
Enhancing Financial Stability

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Indonesia has made great strides in the last decade in improving macroeconomic and financial stability. As a result, the country's financial system withstood the contagion from the global financial crisis that started in 2007 and Indonesia emerged as one of the best performing economies in the world in 2009. In 2010, the IMF's Financial Sector Assessment Program (FSAP) identified a number of vulnerabilities and recommended key measures to boost financial stability in the following three areas: bank regulation and supervision, crisis prevention and resolution, and Bank Indonesia's (BI's) financial autonomy. In addition to specific financial sector issues, progress in enforcing the rule of law, especially creditors' rights, is an overarching consideration for improving the performance of the Indonesian economy, with critical implications for the ability of the financial system to function efficiently.

This chapter summarizes the main recommendations and conclusions of the FSAP review. These conclusions are placed in a broader context by describing the substantial improvements in financial stability achieved during the last 10 years and by drawing on cross-country experiences in key areas.

MAJOR ACHIEVEMENTS SINCE THE LATE 1990s

Since the late 1990s, bank regulation and supervision have been strengthened substantially in Indonesia. Improvements include stricter loan classification and provisioning, tightened related-party lending limits, a higher capital adequacy requirement, and a tightened foreign exchange open position limit. In particular, the capital requirement was raised from 4 percent to 8 percent of risk-weighted assets in 2001. Empowered by the 1999 Bank Indonesia Act, BI took measures to improve banks' transparency and corporate governance, enhance on-site and off-site supervision, and institute fit-and-proper tests for controlling shareholders and bank management (Morales, 2007). More recently, BI launched a second generation of reforms. These initiatives include the development of a new rating system architecture and methodology to support individual bank risk assessments, the implementation of consolidated supervision, and a progressive move toward the requirements of Basel II.

The improvements in banking regulations and supervision are also reflected in banks' financial positions. Despite a mild slowdown in economic activity in 2009, banks reported a robust 2.6 percent return on assets. The capital adequacy ratio stood at 17.4 percent, well above the regulatory minimum of 8 percent and BI's informal target of 12 percent. The nonperforming loan ratio stood at only 3.3 percent with reserve coverage of more than 60 percent.

The authorities have also introduced the main components of a comprehensive financial safety net (FSN). These components include (a) a lender-of-last-resort facility; (b) a deposit insurance scheme, a deposit guarantee agency (LPS), and a bank resolution framework; and (c) a Financial Stability Forum, with the participation of BI, the Ministry of Finance, and the LPS to coordinate the government's actions if there were to be systemic risks to the financial sector. Nevertheless, the FSN should be further strengthened by passing the FSN law as noted below.

STRENGTHENING BANKING REGULATIONS AND SUPERVISION

The recently completed FSAP report recommended strengthening the definition and calculation of regulatory capital and regulating interest rate risks. The FSAP's recommendations are informed and supported by stress test results.

Stress Test Results

The results of extensive stress tests show that the banking system is generally robust. The system demonstrated resilience to all but the most extreme shocks thanks to significant capital and liquidity buffers. The stress tests put banks under a set of extreme shocks representing unlikely tail risks. These shocks included a severe economic downturn scenario and a number of shocks to market risk factors. Even under these extreme shocks, only a few banks are vulnerable to credit risks, followed by interest rate risk, and liquidity shocks. A few large banks are susceptible to concentration risk. However, exchange rate and contagion risks are not major concerns.¹

Prudent Banking Regulations and Supervision

The stress test results underscore the importance of prudent banking regulations and supervision. Given that credit risk remains the most potent of risks, following international best practices in asset classification and provisioning, and ensuring the quality of banks' capital are both crucial. Banks' vulnerability to interest rate risk highlights the importance of issuing a regulation on interest rates to limit the sensitivity of banks' portfolios to this risk.

Although the quality of banking supervision has increased markedly in recent years, the assessment of compliance with the Basel Core Principles for Effective Banking Supervision identified a number of areas for improvement:

- Ensure that all items included in capital meet the permanence and availability requirements to cover losses and that risk weights properly reflect the quality of bank exposures.
- Strengthen the regulatory definition of exposure and eliminate exemptions from prudential limits, including related-party exposure.

¹A full discussion of the stress test scenarios is contained in IMF (2010).

- Upgrade asset classification and provisioning norms, including the treatment of restructured loans.

In addition, the authorities need to address deficiencies arising from application of nonstandard risk weights to ensure that they cause no capital shortfalls during the transition to Basel II. BI plans to complete implementation of Basel II in 2014, deploying Pillar 1 in 2011, Pillar 2 in 2012–14, and Pillar 3 in 2011–14. Initially a simplified approach will be adopted. Basel II is a complex framework with three mutually reinforcing pillars. Pillar 1, minimum capital requirements, needs to be complemented by Pillars 2 and 3. Any revisions to the Basel II framework by the Basel Committee on Banking Supervision would also need to be properly reflected. Consistent with the Basel Core Principles assessment findings, BI also needs to improve its supervisory capacity with regard to the oversight of banks' risk-management systems. In addition, Indonesia's adoption of new accounting standards based on International Accounting Standards 32 and 39 should be managed and implemented carefully because they potentially affect banks' capital.

CRISIS PREVENTION AND RESOLUTION

The FSAP recommends that Indonesia strengthen its prompt corrective action (PCA) regime to reduce undue delays in resolving problem banks, strengthen the financial safety net law, and ensure coordination of macro and micro supervision.

Prompt Corrective Action Regime

The FSAP recommends that the PCA regime be strengthened to increase its effectiveness in containing emerging problems. The existing regime consists of two phases: Problem banks that meet certain criteria are first put under intensive supervision, and then, if their conditions deteriorate, under special surveillance. The regime ends when a bank is declared failed and sent to LPS for resolution. Until end-2010, there was practically no limit to the time that a problem bank could remain under intensive supervision before being transferred to special surveillance, under which it must be rehabilitated or have its license withdrawn within nine months. With protracted action plans and weak legal protection for supervisors, banks tend to remain troubled for an extended period and are rarely placed under special surveillance. This process raises the expected cost should the bank finally fail. A well-designed PCA mandating corrective actions as soon as a problem emerges has the added benefit of giving supervisors more protection by making explicit the required actions when certain trigger points are breached.

Besides curtailing supervisors' discretion and reducing political interference, a well-devised PCA regime encourages banks to maintain high capital ratios and reduce risk exposures. Because measures for capital restoration and resolving failing banks are mandated, a PCA regime limits the scope for forbearance and provides some insulation from political pressure against taking tough measures. With regard to incentives to banks, moderately well-capitalized banks have the incentive to strive for a higher capital level so as to reduce the intensity of

supervision; and struggling banks are encouraged to improve their capital levels to avoid being placed, at least temporarily, under the control of regulators, or worse, being closed or merged with other institutions.

The experiences of other countries have shown that a properly implemented PCA regime promotes financial stability. Benston and Kaufman (1997) note that regulators acted more timely to impose corrective action against poorly performing institutions and to resolve failing institutions in the 1990s following the enactment of the Federal Deposit Insurance Corporation Improvement Act, which established the PCA regime in the United States. As a result, the level of nonperforming loans and the number of troubled banks declined greatly. The ratio of book value capital to assets for the banking sector climbed above 8 percent at the end of 1993 for the first time since 1963.² Aggarwal and Jacques (2001) show that PCA standards, along with restrictions on the activities of undercapitalized banks, have reduced the risk levels in both adequately capitalized and undercapitalized banks. Both groups have increased their capital ratios and accelerated their adjustment to the desired leverage ratio.

Many other countries have now adopted the PCA regime. After its banking crisis, Japan enacted PCA legislation in 1998, as did the Republic of Korea. Thailand implemented a PCA regime when the Financial Institution Business Act was adopted in 2008. PCA regimes have been implemented in many Latin American countries, such as Brazil, Mexico, and Peru, and its adoption is also being considered by many European countries (Eisenbeis and Kaufman, 2007; García, 2008; and Mayes, 2009).

The Indonesian authorities moved swiftly to deal with some weaknesses in its PCA regime by issuing a regulation in January 2011. Triggers for intensive supervision were made less lenient and linked to more explicit and measurable indicators. Banks under intensive supervision must improve within a year or be placed under special surveillance. The 1-year limit can be extended only once, and specific conditions must be met to do so. A bank under special surveillance must resolve the problem within 3 months or be referred to the LPS for resolution. For such banks, BI can freeze certain banking activities if conditions deteriorate or if the banks are in breach of regulations; stricter measures can be taken if, in the view of BI, the banks do not make serious efforts to resolve their problems.

Nevertheless, further strengthening the legal underpinning of the PCA regime in Indonesia will also be essential to ensuring its effectiveness, specifically to correct the perceived legal vulnerability of supervisors, which has been identified as a cause for weak enforcement. The Banking Act should be amended to clarify the powers of the banking authorities to prevent and to confront serious banking problems at different stages. In particular, it should specify more clearly the preventive and corrective actions that supervisors can take to confront early problems and require increasingly intrusive corrective measures if a bank's condition deteriorates.

²Measured by market value, the capital-to-asset ratio increased even more as stocks were traded at about 80 percent of book value in 1990, and at close to 150 percent of book value in 1996.

Strengthen the Financial Safety Net

The Financial Safety Net (FSN) needs to be completed with the passage of the FSN law. Although many critical elements of an FSN are in place, in light of the potential establishment of an integrated supervisory authority (OJK) in Indonesia, passage of a new FSN law that clearly defines a framework for dealing with banking and broader financial sector problems is urgent. This law should be introduced to ensure that a proper legal framework is in place for financial crisis prevention and resolution. In addition, the deposit insurance fund needs to be increased in proportion to its recently increased deposit coverage.

An FSN law needs to address the following issues:

- *Clarification of the roles of BI and the Ministry of Finance as lenders of last resort* and the access criteria to lender-of-last-resort facilities.
- *Crisis-management framework.* A crisis-management decision-making framework and procedures were introduced during the global financial crisis by a presidential decree, which has since lapsed. Therefore, it is important to explicitly establish triggers for different types of enforcement and crisis-prevention actions, including rules and procedures for dealing with both systemically important as well as nonsystemic banks to increase transparency and promote timely decision making.³ In addition, in the event that the OJK is created, the roles of the different authorities also need to be redelineated.⁴
- *Legal protection for staff* dealing with the resolution of problem banks. Staff need better legal protection against “second guessing” of their decisions because managing a failing bank is inherently risky. Concerns regarding the strength of legal protections may inhibit the full use of the resolution powers contained in the LPS Act.

The LPS fund needs to be increased in proportion to its increased coverage. In late 2008, during the global financial crisis, the coverage of deposits was increased 20-fold to provide depositors with the appropriate assurance regarding the safety of their deposits. Similar measures were implemented by many countries across the world. As a result of this expanded coverage, the ratio of the LPS fund to insured deposits has declined substantially. Even though LPS can seek a loan from the government when facing liquidity difficulties and an allocation of funds if capital falls below the original capital level, international experience shows that in

³Whether a bank is systemic or nonsystemic may depend on the environment. For instance, at a time of high financial uncertainty, some normally nonsystemic banks could become systemic.

⁴The BI Act as amended in 1999 requires the establishment of a new integrated supervisory agency (OJK) that consolidates the banking, insurance, and securities supervision functions in one institution, and the deadline was postponed to end-2010 by the 2004 amendment to the BI Act. The FSAP review identified a number of major risks in the establishment of an integrated OJK. It advised extreme caution, given the potential for loss of existing supervisory capacity and anticipated problems in coordinating micro- and macroprudential policies between BI and the new agency. The draft OJK law and FSN law were still being considered by the parliament when this book went to press in late 2011.

countries where a deposit insurance fund is undercapitalized, problem banks tend to be bailed out or kept open.

Ensure Coordination of Macro- and Micro-Supervision

The recent global financial turmoil highlights the importance of complementing microprudential supervision with macroprudential oversight. The common exposure of financial institutions to risks and the covariance of such macroeconomic risks can create systemic events, such as those that occurred in some countries in response to a run-up in real estate prices. The objective of microprudential supervision is to limit the likelihood of the failure of individual institutions, or to reduce “idiosyncratic risk.” It cannot capture the common exposure of the system. In contrast, macroprudential supervision strives to limit the costs to the economy of financial distress and lessen the likelihood of the failure, as well as the corresponding costs, of a significant portion of the financial system. This is often loosely referred to as limiting “systemic risk.” Monitoring the potential impact of an individual institution’s behavior on financial system stability and financial infrastructure, as well as the linkage between financial institutions and financial markets, is an integral part of macroprudential supervision.

Macro- and microprudential supervision share common aspects, but also can be in conflict. For example, by ensuring that individual institutions are “safe and sound,” micro-supervision should reduce the systemwide risks or the risk of failure of a financial institution that has systemic implications. In addition, the two approaches share some common tools such as liquidity requirements, minimum capital standards, and loan provisioning requirements. However, micro-supervision, which is intended to reduce an individual institution’s risk, could amplify institutions’ tendency to overexpose themselves during financial booms and become overly risk averse during financial downturns, with a resultant drop in lending and herding into assets deemed safe, thereby overvaluing such assets.

Given the close link between macro- and micro-supervision, coordination among all the relevant authorities is essential to safeguarding financial stability. Although the appropriate architecture and institutional arrangements are still being debated internationally, this coordination is relatively easy in countries where micro- and macroprudential supervisory authorities are lodged in one agency (for example, the central bank) but more challenging when the responsibilities rest with separate authorities. When multiple authorities are involved, it is critical that each authority’s mandate be clearly delineated to avoid regulatory gaps or overlaps.

Central banks are well suited for monitoring and assessing systemic risks. They have expertise and analytical capabilities in monetary and financial stability analysis, and are close to the money and financial markets. The links between monetary policy and prudential policy, as well as the interactions between the financial system and the real sector, further strengthen this rationale.

Ensuring macro and micro coordination will be essential for financial stability before and after the establishment of the OJK. A permanent coordination mechanism should cover the following aspects:

- *Clear legal mandate.* To the extent possible, BI's macroprudential role and OJK's responsibility in micro-supervision should be delineated in their respective laws. To monitor macro-financial stability and assess systemic risk, BI must be able continuously to monitor large banks and financial conglomerates that are systemically important.
- *Coordinated regulatory policies.* As noted above, macro and micro regulations share certain policy instruments, and their objectives might be in conflict at times. Therefore, it is important that macro and micro policy be coordinated and any differences be discussed in the Financial Sector Coordinating Committee (KSSK) chaired by the Minister of Finance, as envisaged under the FSN Law.
- *Fluid information flows.* Safeguarding financial stability will require fluid two-way communication and coordination between OJK and BI. BI needs to continuously monitor individual banks' liquidity, including their balance sheets and their participation in the payments system and the interbank and foreign exchange markets. BI will need access to this data on a continuous real-time basis; OJK will need data with regularity but typically with less frequency. BI also needs to continue its monitoring of systemically important individual large banks and financial conglomerates; this need is recognized in the draft OJK Law. The protocols to facilitate coordination should be established by law.
- *Coordinated crisis management.* BI can use monetary and prudential policies to deal with emerging systemic problems. BI needs to be able to spot weaknesses in bank liquidity and solvency and prepare to take action that is both bank specific and systemic in its lender-of-last resort capacity. OJK and BI need to cooperate closely to prevent a banking crisis from occurring and to deal effectively with any crisis if it were to happen. This will require a new legal framework for an FSN, as discussed in the previous section.

PROMOTING BANK INDONESIA'S FINANCIAL AUTONOMY

The IMF–World Bank technical assistance on assets and liabilities management and the FSAP team recommend that the nontradable government bonds held by BI be restructured into tradable bonds at market terms to enhance BI's financial independence. Supported by prudent fiscal policy, BI has successfully improved macro stability. However, the large stock of non-interest-bearing government bonds on BI's balance sheet and the need to undertake extensive liquidity absorption could, in the extreme, potentially create a conflict of interest in BI's monetary policy implementation, and should be rectified. Setting BI on sound financial footing will promote continued improvement in macro stability, which is essential for a healthy financial system.

TABLE 8.1

Simplified Balance Sheet of Bank Indonesia, End-2009 (<i>Trillions of rupiah</i>)			
Assets		Liabilities	
International reserves	620	Currency in circulation	279
Government bonds, marketable	25	Bank deposits	157
Other claims on government (Nonmarketable bonds)	254	SBI	259
Other assets (net)	16	FASBI	86
		Other liabilities	42
		Unrealized valuation gains/losses	9
		Capital and reserves	84
Total assets	916	Total liabilities	916

Source: Bank Indonesia, *Annual Financial Statements*, 2009.

Note: FASBI = Financial Accounting Standards Board.

THE IMPACT OF NONMARKETABLE GOVERNMENT DEBT ON BI'S OPERATIONS

Corresponding to the excess of liquidity in the banking system, BI's balance sheet holds a large amount of nonmarketable government debt (Table 8.1). On the asset side, BI holds rupiah (Rp) 254 trillion in nonmarketable government bonds (SUPs) that pay close to a zero interest rate. These are bonds that BI received in exchange for providing liquidity to commercial banks during the crisis in the 1990s, and they account for more than one-quarter of its assets. On the liability side, the stock of SBIs is Rp 259 trillion, roughly matching the stock of SUPs. The interest cost associated with SBIs forms the lion's share of BI's expenses, leading to a deficit in some years (Tables 8.2 and 8.3).

This large volume of non-income-bearing assets and stock of SBIs can potentially compromise the effectiveness of BI's monetary operations. The large stock of SBIs makes BI a net borrower from the domestic financial system, which may create a conflict of interest in BI's conduct of monetary policy. When a central bank is a net debtor with a weak balance sheet, financial considerations create a disincentive to raise interest rates when otherwise warranted

TABLE 8.2

Simplified Income Statement of Bank Indonesia, 2009 (<i>Trillions of rupiah</i>)	
	Amount
Revenue	29.7
Foreign reserves	25.6
Money market and credit and financing	2.6
Payment system	0.2
Banking supervision	0.2
Other	1.1
Expenditure	30.8
Monetary operations	22.5
Payment system operations	4.0
Banking regulation and supervision	0.1
General and other	4.2

Source: Bank Indonesia, *Annual Financial Statements*, 2009.

TABLE 8.3

Bank Indonesia Profit and Loss Outcome, 2000–08 (Trillions of rupiah)										
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total profit/loss	2.6	17.6	2.9	1.5	0.7	16.2	31	-1.4	17.3	-1.0
Without extraordinary income/expenditure	27.1	7.6	2.9	-7.2	0.7	16.2	-6.9	-1.4	17.3	-1.0
In percentage of GDP	1.9	1.1	0.2	-0.4	0	0.6	-0.2	0	0.3	0

Source: Bank Indonesia, *Annual Financial Statements*, 2003–09.

by macroeconomic developments, especially when the central bank is subject to reputational risk if its operational balance were to deteriorate further. In extreme cases, the central bank could be tempted to subordinate its policy target to debt-servicing considerations.

Strengthening BI's balance sheet by swapping SUPs for tradable bonds bearing a market interest rate would not only enhance BI's operational independence but would also promote capital market development. Such an exchange requires no legislative changes and will have no impact on the consolidated sovereign balance sheets of the government and BI, holding maturity structure constant. The central bank's domestic debt is part of overall public domestic debt. From this viewpoint, accumulated losses on the central bank balance sheet represent interest-free credit to the government. Eliminating this financing source sets the correct policy incentives, touching on the core of central bank operational independence. In addition, with more tradable government securities on its balance sheet, BI would be able to use repos for liquidity absorption and, therefore, have greater flexibility in implementing monetary policy. Such a swap also would provide an opportunity to develop an integrated strategy for managing public debt, thus promoting market development because it is beneficial to have only one issuer of bills and bonds.

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