

Bank Mandiri: A case in strategic transformation

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Abstract

In June 2003 Bank Mandiri¹ announced that it would sell 20% of its total share capital through an initial public offering (IPO), making it the largest IPO in Indonesia since 1997. Bank Mandiri's IPO, marks the completion of a turnaround that transformed four ailing state banks into one commercially viable giant. Here is an account of this change process².

¹ Mandiri means 'Independence' in the Indonesian language

² This case is condensed version of Bank Mandiri case series (A),(B),(C),(D) written by Sam Garg, Research Assistant, under the supervision of Philippe Lasserre.

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Part A: The merger under Robby Djohan

In the aftermath of the Asian financial crisis, the Government of Indonesia had developed a comprehensive strategy to restructure all seven state banks, recapitalize them thereafter, and eventually privatize them. All the state-owned banks were deeply indebted but were deemed 'too big to fail'. In August 1998 the government announced a grand restructuring plan in which four state banks (see box) - namely Bank Bumi Daya (BBD), Bank Dagang Negara (BDN), Bank Exim, and Bapindo - would be merged and the new entity would be named Bank Mandiri. This was widely criticized due to the potential cost of recapitalization and the moral hazard associated with 'bailing-out' very inefficient banks, but the government argued that if the four banks had been closed, it would have been under obligation to settle all the liabilities of the merging banks totalling around Rupiah 198 trillion (Approximately, U.S.\$25.2 bln)³ at the time, and would have borne the cost of severance packages of more than 26,000 state employees.

Few months after the official announcement, Robby Djohan was appointed Chief Executive Officer by the Ministry of Finance. Sixty two at that time, Robby had a reputation for successfully turning businesses around. He had previously turned around Garuda, the state-owned airline, and Bank Niagara. Previously, he had spent his entire career as a banker in the private sector.

The constituent banks together covered close to 30% of the entire banking business and had about 26,000 employees, 740 domestic branches, and 15 overseas branches and subsidiaries. The losses of each constituent bank were huge. They were incurring additional losses of Rp 2.5 trillion a month (approximately U.S.\$318 Million), as a result of wide negative interest rate spreads.

The constituent banks

(Source: Merger Plan, Bank Mandiri, 22 June 1999)

BBD, BDN, Bank Exim and Bapindo were the constituent banks of Bank Mandiri.

Bank Bumi Daya (BBD)

In 1968, BBD was established as a state-owned Bank. Its business encompassed various areas including the trade finance sector, particularly the financing of plantation agriculture and forestry. There were 8,322 employees, dispersed in 213 offices in Indonesia and four overseas offices (Hong Kong, New York, Tokyo, and Cayman Islands) in October 1998.

Bank Dagang Negara (BDN)

Established in 1968, BDN was one of the oldest banks in Indonesia. As a state-owned bank, Government of Indonesia appointed BDN to focus its business on the mining sector. There were 8,927 employees, dispersed in 190 offices in Indonesia and five overseas offices (Cayman Islands, Hong Kong, Los Angeles, New York, and Düsseldorf) in October 1998. In 1975, BDN was the first bank in Indonesia to design a five-year long-term corporate plan for developing its business. In 1997, BDN also became the first bank in Indonesia to receive the ISO 9002 certification for supervision.

Bank Ekspor Impor Indonesia (Bank Exim)

Its business encompassed various areas, including the trade finance sector, particularly the financing of exports and imports that had been a significant business since its establishment. There were 6,541 employees, dispersed in 255 offices in Indonesia and three overseas offices (Cayman Islands, Singapore, and London) in October 1998.

Bank Pembangunan Indonesia (Bapindo)

Based on a government regulation of 1960, Bapindo was established as a state-owned bank. Its business encompassed various areas including plantations, industry and mining, particularly financing in manufacturing, transportation (especially marine transportation), and tourism, especially hotels. Bapindo became a development bank whose main objective was to expand medium- and long-term loans by using the funds specially received from deposits and the issue of medium- and long-term commercial papers. Bapindo also had an additional task of managing the funds of the state's shareholdings. The fund was intended to finance state-owned companies or projects in form of medium- and long-term loans for development, modernization, and rehabilitation. Therefore, to support this business, Bapindo had been known to have professional human resources in that sector and an operational network adequately distributed in potential areas for these operations. There were 3,160 employees, dispersed in 83 offices in Indonesia and two overseas offices (Cook Islands and Hong Kong) in October 1999.

³ Rupiah is the currency of Indonesia. It is denoted in short as Rp. In 1999, average rate was 1USD= Rp 7,855. Before 1997 crisis the rate for 1 USD was Rp.3000. It went down to Rp14800 in January 1998. In June 2003 it was Rp.8900

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As of 31 December 1998, a profile of the balance sheets of the legacy banks was as follows: (In Billion Rupiah)

Bank	Assets	Liabilities	Equity
BBD	24,639 (U.S.\$3.14 bln)	53,595 (U.S.\$6.82 bln)	(28,956) (U.S.\$3.69 bln)
BDN	32,051 (U.S.\$4.08 bln)	60,546 (U.S.\$7.71 bln)	(28,495) (U.S.\$3.62 bln)
Bank Exim	31,709 (U.S.\$4.04 bln)	58,754 (U.S.\$7.48 bln)	(27,045) (U.S.\$3.44 bln)
Bapindo	13,335 (U.S.\$1.70 bln)	22,393 (U.S.\$2.85 bln)	(9,058) (U.S.\$1.15 bln)

Source: Merger plan, Bank Mandiri. Dated 23rd June 1999

Comprehensive restructuring was immediately required - both to improve the quality of productive assets and to increase efficiency by making improvements to the organization, systems, and human resources of the legacy banks.

Robby Djohan brought in a few new people to the legacy banks for the top management positions but mostly promoted promising junior people to senior positions with the aim of having new blood in the organization when the legal merger occurred after the restructuring of the individual banks. He felt that senior management personnel were demotivated and frustrated and as 'civil servants' were unaccustomed to facing challenges, whereas new people were inexperienced but highly motivated. Very un-Indonesian, his management style was open and direct. He abhorred bureaucracy and unclear communication, and rode a Harley Davidson. This was a shock for senior management but most of them liked the openness.

The merger committee

A merger committee was set up with the following objectives⁴:

- Operational integration of merging banks into Bank Mandiri.
- Legal merger and assets and liabilities transfer from merging banks to Bank Mandiri.
- Recapitalization preparation.
- Support in effective operation of business development in the initial post-legal merger stages.
- Unification of corporate culture.

The vision

The vision of Bank Mandiri was to become 'the trusted bank of your choice' and to do so by becoming a better bank everyday. The bank's mission was formulated to cover five aspects, namely: give priority to market interest, develop professional human resources, provide maximum benefit to shareholders, implement open management, and have concern for society and the environment. The physical appearance of the building, use of different forms, rules and regulations, leadership behavior, work patterns, regulation of employee discipline, corporate governance policy, and code of conduct were designed to be linked to the vision, the mission, and the new logo.

The restructuring plan

For Robby Djohan the situation at Bank Mandiri could be summarized as follows:

- There were too many people in the constituent legacy banks. Although many were not very capable they had spent most of their careers there.
- The assets were in terrible shape and deteriorating. The legacy banks were in loss and there were serious liquidity issues.
- The state-owned banks were being seen and used by the government as 'agents of development' for the Indonesian economy. The banks focused on the wrong markets and were forced to do so by the government. The figures did not reflect their performance accurately. The banks were

4 Source: Merger committee report, Bank Mandiri

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protected and hence their real potential and problems could not be judged properly.

- It was difficult to have an operationally merged entity without having IT integration amongst the four banks.
- The banks operated without comprehensive, documented procedures and guidelines. Their operations depended on the knowledge base and decisions of the officers-in-charge.

The restructuring plan was designed to take care of those deficiencies and consisted of four components: Cleaning and rebalancing of the loans portfolio, institution of an effective credit risk management process, establishment of an employee settlement scheme, and integration of the IT systems.

The loan portfolios - which fell under the following categories: Current [IDR 22,896.0 bln (U.S.\$2.91 bln)], special mention [IDR 9,809.1 bln (U.S.\$1.25 bln)], sub-standard [IDR 14,678.7 bln (U.S.\$1.87 bln)], doubtful [IDR 22,229.1 bln (U.S.\$2.83 bln)], and loss [IDR 68,684.6 bln (U.S.\$8.74 bln)] - were cleaned by transferring all of the loss category accounts to the Indonesian Bank Restructuring Agency (IBRA)⁵, which took place on 31 March 1999.

Robby Djohan decided that Mandiri, which by the end of 1998 was predominantly involved in corporate banking, should be a more balanced bank with 50/50 ratio of corporate and retail business. As the corporate sector in Indonesia was hard hit, it was felt that Mandiri should look to retail banking to diversify risk and seek new growth opportunities.

Although a large distribution network of a total of 740 branches of the legacy banks was already in place, retail banking returns were very low. The branch networks of the legacy banks existed primarily to obtain cheap funding from consumers to lend to the corporations. In order to improve the productivity of the branches and introduce greater efficiencies, the bank introduced the hub-and-spoke branch network in early 1999. In a hub-and-spoke network, a few main branches (hubs) provide a full range of banking services to customers. The rest of the branches (spokes) are stripped down versions of hubs, offering a limited number of services. Spokes do no back-office opera-

tions, these are handled by the hubs they are assigned to. As expected, the bank faced a lot of opposition from staff of the branches that were relegated to 'spoke' status.

In order to improve its credit risk management, the bank requested the help of Deutsche Bank, in order to introduce the 'four-eyes principle.' The four eyes principle, which is employed in most of the major banks in the world, requires that the relationship team is separated from the risk management team in order to avoid conflict of interest - hence two pairs of eyes. Under the new system, each new loan approval was subject to two distinct approvals from relationship management and independent risk management officers.

As part of the effort to establish an employee settlement scheme, the bank introduced a Voluntary Severance Scheme (VSS) on the 27th of February 1999. It had been decided that no employee would get a job at Bank Mandiri just because he/she had been working at one of the constituent banks. This allowed Bank Mandiri to re-select the best employees for the new organization. Though not legally impossible, it was difficult to fire employees in Indonesia - especially in state-owned enterprises - for social and political reasons. VSS was thus a rare opportunity for Bank Mandiri to reduce the workforce: from more than 26,600 in the legacy banks to about 21,250 at the time of the legal merger in July 1999.

Integrating the IT systems of these four banks was no easy task, especially since they had nine different core banking systems between them. It was clear that without having a common technology platform, Bank Mandiri would not be able to offer an acceptable service level to its customers after the merger. The choice was between having a totally new system or choosing one of the many already in use. It was decided that the operating platform used by Bank Exim, called BEST and renamed MASTER, would be selected.

⁵ The Indonesian Bank Restructuring Agency (IBRA) was established under the Ministry of Finance to take over and restructure ailing banks and manage their non-performing assets.

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The legal merger, a difficult start

The legal merger of Bank Mandiri was concluded on 31 July 1999, with a media relations blitz. However, it was clear to both management and employees that a lot needed to be done to make sure the merger worked. In fact, the integration work was just beginning.

Shortly after the legal merger, in August 1999 an article in Asiaweek entitled 'Let The Reform Begin' reported:

'Foreign bankers are most worried about Bank Mandiri's next two years. One concern is that the bank will come under enormous pressure to resume the shoddy lending practices of the past. Robby Djohan, Mandiri's new CEO, promises that the bank will go public in two year's time and says that should ensure that management keeps its attention on the bottom line'.

Financial situation

Highlights of the pro forma balance sheet of Bank Mandiri at the time of the merger as at 31 July 1999 were as follows: (in billion Rupiah)

Assets	223,724 (U.S.\$ 28.48 bln)
Liabilities	219,473 (U.S.\$ 27.94 bln)
Equity	4,251 (U.S.\$ 541 mln)
CAR	8.3%

Source: Bank Mandiri merger plan

Some analysts argued at the time that Mandiri's real equity position as of end-July was arguably negative by Rp1.5 trillion (U.S.\$ 191 mln). Continued running losses, a huge foreign exchange open short position (with the exchange rate moving unfavorably), and the need for additional provisions on non-performing loans, increased the estimated negative net worth to Rp16.6 trillion (U.S.\$ 2.11 bln) by the end of August and Rp18.5 trillion (U.S.\$ 2.36 bln) by the end of September 1999. An Asiaweek article also reported that Moody's had given Bank Mandiri its lowest rating - E - for overall financial strength.

Meanwhile, the IT integration started showing signs of trouble, hindering the gathering of accounting information. Reconcili-

ation of inter-bank accounts was not timely and there was a rapid build-up of unmatched items.

Fortunately, a recapitalization took the form of government bonds for Rp175.34 trillion (U.S.\$ 22.32 bln). Bonds ranged in maturity periods of between three and ten years. The mounting costs made Bank Mandiri's recapitalization controversial. The outspoken Senior Deputy Governor of Bank Indonesia, Anwar Nasution, told the press in October 1999 that Mandiri should have been closed instead of being rescued.

Bank Mandiri reported a net loss of Rp68.2 trillion (U.S.\$ 8.68 bln) in 1999, compared with net loss of Rp124.1 trillion (U.S.\$ 15.80 bln) in 1998. Third-party deposits continued to be the main source of the Bank's funding. Bank Mandiri achieved a small net profit of Rp461 billion (U.S.\$ 59 mln) for the first quarter of 2000.

Credit

Despite the establishment of the 'four eyes principle' for credit risk analysis for corporate loans, a lot of time was required to get the processes right. It was difficult to inculcate the 'credit culture' in employees and the customers. Changing the attitude of an entire system that for years had lent money on the basis of personal relationships and government directives rather than commercial merit was no mean feat. The new risk analysis processes took much longer than initially anticipated and many people (inside and out) advocated a more lenient system so that Bank Mandiri could get to business and profitability faster, insisting that public money would be wasted if banks took so long to assess loan applications.

'Four tribes'

Post-merger Bank Mandiri could be characterized as four 'tribes' from the respective legacy banks. Despite equal grade and job nature, salaries differed depending on which legacy bank the employee came from - significantly so in several cases. Management tried several initiatives to create cohesion among employees, including internal publications and a variety of social activities, but none proved very effective. Engrossed in problems like liquidity issues that could jeopardize the

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existence of the bank, management had little time to talk to employees or communicate frequently enough about the changes the bank was undergoing and why.

Workforce rationalization led to a lot of incomplete work. Due to the lack of processes and adequate documentation, it was impossible for employees to finish the work started by others. The Managing Director of Bank Mandiri, Mr. I Wayan Pugeg, who spent his career in one of the constituent legacy banks, recalls:

'We offered 'golden handshakes' and laid off 5,000 to 6,000 people simultaneously in one to two months after announcing VSS. Due to the high level of anxiety, the employees were not able to focus on the work and many things were left incomplete. Frankly speaking, in my opinion, that was the biggest mistake during the merger process.'

IT challenges

The process of integrating the different systems onto the single platform, MASTER, was very difficult. Andreas Eddy Susetyo, the new IT Director, recalls:

'The first question I asked Robby Djohan when he called me was 'Do you know the whole implication of what you are trying to do [when choosing MASTER at this stage]?' Robby said, 'No'. They did not even have an IT steering committee in the Merger Committee to analyze deeply any decision about IT. Few senior executives understood the decision Mandiri had made. Only after that the board of directors formed an IT steering committee.'

Susetyo joined Bank Mandiri in February 2000. He advised against stopping the MASTER implementation because it was hard to return to the original state in the middle of the implementation process, even though he felt that MASTER was probably too old to support Bank Mandiri's plan. He reflects:

'For me it was a dilemma. I knew MASTER was not suitable for Bank Mandiri's plans but I had to make it work. It was the best way forward given that situation. Time had already been

invested in the conversion of BEST to MASTER. We could not buy time. So, my only feasible option was to figure out how to optimize MASTER to support Bank Mandiri standardized products and operations, as the one new bank in the given short time period. The other complexity was migrating the decentralized system into a centralized system, which the four legacy banks had never experienced before. And, this had to be done in parallel with the implementation of a hub-and-spoke concept.'

Governance

Robby Djohan often felt that the government should not intervene in the management of Bank Mandiri after setting the targets for the top management. The underlying assumption was that the management was capable and the governance was adequate. On the other hand, a working paper at the IMF observed:

'In Indonesia, the recapitalization of the state banks (and of the banks taken over in the early stages of the crisis) is likely to be the most expensive element of the restructuring, due not only to the initial weakness of these banks but also due to the policies of these banks during the crisis - in particular, their lethargy in collecting loans or raising loan rates while being aggressive in raising depositor rates. A 'Too-Big-To-Fail' policy as regards the state banks has moral hazard effects and has to be accompanied by very close monitoring of - and, if necessary, interventions in - the operations of the banks if it is not to prove extremely expensive.'

Part B: Strategy and organizational changes under E.C.W Neloe

Robby Djohan was suddenly replaced on Monday 22nd May 2000 by E.C.W. Neloe. The government did not give any reasons for replacing Robby Djohan. President Wahid had taken the office in October 1999, and on 22nd May 2000 heads of eight state-owned enterprises, including Robby Djohan of Bank Mandiri, and the heads of the other three remaining state banks, were replaced. With Djohan's departure, doubts were raised about the government's commitment to reforming the banking sector, approximately 75% of which was state-controlled, including

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ownership of the private banks that were rescued during the crisis. Observers felt that it was highly risky to change the CEO at such an early stage of the most complex merger in the banking history of Indonesia - and possibly the world.

E.C.W. Neloe had moved up the ladder from a clerical position in the state bank BDN (one of the constituent banks of Bank Mandiri), where he had been the director responsible for retail banking and technology before he left. He was a low-key executive in Indonesian banking, in total contrast with his predecessor who had spent most of his career in private banks (first at Citibank, then at Bank Niaga) and was regarded as a prominent and a proven turnaround manager. Contrary to his predecessor, Neloe was soft-spoken, a quiet but self-assured man. He had joined Bank Mandiri with the mindset of making the best of the situation it was in, irrespective of past decisions.

Strategic direction

Neloe did not bring about any immediate changes upon taking the helm - not even in the vision or the management team. Immediately after joining the bank he was swamped with a variety of problems. Few of them were serious enough to jeopardize the existence of the bank itself, and many were brought about as a result of the rapid restructuring undertaken before the legal merger to get the bank recapitalized quickly. Others were more strategic in nature.

Corporate business

Loan distribution in 2000 between corporate and non-corporate (consumer and commercial) businesses was Rp29.1 trillion (69%) (U.S.\$ 3.31 bln) and Rp13.2 trillion (31%) (U.S.\$ 1.50 bln) respectively. This was a dramatic improvement in just 12 months. In December 1999, 87% of the loans were to the corporate sector. The loan target for 2001 was 66% for corporates and 34% for non-corporate. The emphasis at Bank Mandiri was to fund sectors which were export-oriented or utilized the natural resource base of Indonesia. However, it was decided that the maximum exposure per sub-sector would be no more than 25% of total loans and no sub-sector had yet reached that level.

Corporate credit risk management

Neloe was aware of the important role played by the integrity and quality of personnel. To emphasize the importance of service attitude without losing integrity, the bank promoted '3 no behaviors' - no delays, no errors, no special payments. In its continuing effort to bring high quality experts from abroad, Peter Moerler, a US citizen with 20 years of relevant experience in international banks, was recruited in April 2001 to manage the corporate credit and market risks for Bank Mandiri. The target for 2001 was to reduce NPLs (non-performing loans) to Rp1.7 trillion (3%) (U.S.\$ 176 mln) in 2001 from a high of Rp8.5 trillion (20%) (U.S.\$ 968 mln) in 2000.

An emphasis on retail banking

Retail business was not a major component of the bank's business when Neloe took over the reins. The business had been heavily skewed towards corporate banking - largely due to legacy customers and expertise of the employees. However, the situation was changing, albeit slowly. Targets to move towards retail were aggressive. Neloe continued to work on the vision to rebalance the bank loan portfolio to a 50/50 share between corporate and retail by 2006. Neloe was determined about retail banking. He often said:

'Retail strategy is our plan towards profitability. Although the background of legacy banks is in corporate banking, the future of banking lies in retail.'

Retail credit risk

In order to reduce retail default risks, the bank introduced a consumer credit scoring system. The objective was to reduce default rates to a range of 5% to 10%. However, the major risk remained the integrity of the credit officer, which was hoped could be avoided with the right processes. It was recognized that it would take a couple of years before the scoring systems could begin to give useful results, however losses would probably not be that big considering that Mandiri's credit card default was in single digit. The skeptics' view was that consumer credit default might cost a lot as Mandiri might be carried away by an over-riding objective of increasing market share quickly. Some experts in consumer credit risk management

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said that banks all over the world usually suffered huge losses until they could fine-tune their systems well; the data gathering for such systems typically took 18 months.

Changing people and culture for retail banking

Bank Mandiri had been expending considerable effort putting together the pieces required for retail. It was clear that one of the biggest hurdles would be the mindset of the employees as the legacy banks primarily engaged in corporate banking. Corporate banking, a different business altogether, was mainly a function of relationships and, loan amounts being very large, did not require the bank to actively seek customers. As Keat Lee, the Finance Director puts it:

'We have the advantage of a strong capital base and we have been profitable. Some other banks, however, might have the retail banking culture. SME and consumer loan growth is hard work. Corporate banking is easy. Retail banking is the tough one where you need to have efficient processes and mindset. Also, there is a difference in approach. Corporate banking is being centralized. Retail banking, however, requires decentralization of distribution to reach the customers.'

To fill the gap, Mandiri recruited 2,000 new frontliners and trained all the branch staff under a contract with Citibank signed in early 2000. The old frontliners were moved to back-office operations to give the new ones a chance to project a fresh new image of the bank.

Human resources

Neloe reflects on his management philosophy:

'I came to manage this bank, not to fight it. If I wanted to fight, I would have brought my own team. I didn't bring anybody. I came alone to work with the support of the existing team. A new team could have created friction.'

Salary and reward

The salary and reward system had created some unpleasantness amongst employees. During the merger, it had been announced that the salaries would at least remain the same if

and when employees of the legacy banks were selected to join Bank Mandiri. Clearly, adjusting all salaries to the highest salary in the grade did not make commercial sense for Mandiri. The situation was not helped by the traditional Indonesian socio-commercial practices, whereby one could find his/her colleague's salary either by asking the Human Resources department or the colleague directly in which case he/she would be obliged to reveal it. Neloe says:

'In a merger, we cannot satisfy everybody. In a merger, people would go through pain. Many things would be unfair and unequal in the beginning. We are trying to make things better.'

The management, indeed, had been trying to remove discrepancies in salaries for each given grade by offering higher bonuses and annual increments to employees with lower salaries. The goal was to bridge the gap by 2003 or so. However, since 1999 the legacy 'tribes' had begun to enlarge their social relationships within Mandiri with colleagues from other legacy banks. To help create a culture of efficiency and service Mandiri recruited a large number of employees, both Indonesian and expatriate, from private sector banks. These new recruits were instrumental in bringing together the four tribes. No other state bank had so many expatriates - if at all - though many banks engaged expatriates as consultants.

As the Managing Director Agus notes:

'Our biggest challenge, we thought, was how to integrate people from four different legacy banks. However, it turned out that the bigger challenge was to make them think and work like in an efficient private bank.'

Re-organization

Neloe took the first six months to evaluate the systems, structures, and people at Bank Mandiri before taking steps to restructure the organizational design. The objective was to make the new organization much leaner than before, with three, rather than four, layers of hierarchy in the head office. As desired by Neloe, the new flatter organizational structure enabled him to have more direct contact with the people in

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charge of functional groups. Nobody was retrenched from Bank Mandiri in the re-organization exercise.

As in any re-organization, however, not all employees were happy. Despite the communication efforts of management employees were reluctant to understand the benefits. In terms of hierarchy, employees had moved closer to the board and, as management argued, potentially had a better chance of rising higher when they did so. However, many lost their former high-sounding titles. Few employees had their jobs changed to completely new functional areas, or had their job scope diminished. Neloe recalls:

'They [the employees] even wanted to demonstrate against the reorganization. I said 'Fine - go ahead. That makes it easier for me to fire you.' You have to be very strict in this case. When they were not chosen for a particular top position in the re-organization, it was because there were fewer 'top' positions in the flatter organization. We wanted to choose the best people for those positions'.

Neloe reflected on this new reality and said:

'There are three types of management: by persuasion, achievement-oriented, and authoritarian. My style is a combination of the last two. In critical situations like we are in, you have to be more authoritarian. The employees need to understand that we need to go fast. Short-term difficulties will be there but once they know you, they will accept. I have managed people for 30 years. I never have any enemies in the end at all.

I tell my employees: work hard and you will get promoted.'

Relations with the government

Being the largest bank of Indonesia, Bank Mandiri was carefully watched by Indonesian and international observers with an economic interest in Indonesia. Neloe had been prudent and successful in managing the relationship with the government. He had been putting in due effort to understand the views of Bank Mandiri's only shareholder - the Government of Indonesia: Being wholly owned by government, it was no mean task to work solely with commercial considerations in mind. After all, the government had all the shareholders' rights. However, it had been careful not to intervene in any major visible way to subvert the commercial interests of Mandiri. Bank Indonesia (BI), the central bank, had placed about four full-time auditors in the head office of Mandiri to keep a watch on staff and their practices.

Financial strength

Since its formation, Mandiri had gone through a tremendous struggle in the tough domestic and international environment. Many new and unexpected problems were confronted along the way and several old ones were uncovered. The management team had worked relentlessly to resolve the issues. As a result of the rationalization of the workforce and branch network, the new credit risk management system, streamlining of the processes, and systematic restructuring of non-performing assets, its financial results had improved quickly and considerably.

Key Ratio	2000 (9 months)	2001 (9 months)
Profit After Tax	Rp 1.59 Trillion (US\$181 million)*	Rp 2.10 Trillion (US\$217 million)*
Capital Adequacy Ratio (CAR), %	31.39	29.33
RoA, % p.a. before tax	1.15	1.47
RoE, % p.a. after tax	14.02	22.79
NPL, %	50.71	12.75
Net Interest Margin (NIM), % p.a.	2.46	2.99
Cost to Income Ratio	33.37	32.75
Loan to Deposit Ratio (LDR)	26.56	23.94

*At exchange rate of Rp 8,780 (for Sep 2000) and Rp 9,675 (for Sep 2001). These are the rates used across the whole of this article

Source: Eurobond Roadshow Presentation, Bank Mandiri

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The bank also compared favorably with most major restructured competitors (see below).

Comparison with major restructured competitors (30 September 2001)

Ratio	Bank Mandiri	BNI	BCA	Danamon
Return on Assets (EBIT)	1.5%	2.0%	3.0%	1.4%
Return on Equity (EAT)	22.8%	18.2%	32.1%	17.7%
Net Interest Margin	3.0%	2.5%	5.6%	4.0%
Fee-based Income Ratio	17.1%	38.2%	16.8%	16.1%
Efficiency Ratio	31.4%	37.26%	35.6%	36.0%
CAR	29.3%	18.2%	36.7%	39.0%
NPL	12.8%	18.3%	4.1%	7.0%
Number of Branches (Unit)	601	671	819	475
Total Assets (Rp trillion)	236.6	122.4	99.6	52.9
Total Loans (Rp trillion)	42.5	31.5	12.0	9.0
Total Deposits (Rp trillion)	177.0	90.2	87.7	34.5
Profit After Tax (Rp trillion)	2.1	1.3	1.9	0.6

(Source: Eurobond Roadshow Presentation, Bank Mandiri)

In recognition of its performance, several prestigious awards were conferred upon it - 'The Best Bank Awards' and 'The Best Trade Finance Bank' by Global Finance Magazine of New York in 2001, 'Country Award for Achievement' by Finance Asia Magazine - Hong Kong in 2001, 'Bank of the Year 2001' by The Banker Magazine of London, and the 'Great Achiever Award 2001' by Visa International.

However, there were several financial fronts on which Bank Mandiri needed to improve significantly to compete efficiently in Indonesia. Mandiri not only had a high percentage of assets as recapitalization bonds but was also sensitive to interest rate increases as a large percentage of recapitalization bonds were fixed-rate bonds. The funding mix of Bank Mandiri was relatively unfavorable when compared to other major banks in the market, resulting in a low interest spread of 1.4% compared to 2.3% for BNI and 5.3% for BCA. While the fee-based component of its income was similar to the major local banks, there was both a need and a potential to increase it. Overall, interest from the recapitalization bonds was still a big component of income.

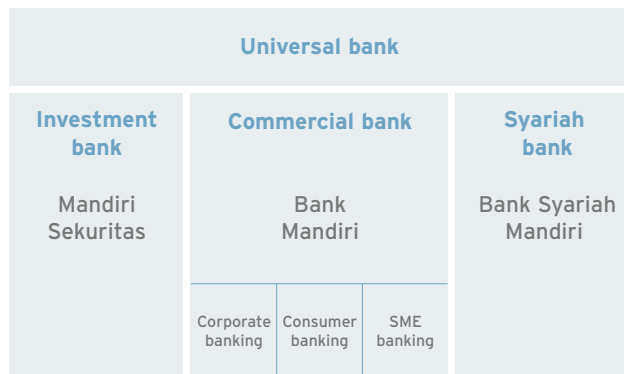
Part C: Toward the future

E.C.W. Neloe declared in late 2001:

'Our strategy is to evolve rapidly into a universal bank, serving large corporations, consumers and small- and medium-sized enterprises...We will be able to deliver the most comprehensive, modern banking services in Indonesia, Southeast Asia's largest marketplace, because we have the capital strength and the geographical reach, and will soon have the technological means to do so.'

Neloe envisioned Bank Mandiri as a universal bank, comprising an investment banking arm 'Mandiri Sekuritas', a commercial bank serving corporates, consumers and small and medium enterprises (SMEs), and an Islamic banking arm 'Syariah Bank':

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He had three top priorities. The first was to develop the retail banking business, which combined the consumer and SME banking business. The second was to further enhance Bank Mandiri's capabilities. The third was to privatize the bank.

The challenge of retail banking

Since its formation in 1999, Bank Mandiri had aimed to have more small and middle sized enterprises (SME) and consumer business in its loan portfolio, primarily as a result of IMF pressure for a diversified risk exposure in Mandiri's corporate-skewed loan portfolio. In addition, there was no apparent growth opportunity in corporate business: most companies had been adversely affected by the crisis that erupted in 1997 and had not recovered. As a result of the rationalization, and in a quest to create a more efficient hub-and-spoke branch network design, the number of branches was reduced from 740 to 546 in 2000. The number had since risen to 601 in 2001 as smaller new branches and cash outlets were opened to increase the distribution reach in line with Mandiri's retail banking strategy. While the broad strategy of becoming a more balanced bank by moving from corporate to retail had existed since 1999, it had not been articulated quantitatively. When Neloe joined Mandiri, he decided to continue the retail strategy and to give it more substance by initiating the development of a well-documented business plan. He reflects:

'In the past, our [Bank Mandiri's] policy was to move towards retail but there was no targeting. There was no market seg-

mentation and no focused efforts. Everything applied to all the customers!'

One major challenge for Bank Mandiri was to re-align its corporate-oriented business processes for the SME and consumer market. This was particularly true for credit approval. In the early days, Bank Mandiri's main focus had been to develop a comprehensive risk management system for corporate lending, because corporate loans remained a major portion of the portfolio, and reducing Non-Performing Loans (NPLs) was a top priority. Although Bank Mandiri had begun to revise its credit approval process for consumers and SMEs, the slow, cumbersome process continued to be a big hurdle in attracting customers. About one and a half years were required to collect the data to fine-tune the credit risk management systems so that the credit approval process could be fast enough for the retail customers while allowing the bank to make a proper risk assessment.

In addition to developing the electronic banking channels and enlarging the ATM network, Mandiri had begun to re-evaluate its hub-and-spoke branch network design, realizing that the system could not work in Indonesia in its original form. In cities and other areas of concentrated population, it started centralizing back-office operations even further for efficiency reasons. In far-flung areas where population was sparse and the system could not offer convenient and quick services⁶ to retail customers, traditional branches were being re-instated.

Anwar, the Director of retail banking felt strongly about building the brand:

'Customer stickiness is high in Indonesia. However, with increasing competition there might be a price war. But, in the end, the brand matters. We have been building up a brand for the bank. People perceive us as the safest bank even though the government has equal or similar ownership in the 15 largest domestic banks of Indonesia. However, we have not been spending much money on advertising. It is just recently that we have started spending what we need to spend given our asset size.'

⁶ For instance, sometimes the distance did not allow customers in far-flung areas to easily access the full-range of services offered only by the hub. With large distance between the hub and spokes, it took a long time for spokes to complete the transactions when it needed to contact the hubs physically.

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Bank Mandiri's primary targets in the retail segment were the 'Upper Consumers' and 'Small Business/Owner Operator' segment of commercial. The bank had launched various initiatives around the four main themes of (a) reshaping distribution channels, (b) building proactive sales and product capabilities, (c) enhancing process efficiency and infrastructure, and (d) addressing NPLs and pricing. The prime initiatives were priority banking branches for high-value consumers, and commercial business centers (CBCs) for SMEs.

Developing the capabilities

Corporate culture

Neloe's major concern was the bank's corporate culture:

'We have been trying to develop a new corporate culture of service and efficiency. Corporate culture depends on the goals of the company. We have a mission and vision statement, we promote 'Three No's Behaviour'⁷, we have a five-year plan. But, we have not really been able to develop a culture as good as I would like to have. I still hear employees referring to colleagues that are from this or that legacy bank. It is already more than two and a half years - they should all think and behave like Bank Mandiri employees and not of the legacy banks. Nurturing corporate culture in the branches is easier than in head office. In the branches, everything can be quantified and we know how they are doing based on the performance of the branch. But in the head office the situation is different. We hope things will get better soon with our new policies and systems. In most board meetings, I talk at least five minutes about the importance of corporate culture and encourage other board members to express their views. But, the question is how to make sure that it cascades down well to all the levels of the organization.'

Since late 2001, Bank Mandiri had been in the process of establishing a new Performance Management System (PMS). Earlier, for instance, the branches were run as independent profit centers. However, the new PMS required each of the eight business units in the new organization to sign a business contract with each other with a pre-defined Service Level Agreement (SLA). Keat Lee says:

'Earlier branch managers used to manage their branches, then the hub-and-spoke system came along during which many 'spoke' managers lost their independence and power. Now, we have the new PMS under which each business unit will sell services to the other business units. A proper contract will be signed between the business units. This means that the branches will be run as part of the distribution network business unit and not as independent profit centers. ...All this will take years to be developed and used fully. It will be a difficult transition but hopefully it will deliver the benefits. The new PMS will force people to think about the cost of distribution and services. We will begin to roll out the system in April 2002. We have been preparing them [the employees] for this mentally for over a year now. It is going to be a major shift in how the employees think and do their jobs. It will also require a mental shift from senior management on how they run the business.'

Another major concern of the management was the productivity level of its employees. Cost per employee was the highest amongst the domestic banks. It was envisaged that the new performance appraisal system would also allow a much better procedural evaluation of an employee's performance. Neloe had been encouraging such variance and improvements in the reward system and explains:

'Now, we give different bonuses according to different performance levels - something that is unheard of in state banks. Initially, there was big noise internally and in the press. But, we have to give reward our employees when they put in extra work. We do that, for instance, with credit recovery units to encourage them to restructure loans well and quickly. In addition, we plan to have an Employee Stock Ownership Program, which will include a Management Stock Options Program. '

Dr Supomo, Executive Vice-President, added:

'When we introduced the new organization structure, besides restating our vision, mission and shared values, we also introduced new daily behavioral guidelines for our employees. We call it 'Three No Behavior': no delays, no errors, and no special

⁷ No delays, no errors, and no special payments. It was an internal campaign to promote efficiency and good work ethics.

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payments. This aims to change the old perception of the state-owned banks as bureaucratic and poor at serving customers, even though it was not always true. The 'Three No Behavior' policy has been widely communicated both internally and externally. Besides, every employee should fill out annual disclosure as a code of conduct.'

Recruitment

Traditionally, employees in the state bank were generalists with experience in a variety of departments. To increase efficiency levels, Bank Mandiri needed specialists as well. Neloe was concerned about recruitment quality:

'When I joined the bank, I found that the recruitment process and output was no better than what used to be in the pre-crisis days. I told Citibank that I wanted people as good as at Citibank. They taught us how to recruit. We will begin to see the results in three years or so.

I am very concerned about the 50 new recruits under the Officer's Development Program (ODP) every year. ODP participants are prepared to take strategic positions at the bank. I talk to them directly about their vision and mission. We have good people in this third ODP batch with the help of Citibank. In state banks, we didn't discuss salary but in Bank Mandiri I asked them [the new officers] what they wanted and we discussed.'

Citibank served as a general benchmark for the Indonesian banking industry. Bank Mandiri regarded it as a model and had engaged it for training its new officers and customer service representatives.⁸ Mandiri was quite pleased with the results and had continued to engage Citibank for its ODB program, which was revised regularly.

Initial public offering

In a Letter of Intent signed with the IMF⁹, the Indonesian government had committed to privatize Bank Mandiri by March 2001. However, in view of the poor macro-economic conditions, the deadline was extended several times to the middle of 2003.

An IPO would give Bank Mandiri better access to capital in future and provide the impetus to continue the transformation of the bank. It would put 20% of the bank in investors' hands, a move that would foster transparency and accountability. The senior management of the bank was highly committed to the IPO and, indeed, wanted to see the government's holding sold down or diluted to below 50% sometime in the near future.

The preliminary due diligence commenced in June 2001 and it was hoped that 80% of the offering would be subscribed by overseas institutional investors.

With the global economic slowdown and recession prevalent in several major economies of the world since 2001, the IPO was already a monumental task. The IMF, however, was unmoved as revealed by a comment made by David Nellor, its senior resident representative in Indonesia, to Forbes magazine in November 2001:

'The Mandiri IPO should proceed as quickly as possible.'

'It is not going to be easy, but we have to give it a shot if we are to go anywhere,' reflected E.C.W. Neloe.

Kuan Keat Lee, had similar views: 'If we don't do it now, Indonesia will not be on the radar screen of the international investment community.'¹⁰

On the 22nd of June 2003, the Indonesian government confirmed that the 20%, increased from 10% due to heavy demand, of Mandiri bank shares that will be sold through an IPO had already been over 3 times oversubscribed. On the 15th of July, the bank was praised for the performance of its shares on the stock market. On the 29th of August 2003, Bank Mandiri announced a profit after tax of Rp 2.24 trillion (U.S.\$ 270.9 million) for the first six months of the year 2003, up 26% from the same period in 2002.

⁸ Citibank had a training and recruitment arm.

⁹ Letter of Intent (LoI) signed with IMF said that the first offering would be up to 30%.

¹⁰ Source: The Asian Banker, 29 November 2001. Section: Industry Watch.