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**Designing an Integrated Financial Supervision
Agency: Selected Lessons and Challenges for
Indonesia**

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CIES DISCUSSION PAPER 0405

**Designing an Integrated Financial
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Selected Lessons and Challenges for
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Abstract:

Having initiated reforms in its financial sector in late 1997, the government of Indonesia introduced a new central bank independence act in early 1999. The next task for the government of Indonesia is to devise a safety net system for the financial sector. This study draws essential lessons from the experiences of other countries to highlight a number of key challenges facing Indonesia, especially at early stages of designing its unified financial sector supervisory agency.

Key Words: Unified Financial Sector Supervisory Agency, Bancassurance
Central Bank, Indonesia.

JEL Classification: E58, E61, G21, G28

1. Introduction

With the creation of new financial instruments and services offered by various financial institutions, countries have found that boundaries between the different types of financial institutions such as banking, securities, and insurance have blurred (Taylor and Fleming (1999)). In their study of 14 countries, Martinez and Rose (2003) find that at the end of 2001, the market shares of financial conglomerate in the banking sector, the securities industry and the insurance industry had significantly and rapidly climbed to around 71 percent, 63 percent and 70 percent, respectively.¹ The increasing presence of financial conglomerates is also highly visible in major Southeast Asian economies.² The role of *bancassurance* (whereby commercial banks actively distribute insurance products as well) for instance has seen a phenomenal growth as a result of broad-based financial deregulation in a large number of Asian economies. By 2006, bancassurance can potentially account for 13 percent of total premiums collected in Asia's life insurance sector, and 6 percent of the non-life insurance sector (Sigma (2002)).

As in neighboring economies, the commercial banks in Indonesia have also been permitted to play active roles in the security and insurance sectors (Table 1). While at present financial conglomerates in Indonesia are arguably still in an early stage, but by no means are they insignificant. By year end 2003, it is estimated that at least 10 banks deliver *bancassurance* with a potential market of around Rp 14 trillion, and at least 15 banks offer mutual funds, mostly based on government bonds (Hidayat (2003) and Table(2)). It is estimated that up to June 2003, around 85 percent (or roughly Rp58 trillion) of the mutual funds were sold via banking institutions.

¹ Those countries are Australia, Canada, Denmark, Estonia, Hungary, Iceland, Korea, Latvia, Luxembourg, Malta, Norway, Singapore, Sweden, and the United Kingdom.

² A financial conglomerate is defined as any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance) (Martinez and Rose (2003)).

As the role of financial conglomerates continues to rise, concerns become more apparent over the effectiveness of multiple regulatory and supervisory agencies (Taylor and Fleming (1999), Mwenda and Fleming (2001), and Claessens (2002)). Fragmented supervision bodies have been reported to be inept in forming an overall risk assessment of a financial conglomerate on a consolidated basis due partly to a range of sources of financial risks associated with each part of the institution. Abrams and Taylor (2000) for instance argue that while the supervision of banking and securities tend to focus on the risk associated with the asset side of the balance sheet, the financial risk for the insurance company occurs mostly from the liabilities side of the balance sheet.

Consequently, an integrated financial sector supervision body –in which banking, securities and insurance regulation is combined within a single institution— has emerged as a preferred choice to deal with a complex financial system. At the end of 2002, Martinez and Rose (2003) reported that at least 22 countries have adopted an integrated single supervisory agency (Table 3). The Scandinavian economies (namely Denmark, Norway and Sweden) were the first to establish their integrated supervision agencies starting between 1986 -1991.³ The creation of the Financial Supervisory Authority in the United Kingdom was announced in 1997. As a consequence of the country's restructuring process of its financial sector following the break of the financial crisis in late 1997, Korea consolidated all its supervisory agencies for bank and non-bank institutions, securities and futures markets, and insurance into a single supervisory board (the Financial Supervisory Service) on January 1, 1999. The most recent examples of countries adopting a single supervisory body are Estonia, Germany, Ireland and Malta in 2002. Highlighting further the rising importance of this unified supervisory approach, an informal club of “integrated supervisors ---comprising representatives from

³ Norway was the first to establish an integrated supervisory agency in 1986, followed by Denmark in 1988 and Sweden in 1991.

Australia, Canada, Denmark, Japan, Korea, Norway, Singapore, Sweden, and the UK--- met in Sydney, Australia in early May 1999 for the first time.

As in all of the 1997 financial crisis-affected economies in East Asia, a few key reform commitments have been pushed forward in Indonesia, including a plan to establish a single financial supervisory board. Presently, the functions of regulation and supervision of the financial sector in Indonesia are shared among different institutions. The central bank as stated in Article 8 of Law no. 23/1999 is responsible for the tasks of regulating and supervising the banking sector. The ministry of finance is responsible for the insurance sector. The stock exchange is under the direct supervision of its own Capital Market Supervision Authority (BAPEPAM).

The new supervisory institution will undoubtedly alter the landscape of the financial safety net system of the country in the near future. The official target date for the establishment of the single supervisory agency is no later than December 2010. Clearly, this is a mammoth task for the country to deliver within a relatively short period of time. The objective of this paper is to identify selected key potential challenges associated with the initial design process of the integrated financial sector supervisory board in Indonesia.

The remainder of the paper is organized as follows. In the next section, we will briefly review a number of key aspects behind an integrated financial supervisory agency. Sections 3-6 present selected main challenges in the process to establish and to operate the single financial supervisory agency in Indonesia. Brief concluding remarks end the paper.

2. Single Supervisory Agency: brief overviews

Before we jump directly to the Indonesian case, this section highlights some issues behind the on-going strategic debate between the proponents and opponents of a single supervisor. Some of these fundamental matters underlined in the debate will provide

guidelines for our analyses of the Indonesian case to be presented in subsequent sections.

2.1 Proponents of a single supervisor

Several essential arguments are made in favor and against a single supervisory agency. In brief, the proponents of a single supervisory body underline the economies-of-scale and the improvement in the overall comprehensive monitoring of different financial institutions. The economies of scale can be achieved through centralized regulatory functions that permit the development of joint administrative, information technology, and other support functions (Taylor and Fleming (1999)). In most countries where there are few qualified personnel, a single supervisory agency should benefit from the pooling of all available skilled personnel.

The growing number of financial conglomerates providing financial services across different segments of the financial industry (banking, securities and insurance for instance) poses enormous and complex challenges for supervisory authorities, both in developing and developed markets. Having all supervision responsibilities under “one-roof”, the single agency can arguably better understand the risk arising not only in a single financial sector, but also amongst multi-sector financial intermediaries within the entire financial sector. Martinez and Rose (2003) have further argued that, under a system of multiple supervisory bodies, accountability may be easily diffused in cases of regulatory failure at any of the independent supervisory agencies, and that a lack of harmonization in the regulations and in their implementation across institution may arise. However, a single supervisory agency is able to monitor the financial system as a whole, and minimize regulatory arbitrage by applying a consistent approach to regulation and supervision across all segments of the financial system.

2.2 Potential shortcomings of a Single Supervisory Agency

There are at least three general concerns have been expressed against the establishment of a single supervisory agency. First, the success of a single supervisory agency is highly depended upon the strength of the pre-existing multiple supervisory agencies. Abrams and Taylor (2000) argue that to be effective, the newly established supervisory institution needs to emulate/reflect the structure of the sectors that it supervises. Hence, unless independent and effective supervisory agencies have been well established for each segment of the financial system, the merging of these institutions into one will not necessarily improve the supervision and regulation of the financial sector of the economy. In a similar vein, Martinez and Rose (2003) argue that it is imperative to address weaknesses of supervision and regulation at various levels of the financial system before even discussing the number of agencies that should supervise the financial system. It is also important to note that the integration process *should be done only when the financial system is stable.*

Second, at early stages of the transition from multiple agencies to a single one, the past experiences of countries listed in (Table 3) shows that they consistently had initially lower supervisory effectiveness. Martinez and Rose (2003) find a wide range of practical problems, including aspects such as legal constraints, personnel, integration of the information technology system, and budgetary issues that will slow down the establishment of the supervisory agency and that will lengthen the transition stage of the single institution. Based upon their studies of several countries, dealing with the operational tasks to carry out integration can require at a minimum around 2 years, depending critically on conditions in each country.

Third, the establishment of a single supervisory agency can result in a bureaucratic entity unable to rapidly respond to market developments. Reddy (2001) observes that the unification could lead to lack of clarity in functioning due to different objectivities associated with different supervisory roles. This objective may be depositor protection for banks vs. investor protection for capital markets vs. consumer protection

for other financial institutions (Milo (2002)). Furthermore, the operation of a single agency eliminates the system of checks and balances available under the multiple agencies system, hence leading to a concentration of power (Goodhart (2001) and Barth et.al (2002)).

3. The Central Bank Law no.23/1999: pushing for an independent Bank Indonesia

Arguably, one of the cornerstones of the post-1997 crisis reforms on the regulation and supervision of the financial sectors in Indonesia is the enactment of the Central Bank Law no. 23 in May 1999 ---henceforth Law No.23/1999--- and its subsequent amendments. As specified in Articles 7, 8 and 9 of Law No. 23/1999, its primary objective is to provide a legal structure whereby the central bank can act independently in carrying out its duties as the monetary policy maker.⁴

The Law no.23/1999 also clearly specifies that Bank Indonesia will eventually relinquish its role in bank supervision. In an amendment passed in December 2003, a target date of December of 2010 is set as the latest date for the separation of banking supervision authority from the central bank. As stated in Article 34 and 35 of Law no. 23/1999, a new independent financial supervisory institution will be established. In fact, article no.34 initially had specified that the timetable for the establishment of this independent institution should be no later than December 31, 2002, but the date has now been postponed to December 2010. With the Law no.23/1999, Indonesia will follow the steps taken by countries such as South Korea and the United Kingdom where the central bank will no longer have any supervisory responsibility. The new single supervisory agency in Indonesia will not be under the authority of Bank Indonesia.

⁴ Refer to Goodhart and Schoenmaker (1995) for further discussions on the arguments for and against the separation between supervision and monetary policy.

4. Gradual Approach to Establishing a Single Supervisory Agency

The Central Bank Law of 1999 provided the initial impetus to the establishment of the single supervisory authority in Indonesia. One immediate question then is how quickly should Indonesia establish its single supervisory agency? Two contrasting approaches have been taken and are worth highlighting here. The first one is the “gradualist” approach of the Scandinavian countries (Denmark, Norway and Sweden). In sharp contrast, the United Kingdom and South Korea adopted a “Big-Bang” approach.

In its response to the country’s financial crisis in late 1997, the Korean government integrated the supervisory roles of all financial intermediaries within a fairly short period of two years. On January 1, 1999, the Office of Bank Supervision, the Securities Supervisory Board, the Insurance Supervisory Board and the Non-bank Supervisory Board were consolidated into a single supervisory body as the Financial Supervisory Service, the executive arm of the Financial Supervisory Commission. For Indonesia, we strongly recommend the gradualist approach strategy where a two stage approach should be adopted. The immediate task is to improve the current supervisory agencies in the financial sector. In the second stage, the “integration” process of the supervisors should also be carefully managed. The following sections further discuss the two-stage approach.

4.1 Improving the strength of the pre-existing supervisory agencies

The new integrated supervisory agency may organize its departments according to the type of financial intermediaries it supervises (Martinez and Rose (2003)). Essentially, this new institution merges together the multiple supervisory agencies and standardizes the rules and regulations on the supervisory activities. Therefore, the establishment of a single supervisory agency in covering all segments of the financial industry will not be effective at all, unless the country has already established well-run multiple agencies supervising each component of the financial market. If the supervision

of the financial institutions is poor under multiple agencies, it will continue to be weak under a unified agency.

With the objectives to strengthen the domestic banking sector and the supervision capacity, a number of new regulations have been passed since 1999 (Table 4). Similarly, a decree issued by the Jakarta Stock Exchange no. 315/2000, which was then amended by the decree No. 339/2001, beefed up the listing requirement by demanding listing company to have independent commissioner, audit committee, and corporate secretary.⁵ In November 2002, the BAPEPAM issued its decree No. 20/2002 concerning independence of accountant of publicly listed companies in carrying out auditing services. However despite the long list of new regulations and decrees, they have been poorly enforced.

The scandal involving Lippo Bank in late 2002 and early 2003 highlight the deficient quality of the supervisory agencies, including Bank Indonesia, the Indonesian Bank Restructuring Agency (IBRA) and the Indonesian Capital Market Supervisory Board (Bapepam). In late 2002, Lippo issued two different and conflicting third quarter financial reports. The first listed the bank's total assets as 24 trillion rupiah and its net profit as around 98 billion rupiah; but the second stated that the total assets had fallen to 22.8 trillion rupiah and that the bank profits were actually a net loss of approximately 1.3 trillion rupiah (MacIntyre and Resosudarmo (2003)). Furthermore, there were also some concerns on the non-transparent sale of the bank's assets that had been taken over by IBRA.

In October 2003, Bank Negara Indonesia (BNI), a major state bank, was reported to have experienced a loss of around 1.7 trillion rupiah having issued fraudulent Letters of Credit for fictitious transactions involving exports. The scandal highlights the lack of internal control between branches and poor governance in the state-owned

⁵ The main responsibility of the corporate secretary is to keep informed about capital market regulations, to provide public information on the company's condition, to give advice to the

banks. The closures of Bank Dagang Bali and Bank Asiatic in early 2004, unearthed another examples of moral hazard practices, such as related party lending, fabrication of asset records, and fictitious credit records, in the banking industry.

To improve the banking supervision, the adoption of the Basle II Framework endorsed in June 26, 2004 by the central bank governors and the heads of bank supervisory authorities in the Group of Ten (G10) countries, should be considered in Indonesia. The Basle II framework improved further the 1988 Basel Capital Accord and its 1996 supplement by introducing three pillars to strengthen the stability of the financial sector. The first pillar revises the 1998 Accord's guidelines by aligning the minimum capital requirements more closely to each bank's actual risk of economic loss. The second pillar recognizes the necessity of exercising effective supervisory review of banks' internal assessments of their overall risks. The last pillar leverages the ability of market discipline to motivate prudent management by enhancing the degree of transparency in banks' public reporting.

4.2 Integration process: harmonizing supervision practices

Once the performance of different supervisory agencies has been improved, the next stage is the integration process of the agencies. As briefly discussed in section 2, it is pertinent for the unified supervisory body to have an in-depth understanding of the different objectives and practices associated with supervising different groups of financial institutions. In a country where banks dominate the financial sector such as in Indonesia, an ill-prepared supervisory agency may focus its resources on the banking sector at the expense of not sufficiently supervising the other financial institutions. Lack of an overall appreciation of the financial industry on the part of the new supervisory

directors in complying with capital market regulations, and to liaise between the company and its stakeholders.

agency may eventually impair the ability to communicate to the markets its objectives and policies.

An adequate grasp of all the tasks associated with the different supervisory roles is necessary for the unified agency to implement a harmonized set of supervisory practices. One possible approach to achieve this is through a gradual integrating process of the agencies. A number of countries have adopted a semi-unification strategy approach, where one agency supervises two types of financial intermediaries initially (Rose and Martinez (2002)). Malaysia and Australia for instance unified banking and insurance supervision responsibilities. Switzerland and Finland integrated the supervision of the banks and the securities firms. South Africa and Chile unified the supervision of the security and insurance firms.

The objective of this partial unification approach is to let the market conditions influence the unification process. The strong growth of *bancassurance* in the Scandinavian economies during early 1980s was a powerful reason for creating an integrated supervision agency. This model seems more appealing in Indonesia, where banks are by far the largest segment of the financial sector and are launching insurance products, largely facilitated by relatively loose regulations on ownership of banks and insurers (Table 5). Given that the same phenomena is taken place now in Indonesia, it is a natural intermediate step for the country to consider merging its banking and insurance supervision before moving to a fully unified supervisory system.

In short, the failure to develop a unified regulatory and supervisory framework for the financial sector is likely to slowdown or even to prevent the integration process of the former multiple supervisory agencies. The longer the “gradual integrating” processes occur before the target date of 2010, the more prepared the unified agency will be to assume its responsibilities at the schedule date.

5. Independence and accountability of unified supervisory agency

5.1 Independence

To be effective, a supervisory agency must be able to take decisions and carry out its duties without undue outside interference whether it be from ministers, parliamentarians, industry leaders, or other government officials. The lack of independence of the supervisory agencies has long been a problem in Indonesia. Despite its relatively long tenure as the banking sector supervisory agency, Bank Indonesia capacity to supervise and regulate the banking sector was significantly undermined by its lack of independence prior to the enforcement of Law no. 23/1999. Between 1983 and 1999, the central bank was part of the government, and the Governor of Bank Indonesia was given the status of a Cabinet Minister. Under this structure, the central bank was only a member of the Monetary Board, consisting of several economic ministers with the Minister of Finance as the chairman. This board oversaw the overall conduct of monetary policy and financial sector supervision.⁶

During this period prior to passage of Law no.23/1999, the authority of Bank Indonesia to supervise and regulate the banking sector was severely limited. Bank Indonesia had the responsibility to review new proposals for bank licenses, but not to issue the permits (Djiwandono (1999)). Similarly, the central bank could comment upon or even suggest changes in policies affecting the banking sector, such as raising the compulsory reserve requirements, but the Monetary Board would eventually decide whether or not to fully implement the proposed policy change. The lack of independence and full authority for the central bank to regulate and supervise the banking sector also arguably explains the poor handling of the closure of 16 banks in late 1997 and destabilizing events that took place immediately after that.⁷

⁶ In this period banks accounted for over 90 percent of financial assets and liabilities. Insurance was dominated by state enterprises (JAMSOSTEK) and securities firms were just beginning to grow.

⁷ See Djiwandono (1999).

As has also been the experiences of other economies, there are a number of impediments to assemble an independent supervisory board. Two of the most important impediments are the weak legal system and the budgetary constraints facing the government and the supervisory agency.

5.1.1 Legal and Political constraints

5.1.1.1 Legislative requirement

A new law on the single supervisory board should be prepared and eventually be passed by the Indonesian parliament well before the target operational date of 2010.

This new law needs to explicitly and elaborately lay out the objectives of the new agency and the scope of its authority to enforce effectively its regulations. The agency should have at a minimum the power to require information from financial firms, and to assess the competence and integrity of senior management and the owners of various financial institutions.

Ideally, the supervisory board should also be able to take appropriate sanctions against failures to comply with regulatory rules, including having the ultimate authority to revoke licenses to conduct financial activities. Alternatively, if the “regulatory power” is going to be separated from the supervisory authority, a close cooperation between the two institutions is imperative. We cannot have a case where the regulatory institution(s) would undermine the credibility of the supervisory board. Abrams and Taylor (2000) rightfully argue that under this separation case, the regulatory body must respond promptly to recommendations provided by the supervisory board. If the board’s decision is not acted upon, the regulatory body is required to provide proper reasons in a timely fashion.

Although the scope of the new law should be as comprehensive as possible, it is imperative to leave some room for amendments, especially regarding the details of the operations of the supervisory agency. For instance, the supervisory board should always

be in a position to respond promptly to market innovations. To ensure that the supervisory (and regulatory) power of the board is up to date to deal with sea changes in the financial sector, periodic review and amendment of the law will be required.

5.1.1.2 Political Interference

The strongest guarantee of agency independence in three Scandinavian countries is the transparency of the political process (Taylor and Fleming (1999)). The lack of an established and mature political system in a country often leads to incidences of interference that compromise the independence of the supervisory agencies. Lessons from recent experiences in the restructuring process of the banking sector in Indonesia should provide a clear message on the cost of political intervention. Fane and McLeod (2002) and Enoch et.al (2001) illustrate that government officials often do not have strong incentives to ensure the best outcome from the restructuring process. Quintyn and Taylor (2002) argue that political interference by the Financial Sector Action Committee (FSCA), comprised of a number of economic ministers under the coordinating minister, during the Habibie presidency, have often led to non-uniform application of the rules and the treatment received by the restructured banks.

In a similar vein, the Indonesian Bank Restructuring Agency (IBRA) has proven vulnerable to outside political pressures. During its term (1998-2004), the restructuring agency has had 7 heads, and also had moved between two ministries (the Ministry of Finance and the Ministry of State Owned Enterprises). Needless to say that for the new supervisory agency to work effectively, its senior management must be protected from arbitrary removal.

5.1.2 Budgetary Constraints

Another key impediment to independence is on budgetary. To attain quality staff, the supervisory board must compete with the private sector. The supervisory authority

must also have adequate resources to ensure timely and effective data collection and processing. Therefore the pressing issue here will be on the financing side of the operations of the single supervisory board.

Looking at the experiences of other countries, we again find no single successful approach to the budgetary issue. However, two contrasting approaches are worth discussing. The Financial Service Authority in the United Kingdom is funded entirely through an industry levy. In contrast, the principle sources of funds for the Financial Supervisory Service in Korea are mixed of appropriations from the government, the bank of Korea (the country's central bank), and the financial institutions under its authority.

For Indonesia, we recommend a two-stage approach. The Korean approach of financing the supervisory authority could be adopted at the initial stage of operations. Obviously, too much reliance on the funding from either the government or the central bank may expose the supervisory authority to political interference. Hence, we would emphasize here that the contribution of the government and the central bank should not be the major part of the fund and in anycase should be phased out gradually. There should be a timetable for the supervisory agency to move away from the mixed-financing approach in the direction of the UK system, i.e. a total reliance on an industry levy. Given the importance of this budgetary issue, it is also strongly recommended that this matter will be well specified in the new Law on the supervisory authority.

5.2 Accountability

The need for supervisory independence should be balanced by the corresponding requisite that the agency be held accountable for its policies and actions. In the past, we have seen how the action of the supervisory agencies in Indonesia had substantial impacts on the market (especially the financial industry), the overall macroeconomic policies of the government and even the political environment.

Therefore, it is imperative that a committee consisting of representatives from the financial industry, the government, the central bank and the parliament be established to periodically evaluate the performance of the supervisory authority.

6. Strengthening Supporting Infrastructure in the Financial Sector

The experiences of other countries have shown that the effectiveness of a single supervisory authority is likely to be very low during an initial transition period. Weak supervision in turn will likely raise opportunities for potentially risky activities by financial institutions. As evidenced in many crisis-affected East Asian economies, including Indonesia, there are a number of incentives for weak financial institutions to expand their exposure to risky projects once they are fully protected under various restructuring schemes introduced at the early stages of a financial crisis. This situation, therefore, leads us to further emphasize the need to strengthen the supporting infrastructure prior to the establishment of a single supervisory agency. The sub-sections discuss what this entails.

6.1 Moving Away From Blanket Protection to a Compulsory Deposit Insurance Scheme.

In late January 1998, the government of Indonesia, in an effort to restore confidence in the banking sector, issued a blanket guarantee of all deposits and other liabilities of the domestic banking system. Although the initial target was to terminate the guarantee scheme by the end of January 2000, the facility continued to be extended well beyond the targeted timetable.⁸

Moral hazard is a danger whenever the government provides any form of “guarantee” or deposit insurance. The blanket guarantee provided incentives for the owners and the management of the domestic banks to continue to absorb deposits from

the market and use them to finance risky projects undertaken either by firms in the same group or by unrelated firms (Fane and McLeod (2002)). With a relatively low CAR requirement (of around 4 percent), the common risky practices of the domestic banks exposed the government in particular and the economy in general to a new round of massive potential losses in the banking sector, and shifted the burden from creditors (depositors) to the tax payers.

Hence, it is imperative that a transparent and self-funded scheme of deposit insurance be established. There have been initial efforts by the Ministry of Finance to gradually establish the Deposit Insurance Agency (DIA). A draft Law of Deposit Insurance Corporation was submitted to the Parliament in September 2003. It is expected that the deposit insurance system becomes operational in 2005. Familiarity with the operations of the DIA should provide valuable input to the future establishment of a single supervisory agency. On the other hand, a poorly designed deposit insurance scheme tends to increase the probability of banking crises (Demirguc-Kunt and Detriagache (2002)).

While waiting for the DIA, it is recommended that the scope of coverage of the present blanket guarantee system be reduced as in the case of Thailand. The coverage limit in that country was first set at 50 million baht per depositor per financial institution, but it was then gradually reduced to 20 million baht to one million baht per depositor per financial institution under the government plan, known as the limited deposit insurance system. Furthermore, the full guarantee accorded to creditors of financial institutions was removed in November 2003

6.2 Settlement System

The payments or settlement system basically consists of the commercial banks and the central bank. In this system, transactions for payment and delivery within the

⁸ At the time of writing this paper (August 2004), the blanket guarantee remains in place.

commercial banks take place and the central bank is responsible to oversee and settle net final transactions. By the nature of the operation of the payments system, the spread of systemic risk in the financial sector lies in the failure of the settlement and payments system. In general, there are two types of risks in the payments system. First is credit risk, wherein a counter-party could not fulfill its liabilities upon maturity and thereafter. Second is liquidity risk, wherein the counter-party could not make payment in full upon maturity, but only afterwards.

Up to early 2001, the settlement system in Indonesia was primarily accomplished under the Net Settlement System. In that system, the final completion process of the payment settlements at the end of a period is achieved by offsetting total payables against total receivables, hence there will only be one net receivable or payable to be settled for each participant account. Under this system, the receiving banks will be exposed to both credit and liquidity risks of the sending banks (Kobayakawa (1997)).

A real-time gross settlement system (RTGS) treats and immediately deals with each transaction of any participant account individually (not in a total lump-sum). The system will allow (suspend) any transaction/payment of a bank to a recipient bank only when its balance is adequate (not adequate). Given the operation of the RTGS in real and continuous time, the system can reduce both types of payment risks. In short, it forces the participant banks to have adequate liquidity if any of them wants to do the transaction. For the supervisory agencies, the Lender of Last Resort, the Deposit Insurance Agency and the Monetary Authority, a well functioning RTGS will provide them immediate information on the liquidity condition of the market. In late 2000, Bank Indonesia introduced the Bank Indonesia-Real Time Gross Settlement System. This facility should play a key role in the overall success of the operation of the financial safety net system in the country. Equally important, smooth and credible operation of the RTGS should enhance the overall liquidity of the financial sector.

6.3 The Judicial System

One of the most important components necessary in implementation of credible supervision of the financial sector is a well functioning legal system. The reform of the legal system has, in fact, been at the heart of the debate on the agenda of political and economic reform in the country in the post-crisis period. Legal reform has the objective of hastening and ensuring the success of the restructuring process of the financial and corporate sectors. The Amendment to the 1905 Bankruptcy code signed in April 22, 1998 for instance was hailed as one of the vital reform measures. The implementation of the law, however, has so far been a disappointment. Lender/investor confidence has been damaged rather than improved by outcomes of cases in the commercial courts.

The high-profile controversy over the Commercial Court's bankruptcy ruling on the PT Asuransi Jiwa Manulife Indonesia (AJMI), for instance, underscored the need for an acceleration of legal reforms. AJMI dodged possible bankruptcy when a three-judge panel on August 23, 2001 threw out a case brought by the disgruntled beneficiary of an unpaid insurance policy for a mere 50 million rupiah, compared to the total assets of AJMI of around 2.1 trillion rupiah at that time (McBeth (2001)).

The number of cases of wealthy businesspeople who have escaped through official negligence continues to rise in Indonesia. The latest one is the case of Adrian Waworuntu, the business consultant from Gramarindo, who is likely to be charged with purposely evading the law after having embezzled Rp 1.7 trillion allegedly in collusion with state-owned Bank Negara Indonesia (BNI) through the issuance of fraudulent Letters of Credit (The Jakarta Post (2004)).

In general, the crucial absence of a law of contempt; pervasive corruption among law enforcers including police, court officials and judges all the way to the members of parliament, mean judgments are rarely implemented (Lev (1998), Lindsey (1998) and Siregar (2001)). Therefore, one vital factor in any plan to improve the legal system in Indonesia is the political commitment of all offices of the government and the parliament.

Ironically, a Presidential Election Bill passed by the House of Representatives in July 2003, facilitates the candidacy of citizens with the status of defendant in running for president or vice president. This underlines further the questionable commitment that the country has in reforming its legal structures.⁹

7. Brief Concluding Remarks

The operations of regulatory and supervisory institutions have been shown to have significant implications for the recovery process since the 1997-1998 financial crisis for most of the affected economies in East Asia (Lindgren et.al (1999), Pangestu and Habir (2002), and Quintyn and Taylor (2002)). In Indonesia, weak and poorly designed regulatory and supervisory boards have consistently been underlined as one of the primary contributing factors to the slow and costly restructuring process of the financial sector. The outcome of recent efforts by the government of Indonesia to reform existing institutions and to design much-needed additional infrastructure in the financial safety net system is therefore going to be critical in shaping the future landscape and stability of the domestic financial sector.

The objective of this study is to highlight a number of primary challenges to the establishment of a single supervisory agency in Indonesia. The list of issues discussed in the paper is not meant to be exhaustive, and obviously more studies are needed in the future. However, there are several issues we wish to re-emphasize as concluding remarks for the paper.

The first and foremost is that the establishment of a single supervisory agency will not automatically resolve the past problems associated with multiple supervisory agencies. Simply changing the structure of the supervisory system will not correct the problems with prudential and market conduct standards, surveillance and enforcement.

⁹ See "Presidential election law reflects democratic flaws: Assembly speaker", The Jakarta Post, July, 7, 2003.

The single supervisory agency is not “a quick fix” tool to address the weakness of supervision of financial intermediaries in Indonesia. Experiences of other countries have shown that making the decision to move to an integrated agency is the easiest part of the process. The actual implementation is going to be the most difficult part.

Furthermore, the risk of the supervisory agency becoming a powerful tool that may be exploited by the incumbent government or political party is very real in Indonesia. The supervisory role of the central bank was one avenue for direct intervention by the government in various aspects of the banking sector, especially before and during the 1997 financial crises. Similarly, there are also much to be learnt from the recent episodes of “political interference” over the operation of the Indonesian Bank Restructuring Agency (IBRA).

Finally, the plan to adopt a unified supervisory agency must come with a commitment to proceed with a much wider scope of economic, judicial and political reforms in the country. The deadline of 2010 for this mammoth task is indeed an ambitious one. However, it does not mean that the country should necessarily abandon its plan to establish a unified supervisory agency. The reform process in the country will continue well beyond 2010. However to help raise the credibility of the single supervisory agency, at a minimum there should be compelling evidence that structural reforms are being undertaken on all fronts well before 2010.

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Table 1: Permissible Activities for Banking Organizations in Various Financial Centers

(Directly or Thru Subsidiaries of the Bank)

Country	Securities¹	Insurance²	Real Estate³	Bank Investment in Industrial Firms⁴
Indonesia	Permitted	Permitted	Not permitted	Not permitted
Malaysia	Permitted	Permitted	N/A	Permitted but Restricted
The Philippines	Permitted for both Universal and Commercial Banks with limitations	Permitted for both Universal and Commercial Banks with limitations	Permitted with limitations for Universal banks only	Permitted with limitations for Universal banks only
Thailand	Permitted	Permitted	Permitted	Permitted but Restricted
Singapore	Banks may hold equity participation in stockbroking firms with MAS approval	Locally incorporated banks may own insurance companies with MAS approval	Limited in the aggregate to 20% of bank's capital	Interests in the excess of 10%, or that give the bank significant influence over the management of a company, require regulatory approval. In addition, a bank may not invest more than 2% of its capital funds in any individual firm.

N/A: No information is available yet (to be confirmed); 1/ Securities activities include underwriting, dealing and brokering all kinds of securities and all aspects of the mutual fund business; 2/ Insurance activities include underwriting and selling insurance principal and as agent ; 3/ Real estate activities include real estate investment, development and management; 4/ Including investments through holding company structures.

Sources: Claessens (2002); Bank of Thailand Reports (Various Years); Bank of Indonesia (various reports), Milo (2004).

Table 2: Selected Banks Selling Insurance and Investment Products**

<u>Countries</u>	<u>Banks</u>
Indonesia¹	Bank International Indonesia; Bank Negara Indonesia Lippo Bank Bank Danamon; Bank Niaga; Bank Pan International (Panin Bank); Bank Central Asia Bank Mandiri, Standard Chartered Indonesia; and Citibank Indonesia.
Malaysia	Maybank; Affin Bank; Bumiputra-Commerce Bank; Southern Bank; Citibank (Malaysia); HSBC (Malaysia); OCBC (Malaysia) Bank; United Overseas Bank (UOB); RHD Bank; EON Bank;
Philippines	Bank of the Philippine Island; Philippine National Bank; Allied Bank; Equitable PCI Bank; BDO Unibank; Security Bank Corporation.
Thailand	Bangkok Bank; Kasikorn Bank; The Siam Commercial Bank; Bank of Ayudhya; The Thai Military Bank; Standard Chartered Nakornthon Bank; Bank of Asia; UOB Radanasin Bank; DBS Thai Danu Bank; Krung Thai Bank; Bangkok Metropolitan Bank; Siam City Bank and Bank Thai.

Source: Various websites of the listed banks and the central banks of the countries.

^{1/} By end 2003, it is estimated that at least 10 banks deliver *bancassurance* with the potential market at around Rp 14 trillion, and at least 15 banks offering mutual funds, mostly based on government bonds (Hidayat (2003)). It is estimated that up to June 2003, around 85 percent (or roughly Rp58 trillion) of the mutual funds were sold via banking institutions.

**/ For each of the banks listed, we examine the list of products and services that the intermediaries provided. In each of them, we find at least an insurance product or an investment product, or both being offered by the banks.

Table 3:
Countries with a Single Supervisor

1. Austria	2. Bahrain
3. Bermuda	4. Cayman Island
5. Denmark	6. Estonia
7. Germany	8. Gibraltar
9. Hungary	10. Iceland
11. Ireland	12. Japan
13. Latvia	14. Maldives
15. Malta	16. Nicaragua
17. Norway	18. Singapore
19. South Korea	20. Sweden
21. United Arab Emirates (UAE)	22. United Kingdom

Source: Source: Martinez and Rose (2003).

Table 4:
Selected Newly Introduced Rules on the Banking Sector Since 1999

1). Requiring banks to appoint Compliance Directors, responsible for ensuring the banks' compliance with existing regulations (BI regulation No. 1/6/1999)
2). Strengthening legal lending limit regulation (BI regulation No. 2/16/2000)
3). Submission of the quarterly and annual financial report to Bank Indonesia (circular letter No. 3/30-31/2003).
4). Application of risk management for commercial banks (BI regulation No. 5/8/2003).
5). Implementation of Know Your Customer Principle (BI regulation No. 5/21/2003).
6). Enhancing the competence and integrity of bankers by imposing a Fit and Proper Test on each bank's shareholders and management (BI regulation No. 5/25/2003).
7). Strengthening Bank Indonesia Supervisory function and the status of bank (BI regulation No. 6/9/2004).
8). Application of risk management for transaction through internet (BI regulation No. 6/18/2004).

Source: Bank Indonesia Website (www.bi.go.id)

Table 5: Ownership Regulations governing banks and Insurers

Countries	Maximum % of bank's shares held by insurers	Maximum % of insurer's shares held by banks	Creation of banking subsidiaries by insurers	Creation of insurance subsidiaries by banks
Indonesia	100% (the placement is limited to 10% of total investment of an insurance company)	100%	Permitted	Permitted
Malaysia	20%	100%	Not permitted	Permitted
Philippines	100% (subject to a limit of 10% of an insurance company's total admitted assets)	100%	Permitted	Permitted
Singapore	100%	100%	Permitted	Permitted
Thailand	10%	10%	Not permitted	Not permitted

Source: Sigma (2002)

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