

# Bailout to Bail-in: An Effort to Overcome The Financial Crisis in Indonesia

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**Abstract**—Bailout is an alternative in handling the financial crisis. The fundamental purpose of bailout policy is for the public interest. This research purposed to find out why the bail-in mechanism replaced the bailout mechanism, an alternative to handling the financial system crisis in Indonesia. In this normative research, the secondary data were used. In order to analyze the data, qualitative data analysis technique was implemented. In conclusion, this research found out that bailout in Indonesia in the case of Bank Indonesia Liquidity Assistance (BLBI) and Century Bank showed bad impacts of bailout implementation mechanism. Based on Law on Prevention and Mitigation of Financial System Crises (UU PPKSK) and its implementing regulation, the systemic bank was now obliged to solve financial problems with its own effort in accordance with action plan they made. This mechanism is called the bail-in mechanism, replacing the bailout policy mechanism in handling the financial crisis in Indonesia.

**Keywords**—bailout, bail-in, bank Indonesia, government, law, purpose.

## I. INTRODUCTION

The economic crisis will have a bad impact and even become a source of failure of the development goals of a country. More specifically, the economic crisis is one of the reasons for the poor management of banking institutions that become the main economic pillar in a country. The economic crisis that will have a serious impact on the achievement of a country's objectives should be addressed and resolved proportionally, by minimizing the negative impacts of the crisis handling and resolution to society as much as possible. The bailout is one of the banks' alternatives in handling the financial problems financially imposing the banks' problems to the State Budget (*Anggaran Negara*). This bailout mechanism is not considered providing a sense of justice for society and causing a moral hazard for other economic actors. The bailout policy in Indonesia was implemented in the distribution of Bank Indonesia Liquidity Assistance after the monetary crisis in 1997 and Century Bank case in 2008. Based on the description above, this problem of this research was why bail-in mechanisms replaced the bailout mechanism which became an alternative in handling the financial system crisis in Indonesia.

The importance of this issue to be researched is to know and analyse the reasons for the change of bailout mechanism to bail in mechanism in solving banking problems in Indonesia. Every change always creates legal and economics for further review.

Previous research in relation to bail out mechanism from legal aspect has been done among others [1]. In that study concludes that the Bank of Indonesia's Bank of Indonesia (GBI) letter to the Minister of Finance as Chairman of the Committee of Finance Stability System (KSSK) No. 10/2 / GBI / DPNP / Secret on November, 20th, 2008. Sitorus tried to find a middle ground on the issue [2]. The standpoint of administrative law is used as an analysis in finding the right solution [2]. Furthermore, Bailout also is seen from the aspect of potential criminalization [3]. She also conducts the research in examining aspects of Bailout Policy Century Bank and Potential Criminalization of Public Policy. This problem of this research was why bail-in mechanisms replaced the bailout mechanism which became an alternative in handling the financial system crisis in Indonesia. This study examines the reasons for the juridical aspect of why the bailout mechanism is replaced by a bail-in mechanism to overcome the banking crisis in Indonesia. This led to differences with previous research and complemented the understanding of bailout and bail-in mechanisms in juridical concepts.

The rest of this paper is organized as follow: Section II describes the proposed method. Section III presents the obtained results and following by discussion. Finally, Section IV concludes this work.

## II. PROPOSED METHOD

This research used normative research and secondary data. To analyse the data, qualitative data analysis technique was conducted. Figure 1 below is a flowchart showing the steps in conducting the research:

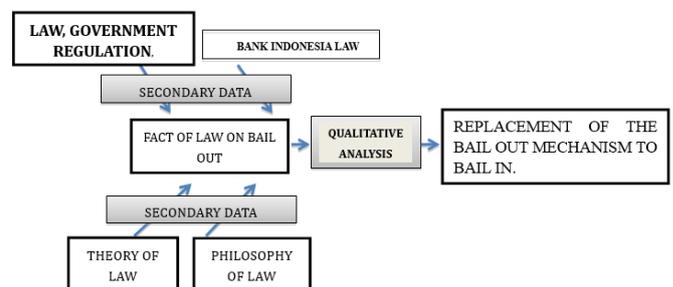


Fig. 1. The Flowchart Of The Research

## III. RESULTS AND DISCUSSION

This section presents the results obtained and following by discussion.

### A. Results

*a. Bailout Experience in Indonesia*

The bailout is a government intervention in providing financing facilities for banking institutions whose funding becomes the burden of government. In Indonesia, bailout policy has occurred with a policy of Bank Indonesia Liquidity Assistance. It is a liquidity assistance facility provided by Bank Indonesia to banks experiencing liquidity difficulties during the monetary crisis in 1997. There were 48 banks granted Bank Indonesia Liquidity Assistance fund. The purpose was to maintain public trust in banking institutions in Indonesia. Nevertheless, there found various irregularities. The audit of Audit Board on the use of Bank Indonesia Liquidity Assistance fund by 48 banks concluded that there had been an indication of irregularities of Bank Indonesia Liquidity Assistance which was supposed to be used to assist banks having difficulty, but the use was disregarded [4].

Bailout in Indonesia also occurred in the case of Century Bank in 2008. Century Bank was a bank established at the beginning with the name of Bank of Century Interest Corporation (CIC). The bank was based on the 1988 Deregulation Package issued by the government, one of which allowed a bank to operate with a minimum initial capital of 10 billion rupiahs. In 1997 CIC Bank became a public bank. Then, in 2003 CIC Bank encountered a problem in selling securities in foreign currency. Bank Indonesia, normally having the task of arranging and supervising banking institutions, suggested a merger. CIC Bank later merged with Danpac Bank and Pikko Bank to be Century Bank in 2004. However, in 2008 Century Bank's balance as a merged bank still had foreign currency securities failed to be paid. In 2008 Century Bank's CAR was -3.53 %. To address to this situation, Bank Indonesia provides assistance facilities to Century Bank normatively based on Law No.23 of 1999 [5] amended by Law No.3 of 2004 [6], adding Article 11i with paragraph (4) and (5).

Paragraph (4): In the event that a bank is experiencing financial difficulties that have systemic impacts and potentially lead to crises endangering the financial system, Bank Indonesia may provide emergency financing facilities whose funding becomes the burden to the government.

Paragraph (5): Provisions and procedures for decision making concerning the financial difficulties of banks with systemic impacts, the provision of emergency financing facilities, and funding sources derived from the State Budget Revenue and Expenditure shall be stipulated in a separate Law established no later than the end of 2014.

Based on these provisions, Government Regulation No.4 of 2008 concerning Financial System Safety Net (JPSK) was issued in connection with the implementation of the duties of Bank Indonesia as Lender of the Last Resort.

When associated with the case of Century Bank, the chronology of rules relating to Government Regulation No.4 of 2008 coming into force on September 15, 2008, can be reviewed as below.

- a) The decision of House of Representatives plenary meeting on December 18, 2008, in essence not rejecting or approving Government

Regulation No.4 of 2008 meant the House of Representatives did not refuse. (DPR, 2008)

- b) The Head of House of Representatives wrote to President to propose a Bill (*RUU*) on Financial System Safety Net. Meanwhile, on September 30, 2009, the Commission XI of Government Regulation was turned down to be Law on September 30, 2009, based on Article 22 of the 1945 Constitution and Law No.10 Article 25.

It means if Financial System Stability Committee (KSSK) established based on Government Regulation on Financial System Safety Net Article 18(1) in banking declares a bank failed and suspected to have systemic impacts by Bank Indonesia, Financial System Stability Committee shall decide whether the failed bank has systemic or non-systemic impacts.

Article 18 paragraph 2 mentions the Settlement or Handling of Failed Bank as referred to paragraph 1 is conducted by Deposit Insurance Corporation (LPS). Financial System Stability Committee asks Deposit Insurance Corporation to include capital in Century Bank on November 21, 2008.

Financial System Stability Committee action was established because of Government Regulation, while Deposit Insurance Corporation included capital based on Law of Deposit Insurance Corporation (Article 39, 41, 42).

- c) Based on Law No.10 of 2004 Article 25 Paragraph 4, if Government Regulation is turned down, the president is able to propose a Bill to revoke the Government Regulation.

The discussed issue is related to the determination of Century Bank as a systemic bank. From the theoretical aspect, the systemic risk can be seen from two interpretations [7]:

*"The first interpretation relates to the risk of a domino effect of failed bank able to undermine the national economic system. The second interpretation is a classic bank rush scenario where bank customers are together pulling their money from the bank regardless of the condition of the bank."*

Systemic risk in the case of Century Bank is feared because bank customers will widely withdraw funds from banking institutions if Century Bank was not saved since it would lead to bank runs. This situation would affect society trust in banking institutions. On the other hand, the vulnerability of the economy would further worsen the banking condition, along with Mitchell's The Business Cycle Theory [8]:

*"The basic idea is that when the economy goes into a recession or depression the returns on bank assets will be low. Given their fixed liabilities in the form of deposits or bonds the may not remain solvent. This may preclude a run of banks."*

This suggests that the bad condition of a country's economy will affect the banking development in that country. As the economy generally experiences

uncertainty, which is a systemic risk in practice, it is in accordance with Keynes that uncertainty is a natural feature of the economy. Fighting uncertainty is just like fighting nature [9]. It means, according to Keynes theory, the role of government in crisis is still needed. The government, in this case, should be the lender of last resort. According to Keynes, when a crisis happens, the government must help.

The above explanation can be examined that what the Financial System Stability Committee does determines whether a bank has a systemic impact based on existing Government Regulation No. 4 of 2008. If, after determined, the mechanism of a bank has a systemic impact, the handling is handed to Deposit Insurance Corporation and handled based on Law No. 24 of 2004 on Deposit Insurance Corporation, no longer based on Government Regulation No. 4 of 2004. The case of Century Bank evolved due to indecisive bailout mechanism. It was also due to the great political influence in the implementation of existing arrangements.

The experience of the bailout in Indonesia as described above showed that the assistance facilities provided by the State Budget (society's money) actually intended to be able to avoid a greater loss to society (public interest) in fact caused great and prolonged problems later. There were more bad impacts from it, not only the financial impact but also the moral hazard impact on other economic actors. The aspect of the law expedience originally intended for the greater public interest in its implementation caused loss to society.

#### *b. Alternative of Bail-in in Indonesia*

Seeing the adverse impact of the bailout, bail-in becomes an alternative to the financial crisis settlement was said by Stefano Luchini [10].

*” States has traditionally face banking crisis through, the so-called bail out tool. Public resources have been used for a long time in order to rescue banks putting the burden tax paying. Since the beginning of the crisis the European commission has adopted special state and rules for the rescue of bank providing guidance on the use a bail out principles but without any precise exit strategy. In order to reduce public support to bank, the banking communication and the new bank recovery and resolution directive introduced the bail in (or burden sharing), tool putting the burden of bank rescue on shareholder and subordinates’ creditor while minimizing the burden tax payers”*

As Stefano Luchini says that bailout is a solution to the financial crisis imposing the impact of the crisis on the public fund or called taxpayers. It can be understood that who and what causes liquidity difficulties causing the crisis is not necessarily the society. Nonetheless, the impact of the crisis is borne by society. Therefore, the mechanism of handling the financial crisis should be diverted from the mechanism of the bailout to bail-in mechanism, a mechanism to overcome the financial crisis by imposing the crisis handling to the shareholders or creditor of the company.

The role of regulation is essential in facing financial crises as Aikins [11] says:

*“I argue that mutual co-existence of the market and the government is beneficial to society and that periodic global financial crisis occurs because of the failure to learn from history and ineffective regulatory governance. Governments need to put in place a proactive regulatory framework to guard against regulatory capture, arbitrage, and forbearance in order to control financial market excesses.”*

In Indonesia, the bail-in mechanism is set forth in Law No.9 of 2016 on Settlement and Handling of Financial Crisis [12]. As a follow-up of the Law, the Financial Services Authority as an agency that plays a role in the mechanism of settlement and handling the financial crisis issued 3 Regulations of Financial Services Authority (POJK) as below.

- a) Regulation of Financial Services Authority concerning the Supervision Status and Follow-Up of Commercial Bank Supervision.
- b) Regulation of Financial Services Authority concerning Intermediary Bank.
- c) Regulation of Financial Services Authority concerning Recovery Plan for Systemic Banks.

The regulation contains obligations for banks to create a Recovery Plan. Recovery Plan is required to be made through the banks are in normal condition, but actually, there are significant problems in the banks. The Recovery Plan accommodates the obligations of the controlling shareholders and/or other parties to increase the bank's capital and convert certain types of debt into bank capital. The provisions in Law of Prevention and Mitigation of the Financial System Crisis which are then followed by Financial Services Authority with 3 Regulations of Financial Services Authority informs the systemic banks to solve their financial problems with their own efforts in accordance with the action plan they make themselves. This mechanism is said to be a bail-in mechanism in Indonesia.

#### *B. Discussions*

##### *a. Legal Function in Economic Development*

Law viewed from its function can be divided into 2 views. They are the law only able to follow the development of society and the law serving as a tool to engineer society.

The first view is proposed by two theories, the theory of School of History (*Mazhab Sejarah*) by Von Savigny and the theory of Decision (*Beslissinggenleer*). In his theory, Von Savigny mentions that law is not made, but it exists and grows up together with society (*das recht ist nicht gemacht aber ist und wird mit dem Volke*) [13]. This school is based on the fact that there are considerable nations in this world, each of whom has a Volkgeist (soul of society), and differs according to time and place [14]. The next theory by Ter Haar, Decision theory, suggests that law is only the customs recognized by the rulers (customary chiefs) in the decisions [15]. Consequences and legal functions will grow together with changes in society, so law, in this case, will change along with the changes occurring in society. The law exists

after the development and change of society. In this case, lawmakers are backward looking. This understanding, when viewed from law function perspective in economic development, means that law will always be left behind by the dynamics of the society rapid development.

According to Wignyoebroto, when seen from its function, the law is a tool of social engineering [16]. This function brings the consequence that law must become a tool or means able to change and renew the society as aspired. Due to the consequence of law function as a tool for reforming society, the law governing and directing the development of society must first exist before the change of society. Lawmakers oblique to always be forward-looking. When facing various society changes requiring legal certainty in regulating such changes in today's economic development, it is more appropriate to state that law can be used as a tool to engineer and change society. Lawmakers must be forward-oriented in the sense of predicting future social development. By doing so, the law objective in providing certainty, justice, and benefit can be realized. It is supported by David Harrison who emphasizes that the importance of legal functions in economic activities, especially banking activities, can be seen from the history of banking development in Indonesia in particular and the development of international banking in general [17].

#### *b. Bailout Objective and Its Bad Impact*

The term *bailout*, as stated by Posner and Casey [18], Bailout is pointed out as follow.

*“Bailout is general term for extending financial support to a company or a country facing potential bankruptcy threat. It can take the form of the loan, cash, bonds, or stock purchase. Bailout may or may not require reimbursement and is often accompanied by greater government oversee and regulations.”*

According to Posner and Casey [18], in addition, the purpose of the bailout is to maintain public trust. They state: We can make some progress by observing that in common parlance the word bailout refers to a subset a transfer where the transfer is intended to rescue an agent who cannot meet its financial obligations. Even here, however, some complaints are obscure. If the government is willing to subsidize a manufacturer of solar power panels giving it money, making loans to it or guaranteeing its debt (as it often is), then what's wrong with a policy of paying off an unpaid debt if otherwise, it would default? The effect of all the policies is the same to lower the cost of capital for the beneficiary the policy justifications is also the same to encourage people to invest in solar power. Therefore, the bailout is able to be an alternative in crisis resolution. It was going well in Mexico.

According to the conventional view, the International Monetary Fund's bailout of Mexico in 1995 was a success because it restored confidence in the collapsing peso, led to a quick economic recovery, and possibly stemmed the outbreak of a global systemic financial crisis. The bailout, moreover, helped keep Mexico on a market-oriented track. Proponents of those views rarely mention the high costs of the IMF's intervention to ordinary Mexicans, and they downplay the cost—namely in the form of moral hazard—to

the world economy. More importantly, policymakers have never seriously considered market-oriented alternatives to official bailouts in Mexico or elsewhere, yet the evidence strongly suggests that market solutions offer greater benefits and lower costs [18].

Basically, the bailout mechanism is intended for the benefit of society, that is maintaining public trust to invest, as widely known that the investment factor is the largest part affecting economic growth. This opinion provides an understanding that the element of the bailout can be seen from several things:

- The bailout is the mechanism of funding facility.
- Those involved in bailout are the government and financial institutions in general. However, the dairy farmers, poor people, and research universities can be the parties receiving the government loans. Since banking institutions are one of the bailout recipients from the government, the party giving the loan is the government.
- The funding facilities may be in the form of loans, cash, bonds, or stock purchases.
- Bailout occurs when a company has liquidity problem able to cause systemic risk triggering a bigger financial system crisis. It is intended to maintain public trust in financial institutions.
- The source of funding facility is the government.
- Because of funding from the government (money from society), the supervision of the funding facility implementation becomes crucial.

The objective of the bailout is to maintain public trust. This means the purpose of bailout policy is for the public interest. The effectiveness of this policy can be seen in the experience of the State of Mexico.

Bailout in practice also causes adverse effects, especially the emergence of moral hazard, as mentioned by Miron as follows [20]:

*“In my assessment of the financial crisis yield two main lessons. The first is that redistribution to the low-income household should be direct and, on a budget, not indirect and off-budget as in subsidized mortgage credit. The second lesson is that moral hazard from bailing out private risk-taking are substantial even these do not appear immediately”*

Moral hazard for other economic actors who rely on government intervention in the failure of their businesses will not be seen immediately but will be very dangerous to the economic situation.

Normally bailout policy is one alternative to handle financial difficulties for banking institutions, in which it is also able to trigger a worse financial crisis. The aim

of the bailout policy is basically to maintain public trust, for the purpose of public interest. The experience in Indonesia based on the Case of Bank Indonesia Liquidity Assistance after the monetary crisis and the Century Bank case in 2008 shows that bailout policy has had a prolonged adverse impact until the present time. The experience of bailout policy in Indonesia serves as an example of the underlying objective of bailout policy, especially in Indonesia. This does not mean that the bailout policy is an incorrect policy to handle the financial crisis in a country. Legal mechanism and supervision of the implementation of the bailout are required so that the fundamental objectives of the bailout can be achieved.

It is very unlikely that a troubled bank will occur and potentially lead to a financial crisis in the future. On the other hand, the potential financial crisis caused by banking problems is very likely to happen. Law should exist before the existing problems and the arrangement should already exist before the problem occurs. The Prevention and Mitigation of Financial System Crisis is an example of a legal function as a tool for public engineering or law is a tool of social engineering.

#### IV. CONCLUSION

The purpose of the bailout is to prevent a financial crisis that will endanger the economy by giving funding facilities which are later burdensome to the society. The bailout experiences in Indonesia in the case of Prevention and Mitigation of Financial System Crisis and Century Bank show the adverse impact of the bailout implementation mechanism. The bad impact of the bailout in Indonesia is due to both the weak law as well as political factors. Therefore, the Law of Prevention and Mitigation of the Financial System Crisis and its implementing regulations regulate systemic banks to solve financial problems with their own efforts in accordance with their own action plan. This mechanism is known as a bail-in mechanism.

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