ATLANTIS PRESS

Advances in Social Science, Education and Humanities Research, volume 583

Proceedings of the International Conference on Environmental and Energy Policy (ICEEP 2021)

The Role of Central Bank as the Lender of Last Resort in the Pandemic Covid-19 Era, a Study of Emergency Liquidity Assistance

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Abstract–**The condition of systemic banks can affect the financial system stability when they face liquidity problem, in which an intervention by the government act as prevention and handling of liquidity problems to prevent contagious effect. Meanwhile, in Indonesia, emergency liquidity assistance (ELA) during a crisis was abolished through Law No. 9 year 2016 (PPKSK Law) which causing Bank Indonesia's lender of last resort (LoLR) facility in dealing with systemic bank liquidity problems only in the form of short-term liquidity loan (PLJP). The purpose of this paper is to track on the condition of ELA in Indonesia which was provided by Bank Indonesia as LoLR post the enactment of Law No. 2 year 2020 during the Covid-19 pandemic era. The research method used is normative juridical, and the data obtained were analyzed using analytical descriptive method. Considering that pandemic has limited economic activity, the government has added the authority of Bank Indonesia to provide special liquidity loans that can be provided to systemic banks if PLJP does not significantly resolve the liquidity problems. In other words, special liquidity loans revive ELA which was abolished through PPKSK Law, so that there is an ELA which includes settlement in the era of the covid-19 pandemic and becomes a backup scheme to avoid ongoing problems from systemic banks.**

Keywords– **Emergency Liqudity Assistance, Lender of the Last Resort.**

I. INTRODUCTION

Bank Indonesia as the Central Bank of the Republic of Indonesia, has a role and function as a lender of the last resort (LoLR) for banks that faces liquidity problem or difficulties. This should be the last step or solution after making efforts to resolve liquidity problems such as seeking funds through to the money market, which if not successful, will require the support from Bank Indonesia as LoLR.[1] LoLR itself known as the action to maintain financial system stability in order to realize sustainable economic growth. In addition, with the assistance of Bank Indonesia to resolve banking liquidity problems. [2]

According to the World Bank's research, from February to April 2020, policy initiatives in the financial sector that have been issued by several countries can be grouped into liquidity support by monetary authorities to expand short-term bank funding, prudence in providing arrangements related to relaxation and supervision including capital buffers, government sponsored debtor assistance and monetary policy that includes lowering interest rates.[3]

With respect to Indonesia, the issuance of Law No. 2 year 2020 deemed as a step to deal with threats that endanger the national economy or financial system stability. The enactment of the Law also grants additional authority for Bank Indonesia allowing the central bank to provide Special Liquidity Loans (a.k.a as Pinjaman Likuiditas Khusus or PLK).[4] PLK is given to a Systemic Bank which obtained a short-term liquidity loan but is still facing liquidity difficulties based on which then such Systemic Bank is required to apply for to Bank Indonesia. Unlike to another form of LoLR namely Pinjaman Likuiditas Jangka Pendek or PLJP, which is a short-term liquidity loan, the decision to grant this PLK does not rest solely with Bank Indonesia, but shall be based on a decision by a committee named Komite Stabilitas Sistem Keuangan or the Committee for Financial System Stability (KSSK).[5]

The PLK liquidity facility provided to systemic banks upon obtaining PLJP, however, is similar to emergency liquidity assistance (also known as Fasilitas Pembiayaan Darurat or FPD) by Bank Indonesia which was regulated in article 11 paragraph (4) and (5) of the Bank Indonesia Law. Thereafter, by the Law No. 9 of 2016 concerning the Prevention and Resolution to Financial System Crisis (Pencegahan dan Penanganan Krisis Sistem Keuangan/PPKSK Law), the validity of the FPD was revoked, and ever-since then the PLJP remains as the only LoLR facility from Bank Indonesia.[6]

With the abolition of the FPD by the PPKSK Law, nevertheless, there is potential issue to arise if the bank requesting for the PLJP were unable to meet the requirements as stated in the Bank Indonesia Regulation on PLJP, or, the PLJP provided fails to resolve the bank's liquidity problems.[7] The former FPD, however, covered the basic principles of emergency liquidity assistance theory. As such, it is necessary to conduct further analysis on how the Covid-19 pandemic era may affect the position of ELA provided by Bank Indonesia in its capacity as LoLR. it can avoid contagion effect so as to maintain the reputation of the banking system and public trust.[8]

In the event of a financial crisis, the central bank as LoLR can provide large amounts of emergency liquidity assistance to deal with systemic financial difficulties. The central bank provides credit to prevent more severe failures of important or systemic institutions and also a measure to address non-functioning interbank markets and increase liquidity in certain financial markets. In general, emergency liquidity assistance in times of systemic crisis should be an integral part of a comprehensive and well-designed crisis management strategy.[9]

As the Covid-19 pandemic has spread, it has limited the course of business activities, both essential and non-essential sectors. The economic restrictions imposed by the government to prevent the spread of the virus also have an impact on business actors, such as reduced income, which becomes a challenge to cover production costs. Therefore, the financial sector, especially banking institution, plays important roles to enable resolving funds needed. In this circumstance, policy intervention from the government is needed to address urgent conditions which may disrupt economic growth. [10]

II. FINDINGS AND DISCUSSION

The establishment of Bank Indonesia was based on the mandate in Article 23D of the 1945 Constitution of the Republic of Indonesia. It was then regulated for the first time through Law no. 13 of 1968 concerning the Central Bank, in which the position of Bank Indonesia as lender of the last resort (LoLR) has been stated.[11] Based on Article 32 paragraph (3) of Law no. 13 of 1968, Bank Indonesia can provide liquidity credits to banks to overcome the difficulties they face in an emergency condition. The LoLR function itself is in line with the objective purpose of Bank Indonesia which is to achieve and maintain the stability of Rupiah value, in which Bank Indonesia has an interest in maintaining financial system stability to support economic stability.[12]

Bank Indonesia as the central bank with its LoLR function has previously provided emergency liquidity assistance or ELA based on Article 11 paragraph (4) and (5) of Law No. 3 year 2004 concerning Amendments to the Law of the Republic of Indonesia No. 23 year 1999 concerning Bank Indonesia which was implemented in the form of an FPD. [13] This FPD by Bank Indonesia will be given when a bank experiencing financial difficulties has a systemic impact and it is highly probable that its failure may cause crisis that affects financial system stability. In essence ELA means experiencing liquidity difficulties to have a systemic impact, Bank Indonesia can provide emergency liquidity assistance or FPD for a longer period of time than short-term assistance. It can be said that this FPD is a bail-out system whose funding comes from the government and is a long-term funding facility. However, the enactment of PPKSK Law has revoked the position of the FPD.[14]

Thus, upon the effectiveness PPKSK Law, Indonesia is yet to have an ELA which construes to cover liquidity difficulties in crisis conditions. Considering that in general, ELA is a mechanism to deal with bank liquidity difficulties and to prevent bank conditions from getting worse or have an impact to national financial system stability.[15] Some of the characteristics of ELA are funding facilities based on a policy carried out by the central bank, ELA recipients are banks in a solvent condition, Liquidity problems experienced by banks is a short-term or temporary or occur suddenly, the purpose of providing ELA is to prevent banks that experiencing liquidity problems to becoming insolvent, and Preventing widespread impacts on the stability of the national financial system. [16]

On the contrary, the LoLR facility that Bank Indonesia may provide is only a short-term liquidity loan, which does not meet the characteristics of ELA theory since it is only given in a form of short-term funding for banks that are solvent and have liquidity problems. Therefore, an ELA is needed by Bank Indonesia which includes and covers the facilities during a crisis with rigid requirements. After several years, the Government issued Law No. 2 year 2020 as a response to cope with COVID-19 pandemic in Indonesia. The Law granted a new authority to Bank Indonesia as LoLR which is to provide Special Liquidity Loans. [17]

Whereas Special Liquidity Loans are provided for Systemic Banks that experience liquidity difficulties and do not meet the requirements of the PLJP, whereby the funding is guaranteed by the Government and provided based on a KSSK decision. In addition, this Special Liquidity Loan can be applied for Systemic Banks that have obtained PLJP but are still experiencing liquidity difficulties. This Special Liquidity Loan can be considered as an ELA because Special Liquidity Loan becomes a backup scheme if the PLJP is unable to overcome liquidity difficulties experienced by banks with systemic impacts or in a crisis situation. [18]

This Special Liquidity Loan is granted and becomes the authority of Bank Indonesia, however, the discussion and decision making is in the forum of KSSK and is also guaranteed by the Government. This is what distinguishes Special Liquidity Loans from PLJP, whereby PLJP is the authority of Bank Indonesia and is fully granted based on a decision of Bank Indonesia independently. Meanwhile, Special Liquidity Loans requires a coordination, discussed on the forum of KSSK and involve the decisions of all KSSK members. This is a similar scheme as the intervention carried out by the Bank of England as LoLR when dealing with banks that have a significant systemic impact.[19]

It was also stated by the Chancellor and the Secretary of State for Business in his latest White Paper on Banking Reform that “A zero-failure financial system is not our aim, nor should it be.” where the Bank of England develops its framework for monetary policy and liquidity operations,[20] and summarizes its approach in the Sterling Monetary Framework (SMF) document, also known as the 'Red Book'. The most important changes here is related to the liquidity insurance tools set up to deal with liquidity problems faced by banks, individually or collectively, during times of stress. To prevent SMF's ineffectiveness in preventing or to slow down the crises, there is a Bank of England Memorandum of understanding (MoU) with HM treasury (UK Government Treasury) and the Financial Services Authority that an ELA can be provided as an ELA outside of SMF's existing parameters.[21]

The MoU became the basis for granting ELA in the UK which also stated how these institutions would work together to manage the crisis situation. Therefore, any decision to grant, extend the ELA and its terms and conditions must be based on the decisions of the three parties in the MoU (Bank of England, HM treasury, and Financial Services Authority).[22]

III. CONCLUSION

The judiciaThe occurrence of the Covid-19 pandemic has brought in the government's decision to issue Law No. 2 year 2020 to deal with the impact of Covid-19. The Law has strengthened Bank Indonesia's function as LoLR by improving the existing PLJP and adding special liquidity loan facilities. Special liquidity loans seem to revive the former FPD so that LoLR can reach a wider range with the existing provisions. The provisions for providing special liquidity loans requires the results of a decision from the KSSK's forum. Thus the provision of special liquidity loans must involve KSSK members whereby this is a form of prudential steps taken by the government. This is as happened in the UK, where in providing or giving ELA outside of SMF (a form of monetary policy and liquidity operations) to systemic banks, the involvement of the Bank of England, HM treasury, and the Financial Services Authority is required. As such, the provision of ELA outside the existing SMF parameters and in crisis situation in UK requires an MoU between the three parties as the underlying.

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