KnE Social Sciences

ELEHIC
The Third Economic, Law, Education and Humanities International Conference
Volume 2023

Conference paper

Systemic Bank in the National Banking's Legal System

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Published 24 July 2023

Publishing services provided by Knowledge E

Selection and Peer-review under the responsibility of the ELEHIC Conference Committee.

Abstract.
Disrupted banking system may lead to financial risk as its characteristics links one market to another and one financial service institution to another. If a bank fails, another bank may do so, and even non-banking system, financial system and generally domestic macroeconomics and other states may fail; thus, systemic risk attracted both central bank and banking supervising institutions' attention throughout world. This study wants to answer the question: Why a bank is called Systemic Bank and how is the Systemic Bank regulation in national banking system? The descriptive analytic research used normative approach, with secondary data. The study found that a bank is called systemic as the banking world's default risk can be systemic related to its transmitting ability, and a bank's failure can contribute to another's failure in banking transaction. The effect of default bank can spread to non-financial companies for the bank provides loan to other companies. The Law No.9 of 2016 about Prevention and Management of Financial System Crisis is published leading to the regulation about the assignment of Systemic Bank. Coordinating with Bank of Indonesia the OJK assigns Systemic Bank and Capital Surcharge semiyearly in normal condition. The method of assignment is implemented with several indicators: size, complexity and interconnectedness. If OJK decides earlier the measures to be taken to deal with the Recovery Plan that cannot make the bank sound, recommendation given will be to publish publicly the list of Systemic Banks to give appropriate information and law protection to the public.

Keywords: Systemis Bank, Legal System, National Banking

1. INTRODUCTION

A company operating primarily in fund collection and distribution is called a bank. Some typical activities distinguish bank from other companies in relation to its primary business indicating that the operational fund of a bank is largely not its own and it should always provide it as soon as the owners need. The bank can maintain the public trust through keeping its position liquid. Another typical activity indicates the fund used by the bank largely imposing cost burden, for the fund is collected from the people through the payment of interest rate. In other words, the income will be obtained after the cost has been spent.

The payment system owned by the bank only is another peculiar characteristic of bank. It allocates fund to the parties by their right and obligation. Hence, the disrupted banking system can result in financial risk due to its characteristics linking one market to another and one financial service institution to another. The perception of bank failure is important particularly to public policy because the fear that the bank failure may spread to other banks or even go out of banking system, to financial system entirely, domestic macroeconomics and other states. But it does not apply to other company's failure, for instance, the failure occurring in steel factory, software producer, or grocery store will not spread to other companies in the same industry. The development of policy in all countries has kept and will keep focusing on bank failure; that is why stricter regulations are made for the banks than that for other companies. Thus, the fact that the central banks or the banking supervising institutions throughout world pay attention to the systemic risk is unsurprising.

The bank should keep getting public trust, despite the systemic risk. The people's availability to participate in banking activities such as saving or investing their money, depositing and borrowing money to start or to expand their business reflects the extent of public trust in banking industry. People's contribution and participation is vital to the banking industry and to their wellbeing, and in turn to the development.

2. METHODOLOGY/ MATERIALS

Recalling the problem discussed, this study used normative approach as research method or called doctrinarian legal research, library research, or document study. Secondary data (literature) was used fully in this study. This study was descriptive analytical research that describes the condition of object investigated and the factor influencing the data obtained were then collected, organized, explained and analyzed.

3. RESULTS AND DISCUSSIONS

3.1. Why A Bank is Called a Systemic Bank?

The size of Indonesian financial sector substantial nominally, ranging between 1,186 trillion in 2000 and almost 3,967 trillion in 2010. In that period, a number of financial sectors have implemented financial reform significantly, despite very low diversification rate in financial sector. Banking becomes the dominant sector (80%), while leasing, pension fund, mutual fund companies, and etc. occupy the rest, 20%.

Compared with other sectors, the banking sector has systemic risk for some theoretical reasons. *Firstly*, typical (systemic) characteristic belongs to banking system. Financial system is composed of banks the default condition of which can potentially spread to other sector. In certain cases, a failed bank affects not only the bank's price, but also other banks' price. Nevertheless, some other banks do not provide systemic failure in default condition. *Secondly*, the risk of default in banking world can be systemic in relation to its spreadability or due to the inter-bank risk diversification action, such as securitization. Securitization can increase the probability of joint failure through facilitating the interbank risk distribution. *Thirdly*, default bank can individually have transmitting effect on non-financial company because a bank provides credit or loan to other companies. Hence, if a bank is in default, the loan supply to the companies will decrease. Some banks in default condition can affect not only other banks but also all shares. In this situation, the increase of default risk in a bank can result in the increase in the risk of all financial markets and even economies. This risk is called systemic one that can be diversified so that the investor can impose premium to this risk.

A failed bank can have an impact on another bank's failure, for basically the banks are interconnected in banking transaction. The transaction includes, among others, the loan fund provided to debtor that will in turn get into other banks. Debtor uses the loan fund to repay their debt to another party, and some repayments are done using checking account medium. The checking account is submitted to the bank and then used by debtor consumers, and so on. All payments made through bank will be connected to other banks, because all banks do interbank borrowing or obtain the loan from other banks. If a bank cannot do payment to another bank or party in a transaction, the bank that should receive payment from the first bank will be in trouble and so on. Therefore, if the first bank should be shut down, the bank surely still has financial obligation to other parties including other banks connected to the bank in the financial transaction. Therefore, there is a systemic relation between one bank and another.

Indonesian banks are substantially dependent and interconnected to other banks, indicating that the banks in Indonesia have relatively similar risk source and *bank's risk taking behavior* between one and another so that the risk change in individual banks exerts relatively strong systemic effect on the risk of banking system. The bank competition level in Indonesia tends to be low. Indonesian banking competition level is categorized into monopolistic one. In this category each of banks has its own market segment and strong market power enabling it to assign relatively high price from its marginal cost. The bank competition level has evidently negative relation to systemic risk so that the higher the bank competition level, the lower will be the systemic risk. It represents the paradigm of competition stability more appropriate to the empirical condition of Indonesian banking. The higher level of banking competition will lead to the stronger stability of banking system and the lower systemic risk.

As a company, Bank has default risk, the risk of incapable of fulfilling its financial obligation. The risk of default in a bank is theoretically systemic due to the natural characteristic of banking industry in which a bank's failure can be systemic. A bank's default can lead other banks to be in default that can trigger the default in the banking system (*cascade of failure*). The more likely the banks fail in a banking system, the higher will be the systemic risk in the banking system. A systemically important bank is the on that can trigger the collapse of banking system. The large bank can result in systemic risk in such a way that the bank's default can lead other banks to be in default. Thus, the bank with very large systemic effect is called *Too Big To Fail*, and it is too risky for the government and the monetary authority to leave this bank into default.

As the banking sector is one of primary funding sources for the companies, a bank's failure also can affect the companies operating in non-financial sector. The default risk of individual banks affects significantly the systemic risk (banking industry risk) is affected significantly in the state where the structure of bank industry structure is dominated by large banks. Meanwhile, in the state with more even structure of banking industry competition, the default risk in individual banks does not affect the banking's systemic risk significantly.

3.2. The Systemic Bank Regulation in National Banking System

Systemic bank is defined as the one having a large number of assets and diverse product complexities with financial conglomeration. In addition, in the case of failure or shutdown a systemic bank is also connected to other banks and the bank's position is irreplaceable. The systemic bank has at least 3 criteria:

1. Bank scale size

A bank is categorized into systemic bank if it belongs to the large-scale bank or Commercial Bank based on Business Activities (Indonesian: *Bank Umum Kegiatan Usaha* or BUKU) 4 and BUKU 3 categories. In both categories, Bank has broad-scope business activities. The word broad means product and service diversity and equity capital in other financial institutions with international scope. Not only product and service coverage but also bank scale reflect total asset and amount of deposit the corresponding bank has. The more the amount of asset, the higher will be the risk of systemic effect when the bank faces some problems.

1. Connectivity

A large bank operates business activities in not only fund collection and distribution but also in cooperation with other institutions, other banks, and other financial institutions. The Bank even also keeps expanding its business through other financial sectors both at home and abroad. Unsurprisingly, the banks are highly interconnected.

1. Product and transaction intricacies

The larger scale and core capital of a bank will result in the higher category level of it, because the corresponding bank has an opportunity of creating product in diversity and intricacy with broader scope.

The people should unecessarily worry to use banking product and service, despite systemic effect in several banks. The existence of systemic bank category or group represents stricter management and regulation. Additionally, the corresponding bank also tends to operate its business activities more cautiously to preclude fault from occuring.

George G. Kaufman assumes that systemic risk occurring due to the interconnection of all economic agents. This interconnectedness contributes or establishes a surprising chain to any agents that is spread to the others. Individual or institutional balance of these agents includes capital for the others; if the capital value of an agent diminishes, the value of capital will diminish, influencing the agent's consuming behavior and likewise the income and capital value of other agents. Furthermore, if the value of lost capital is higher than the agent's capital, the agent will fail in repaying its debt obligation. This eventually will reduce the capital value in the agent creditor's balance and trigger chain reaction, including reduced expense and failure.

The Law No.9 of 2016 published about Prevention and Management of Financial System Crisis leads to the assignment of Systemically Important Bank. OJK in coordination with BI will establish Systemic bank and *Capital Surcharge* routinely semiyearly. The systemic-assigned Bank should obligatorily generate capital surcharge corresponding to its own group (bucket). OJK assigns capital surcharge by subdividing the bank with systemic effect into five buckets:

1. The capital surcharge 1% of Risk-Weighted Asset according to Ratio (ATMR) designates Bucket 1,
2. The *capital surcharge* 1.5% of ATMR designates to Bucket 2,
3. The *capital surcharge* 2 % of ATMR designates Bucket 3,

4. The *capital surcharge* 2.5% of ATMR designates Bucket 4, and

5. The *capital surcharge* 3.5% of ATMR designates Bucket 5.

Capital Surcharge is defined as additional capital functioning to mitigate the negative effect on the stability of financial system in the case of Systemic Bank failure by improving the Bank's loss absorption capacity, as mentioned in the Article 1 clause (3) of the Indonesian Financial Service Authority's Regulation (POJK) Number 2/POJK.03/ 2018 about the Assignment of Systemic bank.

To prevent the financial system crisis in banking sector, OJK in coordination with BI establishes Systemic Bank. It is in line with Article 17 clauses (1), (2), (3) and (4) of the Law of Financial System Crisis Prevention and Management (UU PPKSK). The Systemic Bank is established in the normal condition of financial system stability. OJK, in coordination with BI, refurbishes the table of Systemic Banks periodically semiyearly. It also delivers the output and the refurbished table of systemic Banks to the Committee of Financial System Stability. Additionally, the message of Article 17 is mentioned in Article 2 of POJK Number 2/ POJK. 03/ 2018 in clauses (1), (2) and (3) stating that OJK establishes systemic bank and *capital surcharge*; OJK in coordination with BI establishes systemic banks and *capital surcharge*. Systemic banks and *capital surcharge* are established semiyearly in: (a) March using the data of position in December of previous year; and (b) in September using the data of position in June of the year.

In assigning Systemic Banks, OJK develops a methodology to assign systemic banks, as mentioned in Article 5 clauses (1), (2), (3), and (4) Number 2/ POJK.03/2018 about the establishment of Systemic Bank. The establishing method is implemented using the following indicators: (a) size; (b) intricacy; and (c) interconnectedness. The methodology of establishing systemic banks is used in establishing the systemic banks semiyearly. The methodology of establishing Systemic Banks is reviewed by OJK at least 1 (once) in 3 (three) years.

The number of systemic banks will expectedly increase continuously in the future because of more consolidation made in banking industry through either merger or acquisition. It encourages the rise in the capital the bank has leading it to belong to systemic bank category. Thus, the raising number of systemic banks is defined as the rise in the bank's capital value so that a tighter supervision is required over the financial system. The raising number of systemic bank does not always means negative, but the increased risk particularly due to rupiah attenuation should be observed closely. The large important bank with significant effect on banking and financial industries and national stability is the essence of systemic bank. Excluding banks from the systemic criteria means that their quality, performance, and supervision degrade.

The larger the capital of a bank, the more likely will be the bank systemic when it should be shut down. It implies that all parties agree and can accept it. In contrast, the bank with small capital has lower systemic potency.

The Bank of Indonesia (Indonesian: *Bank Indonesia*) used systemic criteria in 2008 with European Union's *Memorandum of Understanding* (MOU) on June 1, 2008 as its analytical framework, stating among others: "..... *in a such situation, one may also need to place more reliance on qualitative information*". In other words, the qualitative assessment is an element more important than the recent quantitative information. The perspective of European Union's *Memorandum of Understanding* (MOU), of course, builds on their long experience with managing and preventing the financial crisis.

Four (4) aspects are used by European Union's MOU in analyzing the Failed Bank presupposed to be systemic: (a) Financial institution, (b) Financial Market, (c) Payment System, and (d) real sector. One aspect is added to the four aspects by the Bank of Indonesia, i.e. market psychological factor. Thus, a total of five aspects are studied. The addition of market psychological factor is inseparable from the experience with banking crisis in the period of 1997/1998 replete with market psychological element. These five aspects are used by the Bank of Indonesia to conduct a systemic study on Bank Century, either qualitatively or quantitatively.

The Systemic Banks facing liquidity difficulty are allowed to apply to the Bank of Indonesia for short-term liquidity loan or short-term liquidity financing based on sharia principle, as mentioned in Article 20 clauses (1), (2), (3), (4), (5), (6) and (7). To afford short-term liquidity and short-term liquidity financing based on sharia principle, OJK makes an appraisal on the fulfillment of solvability requirement and the soundness level of Systemic Banks, and BI along with OJK makes an appraisal on the fulfillment of bail requirement and the estimation of Systemic Bank's ability of repaying short-term liquidity loan or short-term liquidity financing based on sharia principle.

The short-term liquidity loan (PLJP) should be granted with high-quality bail in the form of the sufficient number of securities bail as the guarantee; systemic banks can use credit asset with smooth collectability as the bail. The PLJP is provided referring to BI's Law. Coordinating with BI, OJK supervises the systemic bank receiving PLJP to ascertain its use, implementation, and repayment plan as agreed.

The explanation of Article 20 clause (1) of UU PPKSK states that referring to the BI's Law, the bank facing liquidity difficulty is allowed to apply to BI for PLJP as the lender of the last resort as long as the corresponding bank qualifies the solvability requirement and has acceptable bail. The explanation of clause (2) states that this provision of PLJP appropriation takes into account the authority that BI and the OJK have. OJK is authorized to make an appraisal on the bank's solvability and soundness based on the provision mentioned in POJK. As the one that will give loan or financing, BI's needs to appraise the bail and to estimate the Systemic Bank's ability of repaying PLJP conducted according to BI's regulation. To make appraisal, BI should cooperate with OJK as the supervisor that knows well the recent condition of Bank's asset and obligation and the Systemic Bank's financial condition entirely.

Article 14 of POJK Number 2/POJK.03/2018 about the establishment of Systemic Bank and *capital surcharge* states that if the Bank established to be systemic bank does not meet their obligation of developing *capital surcharge*, an administrative sanction will be imposed to it as follows:

1. Written reprimand
2. Ban of expanding certain business activities;
3. Suspension of certain business activities;
4. Prohibition of developing office network;
5. Bank's degraded soundness; and/or
6. Inclusion of administrators and/or shareholders and administrators of Financial Service Institution according to the provision of legislation on the fit and proper test.

Encountering financial stress that can endanger business sustainability, the Systemic Banks should be able to decide the plan to do as included into the Recovery Plan to Systemic Bank. The Systemic Bank should obligatorily develop and submit its Recovery Plan to OJK.

Article 3 of POJK Number.14/POJK.03/2017 about recovery plan to Systemic Bank states:

1. The shareholders, through General Meeting of Shareholders, should obligatorily agree the Recovery Plan
2. In the case of the Recovery Plan submitted to OJK not agreed by shareholders in the General Meeting of Shareholders as intended in clause (1), the Systemic Bank should ask for agreement in the next General Meeting of Shareholders.

A guideline of Recovery Plan should be owned by Systemic Bank, containing at least:

1. Those taking part in and responsible for:
2. Developing Recovery Plan
3. Delivering *Recovery Plan* and
4. Communicating *Recovery Plan* to all ranks and levels of the Systemic Bank
5. Those taking part in and responsible for doing evaluation and stress testing on Recovery Plan; and
6. Those taking part in and responsible for the Recovery Plan implementation.

A reliable management information system should be obligatorily developed by Systemic Bank to support evaluation and stress testing on Recovery Plan and the Recovery Plan implementation. Furthermore, Article 10 of POJK mentions that *Recovery Plan* should contain at least:

1. Executive summary;
2. General description of Systemic Bank;
3. Recovery option; and
4. Disclosure of *Recovery Plan*

Article 38 confirms that in the case of Systemic Bank having implemented Recovery Plan but no improvement is found in its condition, OJK can set other action conforming to the provision of legislation.

4. CONCLUSION AND RECOMMENDATION

Why a bank is called systemic? It is because the risk of default in banking world can be systemic in relation to its spreadability or the interbank risk diversification action. A failed bank can lead another to fail, because basically all banks are interconnected in banking transaction. The transaction intended is, among others, any fund given to the debtor as the loan that will in turn get into other banks. Default bank can individually have transmitting effect on non-financial company because a bank provides credit or loan to other companies. The banks in Indonesia have strong interdependence and interconnection to other banks, indicating that they have risk source and *bank's risk taking behavior* similar to that of other banks so that the change of risk in individual banks has potential systemic effect on the risk of banking system.

The Law No.9 of 2016 published about Prevention and Management of Financial System Crisis leads to the Regulation about the establishment of Systemically Important Bank. Systemic bank and *Capital Surcharge* will be established routinely semiyearly by OJK in coordination with BI. Capital surcharge should be created obligatorily by the Bank established to be systemic according to its own group (bucket). *Capital Surcharge* is additional capital functioning to mitigate the negative effect on the stability of financial system in the case of Systemic Bank failure by improving the Bank's loss absorption capacity. The establishing method is implemented using some indicators: size, complexity and interconnectedness. The methodology of establishing Systemic Bank is used in establishing the systemic banks semiyearly. OJK reviews the method of establishing systemic banks at least 1 (once) in 3 (three) years. Systemic Banks should obligatorily develop and submit their Recovery Plan to OJK, if they find financial stress condition.

If OJK has decided earlier the measures to be taken to deal with the Recovery Plan that cannot make the bank sound, the author will recommends it to publish publicly the list of Systemic Banks to give the public appropriate information and law protection.

If the soundness of Systemic Bank cannot recovered through Recovery Plan, OJK should have been able to decide any more measures or action to take, and OJK should decide them earliear rather than wait for the Recovery plan's ability of making the Systemic Bank sound. The author recommends it to publish publicly the list of Systemic Banks to give the public accurate and reliable information and law protection.

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