SAFETY NET OF THE FINANCIAL SYSTEM IN THE PERSPECTIVE OF INDONESIAN BANKING LAW

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Abstract

The world's economic conditions has shown a tendency of recession to re-occur in particular in developed countries, it is caused due to the worsening global economic and financial conditions that could have been worse than the crisis conditions of the last 2008. Related to that global financial crisis, it's very likely that they have an impact on economic conditions in Indonesia, and the most highly vulnerable is in banking sector. If this condition (Safety Net) is not anticipated and dealt with seriously and comprehensively by the Government, it could have an impact on a deep financial crisis. The condition does not only affect the poor aspects of banking liquidity, but also on the solvency and profitability of the banking institutions.

Financial Safety Net is one of the main pillars of economic activity, so that with the specific and explicit arrangement, the occurrence of bank runs can be pursued and prevented, it can minimize the possibility of a financial crisis, and it can reduce the frequency and impact of economic contraction in Indonesia.

Given the large number of costs that must be borne by the State in the management and resolution of crises and the breadth of the impact of the crisis, we need a fine and effective crisis management. A good and effective crisis management must be supported by a legal framework in the form of legislation and policies to deal with the crisis that clearly distinguished set of roles, responsibilities and effective mechanisms of coordination from each related institution to some monetary authorities in the Safety Net. Crisis management also needs to be supported by the organization and effective leadership so that they can develop strategies and crisis management measures quickly and effectively in the event of a crisis.

Keywords: Economic crisis; Financial Safety Net and Banking Law.

1. INTRODUCTION

1.1 Background of the Problem.

The current global financial crisis has resulted financial system in some countries can not perform its functions and its role effectively . The condition is feared to have a negative impact on the stability of the financial system and to threaten the sustainability of the national economy .

Global financial crisis that is currently happening in the Americas , Europe and Asia are essentially derived from the weakness of the existing quality of the financial system globally in the world. Overall if the global crisis that occurred at this time is not to be anticipated and dealt with seriously and comprehensively by the Indonesian government, it will impact the deepening financial crisis. Furthermore , the condition does not only affect the poor aspects of banking liquidity, but also on the solvency and profitability of the banking institutions nationally, given the banking institution's market is dominant in the financial industry in Indonesia, systematically the financial sector may experience a re-paralysis as conditions that occurred over the year 1997-1998.

Considers the impact and the loss of such a large response to economic conditions of a country as a result of the instability of the financial system, and the crisis resolution measures which takes a long time, then it is time to optimize the stability of the financial system function and the need for effective and comprehensive coordination both from the government and the Central Bank as public policy makers in each hemisphere of countries in the world today including in Indonesia after the crisis of financial and banking years 1997-1998. However, the conditions that exist at the moment, especially in Indonesia, states that the legal and institutional framework are not maximally done of each of the institutions that has the overall responsibility in maintaining the stability of the financial system.

In order to carry out the mandate of the Constitution of 1945 and Act 23 of 1999 jo. Law No. 3 of 2004 concerning Bank Indonesia, especially with regard to the regulation of decision making under conditions of financial difficulty which has a systemic impact and anticipate the threat of global financial crisis that could endanger the stability of the financial system and the national economy, there is a need to make a strong legal foundation, inter- agency coordination mechanism involved in coaching the national financial system, as well as decision-making mechanism so that preventive measures and crisis management can be done in an integrated, effective and efficient way .

Based on that idea, the government should issue regulations Financial Safety Net that is futuristic and not only as a precaution and a handling of a crisis at a particular time. Drafting legislation on Financial Safety Network Systems (Safety Net) should be drawn up as plans, integrated and systematic, and is supported by procedures and real methods, standard and meet the standard concept that can bind specifically to all institutions that are associated with the activity of the financial system in Indonesia.

2. IDENTIFICATION OF PROBLEM

From the view presented in the background of the problems above, then this article will take the problems discussed namely: How does the function of the safety net of the Financial System in the Indonesian legal perspective?

3. THEORETICAL FRAMEWORK

Law, according to Mochtar Kusumaatmadja, interpreted in the broadest sense is not only the overall principles and the rules that regulate human life in a society but also includes institutions and processes that embody the validity rules that happen in reality.[2] Furthermore, it can be said that where there are people, there is a law. Thus an essential element of the law is that the law is something pertaining to humans , where humans live in a community called society.[2]

The main objective of the law is to realize the legal order. The goal is in line with the primary function of the law, which is to set something. “Orderliness” is a basic requirement for the existence of a society. The need for orderliness is a fact and an objective necessity for every human in a society.[1] The adherents of the positive law theory states "**rule of law**" as the purpose of the law, in which the orderliness or regularity would not have been possible without the lines of a definite life behavior. Regularity will only exist if there is a certainty of the law which must be made in the exact form as well (written).[3]

Indonesia is a country of law (*Rechtsstaat / the rule of law*), as underlined in article 1 paragraph (3) of the 1945 Constitution (Amendment 4) which states that Indonesia is a State Law. As we know that the basic idea of the state of Indonesian law could not be separated from the basic idea of “*rechtsstaat*” or State law which is adopted by the Dutch who laid the foundation for the legal protection of the people on the principle of legality, which states that all have to be positive. It means that the law must be consciously created.[3]

In a modern *rechtsstat*, the function of legislation does not only give shape to the values and norms that apply and live in the community, and the Act is not just a product of the state function in the areas of regulation. Furthermore, legislation is one of the methods and effective instruments available to manage and direct the society towards the expected goals . In practice this is what is done by the legislators because this time the legislators power is giving way and showing the way for the realization of the ideals of the nation through the creation of law.[3]

The development of national laws is aimed to achieve an objective of the establishment and functioning of the national legal system,[3] as well as what is contained in the legal regulation particularly with respect to economic regulation relating to the Financial Safety Net in Indonesia. In order to realize a solid economy in Indonesia and legal economy development, there should be an adjustment in policies and legislation in the field of economy and monetary that has been taken by the Indonesian state. Monetary policy as one of the important policy of national economic development policy should be directed in effort to create and maintain monetary stability. Difficulties for the maintenance of monetary and banking stability are becoming increasingly obvious with the occurrence of the financial crisis and the economic crisis.

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[1] Lili Rasjidi dan IB. Wyasa Putra, *Hukum Sebagai Suatu Sistem*, PT. Remaja Rosdakarya, Bandung, 1993, hlm. 127.

In this regard, one of the main pillars of achieving the stability of the financial system in Indonesia is the need of *Financial Safety Net* which in general can prevent a *bank run*, can minimize the likelihood of financial crises, and can reduce the frequency and impact of economic contraction in Indonesia.

The financial system is basically the order of a country's economy that has a major role in providing facilities for financial services by financial institutions and other supporting institutions, such as money market and capital market. Indonesian Financial System, in principle, can be divided into two (2) types: the banking system (monetary system consists of the monetary authorities and commercial banks system) and other financial institutions system, including non-bank financial institutions.[3]

Focused on financial system grouping in Indonesia, it can be explained that the monetary authorities and the banking system is part of the monetary system in Indonesia. The monetary authority is what is stipulated in Law No. 23 of 1999 jo. Law No. 3 of 2004 concerning Bank Indonesia (hereinafter referred to as *the Act of BI*) which expressly states that Bank Indonesia is the policy responsibility authority, commonly called as monetary authorities.[3]

Financial stability in Indonesia is an important factor as financial stability is an essential requirement precondition for economic growth. If financial institutions and financial markets acting as financial mediators are in an unstable condition or uncertainty, it is certain that economic activity will be difficult to run optimally due to the low activity of production, consumption, and investment. In addition, under conditions of high inflation, it will be difficult also for the economy of a country to remain competitive in the face of global competition.

Thus to achieve a stable financial sector conditions, it is a requirement for a healthy financial institution, stable financial markets, regulatory agencies and competent supervision [3] and regulations and effective laws as an umbrella legislation in Indonesian financial system in the form of Financial Safety Net .

Financial Safety Net is one of the main pillars of economic activities in Indonesia whereas the specific and explicit regulation can pursue and prevent the occurrence of *bank run*, can minimize the possibility of a financial crisis, and can reduce the frequency and impact of economic contraction in Indonesia.

As noted above, it can be confirmed that the financial system, especially in Indonesia plays a very important role in the economy along with the function to channel funds from the excess funds to those in need of funds, whereas the settings need to be supported by legislation and specific regulations in the form of financial Safety Net because if the financial system is not working properly, then the economy will be inefficient and expected economic growth will not be achieved.

3. DISCUSSION

Financial and banking crisis that occurred in 1997-1998 has provided a very valuable lesson about the importance of creating a legal framework which is definitely for the stability of the financial system which can be realized in the form of the financial safety net system. Stability of the financial system is the realization of a series of processes and activities that begun with monitoring (*surveillance*) and identification of the possibility of a crisis to occur to the prevention of such crisis. Aspects of monitoring and identification of the crisis is one of the important pillars in maintaining the stability of the financial system because the preventive and anticipatory measures are seen as a less expensive step than to solve the crisis *(crisis resolution).*

Maintaining the financial stability is one of the main functions of the Central Bank in addition to maintaining monetary stability. Financial stability depends on the 5 (five) related elements, namely: 3

a. A stable macroeconomic environment;
b. A Well -managed financial institutions;
c. An efficient financial markets;
d. A supervision framework and the implementation of *Prudential Principle*, and
e. A safe and reliable payment system

For Bank Indonesia, the dutyas the central bank, an institution that maintains the monetary stability (monetary authorities), is not sufficient without the support of a healthy financial system stability. The turmoil in financial institutions especially banks is one source of instability. Therefore, the banking crisis should be prevented or treated in order to avoid disruption to the payment system and the smooth flow of credit in economic activities. Based on the above problem, then the effort to build a stable financial system at this time requires the rule of law (*legal framework*) that can be used as the basis for the management of the central bank as a whole especially in Indonesia .

As recognized in *the legal framework,* the financial system and national banking institution that is applicable during the crisis, Bank Indonesia as the central bank at the time was still part of the banking authority (part of the government/not an independent institution), was not equipped with a number of legal instruments and appropriate legislation when it should take emergency measures to address a *systemic risk* in the banking sector, which resulted in a weakening of a national banking system in Indonesia.

Related with the completion of the financial crisis in Indonesia as a result of the global crisis that occurred in some developed countries in the world, there are at least two (2) things to do as a form of regulation and permanent legal foundation of the efforts that will be taken by Bank Indonesia as the central bank in coordination with the Government in an attempt to rescue the national banking system namely:

a. Effective regulation of the *legal framework* relating to the preparation of a set of rules aimed at tackling the crisis or *systemic risk* with legal norms formulated differently from the rules governing banking operations under normal conditions. In order that the actions taken by the competent authority in overcoming crisis can be justified by law, in addition to the legal rules that govern normal conditions, there is a need to draw the underlying legal *framework* of crisis management that is strategic *(crisis strategy management)*
b. Regulations that are made are also associated with Bank Indonesia's policy in doing its function as *lender of last resort* that is in the policy provision of liquidity support to the rescue of national banking as an effort for the rescue of national economy.

Related with the above description, in order to carry out the development of national law, in particular with regard to the development of economic law, then the law reform in the banking sector in particular and the financial system in general in Indonesia is very necessary to provide a foundation for the implementation of the overall development in banking law. The existing legal instruments of financial system will serve as a cornerstone in the implementation of all activities related to the development of the banking law and economic law as a whole.

In order to execute the mandate in particular Article 11 verse 5 of the act of BI [3] about decision making under conditions of financial difficulty that has a systemic impact and to anticipate the threat of global financial crisis that could endanger the stability of the financial system and the national economy, there is a need to make a strong legal basis, mechanism of coordination between agencies involved in the development of the national financial system, as well as decision-making mechanism, so that preventive measures and crisis management can be done in an integrated, efficient, and effective way.

It can be explained that in the legislation related with the regulation and management of the Financial Safety Net System in Indonesia in particular may include four (4) key elements, namely: Regulation and an independent and effective supervision; an adequate *lender of the last resort* (LoLR); Deposit Insurance (deposit insurance agency) and Management and Settlement of a troubled Bank and the settlement of a financial crisis systemically.[3]

a. Regulation and Supervision which is Independent and Effective.

The main target of Regulation and Supervision in the function of the Financial Safety Net System in Indonesia is to promote the safetiness and healthiness of financial institutions through a continuous evaluation and monitoring including the assessment of risk management, financial condition and compliance to legislation and regulation of the established financial system. In the regulation and effective supervision, it will be the first safety net with the ultimate goal that is certainly to create and maintain financial systems, particularly healthy banking institutions. Factor of weak supervision factor is one of the causes of the weakness of the financial system; therefore it is necessary for prudential supervision.[3]

Financial Services Authority has now been established as a watchdog in the financial sector (Banks and Non- Bank) based on Law Number 21 Year 2011 on Financial Services Authority (FSA)

The implementation of Financial Safety Net, which is the primary focus in determining the condition of the banks before the crisis, is that supervisors are able to quickly distinguish between banks that are likely to successfully survive with the troubled banks. The main characteristic of a systemic crisis is that the financial condition of a bank can deteriorate rapidly due to deteriorating economic conditions and or a massive withdrawal of funds by the customer *(bank run)* .

The stability of the financial system will only be realized if there is a balance of interests between the various *stakeholders* - shareholders, depositors, borrowers, lenders, managers and supervisors. Therefore structuring and a good management (*good corporate governance*) is a significant factor in the framework of a monitoring implementation in the field of financial sector in Indonesia. Thus there is a need to develop further the concept of transparency of financial institutions through *disclosure* obligations that are truly effective. In line with the concept of effective monitoring and good corporate governance, there must be a commitment by Bank Indonesia as Indonesia's Central Bank to continue to perform and improve the effectiveness of supervision of banking institutions in Indonesia as planned and in a comprehensive way.

b. Lender of the Last Resort (LoLR).

Lender of the Last Resort (LoLR) can be defined as the liquidity facility granted discretionary (based on wisdom) to a financial institution (or the market as a whole) by the Central Bank in response to a disturbing turbulence which causes an excessive increase in the demand for liquidity which can not be met from alternative sources.[3]

The experience during the crisis in Indonesia year 1997-1998 showed that the function of the effective *LoLR* can prevent panic to the events of insolvency anticipation in banking institutions. Therefore the Central Bank can encourage the recovery of financial crisis by giving a lend for its role as *LoLR*. Under normal conditions, *LoLR* aid should be based on a clear rule. Policies and regulations of transparent *LoLR* can reduce the likelihood of crisis. *LoLR* under normal conditions can only be given to solvent banks with sufficient and qualified scheme, while for the insolvent bank the more stringent and effective resolution policy must be adopted.

In a systemic crisis, *LoLR* should be an integral part of a comprehensive crisis management strategy and should be well defined. There is a need for exception of systemic risk in granting *LoLR* to the banking system. Payment terms can be loosened to support the implementation of a systemic program of bank restructuration. In addition, regulations of *LoLR* facility must also provide a clear determination of the basic principles, specific criteria, the regulatory framework as well as the procedure about the systemic crisis and or the potential failure of a bank that can lead to the systemic crisis.

c. Deposit Insurance Agency

In general, Deposit Insurance aims to transform 3 (three) interrelated things namely: to guarantee customer deposits especially small customers; to maintain public confidence in the financial system in particular banking institutions; as well as to maintain the stability of the financial system. Thus, in particular the existence of Deposit Insurance is intended to prevent *bank run.*

To restore public confidence that had been disrupted as a result of the financial crisis in 1997, the Government then issued a policy of *blanket guarantee* program that gave full assurance to all depositors and creditors of national banks by the Decree of the President of Republic of Indonesia Number 26 Year 1998 (Presidential Decree No. 26/1998) date January 26, 1998 about insurance against bank payment obligations. The program generally has managed to restore public confidence to the national banking institutions. However, the presence of a very broad guarantee program may weigh on the state budget and can lead to *moral hazard* not only for bank managers but also for the customers. The management of the bank will be less motivated to carry out bank operations in a careful way while customers pay less attention to the bank financial condition when they deal with the bank.

In Indonesia, after a long process, finally on 22 September 2004 the government issued Law No. 24 Year 2004 on Deposit Insurance Corporation (Deposit Insurance Agency (LPS)). In accordance with the provisions of Law No. 24 of 2004, LPS has two (2) functions: Ensuring customer deposits and conducting bank settlement or bank handling that is unsuccessful to be maintained or failed banks. This Law also states clearly on the legal status, governance, assets and liabilities management, reporting and LPS accountability and its relationship with other organizations. It is important to ensure so that LPS is independent, transparent, and accountable in carrying out its duties and authorities.

The insurance of bank customer deposits done by LPS is limited. This policy is adopted to reduce the burden on the state budget and to minimize *moral hazard*. However, customers' interests are optimally maintained. Every bank operating in Indonesia, both commercial banks and rural banks (BPR) is required to participate in this insurance program. Types of bank deposits that are guaranteed include: savings, checking, certificates of deposit and time deposits as well as other types of deposits that are equivalent.

In applying the limited guarantee scheme to LPS, it needs to be clearly arranged on the mechanism of coordination between LPS with relevant agencies mainly Bank Indonesia and LPS in the handling and giving the resolution against troubled banks. The mechanism of coordination can be set with reference to other countries such as in the form of a Memorandum of Understanding. In connection with the threat of a global financial crisis, associated with LPS in Indonesia, the government has issued Law No. 7 of 2009 that specifically modifies the provisions of Article 11 of Law no. 24 Year 2004 on LPS in which customer funds are guaranteed by the government on national banks to the tune of Rp.2,000,000,000.00 (two billion rupiahs).

d. Handling and Settlement of Troubled Bank as well as the settlement of Financial Crisis Systemically (Crisis Management)

In line with the widespread of financial integration process, there is a requirement to have a responsive policy, both in supervision and management crisis. Given the large amount of cost to be borne by the State in the management and resolution of the crisis and so widely raised impact from the crisis, then there is a need to have a good and effective crisis management. A good and effective crisis management should be supported by the availability of the legal framework in the form of legislation and a clear policy of crisis handling that set roles and responsibilities as well as effective mechanisms of coordination from each associated institution with the monetary authority in Safety Net Finance System in Indonesia. Furthermore crisis management should also be supported by an effective organization and leadership so that it is able to organize a strategy and crisis handling measures quickly and effectively if the crisis occurs.

5. CLOSING

5.1. Conclusion

Financial Safety Net system is one of the main pillars of economic activities in Indonesia, with the specific and explicit regulation the occurrence of bank run can be prevented, can minimize the possibility of a financial crisis, and can reduce the frequency and impact of economic contraction in Indonesia. Thus it can be said that in setting up and managing Financial Safety Network specifically includes four (4) key elements function as: Regulation and independent and effective supervision; sufficient *lender of the last resort*; Deposit Insurance (LPS) and handling and settlement of troubled bank as well as the settlement of financial crisis systemically (crisis management).

The financial system especially in Indonesia plays a very important role in the economy along with the function to channel funds from the excess funds to those in need of funds where the settings need to be supported by special legislation and regulations in the form of Financial Safety Net because if financial system is not working properly, then the economy will be inefficient and expected economic growth will not be achieved.

5.2. Suggestions

a. The implementation of function of the Financial Safety Net System must be implemented in an integrated manner with other financial sector policies, in particular the implementation of the *prudential banking principle* supervision for the prevention of banking crisis;
b. Setting up an effective mechanism of coordination and the development of trusting culture in the implementation of cooperation among relevant institutions. Thus deciding the policy in handling the crisis can be formulated and retrieved quickly and accurately.
c. In order to strengthen the stability of the financial system, it is immediately necessary to issue comprehensive regulations relating to the Financial Safety Net and it is clearly defined about the objectives in setting the elements of Financial Safety Net in Indonesia, duties and responsibilities of each related agency as well as mechanisms of coordination between financial institutions and monetary authorities.

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