Indonesia Financial Safety Net Framework: Bank Resolution and Coordination Challenges

The IADI Asia Pacific Regional Committee (APRC) International Conference
Jogjakarta, 19 July 2017
Outline

1. Background:
   - Lesson learnt from the crisis
   - Legal Framework
   - Institutional setting

2. Bank Resolution framework in Indonesia
   - Resolution procedure
   - Resolution tools
   - Timing of resolution
   - Resolution funding
   - Challenges ahead
Lesson learnt from the Crisis

The design of Indonesia financial safety net to a great degree is influenced by experiences during the Asian financial crisis in 1997-1998 and the Global financial crisis in 2008.

**Legal basis**
- Clear mandates of each institution
- An effective crisis resolution

**Financial sector reforms**
- Refers to international best/common practices to safeguard financial stability and to resolve problem banks in formulating “the best fit” arrangement for Indonesia

**Coordination**
- Coordination amongst institution during normal (crisis prevention) and crisis condition (crisis resolution)
Legal Basis of the Financial System Safety Net Framework

NET I
- Law on the Financial Services Authority (OJK)
- Law on banking
- Law on insurance
- Law on capital market
- Other related laws

NET II
- Law on the Bank Indonesia (Central Bank)
- Law on the OJK
- Law on banking
- Law on Prevention and Resolution of Financial System Crisis (PPKSK)

NET III
- Law on the Deposit Insurance Corporation (LPS)
- Law on Prevention and Resolution of Financial System Crisis (PPKSK)
Institutional Setting:
Before & during the 1998 crisis

Ministry of Finance:
- Fiscal Authority
- General policies on financial sector (e.g. legislation)
- Prudential regulation authority on Capital Market and Non-Bank Financial Institutions
- Deposit insurance program (provision of “Blanket Guarantee” during the crisis)
- Bank resolution (establishment of Bank Restructuring Agency during the crisis)

Central Bank (Bank Indonesia):
- Monetary Authority
- Payment System Authority
- Lender of the Last Resort provider
- Prudential Regulation Authority on banking

Weaknesses:
- Insufficient check and balance mechanism
- Incite moral hazard
- Burden on state budget/taxpayer
Institutional Setting: Current

Ministry of Finance:
- Fiscal Authority
- General policies on financial sector (e.g. legislation)

Central Bank (Bank Indonesia):
- Monetary Authority
- Payment System Authority
- Lender of the Last Resort provider

Financial Services Authority (OJK):
An integrated prudential regulation authority on banking, non-bank financial institutions, and capital market

Deposit Insurance Corporation (LPS):
- Deposit insurance program
- Bank Resolution Authority
 Coordination

- **2004 – 2016:** Memorandum of Understanding (MoU) on the establishment of *Coordinating Forum on Financial System Stability (FKSSK)*

- **2016 – Now:** The establishment of *Financial System Stability Committee (KSSK)* based on the Law Prevention and Resolution of Financial System Crisis (PPKSK)
Challenges in developing an effective bank resolution and crisis prevention
Challenges in developing an effective bank resolution and crisis prevention

- Resolution procedure
- Timing of Resolution
- Resolution tools
- Resolution funding
Resolution Procedure

• Focus on systemic banks: The KSSK involves in the resolution process of systemic bank, whereas non-systemic bank is resolved by LPS

• Determination of Systemic Bank: Predetermined by the OJK in coordination with BI

• Regulation on Systemic Bank to reduce probability of default and to minimize moral hazard:
  - specific requirements on the capital adequacy ratio and the liquidity coverage ratio
  - requirements on capital surcharge capacity which will be used to absorb losses when the Bank undergoes financial problems
  - develop a recovery plan to be approved by OJK
Coordination mechanism on the resolution of Systemic Bank’s solvency problem based on the PPKSK Law

### Timing of Resolution

#### Prevention

**Intensive Supervision**
- OJK notifies LPS to prepare the resolution of solvency problems once a bank is categorized as under intensive supervision.

**Special Surveillance**
- If the bank condition deteriorates (categorized as Bank under special surveillance), OJK shall request LPS to intensify the preparation for resolution.

### Resolution

#### KSSK Meeting
- If the resolution measures by OJK is unable to solve the solvency problems, OJK calls for the KSSK meeting.

#### Bank under Resolution
- KSSK determines the resolution measures for the solvency problems of Systemic Bank, which includes the hand over the resolution to LPS.

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**Supervisory Actions** *(including implementation of Recovery Plan)*

1. **Prepare the resolution**
2. **Intensify the preparation for the resolution**
3. **Resolution by LPS**
The PPKSK Law provides two additional resolution options (P&A and Bridge Bank) for LPS to resolve a failed bank.

- **a. Purchase & assumption (P&A)**
  - Transferring part or all of assets and/or liabilities of Systemic Bank to acquiring banks

- **b. Bridge bank**
  - Transferring part or all of assets and/or liabilities of Systemic Bank to a Bridge Bank

- **c. Open bank assistance**
  - Temporary capital injection

- **d. Liquidation**
1. The PPKSK law adopts the concept of “bail-in” (instead of ‘bail out”) to resolve problems in the banking sector.
   - the use of internal sources to solve both liquidity and solvability problems. This includes the selling of bank’s assets, additional capital from shareholders and other parties, and conversion of certain debts into capital (bail-in-able instrument)

2. The implementation of bail-in concept required a more robust bank at both individual and industrial level:
   - At **individual level**: stringent requirements on liquidity, solvability, and Resolution Plan for Systemic bank
   - At **industrial level**: contribution from the banking industry for:
     - Deposit Insurance Program → to deal with idiosyncratic risk
     - Banking Restructuring Program (crisis resolution fund) → to deal with market risk
Challenges Ahead

a. Manage undesirable consequences of financial safety nets → provides the right incentive to foster market discipline and to minimize moral hazard, avoid the use of taxpayer money

b. Minimize regulatory cost to the banking industry → to preserve its intermediary function to support economic development

c. Adequate time and procedure for an effective resolution measure → early involvement of resolution authority is of utmost importance

d. Sharing data and information between prudential authority and resolution authority → to develop and implement Resolution Plan

e. A lack of Legal protection for policy makers → manage trade off between the speed of decision making process and the proper legal documentation
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