Q&A: Systemic Impact of Bank Century

Bank Indonesia

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Q & A
SYSTEMIC IMPACT OF CENTURY BANK

1. *Why was it necessary to save Century Bank on 20th November 2008?*

a. The failure of Century Bank transpired amid critical economic and domestic banking conditions attributable to the global financial crisis. Such conditions peaked in November 2008 when pressures on the capital and foreign exchange markets as well as exchange rate stability intensified. Furthermore, capital outflows from Indonesia increased as reflected by the sharp decline in foreign ownership of SBI, SUN and shares on the capital market, which weakened the rupiah against the US dollar to more than Rp12,000 per USD. In addition, the banking system experienced tightening liquidity followed by segmentation in the interbank money market (PUAB). Such critical conditions triggered a **dramatic rise in bank risk. Financial instability rose sharply, which was reflected by the high possibility of a financial crisis in Indonesia.**

b. Due to the deteriorating conditions, if Century Bank was not rescued then contagion would have created instability in the financial system and national economy considering the prevailing global economic conditions.

c. Based on these considerations, on the 20th November 2008 the Financial System Stability Committee decided to initiate the recovery of Century Bank **because the Bank was identified as a defaulted bank with potential systemic impacts.**
2. Which methodology/measurements are used by Bank Indonesia to evaluate whether a bank has systemic impacts?

a. Five aspects are used by Bank Indonesia to analyze whether a failed bank is systemic, namely:
   i. Financial Institutions
   ii. Financial Market
   iii. Payment System
   iv. Real Sector, and
   v. Market Psychology.

b. The analysis framework that utilizes the five aspects mentioned was proposed by the Working Committee for the Financial System Safety Net Bill (Komisi XI-DPR RI) 2004-2009, pursuant to Article 7 of the Draft FSSN Bill.

c. In the analysis of Century Bank as a failed bank with systemic impact, Bank Indonesia used quantitative and qualitative data to assess the five aspects mentioned above. The quantitative data used as a basis for the analysis of Century Bank as a failed bank with systemic impact is as follows:
   i. Macroeconomic conditions, including data concerning economic growth, the balance of payments, rupiah exchange rate, capital market conditions and international financial market conditions. The data was sourced from Bank Indonesia, BPS-Statistics Indonesia, the Capital Market and Financial Institutions Supervisory Agency as well as foreign financial publications;
   ii. The decline in DPK (as an indicator of falling confidence) sourced from the Monthly Commercial Bank
Report as well as direct supervision by supervisors from Bank Indonesia;

iii. Interbank stress-testing (contagion effect) sourced from Bank Indonesia reviews using LBU data;

iv. Bank liquidity simulations (against 18 peer banks and 5 banks with similar total assets to Century Bank) sourced from Bank Indonesia reviews using LBU data and supervision data;

v. Impacts on the payment system, sourced from real-time gross settlement and clearing data administrated by Bank Indonesia.

3. Why was Century Bank categorized as a failed bank with systemic impact?

According to the methodology described above, a summary of the analysis to illustrate the Bank’s conditions at that time is as follows:

a. Characteristics:

   • The Bank experienced liquidity shortfalls commencing in July 2008, as reflected by several statutory reserve requirement violations.
   • Century Bank failed clearing on 13th November 2008 due to technical factors, namely a late prefund application.
   • Conditions at Century Bank sparked rumors that undermined public confidence and affected the performance of other banks.
• Despite the shocks in the financial/banking sector remaining sporadic, 23 banks and several rural banks simultaneously experienced extremely low liquidity due to the issues mentioned. Concerns arose that the problems would escalate rapidly and spread to other banks.

b. Real sector and financial system conditions:
• With deteriorating global economic and financial conditions, the domestic financial system was continuously under pressure. This was shown by a drop in the Jakarta Composite Index and a decline in SUN prices, which had the potential to trigger capital flight overseas due to the lack of a full guarantee in Indonesia.

• The balance of payments was under pressure, foreign reserves shrunk, country risk in Indonesia increased and the rupiah depreciated. Domestic demand remained relatively strong despite initial signs of a slowdown in Q-III/2008 expected to reduce imports. However, the rise in foreign debt servicing in Q-IV/2008 required additional caution, especially in terms of the availability of USD and exchange rate instability. Furthermore, the slowdown in economic activity had the potential to exacerbate non-performing loans.

• Conditions in the private sector deteriorated. Various information showed that the private sector was considering several corrections in the form of increased labor, higher production costs and redundancies.

• The response from the Government and Bank Indonesia in order to placate the market was to ease liquidity, raise the
deposit guarantee limit to Rp2 billion, guarantee the availability of foreign exchange to domestic companies, etc. However, the measures taken required an inherent lag before their effectiveness could be gauged.

- Meanwhile, in the face of shocks and a potential financial sector crisis, the Government promulgated three regulations in lieu of a law (PERPPU), namely those pertaining to the financial system safety net, the DIC Act and the BI Act.

c. Analysis of Century Bank’s role in the Economy

- The role Century Bank played in the economy can be seen from its function, namely intermediation and allocating credit, the size of the bank, and the relationship of the bank with other financial institutions. The Bank Indonesia evaluation in November 2008 found that Century Bank’s role in this regard was NOT SIGNIFICANT.

- However, in terms of the number of customers and bank branches, Century Bank can be categorized as relatively large (65,000 customers) with a network stretching throughout Indonesia (30 branches and 35 sub-branches).

- Under non-crisis conditions, the closure of Century Bank would not be expected to trigger systemic impacts on other banks.

- However, under crisis conditions when banks are susceptible to negative news, the closure of a bank has the potential to create contagion, primarily among its peers or smaller banks, which can lead to flight to quality.
Therefore, if the decision was made to close Century Bank, then the closure would undermine public confidence in the banks mentioned and the effects could influence financial system and banking system stability as a whole.

d. Impact of the Closure of Century Bank on the Financial Market

- The situation of the financial market in the second half of 2008, in particular approaching year-end was extremely vulnerable and easily swayed by negative news. The capital market experienced a continual decline in share prices, including bank shares and shares in other financial sectors. Furthermore, the capital market was even suspended twice. Foreign investor confidence in the Indonesian capital market plummeted.

- Meanwhile, the interbank money market (PUAB) experienced segmentation where banks that usually borrowed from PUAB reduced supply to the market.

- The SUN market experienced a decline in prices, which affected corporate bond prices.

- Credit default Swap (CDS) spread in Indonesia increased dramatically as reflected by the increase in country risk. CDS in Indonesia shifted from the range of 350 bps to more than 1200 bps in less than one month in October 2008. (as a comparison, CDS in Indonesia was less than 200 bps in November 2009).

- Holistically, the handling of a failed bank that is not comprehensive will damage financial sector performance and subsequently undermine international confidence.
e. Payment System Analysis

- Market segmentation in the interbank money market (PUAB) became more widespread in November 2008. Data from the final week leading up to 20th November 2008 demonstrated that PUAB transactions only occurred among banks in their respective groups (large banks, small and medium banks). If the medium-sized banks caused flight to quality or capital outflows then small banks would experience liquidity shortfalls. Liquidity shortfalls could not be overcome by PUAB because the large banks that usually supply funds to the market limited their supply.

- Supervision indicated that 18 peers of Century Bank had the potential to experience liquidity shortfalls if flight to quality occurred.

- Meanwhile, if Century Bank was closed five other banks with similar characteristics would also experience liquidity shortfalls due to, among others; these five banks had placements at Century Bank.

- The emergence of rumors or negative news regarding tight liquidity at the 23 banks mentioned would rapidly trigger panic and the potential of a bank run. With the segmented condition of PUAB payments between banks through the payment system, particularly RTGS and clearing would experience gridlock. Such conditions are extremely dangerous for banking system stability.
• PUAB segmentation could actually be overcome if a full blanket guarantee was implemented as expected by the banking community in 2008.

f. Conclusion of the System Analysis based on the Five Aspects mentioned

The decision to identify Century Bank as a failed bank with systemic impact was based on analysis results and professional judgment deemed adequate and accountable. This takes into consideration the analysis mentioned as well as macroeconomic and financial aspects, goodwill, public benefit, and transparency.

This can particularly be seen from the analysis as follows:

• **Through the payment system: medium to high impact.**
  The closure of Century Bank is expected to cause a rush on peer banks and smaller banks, which will affect the effectiveness of the payment system.

• **Through the financial market: medium to high impact.**
  Closure of the Bank would create negative sentiment in the financial market, especially in terms of susceptibility to news that will damage trust in the financial market.

• **Through Market Psychology: medium to high impact.**
  Failure of the Bank will create additional uncertainty in domestic markets, which could be fatal for market psychology that is currently sensitive.

• **Through Financial Institutions: low to medium impact.**
Institutionally, the closure of Century Bank will not have any significant impacts on the banking sector because the Bank’s share in this sector is relatively small.

- **Through the Real Sector: low impact.**
  As the role of the Bank in terms of extending credit to the real sector is not significant the closure of Century Bank will have relatively limited impact on the real sector.

From this analysis, the problems experienced by Century Bank have the potential to trigger systemic impacts primarily through market psychology, the payment system and the financial market.

4. **Is it correct to assume that the systemic analysis of Century Bank was hurried?**

The accusation that the analysis was hurried in incorrect because of the following:

a. **The quantitative and qualitative data used as well as the results of the banking system sustainability review were always reported and presented at the regular Bank Indonesia Board of Governors' Meetings (both weekly and monthly)** ensuring that the governors had up-to-date information to take monetary and banking policy. **Since 28th October 2008, when the governing board initiated Crisis Management Protocol as a way to identify threatening monetary and banking situations, reports and reviews regarding monetary and banking conditions have taken place daily. Also included is information about negative news**
and rumors that could affect market psychology or public confidence. This information and data is presented to the Financial System Stability Committee.

b. Therefore, the Board of Governors have sufficient data and information regarding the conditions and vulnerabilities of the financial system and banking sector to take decisions in order to prevent a crisis and maintain financial system stability.