promises to honour their deposit liabilities are credible. If a bank is widely believed to be insolvent, it will have a difficult time convincing others to engage in payment exchanges with it. Given the great degree to which bank capital is typically leveraged out at any given moment, a tightly networked bank that is unable to meet a payment obligation can have significant impact on other banks’ abilities to clear their own payment obligations. If the numbers are large enough, losses can cascade through interbank networks and can cause system-wide contagion.⁶⁷ If market liquidity becomes low or tight, individual banks will be pressured to maintain sufficient internal liquidity levels by hoarding capital, liquidating assets wherever possible, drawing down their correspondent deposit accounts held at other banks, or borrowing from other banks, if other banks are willing and able to lend. If this happens on a large scale this can induce a downward liquidity spiral, where a falling asset market sows ‘information contagion’ about the economy,

⁶⁶ Prasanna Gai, Neil Jenkinson and Sujit Kapadia, ‘Systemic Risk in Modern Financial Systems: Analytics and Policy Design’ (2007) 8 *Journal of Risk Finance*, 156.

⁶⁷ Franklin Allen and Douglas Gale, ‘Financial Contagion’ (2000) 108 *Journal of Political Economy* 1.

encouraging financial institutions to deleverage and make more sales, drives down asset prices further, and further depressing hopes of future cash flows.⁶⁸

From a complexity perspective, liquidity can be seen as being a relatively intangible product of the interdependent relations of actors with others whose needs and future behaviour are always uncertain. Nevertheless, as with ‘risk’ and ‘confidence’, it is something that is very much acted upon by banking actors through their efforts to strike a desirable balance between the opportunities and dangers that it poses. It is linked to ‘risk’ and ‘confidence’ in the sense that whether or not assets are easily traded in a banking system depends in part on the degree of general uncertainty and confidence that prevails in the market at any given time, yet is distinct because it can be manipulated in ways that the others cannot, such as through interest rate changes or, in extreme cases, government bail-outs. While such measures might produce risk or confidence-inducing side-effects, and are sometimes employed to do so there is never any guarantee that they will.⁶⁹

Confidence

Confidence is the final of the three key ‘issues’ for banking. Banks can only function if their clients, peers, and regulators have enough confidence in them and their solvency to do business with them. It is confidence in a bank’s promise that it will pay out cash on demand, with interest, and at any time that encourages people to deposit their funds with them in the first place. It is a bank’s confidence in the creditworthiness of a borrower that encourages it to convert risk-free, short-term, liquid deposit assets into illiquid, long-term, risky loans. Finally, it is because banks have confidence in one another’s commercial capacities and their respective claims of

⁶⁸ Brunnermeier and others (n 48) 5, 11.

⁶⁹ Paul Langley, *Liquidity Lost: The Governance of the Global Financial Crisis* (Oxford University Press 2015) 177.

solvency that they cooperate with one another through interbank payment relationships, which facilitate funding flows throughout an economy. The British financier Evelyn de Rothschild once famously claimed that ‘the single most important commodity traded in the City of London is confidence.’⁷⁰ Neither a bank nor a banking system can operate without it.

Like with risk and liquidity, confidence is important for regulatory space discussions because of its inherently relational character.⁷¹ When it disappears, relationships break down and the entire edifice of a banking regulatory space can crumble. Financial troubles become economic crises largely when economic problems in one place or sector spark widespread losses of confidence.⁷² It is the loss of confidence in the borrowers, banks, or the economy as a whole that removes liquidity from a banking system causing an economy to slow and contract.

As with risk and liquidity, governments have an interest in intervening in banking in order to ensure sufficiently high levels of confidence to maintain the integrity and coherence of the banking system. It is because of the signalling effect of market changes on individual behaviours that controlling information flows in a regulatory space to sustain confidence is a critically important feature of regulatory intervention, but one whose effects are difficult to guarantee or control. Regulatory obligations on banks to publicly disclose business information, for instance, can theoretically instil greater confidence by removing some uncertainty from the market, thereby encouraging greater investment.⁷³ However, such transparency can also communicate bad information as easily as good, which can cause a confidence problem during an economic downturn. The analytical challenge for policy makers, then, is to determine how much and what

⁷⁰ Evelyn de Rothschild, ‘Banking Must Pursue the Holy Grail of Confidence’ *The Financial Times* (New York, June 24, 2013).

⁷¹ David T. Llewellyn, ‘Reforming the Culture of Banking: Restoring Trust and Confidence in Banking’ (2014) 1 *Journal of Financial Management, Markets and Institutions* 221, 225.

⁷² Brunnermeier and others (n 48) 3.

⁷³ Whether it actually does so in practice, however, is debatable. See: Oren Bar-Gill and Elizabeth Warren, ‘Making Credit Safer’ (2008) 157 *University of Pennsylvania Law Review* 1.

kind of information the sector needs in order to generate sufficient confidence to keep investors investing in the system, keep depositors depositing, and keep banks lending to borrowers and cooperating with one another, but without affecting or dampening competition at the same time. Too much confidence in an economy, however, can also be problematic if it encourages excessive risk-taking by banks and investors, or investment ‘bubbles’ that can distort and make a market vulnerable to being ‘popped’.⁷⁴

Despite its importance, however, confidence cannot be simply created out of thin air and there are no guarantees it will emerge in an economy at any given moment. The post-2008 crisis has demonstrated that even pumping out billions of dollars of liquidity into a banking system can sometimes not be enough to restore widespread confidence.⁷⁵ As an ‘issue’ for a regulatory space, therefore, confidence, like risk and liquidity, motivates and shapes actor behaviour, guides regulatory interventions, but is also a discursive product of information emerging from the aggregated effects of actor relations and interactions within the space. Its importance is well recognized, but its intangibility makes it difficult to manipulate.

ACTORS

Identifying a banking actor for the purposes of a regulatory space analysis is not as straightforward as one might initially imagine. Distinguishing ‘actors’ in terms of every person or institution who participates in banking is quite different analytically from conceiving of every person or institution that is affected or has a stake in it. Any study of a given regulatory space

⁷⁴ José A. Scheinkman and Wei Xiong, ‘Overconfidence and Speculative Bubbles’ (2003) 111 *Journal of Political Economy* 1183.

⁷⁵ Richard Swedberg, ‘The Financial Crisis in the US 2008-2009: Losing and Restoring Confidence’ (2013) 11 *Socio-Economic Review* 501, 514-515.

will have its own idiosyncratic list of relevant actors whose importance and relevance to the regulatory space will vary from case to case and over time. The list of four principal actors offered below is highly truncated for the sake of relevance to the analysis of the Indonesian case study to come in Chapter III as well as for limitations of time and space. It is intended therefore to be indicative and a generalization only for the purposes of the conceptual discussion in this chapter.

Government

Government actors could include those who either craft the legislation that frames banking laws and regulatory instruments, and/or the executive political entities who make the higher level policy decisions that guide the actions of regulatory authorities. In highly centralized systems it might be useful to refer to ‘government’ in a singular sense, while in others it might be more useful to distinguish between different actors within government, depending on the relative coherence of their beliefs, mandates, policy orientations, etc. This may or may not include the judiciary as an arm of government, depending on the nature of a given legal system.

Regulator(s)

Bank regulators are the administrative institutions within a state bureaucracy created to implement government policy in banking matters and to enforce banking legislation and regulations. In many countries, the primary bank regulator is the central bank, although regulatory authority can also be distributed among different agencies, separating monetary

policy-making from regulatory supervision and enforcement. The boundaries of this category are, of course, fluid. Whether or not one should distinguish between the regulator as a singular institutional actor or in terms of the variegated senior civil servants in charge of institution(s) with regulatory functions will depend on a given context and the explanatory objectives of the observer.

Banks

Traditionally, a ‘bank’ is defined as an organization that takes deposits and uses deposit funds to invest in long-term lending contracts.⁷⁶ In some contexts, this may be too restrictive of a definition, particularly when one considers the political dimensions around the question of whether or not non-deposit taking institutions, like investment banks or hedge funds, should be included to subject them to the same regulatory oversight and restrictions as banks. It also may be necessary to distinguish banks according to their different operational concerns or by the different risk balances that they strike. Private banks and state-owned banks, for instance, may in practice behave very differently in a regulatory space because they are subject to very different competitive pressures and risks of failure. Banks can also be further subdivided into populations with different, and sometimes competing, interests, if such a distinction is necessary for a given explanation. For instance, one could imagine banks as consisting of depositors, creditors, borrowers, managers, and owners/shareholders, each of which may have different (and internally

⁷⁶ Diamond (n 62) 402.

variable) reasons for behaving the way that they do at any given time. Again, doing so will depend on one's explanatory objectives.

International Organizations

There are a number of international organizations that are often involved in coordinating domestic and international banking activity around the world. The number of these organizations has expanded over the past century with the negotiated creation of a number of United Nations-related agencies (like the World Bank or the IMF), the development of treaty-based regimes (like the WTO, or the EU), and the emergence of informal and influential 'clubs' of powerful private and public authorities (such as the Group of Eight (G-8), and the Basel Committee on Banking Supervision). These institutions are interconnected and mutually influential, and their influence on domestic banking system in any given country will be variable, depending on how well integrated that domestic system is in global finance and international treaty regimes⁷⁷, as well as on the shape and implementation of domestic banking legislation. Whether or not any such organization plays an important or key role in a given banking regulatory space will depend on the importance and nature of its interactions with other actors within the space. In some cases, their role can be central and endogenous to the space, while in others their influence could be more peripheral.

⁷⁷ Lawrence G. Baxter, 'Internationalisation of Law - the 'Complex' Case of Bank Regulation' in Mary E. Hiscock and William van Caenegem (eds), *The Internationalisation of Law: Legislating, Decision Making, Practice and Education* (Edward Elgar 2010).

RELATIONSHIPS

Describing the relationships between actors that give shape to a regulatory space should involve both identifying their rich individual differences but also determining the effects that their aggregate interconnectivity produces across that space. The section below will explore how different relationships between actors in a banking regulatory space might be imagined. Again, this section is not intended to be exhaustive, and will only draw attention to particular features of inter-actor relationships that might be common and relevant to studies of banking regulatory spaces.⁷⁸ Insights from complexity offered in Chapter I provide a coherent way of explaining variability in actor relationships as the result of conscious (or even unconscious) choices made by actors to relate to one another in particular ways that make sense in their context.⁷⁹ Variability of choices may also reflect a multitude of goals and strategies that motivate actors in their relations with others in a regulatory space. Many of these strategies may be congruent and overlap, others, however, may conflict. The upshot is that the aggregate effects of the variable, contextually informed decision-making of inter-acting and inter-dependent actors is what links context to the dynamics of change in a regulatory space, which permits explanations of how and why changes occur at the micro-level and how they are related to middle- and macro-level space change phenomena.⁸⁰

⁷⁸ There are a number of important relationships that have been left out of the following discussion but which might be critically important for banking studies elsewhere than in Indonesia, such as: manager-shareholder relations; relations between banks and other non-bank financial institutions; domestic-international banking relations; etc. See, for instance: Rüdiger Fahlenbrach and René M. Stulz, 'Bank CEO Incentives and the Credit Crisis' (2011) 99 *Journal of Financial Economics* 11; Luc Laeven and Ross Levine, 'Bank Governance, Regulation and Risk Taking' (2009) 93 *Journal of Financial Economics* 259.

⁷⁹ Schelling (n 36) 14.

⁸⁰ Mitchell (n 38) 221.

Bank - Depositor Relationships

The deposit account is the primary liability in a bank's balance sheet, and a bank's solvency depends on its ability to meet the demands of depositors upon request. Depositors lend funds to banks through these interest-earning accounts because in return banks undertake to pay a modest interest and to honour any demands to withdraw cash from them at any time. While this ability to withdraw on demand is the central attraction of the deposit account, it is also one of the primary sources of risk for a bank, which must at all times be able to anticipate depositor demands for cash, which are uncertain and can fluctuate.

There are two fundamental behavioural concerns about depositors with which banks are typically concerned. First, is the challenge of attracting them to deposit their disposable funds there rather than at a competitor bank. Second, is the concern about when they withdraw from their deposit accounts, with the worst-case scenario being when they collectively choose to withdraw currency at the same time, a so-called 'run' on the bank. While attracting depositor funds is a business and marketing concern, the bank run is the ultimate fear around which much bank risk management revolves. Especially in contexts where there are no deposit insurance or guarantee schemes in place, bank runs result when depositors collectively and simultaneously lose confidence in their banks' abilities to honour their commitments and rush to withdraw whatever currency they can from their deposit accounts before it goes bust.⁸¹

⁸¹ Douglas Diamond and Philip Dybvig, 'Bank Runs, Deposit Insurance, and Liquidity' (1983) 91 *Journal of Political Economy* 401, 404.

The stability of bank-depositor relations is maintained as long as banks can manage their internal liquidity and cash flows and as long as depositor confidence in banks is maintained. This confidence is fragile, however, and subject to the bounded rationality of depositors acting with the limited information available to them about the security of their deposits. This fragility can be addressed by bank actions intended to maintain or build confidence in their depositor clients, and can also be addressed by state intervention, such as with deposit insurance guarantee schemes that, if available, can neutralize the potential of simultaneous depositor runs to banks, but will do so at the cost of whatever disciplining effect the fear of a bank run might have on bank lending decisions.⁸²

Bank - Borrower Relationships

Where depositors are the source from which banks traditionally have derived their operating capital, their profits come from returns generated by leveraging that capital out to interest-paying borrowers. In a competitive environment, bank loans are business products and bank-borrower relations are formal and contractual, with detailed provisions about the scope of remedial actions available to the bank in the event of a borrower's inability to service their loan. Economists are primarily concerned about the economic benefits or costs associated with different degrees of closeness in this relationship. Models of bank/borrower relationships tend to analyse costs and

⁸² Steven Buser, Andrew Chen and Edward Kane, 'Federal Deposit Insurance, Regulatory Policy and Optimal Bank Capital' (1981) 35 *Journal of Finance* 51.

benefits and relative efficiencies of: short- versus long-term bank-borrower relationships;⁸³ or close versus arm's length relations; or between different loan types, like short-term, trade or cash-flow financing.⁸⁴ While long-term, close relationships can be beneficial for parties because the long-term information sharing between borrower and banks can help banks monitor and give them greater confidence in the borrower's ability to repay and thus permit greater contractual flexibility, such relations can, however, leave either side vulnerable to the others' internal fragility.⁸⁵ In contrast, hands-off, short-term debt arrangements allow for more easy bank intervention or more credible threats by banks to take action against delinquent borrowers than might be the case in long-term debt relationships, however it is also much easier to renegotiate debt payment schedules and terms when parties share a long history.⁸⁶

Within a regulatory space, bank-borrower relationships are variable and responsive to contextual constraints. Different market environments can encourage different types of aggregate bank relationships. Ongena and Smith, for instance, found in a study across twenty European countries that firms in countries with concentrated banking systems chose to have fewer relationships with multiple banks than firms in countries with more decentralized banking systems.⁸⁷ Boot and Thakor argue that in countries with well-developed securities and public-

⁸³ Gary Gorton and Andrew Winton, *Financial Intermediation* (National Bureau of Economic Research Working Paper No 8928, 2002) 31.

⁸⁴ Steven Ongena and David C. Smith, 'What Determines the Number of Bank Relationships? Cross-Country Evidence' (2000) 9 *Journal of Financial Intermediation* 26, 32.

⁸⁵ Myron B. Slovin, Marie E. Sushka and John A. Polonchek, 'The Value of Bank Durability: Borrowers as Bank Stakeholders' (1993) 48 *The Journal of Finance* 247, 249.

⁸⁶ Steven Sharpe, 'Asymmetric Information, bank lending, and implicit contracts: A Stylized Model of Customer Relationships' (1990) 45 *Journal of Finance* 1069.

⁸⁷ Ongena and Smith (n 83) 47.

debt markets, banks are faced with greater competition and invest more resources in building relationships with firms and sectoral specialization than they might in economies where banking is the more dominant financing vehicle.⁸⁸ A conclusion one can draw from this, therefore, is that structural and contextual pressures can produce aggregate patterns of bank-borrower relations through an economy. However, large aggregate patterns of bank-borrower relations can also have a wider effect on a banking regulatory space. The following chapter will explore how on the eve of the 1997 crisis, a very high degree of related-party lending and non-performing loans throughout many of Indonesia's banks reflected a largely loose bank-borrower dynamic running through the regulatory space that left it, and the Indonesian economy, vulnerable to the economic shock that the crisis brought with it.

Bank-Regulator/Government Relationships

The central concern of bank regulators is typically to understand what it is that banks are doing, and how to ensure that what they are doing is in line with government policy and is generally good for the economy.⁸⁹ Regulators and banks structure their relationships with one another in ways that are conditioned by formal legal frameworks but also by contextual considerations that might limit a regulator's relative freedom of action in ways not specifically mandated by law.⁹⁰ The degree of influence that either can exercise in shaping that relationship is

⁸⁸ Arnoud Boot and Anjan Thakor, 'Can Relationship Banking Survive Competition?' (2000) 55 *Journal of Finance* 679, 681-682.

⁸⁹ World Bank, *Rethinking the Role of the State in Finance* (Washington DC, World Bank, 2012) 45.

⁹⁰ Scott (n 12) 3.

also variable, also depending as much on law as it does on power relations in different political and economic circumstances, and to different effects. In a rapidly changing environment, closed, fixed rules might hamper flexible responses by either party to adjust, while in a stable environment open principles that allow for case-by-case decision-making might create ambiguity and opportunities to seek out favourable conditions.⁹¹

The simplest way that regulators can control banks is to act as gatekeepers to the banking sector. This is primarily done through controlling the issue of a limited number of banking licenses that formally authorize banks to engage in banking. Regulators can control who wins licenses through neutral and objective ‘fit and proper’ tests of both the capacity and moral standing of a bank and its directors and senior management, or through more subjective means, including patronage in some contexts.⁹² Licensing often also subjects banks to a continuous process of reporting to regulators, who test and evaluate whether or not they continue to meet the standards of licensed institutions. A regulator can compel bank behaviour by threatening to take a bank’s license away in the event of non-compliance,⁹³ the effectiveness of which will depend on both the perceived power of the regulator to follow through on a threat and the value of the license itself.⁹⁴

In competitive environments, threats to bank reputation or financial penalties can also be used to compel bank behaviour. Again, however, threats of penalties might have little influence

⁹¹ John Braithwaite, ‘Rules and Principles: A Theory of Legal Certainty’ (2002) 27 *Australian Journal of Legal Philosophy* 47.

⁹² S. Mansoob Murshed and Djono Subagio, ‘Prudential Regulation of Banks in Less Developed Economies’ (2002) 20 *Development Policy Review* 247, 255.

⁹³ Alan Marcus, ‘Deregulation and Bank Financial Policy’ (1984) 8 *Journal of Banking & Finance* 557, 564-565.

⁹⁴ Gorton and Winton (n 82) 90.

on controlling bank behaviour in circumstances where regulatory authority to intervene is low, or where the costs of transgression are not high or not credible. On the other hand, over-penalization of firms or heavy-handed and highly interventionist regulation can push firms out of the market by making banking no longer a lucrative or desirable business to be in.⁹⁵ Establishing the right balance of intervention to achieve control is a policy dilemma for legislators, such as with capital adequacy ratios (CARs), which require banks to retain certain amounts of liquid capital to mitigate liquidity risk concerns, but that can also impinge on bank profitability if set too high.⁹⁶

Some of the most extreme forms of regulatory intervention are responses to failing banks, where regulators can take banks over, force them through bankruptcy proceedings, or even bail them out, each of which demands a choice of who in the economy will bear the costs (ie. shareholders, taxpayers, creditors, etc.).⁹⁷ Putting a bank through bankruptcy might be cost-effective, but could have deleterious effects on confidence in the economy. On the other hand, bailing out a failing bank demands that taxpayers shoulder the costs of that failure, which, while preserving bank confidence, might have political consequences and create a moral hazard that encourages other banks to take greater risks. Taking over a failing bank and reorganizing it to restore it to viability and solvency, will either incur losses to the state if it absorbs its loss-

⁹⁵ Murshed and Subagjo (n 91) 251-252.

⁹⁶ Milton Harris, Christian C. Opp and Marcus M. Opp, *Macroprudential Bank Capital Regulation in a Competitive Financial System* (Working Paper, October 9, 2014, 2014); Gary Gorton and Andrew Winton, *Liquidity Provision, Bank Capital, and the Macroeconomy* (Working Paper, University of Minnesota, 2014).

⁹⁷ Stephen Lumpkin, 'Resolutions of Weak Institutions: Lessons Learned From Previous Crises' (2008) 2008 OECD Journal: Financial Market Trends 113, 117.

making assets, or to its long-term creditors if the state obliges them to discount the bank's debt to them.⁹⁸

One can imagine that the aggregation of regulator-bank relationships will take the form of observable patterns of intervention and compliance. Strong regulator actions taken against certain banks, for instance, can signal to others an increased strictness in the regulator's approach to bank relations, while inaction can signal the opposite. Such signals can feed back into individual bank decision-making about compliance across a regulatory space, depending on whether or not a particular bank takes them seriously or not.

Bank-Bank Relations

In a capitalist economy, the paradigm of bank-bank relationships is presumed to be competition as banks struggle to win clients and profit-generating opportunities within a banking marketplace that is inherently risky.⁹⁹ From a regulatory space perspective, competition can be understood as a contextual consideration that can affect bank decisions about how to strategize and structure their operations vis-a-vis others in the market. The degree of competition in a given regulatory space can have an impact on the effects and effectiveness of regulatory interventions. The aggregate effect of competitive bank relations can impact the effectiveness of the regulator's relationship with banks as well. Highly competitive markets, for instance, in which the majority of banks vigorously fight for slim margins of advantage can be more sensitive to regulatory intervention than those that are not. In some cases, this might be positive by making regulatory

⁹⁸ So-called 'bailing-in', as labeled by Paul Calello and Wilson Ervin in 2010. Paul Calello and Wilson Ervin, 'From Bail-Out to Bail-In' *The Economist* (London, January 28, 2010).

⁹⁹ Independent Commission on Banking, *Final Report Recommendations* (September 2011, 2011) 153.

intervention more effective, but in others might encourage undesirable behavioural responses, such as withdrawal from the market, or regulatory arbitrage.¹⁰⁰

Competition is not, however, the only form of bank-bank relationship, and being in a state of competition does not necessarily imply that banks are always antagonistic towards one another. In order for banks to provide liquidity to an economy, they have to routinely cooperate with one another to facilitate client payments and transactions. Banks also periodically cooperate with each other and with government authorities in devising banking practice standards in collaborative fora, like the Basel Committee, for instance, and have also been known to cooperate to rescue troubled banks in order to forestall wider panic throughout the banking system.¹⁰¹ Bank-bank cooperation can also have negative aspects, such as when they collude to provide regulators and the public with fraudulent information, such as in the case of the ongoing Libor scandal in the U.K.¹⁰² Whether or not a relationship is characterized by cooperation or competition, or both, though, the key question here is what contextual pressures create incentives or disincentives for particular types of inter-bank relations to emerge, and what reckless or prudential effects they have when aggregated across a regulatory space.

Government-International Finance Organizations

In today's globalized world, domestic banking regulatory spaces regularly come into contact with, and are influenced by, international flows of finance as well as the institutions that have

¹⁰⁰ Dan Awrey, 'Towards a Supply-Side Theory of Financial Innovation' (2013) 41 *Journal of Comparative Economics* 401, 414.

¹⁰¹ S. V. Jayanti, Ann Marie Whyte and A. Quang Do, *Bank Failures and Contagion Effects: Evidence from Britain, Canada and Germany* (Working Paper, 1993), referenced in Gorton and Winton, *Financial Intermediation* 72.

¹⁰² The Economist, 'The LIBOR Scandal: The Rotten Heart of Finance' *The Economist* (London, July 7, 2012); David Hou and David Skeie, *LIBOR: Origins, Economics, Crisis, Scandal and Reform* (Federal Reserve Bank of New York, Staff Report No 667, March 2014, 2014).

emerged over past decades to try to manage them. Governments often have a complex relationship with both because engaging with them brings many policy and political tensions to the fore. Inward flows of international finance, for instance, while increasing aggregate domestic liquidity can also exert competitive pressure on domestic banking institutions, and sometimes undermine regulators' efforts to control money supply or effectively monitor finance flows through an economy. Similarly, for a government interested in accessing sovereign loan financing directly from organizations like the International Monetary Fund (IMF), such financing often comes with conditions attached that may make demands that are incommensurate with a government's political interests. The dynamics of these relationships are variable and subject to ebbs and flows relative to contextual economic changes, conditioned by a number of variables, such as: international treaty obligations, or credit and loan repayment obligations to sovereign lenders, or by degrees of acquiescence, whether voluntary or compelled, by national governments to advice from international advisors. The political tensions and power differentials underlying these relations are brought to the surface in different ways depending on the ebb and flow of a country's political economy. When times are good, national authorities and domestic populations might be resistant to international calls to address structural vulnerabilities, while in times of crisis they may be more prepared to embrace such inputs along with the consequences that come with them.¹⁰³ Indeed, as will be seen in Indonesia, crisis can create opportunities for international entities, in that case the IMF, to exploit periods of weaknesses to leverage greater regulatory and legislative change domestically than was possible at other times.

¹⁰³ Brunnermeier and others (n 48) 56.

RESOURCES

Colin Scott characterizes the regulatory space in terms of a fragmented array of four ‘resources’ that actors can deploy strategically in pursuit of gain or advantage, namely: authority vested by law, wealth, information, and organizational capacity.¹⁰⁴ Regulatory actors, whether governmental or non-governmental, either possess or have access to these resources to varying degrees, correlative to the power and informal authority that they can exercise within the regulatory space.¹⁰⁵ This differentiated access to resources implies a distribution or fragmentation of power, which, for Scott, shapes a regulatory space by influencing the interactions and interdependencies of regulatory actors within it.¹⁰⁶ However, as will be seen with Indonesia in the following chapter, like a barrel of jet fuel, ‘resources’ can provide actors with power if they are used well and to their advantage, but they can also be dangerous if they are used improperly. The case study will demonstrate that one cannot assume that benefits will automatically flow once an actor gains access to one of these four resource in a regulatory space, and sometimes their effects can be dire. The potential and volatility of Scott’s four resources will be briefly explored below in terms of their theoretical relevance for a banking regulatory space, after which it will be possible to explore what influence they had in the particular Indonesian case study that will follow.

¹⁰⁴ Scott (n 12) 334.

¹⁰⁵ *ibid* 336.

¹⁰⁶ *ibid* 334-338.

Wealth

While Colin Scott describes ‘wealth’ as a power-conferring resource in a regulatory space, he does not offer a concrete definition of what exactly it is or how it functions. At most, his account offers a presumption that actors with greater wealth can command greater power, and that such power is linked to an ability to corrupt regulatory processes.¹⁰⁷ In banking, however, the role played by wealth as a resource is considerably more nuanced. Although it might seem at first glance to be the most obvious and relevant of the four regulatory space resources for banking, banks are only ‘wealthy’ to the degree to which they have ready access to capital that they can leverage out for profit. For the most part, banks do not ‘own’ much of the capital that they use since much of their operating capital is owned by third parties, like depositors, who allow banks to use it to issue interest-generating loans. While having lots of capital can make a bank important in an economy, the more that banks leverage out their capital wealth relative to their reserve holdings, the more they expose themselves to risk, such that imprudently over-leveraging its capital ‘wealth’ can make a ‘wealthy’ bank very fragile and weak.

Different types of banks have different sources of capital. Private banks traditionally receive working capital from private depositors, whose funds they must attract away from their competitors. State-owned banks, on the other hand, may be less influenced by competition and more by bureaucratic politics if their capital resources are sourced from state allocation policies. These different sources of capital make banks accountable in different ways, either to their depositors, creditors, or to higher political and bureaucratic powers, but bank actors are similarly

¹⁰⁷ *ibid* 337.

constrained in the ways they can use their wealth, no matter how large it is. While they have license to take risks with investing their capital wealth resources, all banks must balance that risk with their interests in earning sufficient returns and avoiding insolvency. From a regulator's perspective it is critical that they do so in a way that maintains confidence and sufficient liquidity in the overall system to maintain growth in the economy.

Capital is not the only kind of 'wealth' that is relevant in a banking regulatory space. One can also quite easily imagine the 'wealth' of regulators in terms of the size of administrative budget allocations, the size of which can impact their the extent of their abilities to undertake their regulatory mandates. One can also imagine the 'wealth' of borrowers impacting their individual relationships with banks in terms of their creditworthiness and desirability as bank clients. Furthermore, one can consider aggregate levels of disposable depositor 'wealth' available in a regulatory space, without whose pooled liquid deposit funds private banks would be unable to function. As with any of these four resources, the relative importance of different kinds of 'wealth' for any regulatory space analysis will, of course, vary depending on context.

Information

Colin Scott argues that information asymmetries in a regulatory space can produce power differentials when regulated industries enjoy greater access to information than regulators.¹⁰⁸ In banking, imperfect knowledge of the market can cause banks to allocate credit to less than optimal investment opportunities, or to set interest rates at less than fully efficient levels, while knowing more about a market can give them advantages over their competitors.¹⁰⁹ Knowing more than their creditors or depositors can give banks power, but it can also create uncertainties that in difficult, panicky times can induce herd activity, like bank runs.¹¹⁰

Regulatory concerns about information can manifest at the micro-level in terms of degrees of protection offered to unsophisticated investors or the depositing public, while at the middle- and macro-levels they manifest as concerns over the variable ways in which information flows affect a regulatory space. These information flows are omni-directional, but their nature will vary, depending on how micro-level actors are organized and interact, how information is collectively processed and then re-distributed throughout a space, and how accessible and receptive actors are to information that comes to them. One can consider, for instance, how banks derive and use information about their borrowers in determining how to monitor them and to what economic effects.¹¹¹ How much a bank should invest in monitoring borrowers is a business choice related to its tolerance of risk, optimism about general economic conditions, as well as willingness and

¹⁰⁸ *ibid* 334.

¹⁰⁹ Robert Marquez, 'Competition, Adverse Selection, and Information Dispersion in the Banking Industry' (2002) 15 *Review of Financial Studies* 901, 901-903.

¹¹⁰ Steven L. Schwarcz, 'Regulating Complexity in Financial Markets' (2009) 87 *Washington University Law Review* 211, 220-225.

¹¹¹ Gorton and Winton, *Financial Intermediation* (n 95) 38-41.

capacity to allocate resources to it.¹¹² The upshot of this is that information flows even at this single, individual level of a bank monitoring its borrowers can be complex and variable. One cannot assume that information is constant, consistent, or evenly distributed throughout a regulatory space, or that actors have equivalent interests in or needs for it, or that they will interpret it in the same way.

It is important to also consider the connection between information and behaviour within a regulatory space. In an interactive space, individual action produces information that can be received and interpreted at an individual level, or aggregated along with others to produce middle- or macro-level information flows that can condition further action responses by other actors elsewhere in the regulatory space. How such information is produced, how it is used, to what effect, and at what level within a regulatory space is, again, variable and complex. Consider, for instance, the complex effect of information flows between individuals and collective entities in the context of competition. Competition can be thought of as an emergent result of individuals across a market conditioning their behaviour strategically according to information received from the actions of others operating in the same economic environment. However, because of this complex reality, regulatory interventions to mandate information flows for competitive purposes, such as mandatory disclosure requirements, can have non-linear effects. The information produced by mandatory disclosure obligations can simultaneously appear beneficial from a macro-perspective because it increases information efficiency in a

¹¹² Ibid 51-53; Andrew Winton, *Don't Put All Your Eggs in One Basket? Diversification and Specialization in Lending* (Financial Institutions Center Working Paper #00-16, 1999).

marketplace, while at the same time appearing detrimental for individual firms at the micro-level who might otherwise want to keep their business information protected from competitors' eyes. Thus, whether information is produced or used to good or bad effect in a banking regulatory space is often a matter of perspective. The same is the case for legal capacity.

Legal Capacity

When Colin Scott speaks of 'legal capacity' as a power-conferring resource, he primarily refers to authority conferred by a formal legal framework, most obviously the authority granted to a regulator to intervene in the affairs of regulatory space actors for the purpose of government policy objectives. Regulatory frameworks provide formal authorization to a regulator to intervene in specific ways to directly shape a regulatory space. Scott cautions, however, that power in legal relations emerges as much from how rules are interpreted as from how they are enforced, and the former can be considerably influenced by the informal authority of non-state actors, such that both regulators and the regulated jointly construct meaning that guide the legal parameters of their relationships.¹¹³ Regulatory rules reflect specific policy decisions that emerge out of political dynamics affecting legislative and executive branches of government, dynamics which are informed by political tradeoffs of benefits and detriments that such interventions can impart upon the space, which can be difficult to calculate. Non-state actors can also derive benefit from a legal regulatory framework, whether informally through their influence over regulator or legislator decision-making, or formally through licenses or the formal contractual terms that govern their relations with others.

¹¹³ Scott (n 12) 344.

In both cases, however, law is less of a power-generating resource than a mirror of underlying power dynamics. If Scott is right, and legal capacity is really a ‘resource’ in a regulatory space, then it must provide something other than mere power. As a ‘resource’, law in banking is correlated to issues of information and confidence in the sense that the ability of a formal legal regime to confer authority requires that actors in the regulated space understand its authority and respect the credibility of its threats of sanctions in the event of non-compliance. The absence of such credibility can leave a regulator powerless and incapable of intervening effectively in a regulatory space, regardless of how explicitly the legal framework might convey formal authority to it to do so. Similarly, an absence of confidence in the broader legal system can limit the power or effectiveness of formal legal measures that parties use to structure their relationships. In contexts where judiciaries are untrustworthy or corrupt, for instance, banks may have little or no actual power to enforce their loan contracts, regardless of whatever rights the law might formally grant them. A lack of confidence in a legal system can then affect the degree and nature of risk associated with bank business, requiring alternative practices or strategies than those envisioned in law or regulation to either mitigate or avoid it. Thus, while law can impart power as a resource, its ability to do so is neither constant nor guaranteed, but conditional on other dynamics within the regulatory space and the broader political environment in which it exists.

Organisational Capacity

Like with most of the resources, Colin Scott does not provide much detail about what role ‘organizational resources’ play in a regulatory space, although he does suggest that they are multiple and that actors can draw upon them ‘to dominate rule-formation, rule-enforcement or

processes by which sanctions are applied in which they possess no formal authority.’¹¹⁴ This begs the question of what it might mean for a regulatory actor to make use of ‘organization’ as an empowering ‘resource’. At first glance, the connection may be obvious: the better-organized and more capable actors are, the better able they are to pursue their objectives and gain advantage in a regulatory space. For instance, one could intuitively expect that the better a key institution’s internal procedures, workflows, or interactions with regulatory agencies are organized, the more capable it will be to operate within a regulatory space. Legal and regulatory restrictions on how actors can organize, such as rules on disclosure or internal governance, for instance, can affect actor capacities to act, which, when aggregated, can shape a regulatory space by altering the dynamics of things like competition or how and where resources are allocated throughout an economy. Organizational capacity may be connected to ‘wealth’ if funding is determinative of the extent of an actor’s organizational capacity and reach throughout a regulatory space. It can also be connected to information, in the sense that an actor’s organizational capacity to gather and process information can be critical for its ability to function and compete with others in a regulatory space.

In other ways, however, whether an actor’s organizational capacity will create benefits or detriments in a regulatory space is relatively subjective since, as with the other resources, its use invokes a balance, where benefits for some may appear as detriments to others. For instance, whether inter-bank or bank-regulator cooperation is a positive form of efficient information-sharing coordination or a negative form of collusion will depend not only on context but also on

¹¹⁴ *ibid* 336.

one's perspective.¹¹⁵ In short, like with the other three resources, the analytical point here is that knowing how organizational capacity as a resource is used and what it means to actors is as important as identifying how much of it an actor has at any given moment.

CONCLUSION

This chapter has offered an overview of how the components of regulatory space, namely: 'issues', 'actors', 'relationships' and 'resources', might be understood in the context of banking. Doing so with a mind to complexity, however, it has also highlighted some features of these components that have not been emphasized in regulatory space literature to date. For one, the regulatory space is an intensely subjective place, which provides a behavioural nuance to regulatory space discussions about discourse by asking how, why, and by whom discursive knowledge regimes are created. How issues are understood and acted upon by actors, how actors understand and act upon their relationships with each other, how choices are made over how best to employ resources and to what ends, etc. all speak to subjective understandings of the space by its actors. Banking takes on space-wide characteristics or properties when the aggregated effects of actors interactions and behaviour produce patterns that signal that certain behavioural trends are occurring within the space. Such signals convey information whose meaning is variable and relative, depending on how it is interpreted by actors within their contextual circumstances. Thus, this modified regulatory space approach does not require actors to behave identically

¹¹⁵ Cornelia Holthausen and Thomas Rønde, *Cooperation in International Banking Supervision* (European Central Bank Working Paper No 316, March 2004, 2004) 34.

within it, however, aggregated behaviours can produce general impressions of homogenous change, which can feedback to affect the action calculations of other actors in turn. It is with this dynamic construct in mind that we can now turn to Indonesia to answer the original question underlying this study, namely how and why Indonesian banking changed the way it did between 1997 and 2008.

Chapter III

FROM RECKLESSNESS TO PRUDENCE: THE CHANGING REGULATORY SPACE FOR BANKING IN INDONESIA, 1997-2007

INTRODUCTION

The 1997-1998 Asian financial crisis famously wiped out the Indonesian economy and devastated its banking system. Even though Indonesia's banks were known to be imperfect before the crisis, the devastation it wreaked upon those banks came as a surprise to many.¹¹⁶ As losses mounted exponentially through 1997 and into 1998, the banking system effectively ground to a halt and the economy collapsed around it. As more and more fell apart, it became clear that over the previous decade and a half Indonesia's banks had become highly risk-prone and imprudent in the way they conducted their business, operating under a regulatory framework that was poorly and unevenly enforced.¹¹⁷ Barely a decade later, however, the IMF was praising the Indonesian banking sector for having a 'healthy and sound banking system,' one that was conservative and restrained, 'with institutionalized incentives for actors at all levels to behave prudently and not expose themselves to excessive risk.'¹¹⁸ This relatively quick turnaround is a challenge to explain. The crisis devastated the economy and caused widespread social unrest, and initiated a political crisis that brought down President Soeharto's thirty-year regime. Because of this, one cannot easily presume that the Indonesian government was responsible for

¹¹⁶ David C. Cole and Betty F. Slade, 'Why Has Indonesia's Financial Crisis Been So Bad?' (1998) 34 *Bulletin of Indonesian Economic Studies* 61.

¹¹⁷ Sharma (n 4) 131.

¹¹⁸ IMF, *Indonesia: Financial Sector Assessment Program* (n 5) 6, 12.

singlehandedly turning its imprudent and reckless bank sector into one that was restrained and conservative by 2008. The political establishment that survived the crisis was in a poor position to easily command its competitive and reckless bank sector to suddenly behave in a responsible, prudent fashion while the country tried to rebuild itself. Yet, such a widespread behavioural change nevertheless emerged, and in a relatively short period of time.

Building on the analysis of previous chapters, this chapter will try to account for that turnaround. Relying on the adapted regulatory space approach offered in the previous chapter, it will first offer a brief overview of Indonesia's modern economic history, and then highlight how the three banking 'issues' were meaningful to Indonesia's banking actors in ways that shaped how they acted upon them. It will then explore how Indonesia's banking regulatory space changed by mapping the distribution and interaction of those actors within it at three different points in time: on the eve of the crisis in 1997, shortly after the crisis in 2004, and still later in 2007. This will be followed by an account of how regulatory 'resources', discussed in Chapter 2, structured those changing relationships over that timeframe. Throughout, true to the adapted regulatory space approach, the reorientation of Indonesian banks to a more prudent and restrained behavioural footing after the crisis will be described as a middle-level phenomenon whose characteristics are derived from the aggregate effects of micro-level behaviours within a larger, macro-level regulatory space for banking.

INDONESIA'S MODERN ECONOMIC HISTORY

The Birth of a New Indonesian (Patrimonial) Economy

In the early 1980s, a decade and a half prior to the 1997 crisis, Indonesia embarked on a journey to deregulate its economy, embrace market forces, and transition away from a heavily state-driven model of economic development that had characterized the 1960s and 1970s. By 1997, the regime of President Soeharto had been in power for thirty years, and had maintained its grip largely because of the legitimacy it had earned from a successful record of economic resurrection and growth. When Soeharto assumed power in 1966 he had inherited an economy that had been in a downward spiral for a decade. Inflation was very high, the country enjoyed little to no investment or export development, and the state was virtually bankrupt.¹¹⁹ A military man, Soeharto turned to a small cadre of U.S.-educated, neo-classical economists at the University of Indonesia for advice and solutions about how to re-stabilize the economy.¹²⁰ It was their vision of a liberalized, capitalist economy for Indonesia, one that was open to foreign investment and encouraging of domestic private investment, assisted by state institutions to facilitate economic development, that set the tone for the country's economic development for the next three decades.¹²¹

¹¹⁹ In 1966, Indonesia's foreign reserves were practically zero, inflation was over 600 per cent, and the government deficit was 30 times larger than its revenues. See: Amar Bhattacharya and Mari Pangestu, 'Indonesia: Development Transformation and the Role of Public Policy' in Danny M. Leipziger (ed), *Lessons from East Asia* (University of Michigan Press 1997) 390-393.

¹²⁰ This group included well-known figures such as Professors Widjoyo Nitisastro and Ali Wardhana, among others.

¹²¹ Yuri Sato, 'The Decline of Conglomerates in Post-Soeharto Indonesia: The Case of Salim Group' (2004) 1 *Taiwan Journal of Southeast Asia Studies* 19, 21.

Initially, there was relatively little upon which they could build this grand vision. In post-independence Indonesia, the domestic class of merchants and entrepreneurs, upon which that vision depended, was relatively tiny. Yet, small through it was, it was enough to start with and in short order the new regime began to rely on them, and their capital resources, to further national economic development. From early on in Soeharto's regime, it became entrenched practice for the state to funnel economic opportunities and the fruits of economic growth to this small number of businessmen and enterprises. Within time, this privileged relationship became institutionalized and for the following decades lucrative state concessions allocated in the form of subsidized credit, import and export licenses, and production monopolies were steered to select enterprises in key priority areas whose owners were well connected to the Soeharto government.¹²²

This relationship went into overdrive during the international oil crises of the 1970s when Indonesia experienced an enormous windfall from extremely high international prices for its oil exports. The government wasted little time in using its vast new oil wealth to rapidly and deeply develop its state-owned industrial sectors, but continuing to rely on the select, core group of key private enterprises with which the state now had close ties. Economic opportunities flowed in the form of massive amounts of funding and subsidized credit, which were directed to establish new industrial and infrastructural ventures deemed necessary for national economic growth. The state-owned and private enterprises that benefited from this quickly grew and expanded along with the national economy. Many of the private enterprises accumulated more and more

¹²² ibid 22.

businesses under their wings, diversifying their holdings and eventually turning into large business conglomerates that commanded tremendous resources and influence in the economy.¹²³

When the international oil crisis eventually ended in the early 1980s, the price of oil plummeted and the now oil export-dependent Indonesian economy was suddenly faced with a serious imbalance of payments problem.¹²⁴ Needing a new source of foreign exchange revenue to sustain economic growth, Soeharto turned once again to his economic advisors, who interpreted the problem facing the country as a challenge of having to wean the country off of its oil dependence, promote exports, substitute imports, promote domestic savings and make resource allocation more efficient.¹²⁵ From their perspective, the best way to do this would be to deregulate and remove state controls over the economy, open the economy up to freer domestic competition, and support the development of non-oil export industries. This initiated a decade of deregulation, where state controls over the economy were steadily removed, and opening the market to any and all newcomers. By the end of the 1980s, this open market approach succeeded in resurrecting a faltering economy, but it had also brought considerably wild industrial growth and financial speculation with it such that by the early to mid-1990s it seemed to be getting out of hand. By the time the crisis hit in 1997, government authorities had been experimenting with new market control regulatory interventions designed to cool down growth and avoid inflation,

¹²³ *ibid* 21-23; Christian Chua, 'Chinese Big Business in Indonesia - The State of Capital' (DPhil, National University of Singapore 2006) 64-67.

¹²⁴ With oil representing somewhere between 60-80% of all export revenues, Indonesia's current account plummeted along with the price of oil from a surplus of \$2.8 billion in 1980 to a \$6 billion deficit by 1983. See Michael T. Skully and George J. Viksnins, *Financing East Asia's Success* (MacMillan Press 1987) 176; Miranda S. Goeltom, *Indonesia's Financial Liberalization* (Institute of Southeast Asian Studies 1995) 1.

¹²⁵ Skully and Viksnins (n 123) 177.

in an effort to regain some control and restrain the wild private sector forces that deregulation had unleashed.

The 1997 crisis changed everything, however. The devaluation of the Thai baht in July 1997 sparked a region-wide economic downturn. Its first effect in Indonesia was felt as a currency crisis where the rupiah steadily lost 85% of its value over a 10-month period. The widespread insolvencies this caused throughout the economy quickly put a strain on Indonesia's banking system as banks became unable to manage the delicate balance between their short-term liabilities and long-term assets. Liquidity was sucked out of the banking system as banks and businesses scrambled to meet their payment obligations. The economy slowed and began to contract, and multiple banks were hit by panicked depositor runs, as depositors rushed to withdraw their rupiah deposits and trade them for hard currencies to avoid further loss.¹²⁶ The situation took a turn for the worse when the increasingly desperate government turned to the IMF for assistance, which recommended fiscal tightening and the closing of 16 insolvent banks. Rather than restoring confidence in the banking system as the IMF had hoped, this action had the opposite effect, signaling that the government had little confidence in its banks and that any were liable to be closed if things continued. Panic spread quickly throughout the collapsing economy, to disastrous effect.

In the space of mere months, the legitimacy of Soeharto's thirty-year hold on power dissolved and the edifice upon which his patrimonial system had been built buckled under the strain. Amid a backdrop of economic collapse and massive social unrest, Soeharto resigned, and

¹²⁶ Skype interview (Oxford/Jakarta, 5 July 2015).

handed power to what became a series of new governments that struggled to rebuild the country and its devastated economy, along with its thoroughly discredited and shattered banking sector.

Evolution of Indonesian Banking

Indonesia's banking system grew and evolved in parallel to these developments. Banking was an integral part of Soeharto's economic policies, which relied on its state-owned banks to distribute funding and subsidized credit to select economic units considered important to national development.¹²⁷ Although a few private banks and branches of foreign banks had been established early in the 1950s and 60s, through the 1970s the government controlled its banking system by regulating the credit levels and interest rates of all of state and private banks in operation, and issuing no new bank licenses and closing off the banking sector to any newcomers.¹²⁸ During the oil boom, all of Indonesia's windfall wealth was funneled through its seven state-owned banks, which massively inflated their importance as channels for national investment and credit financing,¹²⁹ most of which flowed to client economic interests close to the government. At the end of the oil boom, however, those state oil revenues slowed to a trickle and bank liquidity contracted. The government's market-based deregulation policy initiatives in the decade that followed were partly intended to mobilize the private sector as an alternative source of capital to finance investment and economic growth, rather than oil. This new deregulated,

¹²⁷ Yuri Sato, 'Bank Restructuring and Financial Institution Reform in Indonesia' (2005) 43 *The Developing Economies* 91, 97.

¹²⁸ *ibid.*

¹²⁹ By the 1980s, the state banks dominated the banking sector by a factor of 70-80% of all assets. See: Goeltom (n 123) 2-3.

market-focused economic environment implied a different intermediary role for banking, however, and between 1983 and 1993 the government introduced a number of regulatory reforms to remove or relax government controls over it: entry and licensing restrictions were lifted; centrally-imposed credit ceilings were discarded; restrictive licenses to access foreign capital markets were made more accessible; and banks were given responsibility for setting their own interest rates for their loans and deposit accounts.¹³⁰

These regulatory initiatives inspired rapid and dramatic change. Within a short time, a flood of new, but poorly capitalized, banks received licenses and entered the market. Although the massive state-owned banks were slow to change and continued their decades-long, inefficient and clientelist lending practices, these new banks immediately began to solicit deposit capital from the public on generous terms and began aggressively lending it out again anywhere and wherever opportunities arose. Many of the large business groups that had benefited from decades of political privilege also seized the opportunity to establish their own banks to more easily coordinate financing within their conglomerate empires.¹³¹ Within time, the aggregate effects of these initiatives began to reverse the liquidity and credit contraction that had been caused by the drop in oil prices. Indeed, by the early 1990s assets in Indonesia's financial sector had grown so fast that the government began to worry that the economy was overheating and inflating faster than could be controlled.¹³² Concerned about inflation, between 1991 and 1997 the government

¹³⁰ Malcom Cook, *Banking Reform in Southeast Asia: The Region's Decisive Decade* (Routledge 2008) 34.

¹³¹ *ibid* 33-34.

¹³² William Keeling, 'Jakarta Struggles to Control its Deregulation' *Financial Times* (New York City, June 4, 1992) 4.

introduced a number regulatory measures that were aimed at controlling credit expansion, such as CAR limits and increasing interest rates. It also introduced measures demanding that banks curb their volatile lending practices and adopt prudent governance and internal oversight structures and procedures, based on international standards.¹³³ These early measures managed to marginally slow down the quickly inflating economy, but also encouraged many investors, including most of Indonesia's large business groups, who had become thirsty for financing in this growing economic climate, to seek cheaper, often U.S. dollar-denominated, financing from abroad. By the time the currency crisis hit in 1997, many found themselves terribly exposed and in serious trouble with these foreign currency holdings as the rupiah's value plummeted, and with shocking rapidity, businesses, along with the banks that financed them, became insolvent and began to fail all over the country.

ISSUES

Before turning to descriptions of how banking actor behaviour changed from before the crisis to afterwards, it is worthwhile to pause and consider the particular ways in which the three banking 'issues', 'risk', 'liquidity', and 'confidence' manifested themselves and motivated action by regulatory actors in the Indonesian context

¹³³ Sukarela Batunanggar and Bambang W. Budiawan, 'Problem Bank Identification, Intervention and Resolution in Indonesia' in *Comparison of Problem Bank Identification, Intervention and Resolution in the SEACEN Countries* (The South East Asian Central Banks (SEACEN) Research and Training Centre 2008) 69. These standards were primarily derived from the Bank for International Settlements (BIS).

Liquidity

The central concern for government policy-making in banking through Indonesia's modern economic history has been to manage and maintain sufficient liquidity in the economy to facilitate economic growth and national development. For the first half of Soeharto's regime, this concern manifested as the question of how the state should manage the tremendous oil-wealth that the international oil crisis in the 1970s had brought to the country. Banks, especially the seven state banks, became important purveyors of Treasury-sourced credit to investments deemed important to either national development or to support the crony interests of the regime's powerful economic supporters. In time, this became the distributional logic of Soeharto's patrimonial political system, where resource allocation, including the distribution of cheap, subsidized credit through its state-owned banks, was largely a political choice, linking selective national development objectives to influential economic actors.¹³⁴ When oil prices dropped in the early 1980s, the country was faced with a serious liquidity problem as national revenue plunged, requiring a new distributional logic to maintain the regime's political and economic momentum. Deregulation was the government's answer to that problem, and much government policy in the 1980s was devoted to sourcing new liquidity to sustain economic growth momentum by opening the economy, and the banking sector, to the private sector. Within a decade, this goal had been accomplished. The banking sector ballooned very quickly as new

¹³⁴ This was an incredibly lucrative opportunity for some. The greatest example is Liem Sioe Liong, a businessman and longtime friend to Soeharto who in 1989 was estimated to have a personal net worth of over \$2 billion, making him Asia's single richest private person at the time. See John Bresnan, *Managing Indonesia - The Modern Political Economy* (Columbia University Press 1993) 256.

banks and the new deposit capital they competed for flooded the banking sector with new capital that financed the growth of a new, non-oil export economy, so much so that by the early to mid-1990s, the government was faced with the problem of having too much liquidity. Many new banking actors were aggressively competing for deposit clients and business opportunities to lend to and profit from, but collectively, their widespread assumption of very risk-tolerant loan portfolios were producing a systemic volatility that was new and unfamiliar. Yet, how to control that volatility in this new deregulated economic environment without sacrificing the goal of continued economic growth was a bit of a mystery for policymakers.

The 1997/98 crisis first arrived as a massive liquidity problem when the loss in value of the rupiah rendered firms and banks across Indonesia insolvent, collapsed all confidence in the banking system, caused multiple runs on around half of the banks in the country, and sparked massive capital flight abroad. Recovering from the worst effects of the crisis required, in part, restoring the flow of liquidity through Indonesia's banks. This required a massive process of exorcising any problem banks that had failed, either by closing them down or by taking them over, re-organizing them, and re-selling them to new owners. Half of those that survived the crisis were under-capitalized, so the government expended vast amounts of state resources to inject capital into them to re-balance their accounts and re-establish confidence in the banking sector as a whole. However, liquidity remained quite low for years after the crisis, not necessarily for lack of capital, but for lack of confidence as banks were slow to regain faith in themselves and the economy.

Confidence

In the 1970s, confidence in Indonesia's banking system was equated with confidence in the state itself. The state for decades had been the primary driver behind the nation's development, which had included vast sums of state-backed credit provision through the state-owned banks, which, even by 1997 after over a decade of deregulation, were still easily accessible by those close to the government.¹³⁵ Through the deregulation period of the 1980s, confidence in banking continued to rely on the presence of the state, even in the newly competitive economy, in particular confidence that the state would be there to protect banks that ran into trouble (at least those in the government's favour). By the early 1990s, however, the central bank was starting to have doubts about the new and highly competitive and rapidly expanding private banking sector. From what information it could gather, it seemed that some banks were over-extending their capital bases and issuing large amounts of loans to dubious, non-performing investments that were non-performing, or were concentrating their loan portfolios in loans to related parties. For the rest of the decade prior to the crisis, the government thus experimented with various measures to compel more prudent behaviour and slow growth to sustainable levels. These measures met with limited success, however. Regardless, public confidence in Indonesia's banks remained sufficiently high that the sector continued to grow until the crisis arrived.

The collapse of the value of the rupiah in mid-1997 caused a massive loss of confidence in the economy and the banking system, one that was so bad that it turned a liquidity and foreign exchange problem into a systemic crisis. Once it became abundantly clear that the state would be

¹³⁵ David C. Cole and Betty F. Slade, *Building a Modern Financial System: The Indonesian Experience* (Cambridge University Press 1996) 150.

unable to keep all of Indonesia's struggling banks afloat, multiple waves of bank runs crippled banks across the country as depositors swarmed to withdraw their rupiah deposits from private banks, convert them into dollars, and deposit them in 'safer' state or foreign banks. This had the aggregate effect of forcing the value of the rupiah down ever further, draining liquidity out of the system, and ruining any prospects for a swift economic recovery.

This lost confidence was slow to return in the years following the crisis. Even once the rupiah stabilized in late 1998, it took a few years for public trust that the system could safely operate normally once again to return. And that confidence was forever changed, tinged with an understanding that this new system was loaded with new kinds of risk that hadn't been a concern before 1997. In this new economic reality, the prospect of failure and economic disaster was very real, which had the effect of making banks highly reluctant to lend or take any significant risks for years afterwards.¹³⁶

Risk

As with liquidity and confidence, the way that risk manifested itself in the Indonesian banking regulatory space fluctuated in step with the country's larger economic trends. Indonesia's oil wealth in the 1970s made bank risk a non-issue as long as oil revenues pumped into the national treasury. When the oil taps were turned off in the 1980s, deregulation opened up the economy and the banking sector to competition, which created a new bank-bank dynamic that encouraged both new and old banks to take greater and greater risks with their lending as

¹³⁶ Skype interviews (Oxford/Jakarta, 5, 22, 26 June, 5 July 2015)

market opportunities became more available to those who dared seek them out. Even in that competitive market, though, few banks were concerned about a risk of failure.¹³⁷ The number of banks that had failed in recent memory could be counted on one hand, most of which had failed because their owners had lost favour with the government, which refused to bail them out.¹³⁸ Most banks understood that whatever losses they generated, while unfortunate, could always be absorbed by somebody somehow as long as they maintained good relations with the government or with powerful industrial conglomerates.¹³⁹ Thus, in terms of their lending and financing practices, pre-crisis Indonesian banks were collectively very tolerant of risk in a competitive and political context where restraint and prudence were incompatible with a need to seize market opportunities where available, and relatively unnecessary.

The crisis dramatically changed this. In a swiftly deteriorating economic climate, banks came to learn that the risk of failure now rested suddenly and heavily on their own shoulders. Once depositors realized the same, their confidence in the system broke, sparking bank runs across the country that made economic conditions worsen further. When bank after bank began to fail, the consequences of earlier risk-taking suddenly became very evident. Bank officials interviewed 15

¹³⁷ Skype interview (Oxford/Jakarta, 5 June)

¹³⁸ This was best demonstrated in the Bank Dutta and Bank Summa scandals of the early 1990s. Bank Dutta was an insolvent bank owned by one of Soeharto's personal foundations, which was bailed out after an ill-advised foreign exchange speculative transaction that ended poorly. Bank Summa was an insolvent bank that was forced into a protracted and controversial liquidation by the central bank, generally believed to have been deliberate in order to facilitate the acquisition of its assets by members of Soeharto's family. See Cole (n 134) 136; Cook (n 129) 36.

¹³⁹ Skype interviews (Oxford/Jakarta, 22 June, 5 July 2015).

years afterwards were unanimous in saying that the memory of that trauma continues to influence risk-taking behaviour in Indonesia's banks today.¹⁴⁰

ACTORS in 1997 (pre-crisis)

Due to space constraints, this case study cannot attempt a comprehensive overview of every single actor who engaged in or was affected by Indonesia's banking regulatory space between 1997 and 2008. The discussion that follows will instead focus on only four key actors whose actions and inter-relationships were major determinants of the shape and evolution of the Indonesian regulatory space for banking, namely: the government, bank regulators, state and private banks, and international finance organizations, mainly the International Monetary Fund. This is not to say that other actors, like depositors or creditors, were not also important, but only that their influence was indirect, and they have been incorporated when relevant and necessary within the descriptions of these four. It will also describe them in three different moments of time: 1997, 2004, and 2007. This approach is not only reflective of the mapping technique to which regulatory space has been put in the past, it is also true to descriptions of change through time found in some complexity theory. In the latter, to describe 'change' is to identify something as having different properties at two or more different times, and then explain either how and why those changes were brought about, or how the complex structure of a system might make certain outcomes more likely than others.¹⁴¹

¹⁴⁰ Skype interviews (Oxford/Jakarta, 5, 22, 26 June, 5 July 2015).

¹⁴¹ Auyang (n 37) 213-268.

Government

For the purposes of this study it is useful to imagine the Indonesian ‘government’ in 1997 as a singular, highly centralized, patrimonial political regime surrounding the person of President Soeharto. In this sense it refers to the President along with those features of the bureaucracy and the legislature that gave the concept of ‘government’ coherence and authority. By early 1997, the Soeharto government had been in power for thirty years, and its economic policy at the time was largely focused on consolidating and regaining some control over an economy that had been growing very rapidly and unrestrainedly after deregulation in the 1980s. One aspect of deregulation had been to remove many of the strict controls that the government had over banking in the country, such as its ability to control the money supply by mandating credit limits at all banks. In spite of that loss of direct control, the government and its state apparatus still exercised a commanding presence in the regulatory space through its ability to dole out privileged access to lucrative financial resources, like exclusive production or import concessions, or cheap, subsidized state loans, to client supporters of the regime. Political connections were very valuable in this regulatory space, both for the opportunities they could bring, but also because they allowed one to circumvent the state’s rules and restrictions when necessary.¹⁴²

While controlling access to state wealth was a source of power for the regime, it was also an aspect of its dependence on various economic and political interests who supported it. Soeharto’s political legitimacy largely rested on his thirty-year mostly positive track record, and in 1997 it was as important as ever for him to ensure that his key supporters were assuaged and committed to the survival of his regime. This included those who controlled the dominant interests in the

¹⁴² Bresnan (n 133) 60.

economy, especially the owners of many of Indonesia's 300 industrial conglomerates,¹⁴³ as well as the leadership of the Indonesian military, which managed and controlled much of the state-owned enterprises.¹⁴⁴ Different groups with different strategic interests held influence with the President and central political authority at different times.¹⁴⁵ When the economy was doing well, Soeharto doled out its benefits to his client supporters. When it ran into trouble, however, he tended to turn to academic economists at the University of Indonesia for advice, even when their free-market, neo-classical inclinations sometimes ran against the immediate interests of the regime's vested interests.¹⁴⁶

For Soeharto, deregulation in the 1980s represented a means of maintaining his political legitimacy by keeping the economy growing after the collapse of the price of oil, which required a new source of capital and economic energy.¹⁴⁷ While aspects of deregulation included increasing competition and freeing up the market by breaking up the inefficient government allocation of monopolistic import, export and production licenses, in effect, the regime had little incentive to disrupt the patrimonial system that supported it. Instead, deregulation was primarily a solution to a state finance problem, which, if successful, would secure the government's continued longevity by maintaining the flow of resources to those who benefited from the state's largesse.

¹⁴³ Hugh Patrick, *Corporate Governance and the Indonesian Financial System: A Comparative Perspective* (Discussion Paper No 16, APEC Study Center, Columbia University, 2001) 17. Patrick estimates that there were 300 business groups in the Indonesian economy in 1997, consisting of around 9,766 business units, representing around 13% of the entire GDP of the country.

¹⁴⁴ In 1997, more than half of the entire corporate sector of Indonesia was owned in full or in part by only 10 families. IMF, *Indonesia: Selected Issues* (IMF Asia and Pacific Department, June 27, 2007, 2007) 21.

¹⁴⁵ Andrew J. MacIntyre, 'The Politics of Finance in Indonesia: Command, Confusion and Competition' in Stephan Haggard, Chung H. Lee and Sylvia Maxfield (eds), *The Politics of Finance in Developing Countries* (Cornell University Press 1993); Adam Schwartz (n 109) 53; Cole and Slade (n 134) 322.

¹⁴⁶ Bresnan (n 133) 65.

¹⁴⁷ Kieran Cooke, 'Moves to Mobilise Domestic Funds' *Financial Times* (New York, Tuesday, May 29, 1984) 27.

Although deregulation did turn the economy around, one side-effect of the new economy was the growth of competition in the private sector which became increasingly volatile, such that by the end of the 1980s the government realized that it had few tools on hand to control the country's money supply or how banks were using it. Concerned that the dramatic expansion of the financial sector might turn into inflation, it began experimenting in 1991 with a few indirect regulatory controls, like raising interest rates, establishing minimum capital adequacy requirements and prudent restrictions on excessive intra-party lending, to control, at least to some degree, how much credit banks were issuing and to what ends. On the eve of the crisis in 1997, however, it had yet to figure out an enduring balance between its interest in promoting growth and retaining control.

Bank Indonesia

The main state institution tasked with implementing central government banking policy was the central bank, Bank Indonesia (BI), which was subordinate to the President and Cabinet through the Ministry of Finance.¹⁴⁸ BI's responsibilities were largely technical, and did not include things like defining macro and monetary policy or drafting banking regulations, however, all of which were the separate purview of bureaucratically superior economic and monetary coordinating bodies composed of the heads of the Ministry of Finance and the National Development Planning Board (Bappenas). The deregulation of banking in the 1980s posed a considerable technical challenge for BI because it implied a new and unfamiliar role for it. Through the 1960s and 1970s, BI's primary function had been to control credit limits in the economy, set interest rates in all private and state banks, and oversee the distribution of state

¹⁴⁸ J. Soedradjad Djiwandono, *Bank Indonesia and the Crisis: An Insider's View* (Institute of Southeast Asian Studies 2005) 203-205.

funding and credit through its state banks. Deregulation had removed many of these controls and demanded instead that BI play the role of a detached monitor and supervisor of a rapidly growing, and increasingly private, sector.

By the time the crisis arrived in 1997, BI was still trying to understand and exert its authority in this new role. By and large its internal capacity to exercise its new mandate was limited, hampered by a lack of experience and technical capacity, but also restricted by political manacles that prevented it from enforcing banking regulations when doing so stepped on the toes of politically-connected vested interests who took liberties with them. It was constrained by political pressures to do what it could to facilitate economic and industrial growth,¹⁴⁹ as well as by a limited ability to control how private banks were lending. While the introduction of prudential regulations in the early 1990s gave it legal authority to insist that banks do things like maintain sustainable CAR levels, or diversify their lending portfolios, in general it lacked the internal capacity and experience to effectively monitor whether banks were complying with these measures. While it could order the state banks to stop lending and clean up its non-performing loan portfolios, it had little leverage when the delinquent borrowers were enterprises that were politically connected to the President's inner circle, of which there were many.¹⁵⁰ With regards to private banks, it could only control lending by making credit more or less expensive by manipulating interest rates, or by periodic supervision and inspections, which were relatively few and not systematic enough to reveal more than only a few of the sector's delinquencies. When found, its authority to take remedial action was limited if and when banks in question were

¹⁴⁹ Skype interview (Oxford/Jakarta, 5 June 2015).

¹⁵⁰ These problems were well known. In February 1994, Finance Minister Mar'ie Muhammad told a parliamentary hearing that bad or nonperforming loans had increased by a factor of 360 per cent since 1990, which he blamed on "collusion between borrowers and creditors - a situation his ministry seems unable to monitor or control." John McBeth, 'Banking on Friends - Business and Politics Mix in Bapindo Case' (1994) 157 *Far Eastern Economic Review* 25.

owned by politically well-connected individuals.¹⁵¹ By and large, therefore, banks under its supervision, especially those that were well-connected, were relatively free to pursue business as they wished.

Banks

In 1997, there were basically three major types of banks in Indonesia: state-owned banks, private banks owned by major business groups and industrial conglomerates, and smaller, new banks that operated independently from either.¹⁵² The state-owned banks had been the purveyors and distributors of subsidized credit to select, privileged interests for decades. Their management was in close contact with powerful economic interests in the government and their managers were as sensitive to concerns about their political capital as they were their banks' financial capital. Even in the deregulated economy, state bank managers continued to operate within a framework of political, rather than market accountability.¹⁵³ The result was that state bank behaviour changed little in the new, competitive economy.¹⁵⁴ Although the deregulated economy in theory created opportunities for them to behave more competitively, they were still incentivized to service the investment interests of enterprises that were close to government,

¹⁵¹ Cole and Slade (n 134) 301.

¹⁵² There were also small, rural regional banks as well as a few foreign-owned bank branches, but in 1997 their size and relevance to the regulatory space was relatively limited.

¹⁵³ Bank managers had to please a number of parties within the government to keep their jobs, most notably: Bank Indonesia, which supervised them; the Ministry of Finance, their sole shareholder; and the State Secretariat, that hired and fired them. They also had to avoid treading on the toes of politically connected economic interests eager for the financing they controlled. Michael S. Bennett, 'Banking Deregulation in Indonesia' (1995) 16 *University of Pennsylvania Journal of International Business Law* 443, 447; Tony Shale, 'Top-Level Shakeout Needed to Mend the Financial System' [1993] *Euromoney* 55, 56.

¹⁵⁴ Manggi Habir, 'Banking: Private Treatment' *Far Eastern Economic Review* (Hong Kong, April 28, 1994) 54.

even when they took them to insolvent positions, which they did often.¹⁵⁵ Regulatory measures introduced in the 1990s to inspire more prudent lending behaviour had had relatively little effect on the state banks because their behavioural models were entirely oriented towards political, rather than other considerations.¹⁵⁶

Similarly unconcerned were the private banks owned by major Indonesian business groups. Deregulation had provided an opportunity for Indonesia's major industrial conglomerates to establish their own banks to finance the networks of enterprises that made up the groups. Banking for these banks largely meant lending to constituent or affiliated enterprises on the generous terms.¹⁵⁷ They were also useful in facilitating foreign currency-denominated loans from abroad whenever BI's interest rate hikes made domestic lending relatively expensive.¹⁵⁸ Related-party lending was naturally rife in this community of banks, and risk assessment took place within a certain zone of comfort as they that their parent groups would always absorb any losses they might incur.

The third group of private independent banks pursued business on even less secure footings. Deregulation opened the market by making licenses available and setting generously low base capital thresholds for new banks, and many entered the banking economy with relatively poor capital bases. They also entered a market dominated by large banks owned by the state and private enterprise groups, and therefore had to risk their meagre capital holdings by attracting and investing in assets of dubious quality on generous terms that could not get financing

¹⁵⁵ A 1992 World Bank-funded review of Indonesia's seven state banks revealed that virtually all were technically insolvent, largely because of delinquent loans issued to politically-connected business interests. Cole and Slade (n 139) 101.

¹⁵⁶ Srinivas and Sitorus 16.

¹⁵⁷ Mari Pangestu and Manggi Habir, *The Boom, Bust, and Restructuring of Indonesian Banks* (IMF Working Paper WP/02/66 April 2002, 2002) 7.

¹⁵⁸ Mari Pangestu, *The Indonesian Bank Crisis and Restructuring: Lessons and Implications for Developing Countries* (G-24 Discussion Paper Series, No 23, United Nations Conference on Trade and Development, 2003) 7.

elsewhere.¹⁵⁹ The precarious competitive position they occupied in the economy made them highly tolerant of risk, especially since, after all, economic growth had been relatively constant over the past few decades, and the only bank failures in recent memory had been due to political, not economic or business problems.¹⁶⁰

With the exception of the few existing foreign bank branches, the entire banking sector by and large was over-leveraged and lending imprudently in 1997. Few banks employed any systematic monitoring of current or prospective borrowers, and most loans relied on collateral, rather than monitoring of a borrower's ability to repay, to cover any risk of loss.¹⁶¹ State banks were particularly susceptible to lending large amounts to anybody with sufficient political connections when instructed to do so, and, once issued, rarely monitored how their borrowers made use of their loans.¹⁶² The only risk management tool that existed was mainly credit analysis, which in this period was very localized to personalities at individual branches, none of which were linked to larger risk assessments or mitigation strategies of the banks as wholes.¹⁶³ Collectively, therefore, Indonesia's banks were lending far beyond their means.¹⁶⁴

¹⁵⁹ Skype interview (Oxford/Jakarta, 5 July 2015).

¹⁶⁰ Sato, 'Bank Restructuring and Financial Institution Reform in Indonesia' (n 126) 102.

¹⁶¹ Patrick (n 141) 28.

¹⁶² Cole and Slade (n 134) 120.

¹⁶³ Sato, 'Bank Restructuring and Financial Institution Reform in Indonesia' (n 126) 115. In the words of one former bank manager at a state bank in that period: 'if I was a branch manager in a certain city, I can decide what I like, there is no risk management practice at this time... Anybody who is considered smart in loan business can do what he want. There is no check and balance.' Skype interview (Oxford/Jakarta, 7 June 2015).

¹⁶⁴ By 1995, the aggregate loan/deposit ratio of the banking sector was 138 per cent, well above the 110 per cent mandated by law in 1992. See Cook (n 129) 39.

International Organizations

Before the 1997 crisis, the World Bank, the IMF and international banking associations participated periodically in the regulatory space by providing funding for particular development projects and as sources of technical know-how. When times were bad, the government and its academic economic advisors tended to adopt economic policies that emulated, or at least adapted international models to suit their needs. The new prudential regulatory technologies that the government introduced in the 1990s, for instance, largely originated from international sources like the IMF and the Basel Committee. When applied to Indonesia, however, they proved relatively unsuccessful in shifting bank behaviour and lending practices given the strong contextual dynamics that drove banking in those years. The advent of crisis changed this completely.

ACTORS in 2004

This narrative continues in 2004, seven years after the start of the crisis and just at the end of the IMF's assistance program to Indonesia, and the same year that the World Bank declared the financial crisis to be 'over' for Indonesia.¹⁶⁵ The drama of the crisis and evaluations of its causes have been thoroughly reviewed and debated elsewhere,¹⁶⁶ and instead the following section will

¹⁶⁵ In 2004 the World Bank announced that "Indonesia is turning a corner, from crisis management towards growth." World Bank, *Indonesia: Averting an Infrastructure Crisis: A Framework for Policy and Action* (World Bank 2004) 1.

¹⁶⁶ The literature on the Asian financial crisis and its impact on Indonesia is voluminous. See for example: Blustein, Paul (2001), *The Chastening: Inside the Crisis That Rocked the Global Financial System and Humbled the IMF*, Public Affairs, New York; Goldstein, Morris (1998), *The Asian Financial Crisis*, Institute for International Economics, Washington DC.; McLeod, Ross H. (1998); among many others.

look at how the regulatory space was arranged in 2004. Seven years after the crisis, one finds a profoundly changed banking regulatory space, whose composite actors had aligned themselves in new ways after recovering and adapting to the new political, social, and economic realities of a post-crisis Indonesia.

Government

The Indonesian government in 2004 was something of a paradox. In some ways it seemed changed from Soeharto's time, while in others it demonstrated a continuing allegiance to the patrimonial essence that had characterized its predecessor. There was a political urgency for the post-Soeharto administrations of Presidents Habibie, Wahid and Sukarnoputri, to both fix the economy and distance themselves from the transgressions of Soeharto and the main beneficiaries of his regime during the post-crisis period. At the same time, however, there was a need for the leadership to stay on top of the shifting power dynamics within the new political realm. One of its major objectives in the post-crisis period of course was to repair and resurrect the banking sector. However, Soeharto's successors found themselves in a contradictory bind. While heavily reliant financial and technical support from the IMF to recapitalize and clean up its banks, they were also very sensitive to the widespread popular resentment that the IMF's heavy-handed and intrusive presence in the country was generating. It was popularly acknowledged that early IMF intervention at the start of the crisis in 1997 had been a disaster for the economy,¹⁶⁷ and its

¹⁶⁷ In its October 1997 Letter of Intent with Indonesia, the IMF compelled the Indonesian authorities to implement austerity measures to tighten monetary policy, close 16 insolvent banks, and provide a limited deposit guarantee scheme to demonstrate to the market that the government was serious about cleaning up its

subsequent rescue project was also associated with efforts to open the market to foreign investors and to protect foreign creditors at a time when the country was broke.¹⁶⁸

A second major objective of these governments was to address the evils and excesses of the Soeharto period. Popular discontent with corruption, for which many blamed the country's susceptibility to the crisis, encouraged the government to take visible action against the crony political and economic interests that had supported Soeharto.¹⁶⁹ Many of those interests were famously wiped out by the crisis,¹⁷⁰ but there was a political urgency to do more. Soeharto's successor Habibie demonstrated a commitment to this by demanding that the owners of particular business groups be held individually liable for all of the liquidity support loans they had received from BI during the crisis, ignoring their limited liability as shareholders. This was continued by Presidents Wahid and Sukarnoputri who followed him. It would be a mistake, however, to interpret such actions as a political commitment to dismantle entirely the patrimonial structures that had sustained the previous government. Indeed, the clientelist, distributive logic of Soeharto's government persisted, and his successors, whose legitimacy bases were tenuous at best, sought re-direct the state's largesse to meet the demands of a new economic class of

banks. Instead, the measures induced widespread panic, causing runs at multiple banks and pushing the value of the rupiah steeply downwards. This was not an auspicious legacy for the IMF. Indeed, the widespread street protests in 1998 were as much protests against the IMF as they were calls for Soeharto's resignation. Skype interview (Oxford/Jakarta, 5 July 2015).

¹⁶⁸ Within a year the crisis had taken a severe toll on the country. By the end of 1998 the economy had contracted by a phenomenal 13.6 per cent, per capita incomes shrank by 60 per cent, and it was estimated that upwards of 40 per cent of the population now lived at or below the poverty line. 50 per cent of foreign investments in the country had withdrawn their commitments, and fewer were coming to replace them. Schwartz (n 109) 409-413.

¹⁶⁹ Sharma (n 4) 124.

¹⁷⁰ Sato, 'Bank Restructuring and Financial Institution Reform in Indonesia' (n 126) 102-103.

Indonesian business owners who had filled the economic vacuum that Soeharto's cronies had left behind.¹⁷¹

This political dynamic created a tension between the new governments and the new state institutions that were designated to clean up the banking sector, namely BI and the Indonesian Bank Restructuring Agency (IBRA), a new agency created in 1998 as a condition of the IMF rescue package. By the time Soeharto resigned in May 1998, at least half of Indonesia's banks, both state-owned and private, were insolvent, and needed to be either closed, or restructured and recapitalized. This was a phenomenally costly prospect for the government, but also one that presented very real opportunities for the new government's new supporters, and the post-Soeharto governments had very good reason to try to make sure that restructuring happened along lines that were beneficial to their supporters.

Regulators

In 2004, the regulatory space for banking contained two regulatory institutions commanding dominant positions within it instead of just the one in 1997. The new actor, IBRA, was established by presidential decree in 1998, and was given extraordinary authority to restructure and rehabilitate failing banks as well as to acquire, manage, transfer, and sell assets of insolvent

¹⁷¹ This was particularly evident during the bank restructuring processes between 1998 and 1997, when government officials, including President Wahid on occasion, repeatedly tried to intervene to secure differential treatment for particular business interests whose assets were at stake. See: S. Eklöf, 'Politics, Business and Democratization in Indonesia' in E. T. Gomez (ed), *Political Business in East Asia* (2002) 242.

banks that actually did fail.¹⁷² In a few short years, in fulfilling its mandate IBRA would engineer a massive transfer of ownership and restructuring of Indonesia's private banking sector.¹⁷³ Its first big action came in April 1998, a month before Soeharto resigned, when it suspended the owners and fired the managers of seven banks, representing about 16 per cent of total banking sector assets, that collectively had received over 72% of emergency capital infusions from BI during the crisis.¹⁷⁴ A month later, IBRA moved in a similar manner against the owners and management of Indonesia's largest private bank, BCA, which alone accounting for 12 percent of total banking liabilities in the country, but was crippled by multiple bank runs in 1998.¹⁷⁵ In mid-1998, IBRA began a review of the solvency of the banking sector and in March 1999 announced its findings, declaring that of Indonesia's 140 banks, barely half (73) were in a position to survive without government support.¹⁷⁶ Of the remainder, 38 were closed outright, 9 were selected for recapitalization, and 13 were taken over directly by IBRA.¹⁷⁷ IBRA also took over

¹⁷² The IBRA was modeled on the Resolution Trust Company (RTC) that was formed in the United States to resolve the savings and loan crisis of the 1980s. Jake Redway, 'An Assessment of the Asset Management Company Model in the Reform of Indonesia's Banking Sector' (2002) 38 *Bulletin of Indonesian Economic Studies* 241, 242-243.

¹⁷³ Between 1997 and 2000 there were six rounds of bank interventions taken by state authorities with bank closures happening in November 1997 (16), April 1998 (7), August 1998 (4), and March 1999 (38). Sukarela Batunanggar, 'Indonesia's Banking Crisis Resolution: Lessons and the Way Forward' (Banking Crisis Resolution Conference, CCBS, Bank of England, 9 December 2002) 8.

¹⁷⁴ Charles Enoch and others, *Indonesia: Anatomy of a Banking Crisis - Two Years of Living Dangerously 1997-99* (IMF Working Paper No WP/01/52, 2001) 34.

¹⁷⁵ *ibid* 34-35.

¹⁷⁶ The baseline of IBRA's choices were bank CAR ratings. Banks with CAR ratings of less than -25 percent would be closed; those with between -25 and 4 percent were deemed potentially salvageable and placed under supervision, restructured and recapitalized or merged with others. The extremely large and 'systemically important' banks were rescued regardless of their CAR ratings, however. Batunanggar (n 171) 15.

¹⁷⁷ The remainder that make up the difference were small regional rural banks, that operate like credit co-operatives, which fall outside the scope of this study.

one state bank directly and merged four others together, pooling their deleterious assets and liability loads into a new, single, massive state bank, named Bank Mandiri.

Most of the banks that IBRA closed outright were relatively small, while those it took over and recapitalized had been some of the largest in the private sector, often those belonging to the large business conglomerates.¹⁷⁸ IBRA takeovers effectively returned state control over Indonesia's banks by putting upwards of 85% of all third party liabilities into the hands of the state. After the government recapitalized the struggling banks that IBRA had taken over with a capital injection of an enormous 658 trillion Rp (52% of GDP), IBRA orchestrated their resale along with any of their collateral assets that it had assumed when it took control of them. In so doing, while recouping some of the state's cost of the recapitalization,¹⁷⁹ IBRA also engineered a massive transfer of bank ownership in the economy by auctioning off bank shares and their assets, which were largely bought by private domestic and foreign investors at fire sale prices, sometimes controversially even by their former owners.¹⁸⁰

¹⁷⁸ Around half of the loans that IBRA assumed through this process were intra-group loans, which quantitatively represented probably the most significant violation of pre-crisis prudential regulations. IMF, *Indonesia: Selected Issues* (n 142) 21.

¹⁷⁹ By 2003, IBRA had recovered over Rp 110 trillion in cash and Rp 17 trillion in recapitalization bonds from the sales. Jack Boorman and Andrea Richter Hume, 'Life with the IMF: Indonesia's Choices for the Future' (15th Conference of the Indonesian Economists Association in Malang (July 13-15, 2003)) These are relatively small amounts compared to the Rp 631 trillion that the government spent on bank recapitalization. Ross H. McLeod, 'Dealing with Bank System Failure: Indonesia, 1997-2003' (2004) 40 *Bulletin of Indonesian Economic Studies* 95, 105.

¹⁸⁰ It was hoped that the transparent auction procedures would have the anti-corruption effect of breaking up Indonesia's economic elite. However, with a limited pool of solvent domestic buyers, general reluctance of foreign buyers, and political reluctance to sell off national assets to foreigners, finding suitable buyers was a challenge that was not always overcome. Redway (n 170) 243. See also Vedi R. Hadiz and Richard Robison, 'The Political Economy of Oligarchy and the Reorganization of Power in Indonesia' (2013) 96 *Indonesia* 35, 58.

This was not an entirely smooth process. IBRA struggled to accomplish its task in the face of prolonged and persistent political interference, a dearth of suitable domestic buyers, and a reluctance of foreigners to invest in an economy as volatile and legally uncertain as Indonesia's.¹⁸¹ This was complicated by the lack of a specific legal framework, not finalized until late 1998, to fully authorize IBRA to impose supervision on banks and assume control of their assets.¹⁸² At the same time, however, considering the contextual restraints under which regulators had operated before the crisis, the volatility and uncertainty of the changing political environment and the economic devastation gave IBRA space to act aggressively, under IMF supervision, in ways that would have been unthinkable under the previous regime.

Changes made to BI's role and competencies after the crisis is also evidence of this different contextual dynamic. The IMF had insisted that BI be formally made independent from the central government as a condition of its \$30 billion rescue package in 1998. As far as the IMF was concerned, it was BI's formal subordinate position in the state administration that had limited its ability to monitor, supervise and enforce regulations, and had been a major impediment to pre-crisis efforts to introduce prudential regulations to the regulatory space. Furthermore, during the crisis, because of BI's subordination to government left it vulnerable to instructions to liberally issue large amounts of liquidity funding loans to a number of struggling private banks that were connected to the President.¹⁸³

¹⁸¹ McLeod (n 177) 106; Redway (n 170) 252.

¹⁸² This power arrived in an amendment to the 1992 Banking Law. See Article 37A of *Act of the Republic of Indonesia Number 7 of 1992 Concerning Banking as Amended by Act Number 10 of 1998*.

¹⁸³ By the time of Soeharto's resignation in May 1998, BI had issued up to 60 trillion Rp in this way, equivalent to approximately 10 per cent of GDP. The most controversial recipient was BCA, the largest private bank,

The IMF used the leverage of its conditional financial aid to take these structural weaknesses on by compelling legislative reform. In 1998, the Banking Act of 1992 was amended to give BI overall authority over bank licensing, bank resolution, and the power to impose administrative sanctions on delinquent banks, all powers that had previously fallen under the Ministry of Finance.¹⁸⁴ The following year, a new Central Bank Act explicitly declared BI's formal independence from the government.¹⁸⁵ Between 1998 and 2004, BI received support from the World Bank to increase its internal supervisory and monitoring capacities, and in 1999 it began to employ its new powers by closing down banks that had survived the first round of IBRA closures but which had failed to meet the basic requirements for financial reconstruction thereafter.¹⁸⁶ According to Yuri Sato, the ubiquitous and intense presence of the IMF during these years helped BI ensure that any failed or unqualified banks, once closed, stayed closed, thereby disciplining the Indonesian banking sector in a way that it never had experienced before.¹⁸⁷ Thus, Indonesia's central bank was politically free to intervene in banking to uphold its administrative mandate in ways that it never had been in Indonesia's modern history.

which was connected to the Salim Group, whose owner was a close friend of Soeharto, and a 30% stake of which was owned by some of Soeharto's children.

¹⁸⁴ Act Of The Republic Of Indonesia Number 7 Of 1992 Concerning Banking As Amended By Act Number 10 Of 1998.

¹⁸⁵ Act No. 23/1999 On Bank Indonesia. Article 4(2) of the act reads: 'Bank Indonesia is an independent state institution, which is free from any interferences of the Government and or other parties, except for matters explicitly prescribed in this Act.' This act was later amended in 2004 to establish a balance with the executive with a joint supervisory panel chosen by the House of Representatives and the President.

¹⁸⁶ Enoch and others (n 172) 34.

¹⁸⁷ Sato, 'Bank Restructuring and Financial Institution Reform in Indonesia' (n 126) 110.

Banks

The crisis devastated Indonesia's businesses and banking sector. Initially, any businesses with significant foreign currency debts were wiped out when the value of the rupiah depreciated by 85% over a 10-month period.¹⁸⁸ As unpayable debt loads swelled, the economy ground to a halt as imports stopped and inter-bank liquidity dried up. The government's initial IMF-inspired efforts to slow the plummeting descent of the rupiah and prevent capital flight by closing down 16 insolvent banks and increasing interest rates to 80% backfired badly, instead decreasing public confidence in the banks further and sparking numerous bank runs throughout the country. By the middle of 1997, only a few months into the crisis, 154 banks, holding around half of all banking assets in the country, had experienced at least one run.¹⁸⁹ Through 1998, confidence in the economy and the bank system stayed low, the value of the rupiah continued to fall, and hard currency capital flew to safety abroad or into local foreign bank branches.¹⁹⁰ By the end of 1998, the economy had contracted by 14 per cent, and 75 per cent of all bank assets in the system were now non-performing loans to failing enterprises. Bank equity was effectively negative, and a majority of banks were technically insolvent.¹⁹¹

With IMF help and pressure, the government set up IBRA to clean up and restructure the devastated banking sector. By the end of 2000, the number of banks had decreased from 239 to 151¹⁹² as banks were closed, forcibly merged together, or directly taken over by IBRA.¹⁹³ All in

¹⁸⁸ The value of the rupiah fell from 2,400 in 1997 to 16,000 Rp /U.S. dollar in 1998.

¹⁸⁹ Batunanggar (n 171) 10-11.

¹⁹⁰ Skype interview (Oxford/Jakarta, 5 July 2015).

¹⁹¹ Pangestu (n 156) 15.

¹⁹² This figure includes small regional development banks.

all, 67 private banks had been closed, 12 banks had been nationalized, and 26 banks had been recapitalized (seven state, seven private, and 12 regional rural banks). While four state banks had been merged into Bank Mandiri, none had been closed outright, a fact that did not escape the notice of private bank owners.¹⁹⁴ Of the 42 banks that had been affiliated to business groups prior to the crisis, only seven survived the crisis without being closed or changing owners.¹⁹⁵ Lending effectively stopped throughout the economy, and while the surviving banks struggled to trim down their loan portfolios wherever possible, but the aggregate ratio of capital to assets only became positive after the government recapitalized the surviving banks that needed it.¹⁹⁶

Ownership changes and basic solvency concerns aside, by 2004 Indonesia's banks were behaving differently than they had been in 1997, especially with the way they were managing risk. The crisis had made it absolutely clear that, at least for the private banks, the state was no longer the ubiquitous lender-of-last-resort that it had been assumed to be under Soeharto. In this new economic arena, they would have to bear the cost of their own failures. The bank regulators that oversaw their activities had also demonstrated that they were now politically able and willing to take action against poorly functioning or delinquent banks.¹⁹⁷ Within a year or two of the crisis, most banks, both those compelled by IBRA, but also several of the 70-odd banks that had not needed rescue, invested heavily in internal risk-management systems and procedures,

¹⁹³ Sato, 'Bank Restructuring and Financial Institution Reform in Indonesia' (n 126) 103.

¹⁹⁴ Skype interview (Oxford/Jakarta, 5 July 2015).

¹⁹⁵ Sato, 'Bank Restructuring and Financial Institution Reform in Indonesia' (n 126) 103.

¹⁹⁶ Skype interviews (Oxford/Jakarta, 5, 26 June, 5 July 2015).

¹⁹⁷ Banks that were taken over by IBRA were required to attain a CAR level of 4% or more, produce a viable business plan, and to demonstrate that its shareholders passed the 'Fit and Proper' test of their competence, independence and integrity. Batunanggar (n 171) 15.

often employing international bank experts on secondment from international banks like ING, ABN-AMRO, Citibank and Deutsche Bank to import foreign models and procedures.¹⁹⁸ Sato notes that most banks were developing these internal risk management mechanisms at their own expense.¹⁹⁹

Risk, in other words, meant something different for Indonesian banks after the crisis than it had before, and one of the outstanding effects of the crisis was to change bank risk orientations completely. The banking community roiled in shock as bank after bank failed and as IBRA forcibly closed, merged, or took them over. New management installed by IBRA prioritized incorporating internal prudent policies, procedures, and structures, often imported through foreign banking advisors. Private banks that survived were severed from their conglomerate families and sold off to new, often foreign, investors, who were much less prepared than their predecessors to tolerate imprudent banking activity.²⁰⁰

For the first few years, these behavioural changes happened without specific legislative or regulatory prescription. It took six years for BI to issue regulatory requirements that banks institute risk management practices within their operations,²⁰¹ by which time most banks had already made at least some efforts to develop such measures themselves. Indonesia's bankers had

¹⁹⁸ Some banks made establishing new risk management departments a first priority, more important even than first finalizing their credit departments. Skype interviews (Oxford/Jakarta, 22 June, 5 July 2015).

¹⁹⁹ Sato, 'Bank Restructuring and Financial Institution Reform in Indonesia' (n 126) 117

²⁰⁰ *ibid* 116.

²⁰¹ Skype interview (Oxford/Jakarta, 22 June 2015). One explanation for why BI took so long is that issuing new frameworks takes time, but another is that doing so consolidate and anchor new bank behaviours in place, and to expand on whatever domestic, in-house risk management practices had been established in order to prevent any return to the status ante.

looked into the face of financial disaster and those who had survived it were keen to avoid meeting it again, a fear that is well remembered and persists to today.²⁰²

The IMF

Up until 2003, the IMF was clearly the predominant international organization present in the regulatory space after 1997. It saw the crisis as an opportunity to remove the Indonesian state from the Indonesian economy as much as possible and to dismantle the patrimonial network that had sustained Soeharto's regime.²⁰³ Using its \$30 billion rescue package as leverage, it demanded structural reforms that covered a wide area that included bank and corporate restructuring, industrial reform, and administrative and judicial reforms, all designed and intended to create new market institutions for the post-crisis economy. Although it had ruined its credibility by bungling its first attempt to save the country in 1997,²⁰⁴ its access to massive sovereign financial loan capital gave it considerable power to force Soeharto's successors to comply with its restructuring demands. In the new political context, however, its early failures in 1997 made its subsequent strong-arming of the government seem disingenuous, and caused a deterioration in its relationship with the post-Soeharto administrations, making the latter reluctant in principle to following through with its broad demands. This recalcitrance only

²⁰² Skype interview (Oxford/Jakarta, 5 July 2015).

²⁰³ Grenville argues that the aggressiveness of the IMF's negotiation strategy is evidence of this eagerness to take advantage of the situation, starting in early 1998 when Soeharto regime was on its last legs, which resulted in overly ambitious and stringent demands for institutional reform that the authorities could only accomplish with great difficulty, so difficult that 'is difficult to imagine how any of this could be seen as part of a program to raise confidence.' Stephen Grenville, 'The IMF and the Indonesian Crisis' (2004) 40 *Bulletin of Indonesian Economic Studies* 77, 84.

²⁰⁴ Joseph E. Stiglitz, 'Lessons from East Asia' (1999) 21 *Journal of Policy Modelling* 311.

encouraged the IMF to micro-manage the reform process more, making it more obviously present in Indonesia after the crisis than was anywhere else in Southeast Asia.²⁰⁵

The most significant banking reforms that the IMF forced through were the creation of IBRA and securing BI's formal independence. If the IMF's primary aim was to break up the patrimonial structures that had sustained Soeharto's regime, these initiatives were partially successful. Mass insolvencies and the bank restructuring process had broken up the large business groups that had surrounded Soeharto's inner circle, and the banks affiliated to them were carved off and sold off to new foreign and domestic owners, a change that the IMF hoped would influence domestic banking for the better.

By 2004, however, its program had ended. The strong and heavily intrusive role it played had been so politically controversial domestically that it became expedient for the government under President Megawatt Sukarnoputri to bow to public pressure and formally terminate the IMF program in 2003, limiting it to an external monitoring and consultation role only.²⁰⁶ In 2004, with the restructuring process having only just finished, it was too soon to tell how much things had changed or how long-lasting those changes were going to be.

²⁰⁵ Grenville 84 (n 201); Cook (n 129) 45.

²⁰⁶ IMF, *Indonesia: Ninth Review Under the Extended Arrangement* (IMF Country Report No 03/376, November 2003, 2003) 5.

ACTORS in 2007

Three years later, on the eve of the global financial crisis, it was possible to see which of the post-crisis changes seemed to have taken permanent root in Indonesia's banking regulatory space.

Government

By 2007, many of the patterns that were fresh in 2004 had settled into more durable features of the regulatory space, while others, like IBRA, had departed entirely from it. Soeharto's departure ushered in a new era of decentralized democratic politics, and electoral campaigns at all levels became the new arenas in which political legitimacy and power were battled over.²⁰⁷ However, in 2007 it was clear that while the crisis had brought down Soeharto's regime and dismantled his inner circle of crony supporters, it was still true that access to or control over public office continued to be a source of significant opportunity to gain personal wealth and social power in Indonesia.²⁰⁸ While Soeharto's vast, centralized system of patronage had been broken up, the close relationship between economic and political power persisted, only with new players arranged in a more fragmented political playing field. Perhaps the most spectacular, but not unique, sign of a new political climate came with the impeachment of President

²⁰⁷ Anders C. Johansson, *Political Change and the Business Elite in Indonesia* (Stockholm School of Economics Asia Working Paper No 34, 2014) 38-39.

²⁰⁸ Hadiz and Robison (n 178) 35.

Abdurrahman Wahid by the House of Representatives in 2001, something that would have been unfathomable four years earlier.

Relationships between the government and other actors in the regulatory space were different and more variable than they had been before the crisis. The state as a saviour or protector of failing or troubled banks was now a distant memory, and the greater risk aversion of Indonesia's banks was testament to this.²⁰⁹ The transfer of ownership of many major banks had ruptured earlier connections between the banks and the now dismantled political core, but new economic actors had emerged from the detritus of the crisis, and continued to court the more uncertain and fragile governments that followed Soeharto.

Regulator(s)

In many ways, one of the main beneficiaries of this new and turbulent political environment were Indonesia's bank regulators. Their new formal, institutional independence gave them a window of opportunity at a time when the claims to authority of politicians in government were less commanding or threatening than they had been under Soeharto. By 2007, BI was in a considerably more dominant position than it had been a decade prior, with a greater internal capacity to operate thanks to financial and political support from the IMF and the World Bank. IBRA wrapped up its bank restructuring operations in 2004, which left BI as the sole regulatory authority in a political and economic environment that was still very sensitive to issues of bank solvency and behaviour. This sensitivity gave BI plenty of political legitimacy to implement and

²⁰⁹ Skype interview (Oxford/Jakarta, 5 July 2015).

enforce its legislated mandate. This was dramatically demonstrated in 2005 when BI moved against the senior management of the new, mega state-owned Bank Mandiri, who had begun to show signs of returning its pre-crisis behaviour when it was discovered that its senior executives had taken bribes to arrange approximately \$1.3 billion of loans to powerful enterprises.²¹⁰ In a spectacular and very public fashion, BI orchestrated the removal, arrest, and sanction of Mandiri's CEO, 'Eddie' Neloe, who until then, was widely considered to be 'one of Indonesia's most powerful bankers.'²¹¹ In his place, BI installed new leadership in the ambitious and dynamic person of Agus Martowardojo, who swiftly introduced major internal reforms to modernize bank practices and procedures, and to make them more transparent.²¹² Although BI's supervisory functions were to be carved off a few years later with the creation of a separate Financial Services Commission (FSC), in 2010, in 2007 BI commanded considerable power and authority.²¹³ Its inspection and sanctioning mechanisms had been developed and supported with World Bank help, and it had demonstrated a willingness to use them when necessary, something that banks definitely noticed and came to respect.²¹⁴ From the perspective of both bankers and

²¹⁰ Assif Shameen, 'Indonesia: A Scandal That's Almost Welcome' *Bloomberg Business* (May 15, 2005).

²¹¹ Neloe was initially absolved on a technicality by the courts in 2006. See: Shawn Donnan, 'Mandiri's ex-CEO Acquitted of Corruption' *Financial Times* (New York, February 20, 2006). A year later, however, he and three associates were convicted by the Supreme Court and jailed. See: 'Mandiri Bankers Sent to Jail for Graft' *The Jakarta Post* (Jakarta, September 15, 2007).

²¹² He later became Finance Minister in 2010 and the Governor of BI in 2013. For some respondents, this event represented a watershed for BI in that if Mandiri had been allowed to revert back to its former practices, then that would have undermined BI's position into the future, and returned the banking sector to its former ways of doing business. Skype interviews (Oxford/Jakarta, 5 June, 5 July 2015).

²¹³ Indeed, BI had so much power that in 2004 the question of BI's accountability was raised in the House of Representatives, which legislated the creation of a supervisory board to oversee, but not directly control, its activities. Sato, 'Bank Restructuring and Financial Institution Reform in Indonesia' (126) 109.

²¹⁴ Skype interviews (Oxford/Jakarta, 22, 26 June, 5 July 2015).

the IMF, BI was a competent and credible regulator by 2007.²¹⁵ Thus, when the government introduced new prudential regulations obliging banks to install certain risk-mitigating and oversight mechanisms in their operations in 2003, there was little question that any banks that did not already have such mechanisms in place would have to do so.

Banks

By 2007, Indonesia's private bank sector had been completely transformed from a decade earlier. The banks that had survived the crisis were much more attuned to and wary of risk, and the sanctioning of Bank Mandiri in 2005, had sent a wake-up call that BI's regulatory authority was to be taken seriously. While bank misbehaviour continued, their scope was more muted than it had been before 1997, and regulator reactions and investigations were now a very tangible threat for delinquents.²¹⁶ Revenues throughout the space were, however, very low. Domestic investment was still very low, offering relatively few opportunities for banks to lend.²¹⁷ Indeed, for a few years after they resumed operations, banks by and large were very nervous about lending at all.²¹⁸ Bank assets at the time instead consisted mostly of safe government bonds with low yields, which allowed banks to survive rather than thrive, and gave them to internally restructure amid ongoing political and social tensions and until confidence in the market

²¹⁵ IMF, *Indonesia: Financial Sector Assessment Program* (n 5) 6-12; Skype interviews (Oxford/Jakarta, 22 June, 5 July 2015).

²¹⁶ Abheek Bhattacharya, 'Can Indonesians Bank on Reform? Bad times in the 1998 crisis forced Jakarta to implement good policy for its banks. Good times are now causing it to backtrack' *Wall Street Journal (Online)* (New York City, 30 November 2011).

²¹⁷ Pangestu (n 156) 23.

²¹⁸ Skype interviews (Oxford/Jakarta, 5, 22, 26 June, 5 July 2015).

returned.²¹⁹ Changes in bank ownership had introduced new elements to the regulatory space by breaking up at least some of the most egregious clientelist connections between banks, large business groups, and central governmental power.

Even a decade after the crisis, banks were still only slowly expanding their lending practices. This reflected in part the new restrictions placed on lending by the newly-introduced risk management protocols within banks, but also low demand for long-term lending in a recovering economy,²²⁰ as well as a general, widespread reluctance by banks to take lending risks out respect for the memory of the crisis and their respect for an empowered and stricter regulator looming in the background.²²¹ Indeed, the slow growth of lending in those years became enough of a concern for the government that in 2006 BI actually *relaxed* certain prudential regulations in order to encourage banks to lend more, but only to limited effect.²²²

IMF

By 2007, the IMF had withdrawn somewhat from the regulatory space, having stepped down from the peak of its intervention between 1998-2003. With the termination of its program in 2003, along with the end of IBRA's bank restructuring process and Indonesia's repayment in full

²¹⁹ Skype interview (Oxford/Jakarta, 5 July 2015).

²²⁰ IMF, *Indonesia: Selected Issues* (n 142) 51-52.

²²¹ Skype interview (Oxford/Jakarta, 5 July 2015).

²²² IMF, *Indonesia: Selected Issues* (n 142) 51. These included reducing capital requirements by lowering risk weights and relaxing provisioning and loan classification rules, including for borrowers with histories of default. One respondent noted in passing that Indonesian banks may have even become 'too prudent' since the crisis. Skype interview (Oxford/Jakarta, 7 June 2015).

of its debt to the IMF for its emergency loans during the crisis,²²³ the IMF was left with less leverage to compel significant further change in Indonesia's regulatory space, at least not to the degree that it had between 1997 and 2003.²²⁴ Reflecting on its participation in the Indonesian crisis, the IMF has been self-critical of its early misdiagnosis of the crisis and choice of remedies in 1997, but is quite unapologetic of the forced restructuring it imposed on the country's recalcitrant political leadership, both before and after Soeharto's resignation.²²⁵ In short, it sees its legacy as a mixed one, ultimately successful in restructuring Indonesia's banks and modernizing its central bank operations and the legal framework, but regretful for mistakes it made and its mishandling of Indonesia's political dynamics.²²⁶ Within Indonesia itself, whether deserved or not, the IMF is still remembered for having caused great hardship for its people during the crisis, an opinion shared by bankers in Indonesia, although tempered by their acknowledgement that its technical and financial help after 1998 rescued the economy and banking system, even if it was just cleaning up the mess it created.²²⁷ A mixed legacy, to say the least.

²²³ In October 2006, BI paid off US\$7 billion that it had drawn from the Extended Funding Facility (EFF) that the IMF had granted it between 1998 and 2003. This payment came four years earlier than when it was due in December 2010. See *ibid.*

²²⁴ In a report from July 2003, the IMF acknowledged its lack of leverage by putting forward arguments for why a continued relationship with the IMF would be beneficial to Indonesia, but recognized that its policies had received considerable criticism, and that 'the nature of Indonesia's future relationship with the IMF will be decided by Indonesians'. See: Boorman and Hume (n 177).

²²⁵ IMF, *Recovery from the Asian Crisis and the Role of the IMF* (Report No 00/05, June 2000).

²²⁶ Grenville (n 201).

²²⁷ Skype interviews (Oxford/Jakarta, 22 June, 5 July 2015).

RESOURCES

Information

Colin Scott once described ‘information’ as a resource that regulatory actors exploit to further their competitive interests within a regulatory space. At the onset of the crisis, the government was at a loss for how to rein in the precipitous fall of the rupiah’s value and to prevent the loss of confidence in its banks. Early measures suggested by the IMF to instill confidence by demonstrating strong action by closing a few utterly insolvent banks and raising interest rates to retain domestic capital backfired completely, communicating instead either the government’s inability or unwillingness to save banks that were failing. The meaning of information, thus, is in the eye of the beholder, and for most Indonesians in mid-1997, the message was clear: the economy was in big trouble, and depositors and banks scrambled to protect whatever assets they could as things deteriorated further. The disastrous effects of the crisis signalled to everybody, especially banks, the latent risks that underlay banking in a competitive market economy, and surviving banks responded by installing risk-management tools that had never seemed important before. The strong-armed intervention by the IMF communicated, whether deserved or not, insensitivity in the eyes of most to the plight of ordinary people, which eventually caused sufficient political pressure to move the government to end its program with the IMF in 2003. In contrast, the strong-armed interventions by IBRA and BI in the post-crisis period communicated to banks that their relationship with the central regulatory authorities was now different. Respondents emphasized that in particular the dramatic

action taken against the leadership of Bank Mandiri in 2005 was the strongest trumpet call to banks that BI was an entirely different beast than it had been in 1997.²²⁸ Under Soeharto, BI's limited capacity and political authority to take delinquent banks to task had communicated to banks de facto permission to engage in business activities that were broader than the scope of whatever prudential regulations the government introduced in the early 1990s. This was no longer the case in 2007.

Wealth

During the Soeharto era, wealth, and the ability to create wealth, was intrinsically linked to one's influence with the state and one's closeness to the regime.²²⁹ Over three decades, the symbiotic relationship between the state and private industry gave privileged access to the wealth-generating potential of the state, which later became the basis for the patrimonial state system. Deregulation in the 1980s made access to wealth somewhat less exclusive, but the importance of political connections was far from gone by the time the crisis arrived. Indeed, the opportunities offered by the newly deregulated competitive economy, when combined with dominance of the state and vested interests, spread risk-taking throughout the economy as actors, new and old, strove to seize market share wherever possible. The ability of state banks to source capital from the national treasury was not only their *raison d'être*, as institutions of credit for national development, but also made them slow to adapt and become competitive within the new

²²⁸ Ibid.

²²⁹ Cole and Slade, 'Why Has Indonesia's Financial Crisis Been So Bad?' (n 115) 65.

economy. For the large private business conglomerates, owning their own banks allowed for them to leverage the pooled financial assets of their constitutive companies, sometimes numbering in the hundreds, on generous terms in tightly interwoven financial support networks that, while beneficial internally, left the groups and their banks exposed to rapid contagion when enterprises within the networks began to fail during the crisis. Prior to this, though, the pursuit of wealth during deregulation occurred in a relatively risk-tolerant environment, where there was wide confidence in the economy after three decades of relative success and growth.

When the value of the rupiah began to fall precipitously in 1997, though, wealth suddenly evaporated from any rupiah-denominated investments in the economy, while rendering the significant and widespread debts held in foreign currency by Indonesian investors became immediately prohibitively expensive. Bank lending effectively ceased when their wealth, if measured by bank capital to asset ratios, became quickly negative, and not restored until a few years after the start of the crisis by a massive government recapitalization program and the slow regrowth of confidence in the system.

Legal Capacity

In the 1960s and 1970s, the Indonesian government and its clients used banking legislation to restrict numbers of players in the banking sector and to direct the flow of state wealth to specific development projects. At the end of the oil boom, the economists to whom the government turned for advice sought to change the economic system by altering its legislative framework by removing state controls, changing licensing restrictions, and allowing greater access to the

market. By the early 1990s, however, it was evident that this deregulation process had released a beast and the market was growing too quickly for comfort, so the government tried to contain it by legislative means, providing the regulator with limited authority to implement indirect regulatory measures to dampen growth. Some of these measures included restrictions on inter-party lending or obligatory CAR levels, which were responses to evidence that banks, especially the state-banks, were behaving inefficiently or becoming insolvent and over-exposed. However, the effectiveness of such measures was limited by the degree of authority that the regulator wielded to compel this behaviour at the time. BI's limited capacities and the political logic of Soeharto's regime, along with confidence that the state would step in as a lender of last resort for a failing bank, allowed banks and enterprises close to the government to easily flaunt regulations and pursue risky lending to their fullest extent.

The crisis changed this. The political turmoil it caused, along with the heavy-handed presence of the IMF, allowed for the legislation of new administrative structures, relationships and powers that had not been feasible before, such as the independence of BI and its augmented powers to seize and resolve failed banks. The greater political legitimacy of the regulator, together with the evaporation of faith that the state would automatically guarantee any bank failures, changed the legal relationship of the state with the banks in the sense that banking regulations mattered much more in ways that they had not before the crisis. In the years following the crisis, both BI and IBRA demonstrated their willingness to rely on its legislative powers to take action against major delinquent banking actors, which had an immediate deterrent

effect on Indoensia's banks that had not been possible a few years earlier.²³⁰ BI's takedown of Neloe in 2005 also demonstrated a new use of law as a resource by bank regulators, a resource that could be relied upon to combat previously well-connected people that, in consideration of Indonesia's modern history, was entirely novel and indicative of a very new kind of relationship between the banks, the regulator and the political regime.

Organizational Capacity

On the eve of the 1997 crisis, there was great variation in the organizational capacity of actors within Indonesia's banking regulatory space. BI had been struggling with its lack of experience and capacity to implement its new and unfamiliar role as a supervisor and monitor of the national banking system. This lack of capacity was well-known and created behavioural incentives for banks to operate relatively free of fear that BI would be able to properly investigate or take serious action against most delinquent banks. Furthermore, its political subservience to senior political leadership gave it very little political capacity to take action against well-connected interests. Deregulation limited BI's ability to control the national money supply, and in the 1990s it was required to experiment periodically with indirect regulatory measures that were of limited effect and, in some cases, easily subverted by target banks.

Bank capacity varied greatly. The state banks in 1997 were famously and seriously inefficient, but their connections with the state made it less important for their managers to resolve those inefficiencies than to maintain and nurture their political capital within the

²³⁰ Skype interview (Oxford/Jakarta, 5 July 2015).

bureaucracy and the regime. Banks owned by major business conglomerates had been faster to adopt their operations, and massive capital bases, to the opportunities offered by the new deregulated competitive marketplace in the 1980s, but their lack of concern with risk-exposure or the dangers of the financial interconnectedness of their composite enterprises left them and their internal banking systems hugely vulnerable to the crisis when it came. The small, independent private banks that spawned during deregulation typically usually lacked the capital resources of their larger competitors as well as any internal risk control systems, and were therefore the most vulnerable banking actors in the regulatory space.

In the years after the crisis, the banks that survived spent years investing in new capacity to deal with risk mitigation and governance controls in ways they had never imagined would have been necessary before. Their high, perhaps even excessive, risk aversion after the crisis motivated the incorporation of new organizational technologies within their operations. Such technologies, while providing them with many ways to identify, calculate, and mitigate against potential risks, also contributed to their early reluctance to return to the risky business of lending until several years after the dust of the crisis had settled.²³¹

²³¹ *ibid.*

CONCLUSIONS

Two major conclusions can be drawn from this thesis. One is substantive: the answer to the central empirical question; while the second is methodological: about the uses and limitations of Regulatory Space as an analytical tool. While the former was what originally motivated the research for this thesis, the latter, like penicillin, has emerged as an indirect byproduct of the process that was needed to arrive at an answer to it.

With regards to the central empirical puzzle, namely how and why Indonesian banking changed from recklessness to prudence between 1997 and 2007, this thesis has demonstrated that: 'it was the crisis wot did it'. Such an answer, of course, begs the follow-up question of how and why the crisis brought about this kind of change, and this requires a more considered and detailed response. At one level, perhaps the most abstract, one can say that the crisis fundamentally changed the nature of banking issues in Indonesia. The traumatic experience of the crisis gave risk an entirely new meaning to banking actors. The massive foreign exchange fluctuations in 1997 quickly revealed how exposed Indonesian banking had become over the previous decade to global and domestic credit risk factors, some of which were beyond the banks' or the bank regulator's abilities to control. The dramatic collapse of the rupiah sparked a massive liquidity contraction as banking actors, once realizing how serious the situation was, collectively scrambled to salvage what they could to stay solvent. Credit immediately dried up everywhere, and with nowhere to borrow emergency funds from, firm after firm, and then bank after bank, throughout the country went bust, bringing down the economic and political empires

that had sustained and structured the regulatory space earlier for thirty years. Widespread and worsening economic and financial conditions destroyed any confidence in whatever stability and safety that the market had once enjoyed, throwing Indonesia's surviving banks, and the economy as a whole, into a tailspin from which it took years to recover.

The crisis changed how banking issues manifested in Indonesia, which is reflected in the changing behaviour patterns of regulatory actors. The macro, space-changing impact of the crisis can be explained in terms of how its multiple effects shifted actor decision-making throughout the regulatory space by changing their options and the terms of the choices that faced them. With regards to the bank regulators, the collapse of the Soeharto regime, along with the bankruptcy and collapse of many of his regime's powerful supporters, created a political space for BI and IBRA to fully engage their legislative mandates in ways that had not previously been possible. In this way, there is no contradiction in a state regulator becoming more capable and effective at a time of governmental weakness, political chaos and socio-economic turmoil. While the new actors who filled government after the departure and the collapse of his regime continued to make efforts to interfere in the work of bank regulators, they were less able to do so than their predecessor. Their political ability to manhandle regulatory processes was restricted in the face of greater risks of censure and scandal from a public that was reeling from the devastating economic effects of the crisis and sensitive to, and resentful of, the corruption of the previous era, on which much blame for the crisis was laid. Furthermore, encouraged and supported by the IMF and the WB, both BI and the IBRA (for a few years) engaged their de facto and de jure independence and regulatory powers in ways were not politically feasible prior to 1997. Through

their actions they signalled to other actors throughout the regulatory space not only that they were now a force to be reckoned with, but also that the rules of banking meant something different now: these were now rules that would be enforced more fully than ever before.

Like government and bank regulators, Indonesian banks that had survived by 2007 also faced choices in the post-crisis environment that were very different from those they faced in 1997. In 2007 it was abundantly clear to everyone that they now bore on their own shoulders very real risks of bank failure and bankruptcy, administrative sanctions, and even criminal prosecution if they engaged in certain practices that had been commonplace a decade earlier. They now knew that there were no lender-of-last-resort-like cushions, whether from the state or the large conglomerates, to catch and save them if their banking gambles failed. They faced a regulator that was demonstratively more vigilant, more capable, and more independent than it ever had been before. They were also operating in a very different competitive marketplace. The hyper-competitive pressures of the pre-crisis growth market of the late 1980s and early 1990s had dissipated as bank fears of risk dampened the aggressive thirst for market share that had characterized pre-crisis banking. Indeed, so great was this depressed enthusiasm that it took years before the banking sector as a whole allowed itself grow again. Taken together, these changed contextual circumstances by and large meant that by 2007 Indonesian banks were generally more risk adverse, prudent, and cautious in their business dealings than they had been a decade prior.

Taken together, the collective, aggregate effect of these different behavioural patterns produced an emergent, macro-level impression of space-wide change from recklessness to

prudence at a time of profound political, social, and economic upheaval. That is the empirical answer to the central puzzle.

The second conclusion that can be drawn from this thesis is that for Regulatory Space to explain regulatory change phenomena through time, it needs a more robust framework than it currently has to take account of regulatory actor behaviour. To refresh: in order to address the empirical puzzle that this thesis set out to answer, it was necessary to conceive of regulation in a way that could accommodate a case a regulatory change in a context of profound social, political and economic turmoil that did not necessarily privilege the government or state as the central driver of change processes. Hancher and Moran's regulatory space 'metaphor' offered considerable potential to do this because its central focus on regulation and regulatory processes as structured by actor relationships and their interactions with resources and power offered sufficiently flexibility to deal with such a scenario.

However, when applied to a question of change through time, the metaphor stumbles on a profound and debilitating weakness in the circularity of its logic of behavioural causality. Although one could argue that regulatory space was never intended to provide a causal explanation for regulation, if one applies it to questions of change over time, it is hard, if not impossible, to offer any explanation that does not read any causal mechanism into it. While this might seem inappropriate, given Hancher and Moran's more modest ambitions, this thesis has demonstrated that pushing the metaphor in that direction can be fruitful nonetheless.

In order to preserve the useful flexibility of regulatory space for this case study, it was necessary to modify it in a way that would allow for an explanation of how and why actor

behavioural changes can bring about, but can also be affected by, changes in the regulatory space over time. I argued that it is possible to do this if one incorporates into the metaphor a number principles of adaptive behavioural change, aggregation of behavioural change effects, and signal-generating feedback loops, all mined from the study of Complexity and Complex Adaptive Systems. Doing so not only permitted the kind of explanation of change and of where change comes from that the empirical question demanded, it also had the penicillin effect of offering a novel critique of regulatory space as an explanatory approach.

Whether seen as a ‘metaphor’, or an ‘approach’, or even just a mapping tool, if users of regulatory space take seriously how it frames explanations of regulation in terms of actor and institutional relationship structures, they must also pay greater regard to how it can account for actor choices and behaviours that constitute those relationships and drive change processes. It must also then conceive of how those are related to explanations of the use (and misuse) of power and resources by actors within the space. It was beyond the means and purposes of this thesis to develop regulatory space into a fully formed and complete analytical method, approach, or theory, nor to undertake a thorough behavioural analysis and computation of all actors in the Indonesian banking regulatory space. Regardless, despite its limited scope, the modest modification of regulatory space offered here has nevertheless demonstrated its great explanatory potential, a potential that has yet to be exploited fully.

Such exploitation might turn regulatory space into a greater and more robust explanatory tool than Hancher and Moran may have originally imagined, or wanted. I do not know why they or other scholars have hesitated to make regulatory space more than just a ‘metaphor’. I am not the

first to have modified and adapted it by grafting other analytical principles and tools from other fields to it so that it can do more. Thus, my argument that regulatory space, if modified, can make an important contribution to the study of regulation as a legal and social phenomenon that cannot be captured in other approaches cannot claim to be novel. However, its application to the Indonesian case study required an elaboration of its emphasis on the relational features of regulation that led this thesis to novel, and unexpected, places. For one, it demonstrated how complex (in the vernacular sense) causal explanations of regulatory space change can be. While this finding might counsel caution to practitioners interested in regulatory design, when reverse-engineered, it suggests that change comes from places that might not be readily obvious in other discourses. One important example from the case study, for instance, is the importance of an independent regulator that can discipline a regulatory space. While, again, this is hardly a new claim to make, the regulatory space approach, once adapted to focus on actor behaviour, reveals how ‘independence’ is as much a contextual and subjective concept as it is a legislative and structural principle. Similarly, it has shown how resources within a regulatory space are contextually situated, whose effects, when activated, or used, can be positive and/or negative, depending on perspective and on how actors choose to interact with them. It also demonstrated the critical importance of information flows in terms of their signalling effects on behaviour and change processes throughout a space. All of these bear important lessons and implications for regulatory design, which, one can hope, can and will be taken up by others in the future.

Using regulatory spaces, especially in this modified form, does have consequences, however. Despite the novel findings noted immediately above, it is also true that it is difficult to extract

many ‘lessons’ from a complex regulatory space case study that can easily be replicated elsewhere because of the idiosyncratic complexities that each case will bring with it. Although deriving such universal lessons was not an objective of this thesis, it is worth noting, for instance, that it is not obvious or clear how the outcome of post-crisis prudent bank behaviour could have been brought about absent the profound social and political contextual changes that surrounded them, or how one could distil this case down to a few policy prescriptions or regulatory models to be copied and re-applied the next time a financial crisis comes around, translated into universal solutions applicable to entirely different contexts. In this way, like so many other aspects of regulation, using regulatory space requires that a careful balance be struck between what one hopes it can explain in a specific case, and what it can explain as a universal feature of regulatory phenomena more broadly.

Appendix I - Methodological Note on Sources for the Case Study

The case study around which this thesis revolves was informed primarily by the wealth of secondary data that is publicly available about Indonesia before and after the Asian Financial Crisis. This secondary material was then complemented by interviews conducted by the author with a small selection of Indonesian banking actors who witnessed the period that the case study covers. Of the secondary materials, IMF records and analyses were particularly useful and detailed resources and starting points for both econometric accounts of the crisis as well as for the institution's perspective on events as they unfolded. Political economy academic narratives, especially those by Indonesia specialists like Yuri Sato, David Cole, and Betty Slade provided thorough data and analysis that this paper relied a great deal on to substantiate my discussions about Indonesia's pre- and post-crisis political orders and their relationship to economic structures and patterns through the country's recent history. 'On the ground' journalistic accounts provided helped to give substance to my claims about what context looked like to those living through the crisis and the changes it brought, while more in-depth political and social histories, like Schwartz's *A Nation in Waiting* offered a longer-range perspective on historical change in the country.

With regards to the interviews, I had the pleasure of conducting rather lengthy semi-structured online interviews with four current and former management-level bankers and witnesses to the crisis and its aftermath via Skype. Although their numbers were few, restricted mainly by time and, especially, funding constraints, their insights were considerable and

substantial, and sufficiently diverse in their backgrounds that they proved to be tremendously informative. One came from a management career in the Indonesian state bank sector; another had been a regulator with BI throughout most of his career; two were foreigners who had been seconded as advisors from multinational banks to state and private banks in Indonesia before and after the crisis, and who have been there ever since, now working as senior managers for private and state-owned Indonesian banks. All four were very kind to sacrifice time from their busy schedules to speak with a lowly master's thesis student many thousands of kilometres away.

Despite their richness, however, the interviews were far too few in number to be treated as representative data samples in their own right. Their primary use in this thesis has been to confirm, substantiate, or contradict dominant narratives in the secondary literature that otherwise informed much of this work. While they were too few to prove that secondary data to be either true or false, they were able to challenge the conviction with which some other authors have written about certain features of the crisis, such as the controversial role of the IMF during and after the crisis. Furthermore, because of the diversity of their backgrounds, when the perspectives of the interviewees aligned, I treated that as compelling evidence at least some degree of universality of the respective impression they described, such as their ubiquitous description of the influence of memory and 'fear' of the past on bank decision-making. When they disagreed with one another, this was indicative of multiple perspectives and subjectivities being brought to bear to a given matter.

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