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Research Article

Deposit insurance and financial intermediation: The case of Indonesia Deposit Insurance Corporation

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Abstract

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The article analyzes the impact of the establishment of the Indonesia Deposit Insurance Corporation. The analysis shows that the establishment of the Indonesia Deposit Insurance Corporation has had a significant impact on the financial intermediation in Indonesia. The article discusses the technical aspects of the Indonesia Deposit Insurance Corporation and its role in the financial system. It also discusses the impact of the Indonesia Deposit Insurance Corporation on the behavior of banks and depositors. The article concludes that the establishment of the Indonesia Deposit Insurance Corporation has led to an increase in deposits and a decrease in the risk of bank failures. The article also discusses the impact of the Indonesia Deposit Insurance Corporation on the behavior of depositors and the development of the financial system in Indonesia.

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strengthened by expectations of future government intervention for systemically important banks, raising fears of too systemically important to fail problem and continued political intervention in IDIC policymaking. Overall, IDIC establishment by bolstering public confidence in the banking system has reduced the possibility of a repeat of highly destabilizing runs on banks, hence has contributed to better financial intermediation and financial stability. However, rising moral hazard means that future bailouts are still unavoidable.

Keywords: Intermediation deposit insurance risk premium moral hazard

Public Interest Statement

The establishment of the Indonesian Deposit Insurance Corporation (IDIC) was aimed to prevent a repeat of financial instability that occurred in the aftermath of 1997/1998 economic crisis. The article analyzes the impact of IDIC establishment on the behavior of commercial banks, savers, and borrowers. Results showed an increase in bank deposits and bank credit. In the immediate aftermath of IDIC establishment, while bank deposit level remained unchanged, its composition showed a shift from time and demand deposits to saving deposits with balance that fell within the threshold of IDIC program. Savers also indicated preference for deposit savings in state-owned banks and foreign exchange banks over national private banks and regional development banks. Such behavior seems to wane in the medium term, which attests to restoration

of public confidence in the banking system. The study also shows that the establishment of IDIC enhances custodial services and bank intermediation. The study also shows that the establishment of IDIC enhances bank intermediation and bank credit. The study also shows that the establishment of IDIC enhances bank intermediation and bank credit. The study also shows that the establishment of IDIC enhances bank intermediation and bank credit.



1. Introduction

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institutions and markets is inextricably linked to the development process itself (Claus, Jacobsen & Jera, [2004](#)), and level of financial development is a “good predictor of economic growth, capital accumulation, technological advancement”(Levine, 1997). The banking sector dominates the financial sector in developing countries in terms of assets, hence they form the core of financial intermediation function. Nonetheless, the commercial banking business model is highly leveraged as it attracts short-term third-party funds at lower cost, transforming them into long-term securities (Gertler, [1988](#)), which are subsequently sold to creditors earning the bank higher return. With experience coupled with regulation on prudential banking, banks at any point in time keep just a small percentage of third-party funds they mobilize to meet daily expected cash withdrawals, while investing the remainder in long-term assets that include loans, bonds, and other financial securities. The foregoing encapsulates the working of a fractional reserve banking system (Cochran, Call, & Glahe, [1999](#); O’Leary, undated; Gray, [2011](#)). The problem is that the bank faces maturity transformation risk because in the event there is a surge in demand for cash withdrawals that is attributable to depositors fearing losing their money, rush to the bank in droves to withdraw their money (bank runs) not in only one bank but in a wave that affects many banks in the financial system.¹ That creates a serious problem that forces banks to first seek assistance from other banks through interbank market, then lender of last resort, and finally if all that fails to deliver, resorting to selling assets at fire sales, recall loans before maturity, among other efforts, all of which undermine their solvency in the process. Banks dominate the financial sector in developing, and to a large extent transition economies in terms of assets, hence they form the core of financial intermediation function in these economies (Clausen & Jera, [2003](#)), by providing the bulk of the financial assets. One of the key factors in the financial development of these economies is the provision of financial units (savings and loans) by banks. Thus, besides the provision of financial units, one of the key factors in the financial development of these economies is the provision of other financial services, which is one of the key factors in the financial development of these economies. In the event of a bank failure, the provision of financial units is one of the key factors in the financial development of these economies. The cost of bank failure is one of the key factors in the financial development of these economies. The demand for financial units is one of the key factors in the financial development of these economies.



banking system, and financial system, which ensures financial stability, while at the same time minimizing potential cost from moral hazard, principal agency, and adverse selection problems.

By averting the need for owners of demand deposits to make sudden withdrawals of their deposits at higher-than-normal levels, which would cause liquidity problem for banks as they scurry for funds to meet higher-than-normal cash demand, would in turn cause financial problems for non-financial sector. The importance of deposit insurance has become so vital for financial stability that many now consider it to be a "logical step in strengthening the financial sector's infrastructure (Frolov, [2004](#)).

Incontrovertible evidence succinctly points to the many benefits of a well-designed explicit deposit insurance scheme, including lowering transaction cost, fosters the smooth running of the payments system, enhances efficiency in resource allocation, increases public trust (confidence) in the banking system that is vital for stable financial intermediation, bolsters enterprise growth, innovations, productivity and production of goods and services, fosters industrialization (Hicks, 1989), all of which contribute to higher economic growth (Demirgüç-Kunt & Kane, [2002](#)). Stable and predictable financial stability strengthens financial stability that is essential for financial innovation. Financial innovation, in turn creates conducive conditions for financial deepening, which enhances economic development (Shaw, [1973](#); Gross, [2001](#); McKinnon, [1973](#); Fry, [1978](#); Taguch, [1993](#); Demirguc-Kunt & Ross, [2001](#); Kiyotaki & Moore, [2005](#)).

The objectives of this research are (1) to determine the influence that the Indonesia

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heightened risk aversion of banks had on lending in general and to risky sectors in particular. Premiums participating banks pay, besides having to meet the criteria of deposits preset by IDIC, are also dependent on bank risk profiles. Lending, while vital for the economy, is a major source of risk for banks not only with respect to insurance premiums they pay but also risk-weighted capital and liquidity they are required to put in place, all of which lower profitability, and return. One of the principal aims of IDIC was to reduce the cost of troubled banks on state coffers as bailouts are effected from accumulated premiums. Nonetheless, as the case of Bank Century showed, politics continues to play an important role in decisions that IDIC makes with respect to providing capital injections, restoration, and recovery for troubled banks. While the criteria of systemically important banks are theoretically clear, in practice it remains a gray area that lies between IDIC powers and authority and those vested in the macroprudential authority (the central bank) and the Ministry of Finance of the financial system. More clarity is needed on the powers and authority of IDIC and those vested in the central bank and Ministry of Finance with respect to troubled banks. Meanwhile, to mitigate politics influencing IDIC decision on troubled banks in future, the categorization of banks by systemic importance to banking and financial system should be made ex ante as recommended in financial stability authority instead of ex post. Equally important, there is need to strengthen IDIC independence in its decision policymaking, which is unlikely to happen any time soon as long as IDIC management is appointed and approved by the executive and legislative branches of government, respectively. The rest of the paper is presented as follows. Section [2](#) discusses literature review, followed by Section [3](#) that describes research methodology. The penultimate section presents the empirical results, and the final section concludes with policy implications.

2. Literature



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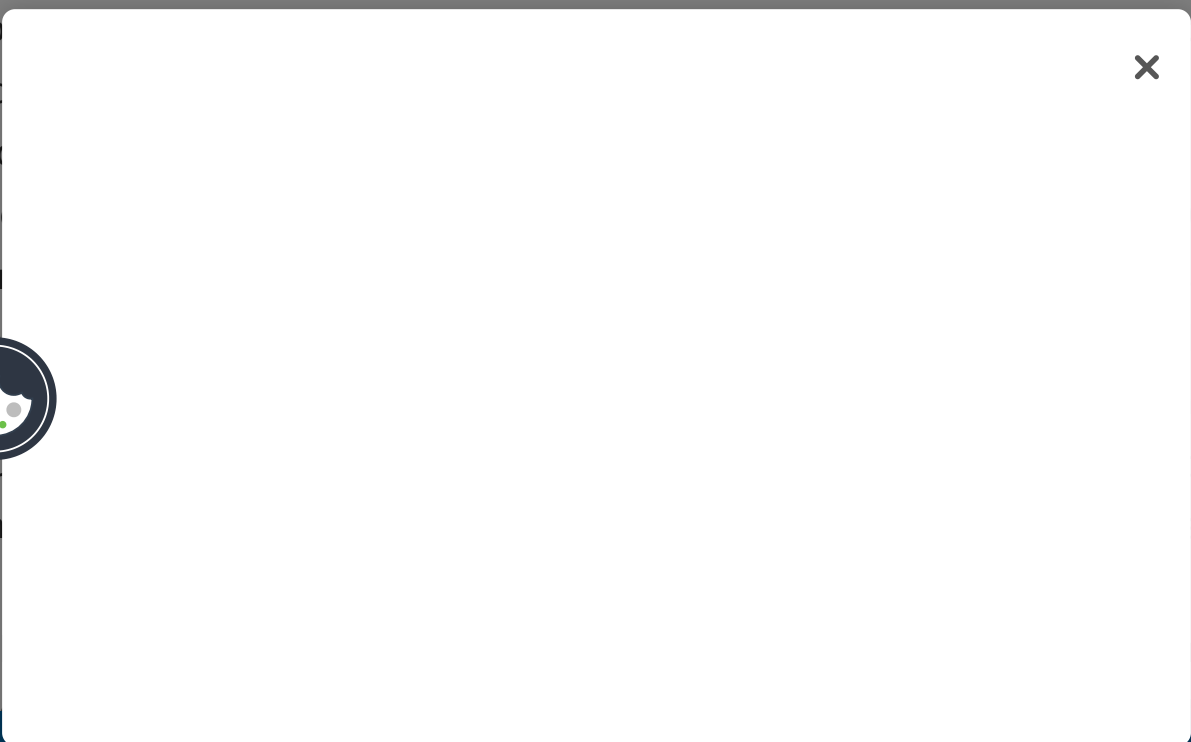
insurance protection for all deposits (blanket guarantee) (Demirgüç-Kunt & Kane, [2002](#); Garcia, [1999](#)).

Nonetheless in practice, deposit insurance schemes take two forms,² implicit and explicit. Implicit deposit protection schemes are not based on stated rules but conjectures that are discernible from previous government actions, while explicit deposit protection schemes have stated rules that delineate the terms and conditions, extent of deposit coverage, and guarantee (Mitchel, [2007](#)). Deposit insurance also differs by objectives of the scheme in place, with voluntary schemes allowing coverage for deposits in banks that pay premiums and exempting those banks that don't pay premiums (and some are comprehensive, obliging all banks to participate in the scheme (Indonesia is one such case), while others are broad in nature and cover various types of deposits.

The incentive structure of an effective deposit insurance system must be in line to reflect the three sources of internal governance mechanisms inter alia board of directors, management, and shareholders; actions of depositors, borrowers, and creditors; and regulatory restraint that is imposed by legislature and implemented by supervisory authority (Garcia, [1999](#)). Failing to achieve that makes deposit insurance programs susceptible to adverse selection, moral hazard, and agency cost problems, increase risk on depositor money, and exacerbates public trust in the financial system, which in turn reduces monetization of the economy, hence financial development (Cull, [1998](#)). Indeed, generous explicit deposit insurance is found to induce bank risk-taking behavior and contributes to bank fragility and eventual crisis. Worth noting as well is

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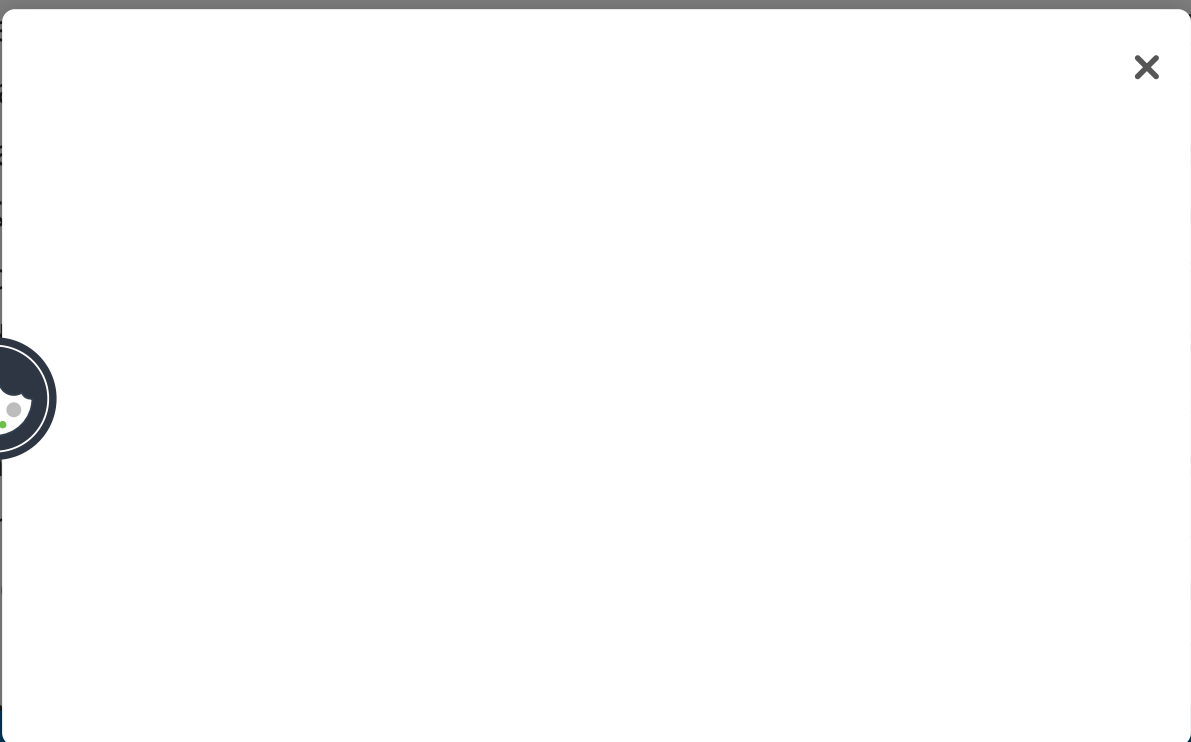
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scheme. It is also found out that the temptation for insured banks to undertake higher risk investment without increasing capital levels as prudential principles would warrant is higher in a highly competitive banking environment, a tendency that increases banking fragility and potential for a banking crisis.

Nonetheless, explicit deposit insurance encourages moral hazard, adverse selection, and agency problems. Moral hazard, which according to Kambhu, Schuermann, and Stiroh (2007) refers to “changes in behavior in response to redistribution of risk,” which in the case of deposit insurance entails the depository institution making riskier investment decisions because it doesn’t have to “meet all the costs caused by bad outcomes,” while depositors in making their saving decisions no longer differentiate between sound and unsound depository institution (for instance, Ioannidou and de Dreu 2005 found that explicit deposit insurance encouraged indiscipline by large depositors). In other words, moral hazard reduces the incentive for bank managers, bank owners, depositors, regulators, and politicians to care much about bank soundness (Garcia, 2000). This is attributed to the fact that depositors, upon ensuring that their deposits are insured, no longer have the interest to monitor bank actions as their money is insured; banks engage in riskier investment than would be the case without insurance and that without having to pay higher interest to depositors or demand from investors on loans disbursed since in the event of bank failure depositor claims are met by the insurance agency.

Moreover, riskier bank investment, which is made in the aftermath of insuring bank deposits, generates high profits (because they generate higher returns), which are to the benefit of bank managers and owners. This is because of the moral hazard created by deposit insurance. Deposit insurance encourages banks to take on more risk because of the premium they pay for insurance. This is because of the moral hazard created by deposit insurance. Deposit insurance encourages banks to take on more risk because of the premium they pay for insurance. This is because of the moral hazard created by deposit insurance. Deposit insurance encourages banks to take on more risk because of the premium they pay for insurance.

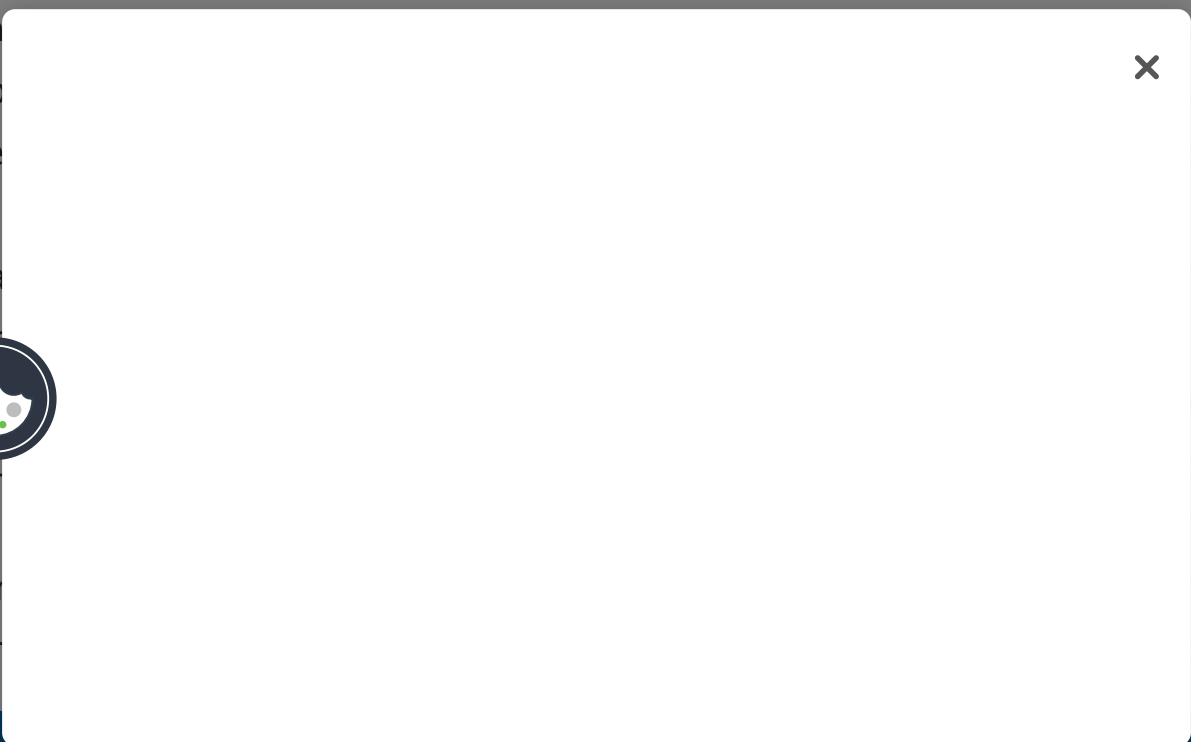


[2002](#); Garcia, [1999](#); McCoy, [2007](#)). Laeven ([2002](#); Cull et al., [2004](#)) finds that explicit deposit insurance and government bailouts (ambiguous policy stance on deposit insurance) increase the opportunity cost of insurance services, an effect that rises with the degree of bank concentration, while Akerlof and Romer ([1993](#)) found strong correlation among deposit insurance, low capital ratios, and excessive risk taking, and Demirgüç-Kunt and Detragiache ([1997](#), [2002](#)) established a positive correlation between explicit deposit insurance and systematic bank insolvencies, which is in part attributable to moral hazard.

Adverse selection arises from IDA setting premiums that do not reflect risk profiles of participating depository institutions, creating a disincentive for large depository institutions, which leads them to withdraw their participation from the program. With fewer participating depository institutions, deposit insurance premiums are raised, making sound banks even more reluctant to join the program.

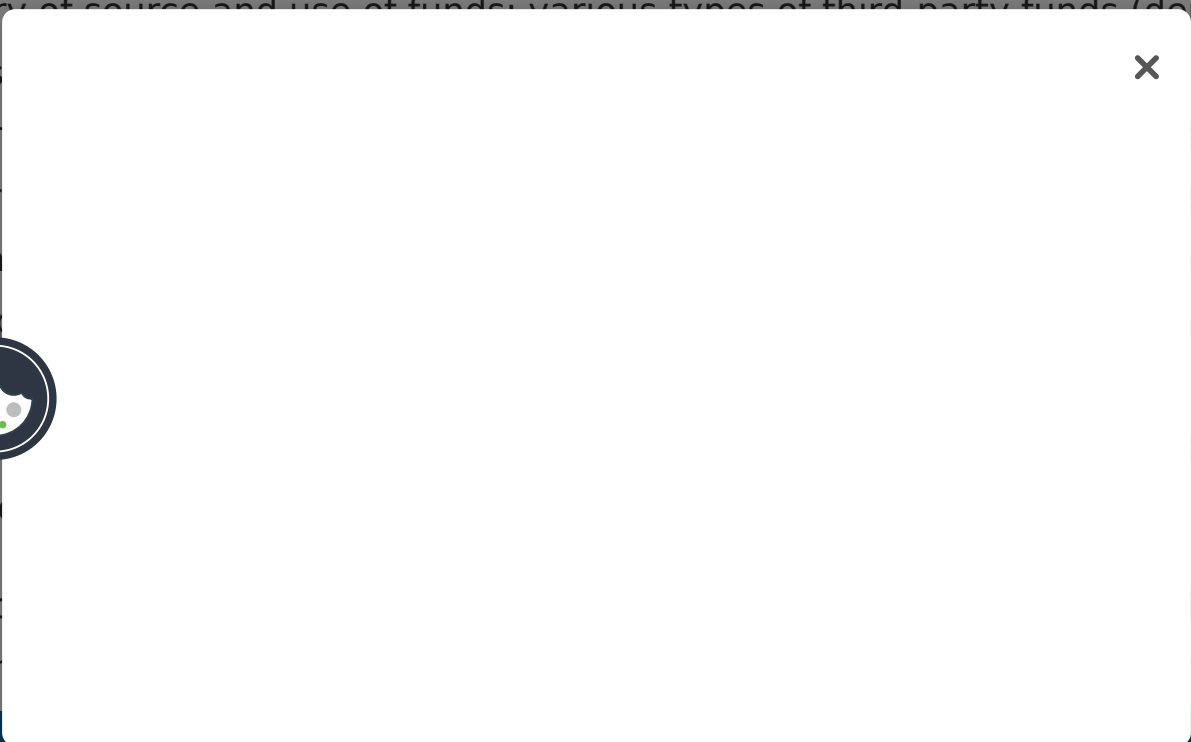
Meanwhile, the principal agency problem⁴ relates to activities and actions of shareholders of depository institutions, management, regulators, DIA, and politicians that enhance their interest (agents) at the expense of the taxpayers who are the ultimate bearers/payers of risk. This is rooted in differences in the interests and source of incentives between financial institution regulators, who influence the timing of the closure of insolvent banking institutions on one hand, and taxpayers and DIA on the other. DIA officials, who are the agents, may decide to delay the closure of troubled banks in order to conceal past laxity in monitoring and supervision, and wait for improvement in economic conditions on the assumption that should reduce liquidity

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3. Research methodology

The research observes all commercial banks in Indonesia, which comprise state-owned limited liability banks, national private banks, regional development banks, and foreign and joint venture banks. As regards data used, the research was based on secondary data that were obtained from Bank Indonesia. The data included number of all commercial banks in Indonesia, with their respective categories; deposits mobilized by different categories of commercial banks in Indonesia in during the observation period; credit disbursed by commercial banks by type of bank in Indonesia during the March 2000–March 2007 period. While data analysis using multiple regress used data for the 2000–2016 period, data for trend analysis was limited to the March 2000–March 2007 period. This was largely because of the need to observe the trend in the relevant variables prior to IDIC establishment and during the transition phase from full blanket guarantee to fully fledged limited deposit insurance guarantee (September 2005–March 2007). Data on all variables that were used were obtained from Bank Indonesia (central bank) and the financial services supervisory agencies (OJK). Meanwhile, analysis techniques used included technical and analysis of variance. Technical analysis involved establishing the trend (if at all any) of the data during the period of observation (March 2000–March 2007), which was expected to help in identifying patterns, if at all. Trend analysis was conducted on three levels, inter alia: (1) the commercial bank level in general, (2) category of commercial bank level, (3) and rural banks level. Data analysis was based on trend analysis of indicators and multiple regression. Using quarterly data, trend analysis involved mapping the composition and trajectory of source and use of funds: various types of third party funds (demand deposits, deposits of commercial banks, deposits of rural banks, and rural banks; a consumption period, induced a test was conducted. The second established funds used



Data on bank assets by type of banks was used to control for bank size in analyzing the variance in sources and uses of funds for commercial banks.

Multiple regression was the third analysis technique used. The multiple regression model used was as follows:

$$BC_t = \beta_0 \text{CONSTANT}_t + \beta_1 \text{BIC}_t + \beta_2 \text{BD}_t + \beta_3 \text{L}_t + \mu_t$$

where BC is bank credit, BIC is Bank Indonesia certificates, and L other variables that influence bank credit. Data was transformed into natural logarithms, after which tests for normality and serial correlation were conducted, with results indicating that variables suffered from serial correlation. To that end, data was either differenced or included AR (1 to 2) and time trend terms in the least-squares model to solve that problem. Interpretation of multiple regression coefficients was based on the significance error of 5%. In other words, if the probability value (p-value) of the coefficient estimate was smaller than 5%, the alternative hypothesis was not rejected (null hypothesis rejected), and on the contrary, when the p-value of the coefficient estimate was larger than 5%, the null hypothesis was not rejected, and the alternative hypothesis rejected.

4. Results and discussion

4.1. IDIC and impact on financial stability

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indebtedness, poor risk management practice (high gross Non Performing Loans (NPL) of 9.3% 1996, 58.7%⁶ in 1998, 8.1% in 2003; and higher-than-threshold affiliated party lending (Brown, [1999](#); Sato, [2005](#))). However, the deep-seated nature of problems besetting Indonesian banking industry came to a head during 1997/1998 economic crisis when economic growth plummeted by -13.7% in 1999, national currency suffered depreciation from US\$/IDR2,500 (1996) US\$/IDR12,000, spike in inflation from 15.7% (February 1997) to 21.7% (February 1998), unemployment surged from 4.7% (August 1997) to 5.5% (August 1998), and underemployed rose from 35.8% to 39.1% (Basri, [2013](#); Sumarto, Suryhadi, & Widyanti, [2002](#)).

Countercyclical policies that Bank Indonesia adopted worsened bank liquidity, while eroding bank assets as default rates surged to (NPLs soared to 27%). Some of the policy measures taken to stem the tide included Bank Indonesia with the collaboration of the Ministry of Finance injected Bank Indonesia liquidity support in the value of IDR145 trillion, closure of some banks, injection of US\$47 billion in government bonds to recapitalize almost the entire banking system, and strengthened financial stability by establishing the financial sector stability committee (KSSK), which with the collaboration of Bank Indonesia and Ministry of Finance was charged with macroeconomic surveillance for potential signs of instability in the economy and recommending corrective measures.

Enactment of the new banking law no. 10/1998 and Bank Indonesia law no. 23/1999, as amended by law no. 3/2004 and Bank Indonesia regulation No. 8/8/PBI/2006, laid foundation for a new banking system and independent central bank. Other measures to

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emergence of a “strong, sustainable financial intermediation function” in the banking sector in Indonesia. The establishment of IDIC was expected to protect customer deposits in commercial banks and rural banks, and monitor potential risk in the Indonesian banking system likely to drain insurance funds.

Moreover, in IDIC regulation no. 5/PIDIC/2006 on handling insolvent banks with potential systemic risk,⁹ and the corporation is also responsible for dealing with unsound banks with potential systemic risk (which are recapitalized), and unsound banks without potential systemic risk, as declared by the banking supervisory agency. In other words, IDIC bequeathed the roles played by the defunct Indonesian banking restructuring agency (all commercial banks are obligated to participate in the Indonesia deposit insurance policy). The IDIC, equipped with initial capital of IDR500 billion injected by the state, became operational on 22 September 2005. The deposit insurance program entailed a phased reduction of the maximum level of deposits per account in Indonesian commercial banks covered by the IDIC insurance program.

If during 22 September 2005–21 March 2006 no maximum was set on a single account, the figure dropped to IDR5 billion during 22 March 2006–21 September 2006.

Subsequently, during 22 September 2006–21 March 2007, IDIC program covered a maximum of IDR1 billion savings on a single account, a figure that dropped to IDR100 million with effect from 22 March 2007¹⁰ to this day.¹¹ Guaranteeing savers’ deposits in the Indonesian banking system is vital for reducing the potential risk of recurrence of the debilitating bank runs sparked off by one, two, or so banks, facing liquidity problems, mismanagement, operations that trigger a plummet in public confidence in

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means that deposits are considered safer in banks that fulfill their obligations with respect to premium and are operated on prudential principles with respect to capital/equity, bank asset risk, management, and liquidity (CAMEL¹² framework).

Additionally, participating banks are required to pay membership fee, which is 0.1% of bank equity; submission of copies of bank soundness, statements of shareholders, commissioners, and directors; statement of the establishment of the bank; operational permit of the bank; report of savings position; monthly financial report, audited annual financial report or report submitted to the bank supervision agency,¹³ report of the composition of shareholders, controlling shareholders for cooperative banks, directors, and commissioners. It is also imperative for participating banks to display evidence of their participation in IDIC program in places that are easily accessible and seen by the general public. The timing of the establishment of the IDIC can be related to the resurgence of public confidence in the banking system attested by rising credit deposit mobilization, bond issuance, and credit disbursement has served as signals for the government to reduce the huge cost it has been incurring since the issuance of the full blanket guarantee policy. Apparently, think tanks in the finance ministry considered the right time to relinquish some of the burden embodied in a full deposit guarantee policy in place since 1998 to the public and commercial banks to bear more responsibility and cost, attendant to the level of risk of their investment decisions. This is the spirit underlying the establishment of the IDIC in September 2005.

The conduct of the deposit insurance program calls for the determination of the applicable interest charged on deposits that qualify for insurance coverage. This is done

by the IDIC. The establishment of the IDIC replaced the full blanket guarantee policy of the government in place since 1998. The IDIC is managed by the general public through the establishment of the IDIC. The IDIC is a non-profit organization established to guarantee the safety of deposits in the banking system. The IDIC is a non-profit organization established to guarantee the safety of deposits in the banking system. The IDIC is a non-profit organization established to guarantee the safety of deposits in the banking system.

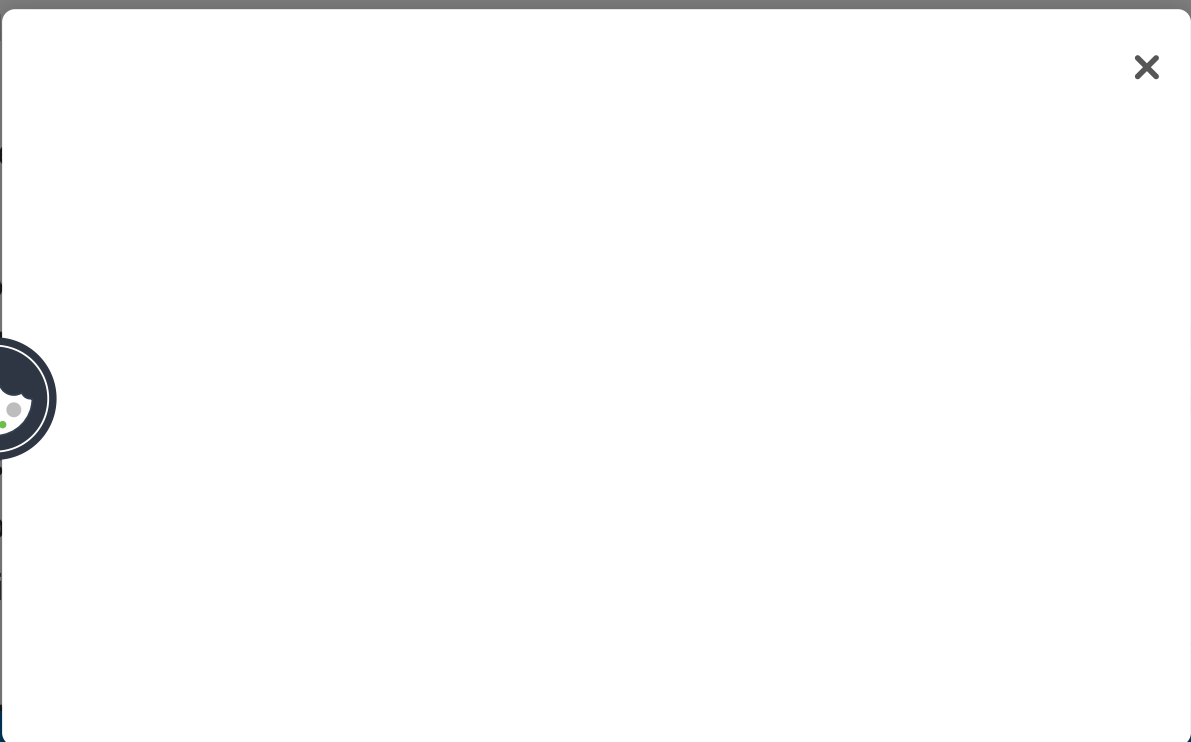
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deposits was 4.50%.¹⁴ Interest rate on deposits in commercial banks and rural banks covered by the IDIC program is reviewed on a regular basis, or in case of need, in accordance with Bank Indonesia (Indonesia Central Bank) interest rate policy.

Thus, the establishment of the Indonesian Deposit Insurance Agency is one of the policies enforced to prevent the recurrence of a 1997–1998 drastic plummet in public confidence in the banking system, which spiraled out of control leading to debilitating systemic bank runs, costly government liquidity and recapitalization bailout packages, financial disintermediation, and economic contraction with concomitant falling aggregate demand, and rising unemployment. The measures are aimed at ensuring stable financial intermediation to economic agents even during an impending financial and economic crisis. In that light, deposit insurance policy must be considered as integral to efforts to strengthen financial that emanate from domestic misalignment problems and external factors, beyond the control of a small open economy. Even the best deposit insurance works in a macroeconomic environment that is stable, predictable. Thus, well-designed deposit insurance programs are as effective as supporting macroeconomic environment, manifested in sound financial institutions, responsible monetary and fiscal policies both domestic, regional, and international. This underscores the importance of various initiatives tailored to ensure current and future financial and economic stability at the national, regional, and international levels.

The IDIC, which came into effect in 2005, created a new regulatory regime that in effect transferred the risk that depository institutions had borne, in the event, of a financial crisis that undermined repayment capacity of lenders, from banks to the DIA. What was

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know that IDIC bears the ultimate risk for third-party funds that fall under its deposit insurance guidelines; and risk aversion from lenders, especially to sectors that are traditionally considered risky (agriculture, especially food crops production, fisheries, and livestock); and micro-, small-, and medium-size enterprises. Thus, there is little doubt that the evolution of the new regulatory regime forces banks to reposition themselves in line with the new high credit risk conditions. Disbursing credit to a sector or enterprise that is feasible but not bankable is now difficult, if not feasible, to do. This is because economic activities funded by the bank significantly impact on the calculation of a bank's risk-weighted assets, thereby the level capital (adequacy) it must have on its books. Issuing loans to economic activities such as micro-, small-, and middle-size enterprises impacts negatively on a bank's risk-weighted assets, and in compliance with prudential banking principles induces banks to increase the size of equity on the bank's books.

4.2. IDIC and bank performance

This research uses chart analysis and analysis of variance to determine the influence, if at all, the establishment of deposit insurance has had on operations of commercial banks in Indonesia. Indicators of bank performance used include bank intermediation indicators: mobilization of third-party funds (deposits: demand, time, and saving; bonds issued and loans received), and loan disbursement (working investment and consumption credit), Bank Indonesia certificates held; and the trend in bank assets and equity.

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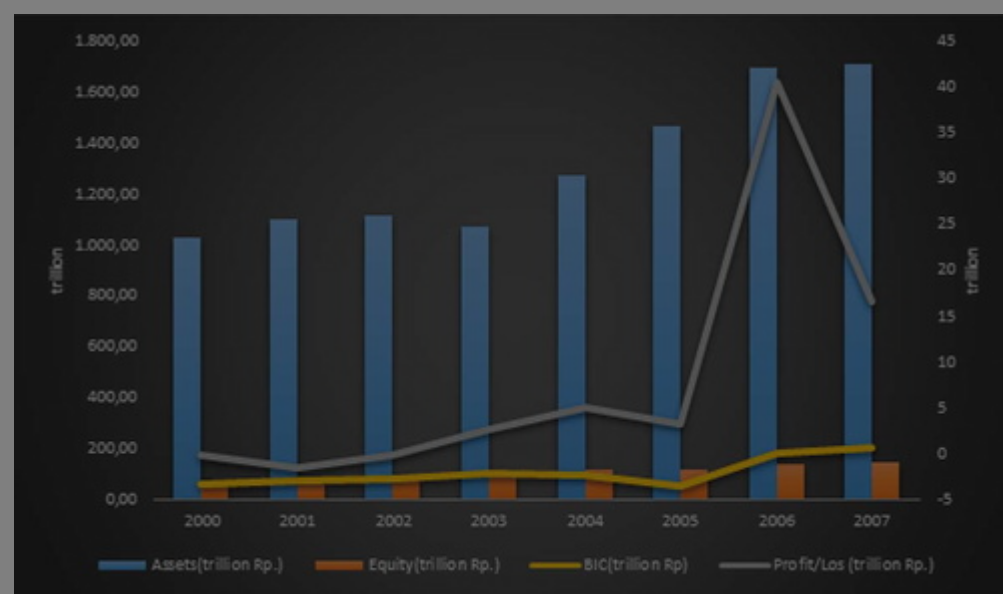


sparked off precautionary measures in bank operations. However, slow growth in 2006 and 2006 in Bank Indonesian certificates points to an interesting signal that the spike in Bank Indonesian certificate holdings was only temporary “adjustment” perhaps to see how things go, and then once it became clear that the rules of the game had changed fundamentally as were the operations, banks then resumed their activities factoring in of new variables in their operations.

Figure 1. Trend in Assets, Equity, BIC, and Profit and Loss, 2000-2007.

Note: *BIC stands for Bank Indonesia certificates.

Source: Bank Indonesia.



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In June 2007, the NPL ratio declines further (6.40% of all loans disbursed). However, the fear by banks of potential risk is reflected in a decline in the performance of loan to deposit ratio (LDR) in late 2005, but recovers in 2006 and March 2007. Moreover, net interest margin rises to 7.70, which indicates that banks are earning higher interest earnings from their investment activities than they pay for financing them. The problem is that the establishment of the IDIC in September 2005 coincided with government policy that hiked fuel prices by more than 114%, which fueled higher inflation expectations, which in turn induced a reversal of Bank Indonesia interest regime from cutting to hiking, all of which compounded bank risk expectations. The temporary nature of the spurt or hike in Bank Indonesia certificates variable and drop in loan deposit ratio may have more to do with efforts by banks to adjust to tight monetary policy regime at the time than a consequence of heightened perceived bank risk attribute

Although the long-term trend, in the long-term, which may be a sign that sets the stage for a mobilized by commercial banks in the general time, at about 40% in 2007 period, the trend in March 2007. Government apparently



period of observation as they “control” 30% of demand deposits in March 2007 from about 17.5% in September 2000.

Thus, keeping money in commercial banks in the form of demand deposits by government entities was not significantly affected by the establishment of IDIC. On the contrary, demand deposits from state-owned enterprises register a downward trend during the entire period, as well as during the period of “interest” September 2005 and March 2007. The same applies to demand deposits held in commercial banks that belong to nonresidents. Thus, demand deposits kept by most entities in commercial banks, with the exception of those belonging to government entities, registered a long-term downward trend, which may or may not be attributed to the establishment of the IDIC. Observing the January–June 2007 period shows fluctuation with growth followed by decline January–March 2007 in demand deposits mobilized by commercial banks. However, April, May, and June post strong growth, an indication an upward trend in demand deposits is underway (Figure 3).

In general, bank deposits in April, May, and June, 2007 experience growth with June 2007, posting very strong gains, an indication that the dip in March 2007 was at best temporary, rather than a fundamental change in the trajectory of bank deposit mobilization. This implies that the establishment of IDIC has not fundamentally altered the basic parameters influencing bank deposits mobilized by commercial banks in Indonesia (Figure 4).

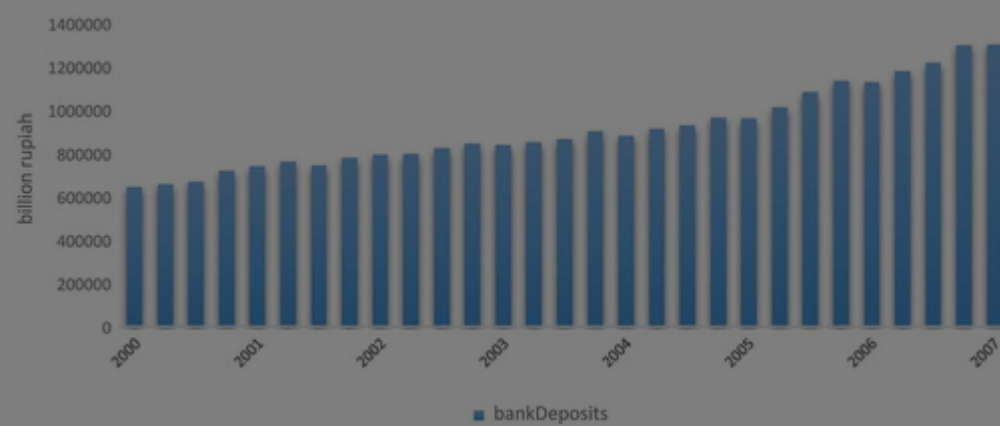
Figure 3. Demand deposit balances September 2000–March 2007 (Billion Rupiah).

Source:



Figure 4. Total Deposits mobilization by Indonesian commercial banks, 2000- 2007 (Billion Rupiah).

Source: Bank Indonesia.



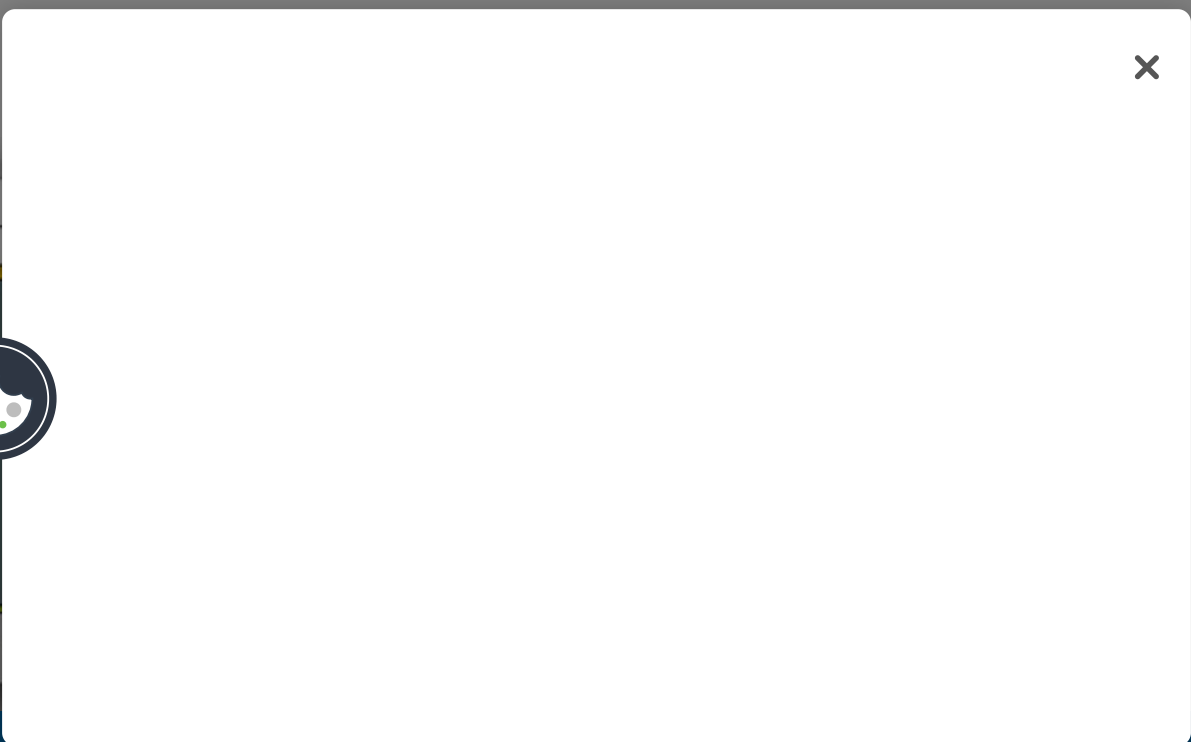
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The expectation is that the coming into effect of the IDR100 million insurable maximum per account in March 2007 would induce savers with accounts that have higher values than IDR100 million to draw down such accounts with the aim of reducing potential losses on accounts that have deposits that exceed IDR100 million (Figure 5).

Figure 5. Trend of Accounts by type for <=Rp.100 million per account, September 2000-March 2007.

Note: *Month DDACCsum stands for sum of deposit accounts; Month SAVACC stands for total number of savings accounts; Month TDACCSUM stands for total number of time deposit accounts.

Source:



This should be in the form of diversifying account types (time deposit, savings, demand) and opening accounts in various banks (Figure 6). However, Bank Indonesia figures show that that is not the case. This is why contrary to expectations the number of banks accounts with nominal value of IDR100 million after experiencing an increase in the September 2005 decreases steadily during 2006 and in March 2007. This is evidence that depositors have not overreacted to the establishment of IDIC by undertaking suboptimal saving methods such as dividing large balance accounts into IDR100 million accounts to ensure that each account met the upper limit of IDIC deposit insurance threshold for each individual account. Such a process, if done, would increase the cost of managing each accounts for the commercial bank and account holder, and in turn increase financial intermediation cost and inefficiency.

Figure 6. The value of Account balances for \leq Rp.100 million per account, by type, September 2000-March 2007.

Source: Bank Indonesia.

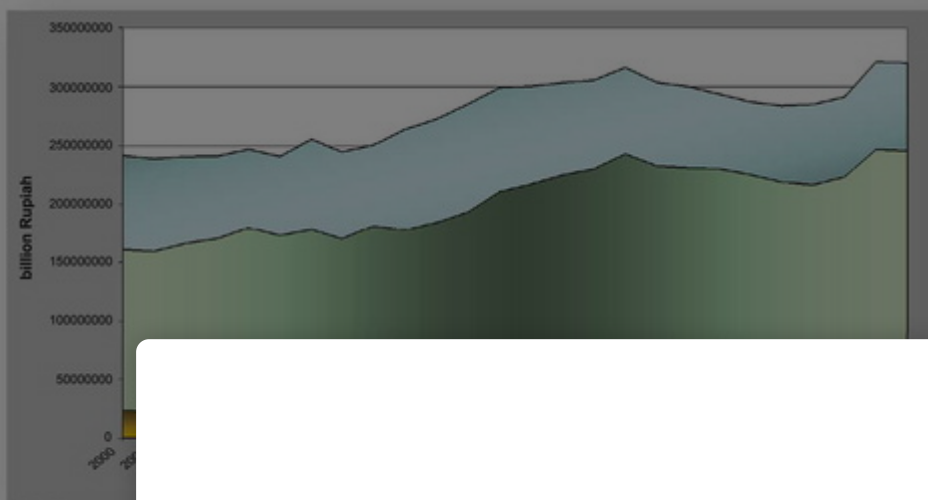
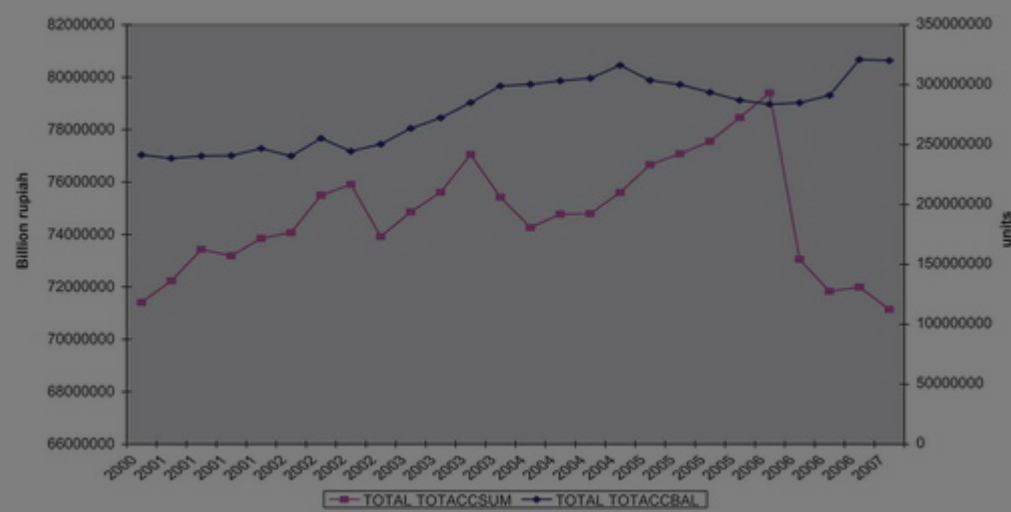


Figure 7. Trend in account balances and Number of accounts, all types combined, September 2000-March 2007.

Source: Bank Indonesia.



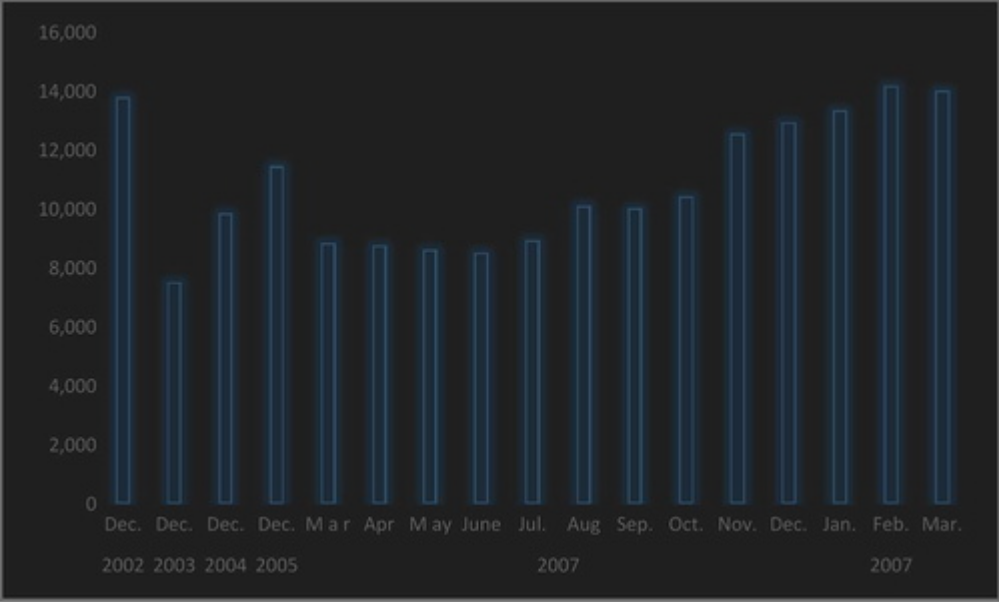
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Thus, the expectation that depositors should reduce the money in time deposit accounts (tied up interests rate, tied up in one bank, which pose higher potential risk) and increase the money in savings accounts and lastly demand deposits does not seem to hold. In any case, a drop in total account balances that occurs in March 2007 is due to lower time deposits balances rather than low demand and savings deposit balances, which should turn the tables on the theory that indeed savers' behavior had begun to be driven by fear of potential risk inherent in the type of deposit accounts where they put their money. Time deposits account balances continued to be larger than savings accounts, and demand deposit accounts, thus no indication that there was a

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The tumultuous and highly fluctuating decrease in the level of loans received by banks that characterizes March 2000–September 2003 settles to a new, but lower threshold in December 2003.

Pertaining to the observation period, September 2005–March 2007, loans received by banks increase slightly in September and December 2005, but decline slightly in March–September 2006. Recovery gets underway in December 2006, which continues through March and April 2007. One could say that the long span of decline that occurs in March–September 2006 represents a delayed reaction to the coming into force of the IDIC, which is understandable as loan transactions are made in advance carrying long maturities. This means that instant renegotiation or reviewing deals that are already in force is not easy. The problem with that notion is that if indeed the March–September decrease



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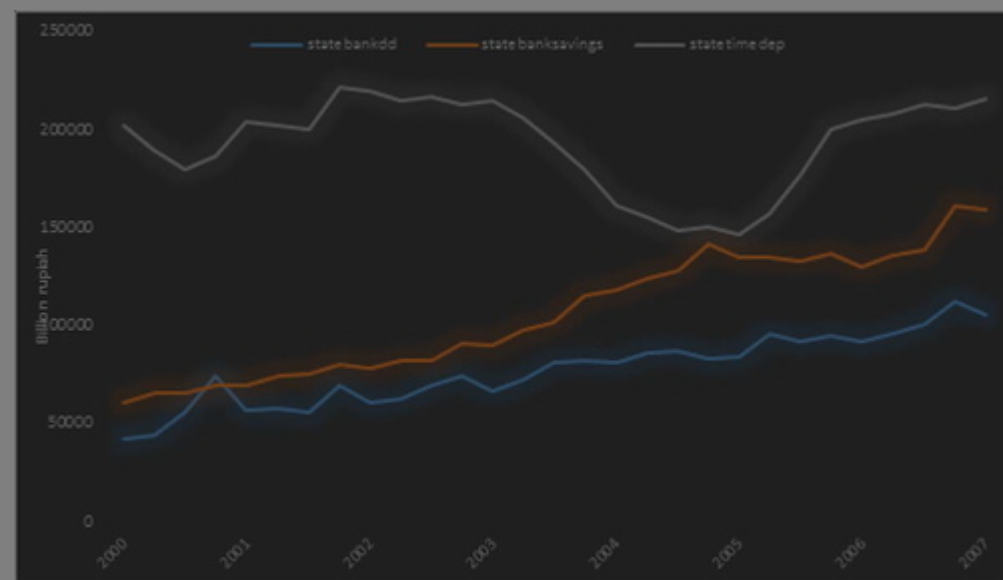
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state-owned banks. The only similarity in the pattern of trajectory appears to occur in the first quarter of 2007, when virtually no change is registered as far as deposits growth is concerned (Figure 9).

Figure 9. Funds mobilization by state owned banks, 2000- 2007 (Billion Rupiah).

Source: Bank Indonesia.



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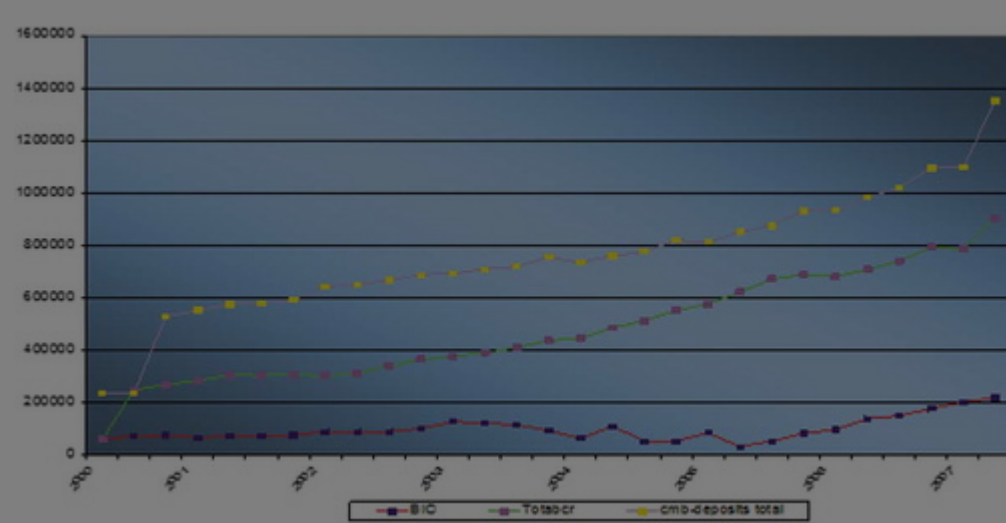
If one takes the third quarter of 2005 as the time when information about the establishment of the IDIC began to have an effective impact on the behavior of depositors, there is indeed a steeper rise in deposits in December 2005 than that experienced in September 2005 for state-owned banks, but the same pattern, even at a steeper rise, in other banks during the period. The trend in deposits stagnates and even

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Note: *cmbdepositstotal stands for bank deposits; Totalbcr stands for Total Bank credit; BIC stands for bank Indonesia certificates.

Source: Bank Indonesia.



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Borrowed funds through the issuing of securities is yet another means available for commercial banks to finance their investment activities. Borrowed funds through the issuing of securities hit the lowest level in June 2003, after which recovery gains full steam in between March 2003–December 2003. At the start of the “observation period,” recovery in June 2005 from the relatively deep plunge in securities issued, which occurs in March 2005, continues in September and December 2005. However, March 2006 sees another decrease in funds mobilized. However, the trend is reversed in the remaining quarters and April 2007. In the backdrop of the above trend, the inference that can be made relating to the impact of the establishment of the IDIC on

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improvement in bank performance and macroeconomic fundamentals than potential risk in the wake of IDIC establishment.

Bank credit disbursed in comparison to Bank Indonesia certificates held by commercial banks shows a steady increase overtime especially the second quarter 2002 (June) until the start of the observation period September 2005 when an apparent threshold is reached with level channeled remaining virtually unchanged for three consecutive quarters September, December 2005 and March 2006. June 2006 sees resurgence of credit growth, which lasts until March 2007, when a significant dip takes effect. The credit disbursement figure for April registers credit growth levels that occurred prior to March 2007, an indication that the decrease in credit expansion in March was of a short term nature rather than the beginning of a new trend.

Nonetheless, loans received by commercial banks, Bank Indonesia figures show a slight improvement (shrugging off) of the effect of the establishment of IDIC but later on nosedives in March 2007 to the lowest level since mid-2003. Robust recovery occurs since then. There is hardly significant difference in total bank deposits (controlled for bank size) in the two periods that is prior to and in the wake of IDIC establishment.

The trend of Bank Indonesia certificates held, on the other hand, shows a steady pattern during March 2000–December 2002, shoots up in March 2003, but experiences fluctuations then after regaining lost momentum in September 2005 (Figure 11). The steady growth that starts in September 2005 is sustained throughout the observation period. The rate of growth in Bank Indonesia certificates held by commercial banks in the aftermath of the establishment of the IDIC is the highest and sustained for the longest sustained period since 2003. The rate of growth in Bank Indonesia certificates held by commercial banks is even as high as 10% in June 2007.

Although the IDIC provides a mechanism for preventing their funds from being used for certificates held by commercial banks, they may be able to put their funds in a bank in Indonesia.

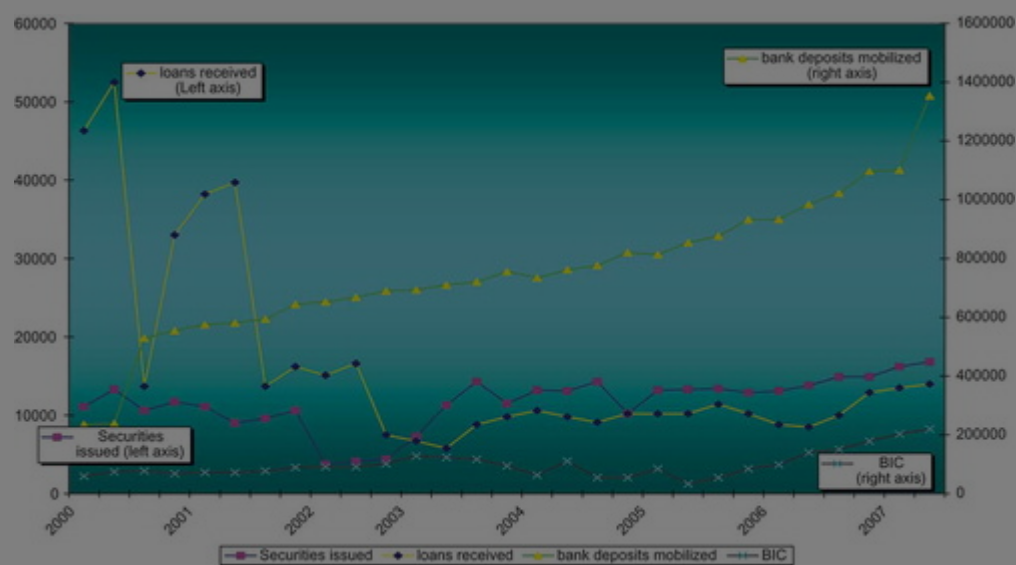


coefficient of bank credit on Bank Indonesia certificates confirms the results obtained by technical analysis.

As pertaining to securities issued, Bank Indonesia figures show a slight knock in the immediacy of the establishment of IDIC body in September 2005. However, December 2006 registers a slight mitigation, which dips slightly in March 2007, but shows recovery since then (Figure 11).

Figure 11. Developments in Bank Indonesia certificates and loans received, by commercial banks, March 2000- June 2007 (Trillion Rupiah).

Source: Bank Indonesia.



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4.3. IDIC establishment and bank credit disbursement to risky sectors and sub

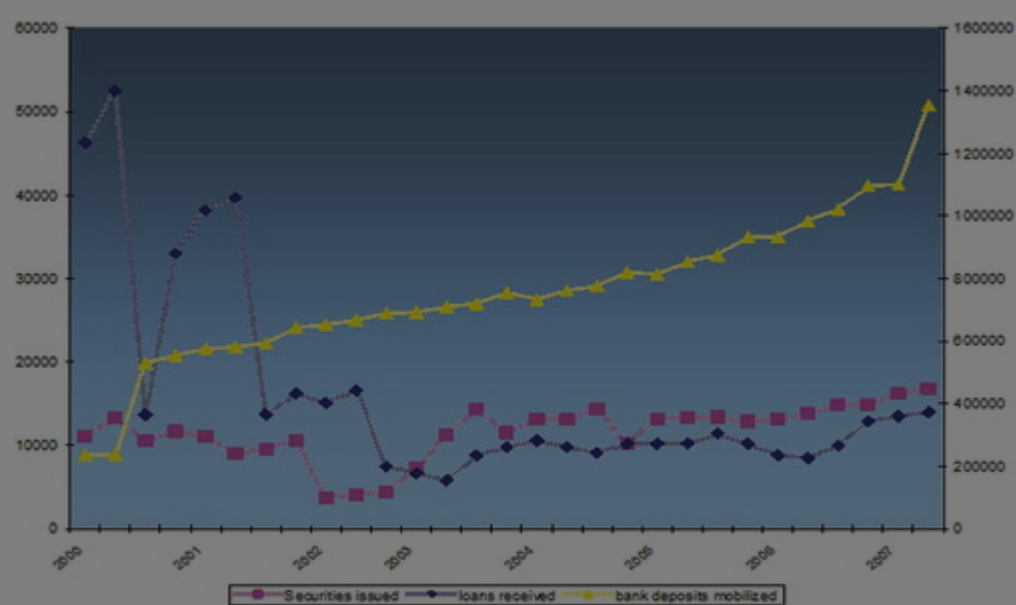
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the level of credit to SMEs after IDIC as theorized, but were not followed by regional development banks, contrary to theoretical expectations. Private national banks and joint venture banks reduced the credit level they channeled to SMEs in the aftermath of IDIC establishment compared to the amount disbursed before IDIC (as theorized) (Figure 12).

Figure 12. Securities issues, Bank loans received and bank deposits, March 2000-June 2007 (Trillion Rupiah).

Source: Bank Indonesia.



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Nonetheless, foreign and joint venture banks do not register significant difference in the level of credit disbursed to SMEs in the wake of IDIC establishment in contrast to the

past before IDIC. This is because the IDIC establishment was more concerned with the security of the assets of the enterprises and the creditworthiness of the borrowers. The IDIC establishment was more concerned with the security of the assets of the enterprises and the creditworthiness of the borrowers.

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funds through borrowing from external sources and providing saving facilities (time and saving deposits).

With respect to Bank Perkreditan Rakyat (BPR) or peoples credit banks credit data, there is an indication that contraction sets in December 2005, one quarter after the establishment of the IDIC. However, March 2006 figures show that credit disbursement returns to growth achieved prior to September 2005 levels, which is testimony to the short-term nature of the decrease registered in December 2005. It is also evident that there is a significant difference between deposits mobilized and credit disbursed by rural banks prior to and after the establishment of IDIC, with levels made in the wake of IDIC establishment higher than those made prior to IDIC. Thus, there is no evidence that the establishment of IDIC in Indonesia has led to the contraction of deposits and credit disbursed by rural banks in Indonesia. What applies to credit disbursed by rural banks in general is also replicated in credit disbursement by sector. There is significant difference in levels of consumer credit, investment credit, and working credit channeled by rural banks prior to and in the wake of the establishment of IDIC.

Meanwhile, credit disbursed by BPR to agriculture, industry, and services also shows significant difference in the two periods, echoing findings unveiled at the general level. There has not been a withdrawal of bank credit facilities from agriculture in the wake of IDIC establishment. In fact, rural banks channel higher levels of credit to agriculture than for industry and services. Nonetheless, rural banks in general disburse more working credit than investment, consumption, and services, which would portend the setting in of conservative lending practices in rural banks credit policy. This generally

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banks do not seem to follow state-owned banks in channeled higher credit levels in the aftermath of IDIC establishment.

In general, however, as far as credit to risky sectors is concerned (SMEs and agriculture serves as a proxy here), figures continue to experience even higher fluctuation than before, attesting to the potential high risk that lending to the sector entails. Thus, the inference that can be drawn in reference to the impact of the establishment of the IDIC on SME credit disbursed by commercial banks in Indonesia is at best varied. While SME credit for industry and agriculture-related activities slightly increases at the start of the period (September 2005), stagnation sets in which with minor “spurts” characterizes the December 2005–December 2006 period, before a decline got underway in March 2007. Pertaining to services, credit disbursed to service-related SMEs registers an upward trend punctuated by steep hikes in some quarters that reach the apogee in June 2006. Since then, the downward trend sets in.

There is no indication, however, that the fluctuation of credit going to the sector is attributable to the establishment of IDIC. Nonetheless, given the strong dependence the sector has had on subsidized state credit, mainly channeled through state-owned banks, which has all but been phased out, there is no denying the fact that any policy that increases the credit risk borne by the lender arising from lending to such a risk sector as agriculture is likely to impact on credit channeled to the sector. Thus, IDIC may have an indirect impact on credit disbursed to the sector since it increases the premium banks have to pay for such credit they lend out.

In the backdrop of the above observation, it can be tentatively argued that the advent of the IDIC has not significantly altered the credit disbursed by national banks, but has left the credit to the sector unchanged. It is worth noting that the foreign and joint venture banks and regional and government banks have more credit to the sector than national and foreign banks. The performance of the credit to Bank Indonesia is also worth noting. This



Indication that with respect to working credit disbursement in general banks are doing their job depending on their evaluation of creditworthiness of credit recipients as per normal convention. Improving creditworthiness, indicated by better macroeconomic fundamentals, especially the cost of borrowing, which has been decreasing in line with Bank Indonesia cutting its prime lending rate, coupled with high consumption spending (private and government), rising exports, recovery in investment inflows, and improvement in foreign reserve position, provides positive signals to lender to lend more. And this is exactly what they are doing.

Apparently, the effect of IDIC establishment on working credit disbursement has hardly impacted bank lending for working capital purposes. As pertaining to investment credit to total investment credit disbursed by commercial banks, which being of longer maturity is relatively more sensitive to changes in risk projections than working and consumption credit, shows wide fluctuations in the entire period, with periods of growth often followed by deep dips. This is found to be the case as regards investment credit disbursed by all bank types. There is a significant drop in investment credit that occurs in March 2007, which might be an indication that banks are factoring in potential risk likely to arise from the effecting of IDIC key provision pertaining to deposit insurance. In general, investment credit made by commercial banks to various sectors, with the exception of mining, shows an upward trend with the services sector outperforming other sectors. There is no evidence of an apparent structural change in the trend of investment credit disbursement occurring in the aftermath of the establishment of the IDIC in September 2005. Investment credit to all sectors follows patterns that are set many quarters before the third quarter of 2005 (September 2005), an implication that, at least

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Nonetheless, there is significant difference in investment credit (asset-weighted) channeled by the four bank types in the aftermath of the IDIC establishment, with foreign and joint venture banks channeling the highest level, followed by regional development banks, private national banks, and state-owned banks. Apparently, contrary to expectations, state-owned banks shy away from channeling high levels of relatively riskier investment credit than foreign and joint venture banks, private national banks, and regional development banks. In general, investment credit showed significant growth since March 2007 reaching IDR169.83 trillion in July 2007 (Kompas, October 10, 2007). The growth in investment credit in July, which was 25% higher than that in July 2006 (IDR135.7 trillion), was also higher than the growth posted by working credit and consumption credit of 22.13% and 18.64%, respectively.

Such substantial gains in investment credit disbursed by banks is indicative of the fact that the effect on credit disbursement on bank credit, if at all, was short term and was transient rather than a long term, fundamental in nature, as far as bank credit policy is concerned. Investment credit is far riskier than either working or consumption credit due to the long-term nature, which entails complications in making accurate projections of future operations, costs, and returns of ventures to which it is channeled. However, the fact that banks have started channeled investment credit in substantial amounts diminishes the likelihood that the establishment of IDIC in September 2005, and the effecting of the maximum of IDR100 million per individual account covered by the insurance policy under IDIC scheme, has had fundamental impact on bank credit disbursement in Indonesia.

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banks. However, in general, bank credit disbursed for consumption purposes shows a steady increase since January 2006 and continues the trajectory through June 2007 by posting substantial growth. The general trend of consumption credit issued by all types of commercial banks is upwards,¹⁵ following apparently similar highs and lows, an indication of being under the influence of similar underlying factors over time. Private national banks show the briskest performance, followed by state-owned banks, regional development banks, and foreign and joint venture banks, in that order.

The behavior of banks shows a shift from risk averseness to risk taking as far as intermediation is concerned (Tables 1 and 2). Bank deposit significantly influences bank credit coefficient magnitude (0.793751), T-statistic (6.492055), and p-value (0.0000); while the coefficient on Bank Indonesia certificates has the expected negative sign, it is not significant (-0.000811), T-statistic (-0.038324), and p-value (0.9695). Results for the annual time series showed that coefficient of bank credit disbursement was positive and significant (2.853100), T-statistic (5.505086), and p-value (0.0006); the Bank Indonesian certificate coefficient had the expected negative sign but not significant (-0.023592), T-statistic (-1.423359), and p-value (0.1924) (Table 2). In other words, both annual and monthly time series generate results that are similar with respect to signs on coefficients but differ slightly on magnitudes of the coefficients. We tried to run a cointegration regression of the model that produced similar results with the only difference being that the dummy variable was significant and had a positive sign (Table 3). The regression findings may reflect the fact that in the medium term in the wake of the establishment of the deposit insurance regime there was perception among banks that bank credit disbursement was no longer as risky as it was prior to IDIC

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Table 1. Multiple regression results of Bank deposits and Bank Indonesia certificates on Bank credit disbursement



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Table 2. Robust Tests of Equality of Means



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Table 3. Cointegration regression results of source of funds and Bank Indonesia certificates on bank credit disbursement (monthly time series)



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Bank assets differ among bank types and show differential impact of the establishment of the IDIC on growth. Assets of state-owned banks experience higher growth in size than before the IDIC; private national banks suffer a slight reduction in size; foreign and joint venture bank assets also experience a tampering of the asset size like private national banks, but the “correction” appears to be sharp; and regional bank assets seem un-

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Thus, the trend in bank assets shows differential trajectory by type of ownership, as theory posits. Nonetheless, there is a catch. The two periods used in the study to examine the trend of bank assets, that is, prior to and in the wake of IDIC establishment, also marked the two periods when banks were exposed to relatively low inflation and high inflation, respectively, induced by Government of Indonesia policy that implemented a 114% hike in fuel prices. In fact, the second phase of fuel price hikes was effected in October 2005, 1 month after the establishment of IDIC in September 2005.

As regards the trend in asset portfolio, private national banks maintain their dominance in asset share both prior to and after the establishment of IDIC, followed by state-owned banks, foreign and joint venture banks, which is not surprising given the little time that separates the two periods. Meanwhile, with respect to developments in the trajectory of bank deposits, analysis results indicate that there is no significant difference in total bank deposits (controlled for bank size) in the two periods that is prior to and in the wake of IDIC establishment. When bank savings deposits are controlled for respective bank size (using bank assets), regional development banks do not show significant difference in savings deposits mobilized prior to and in the aftermath of the establishment of IDIC; so were private national banks. On the contrary, there is a significant difference in the level of savings deposits mobilized by state-owned banks and foreign and joint venture banks in the two periods. State banks experienced a decrease in saving deposits after the IDIC compared to the period before its establishment; while foreign and joint venture banks experienced an upward correction in savings deposits (IDIC establishment reduced an even sharper decrease in savings)

declined, as development banks. The in its asset-weighted the run to safety is at savers may onal and foreign banks seem to win the increase in asset-weighted the manifest in line with Chessini banks plays



program. This is because foreign and joint venture banks, having not suffered as poorly during the 1997/1998 economic crisis, were in the immediate aftermath of IDIC establishment still considered safer custodians of customer funds than state-owned and national private banks. Nonetheless, the fact that there are still Indonesian depositors putting their money in unhealthy banks long after IDIC establishment (Bank Century and Bank Global) shows that IDIC and Bank Indonesia (financial institution supervisor at the time) have yet to establish foolproof onsite and offsite supervisory mechanisms that have the ability to detect early enough banks that are likely to face insolvency for closure before they do even more damage.

5. Conclusion and policy implications

The role of the Deposit Insurance Corporation has never been more important than in today's turbulent, high-risk banking sector. To strengthen public confidence in the banking sector, the Indonesian government established IDIC. IDIC insurance policy, which is mandatory to commercial banks, guarantees security of third-party funds in return for a premium that is based on risk profile of the respective commercial bank, but is applicable to accounts with a maximum of IDR 2 billion,¹⁶ and interest paid on deposits that must not be above the maximum set periodically by IDIC (<http://www.adb.org/prINTER-friendly.asp?fn=%2FDocuments%2FSpeeches%2F2007%2Fsp2007011%2Easp&news=none>).¹⁷ This

shows the extent to which the Indonesian government believes and considers sound bank int... Going back to resea... C establish... er factors (high int... riod, among others), The t... continued its expa... ibutable to moral ha... posits. It is also true... e in total bank de... th of deposits... t level of



and joint venture banks, and there is significant difference in asset-weighted credit prior to and after the establishment of IDIC, the same applies to the case of credit disbursed by private national banks, and foreign and joint venture banks, and regional development banks. Nonetheless, over time, the proportion of savings deposits in total savings seems to go back to the level prior to the IDIC establishment, with savings deposits placed in state-owned and foreign and joint venture banks experiencing a slight decrease compared to a steep decline in savings deposits in national private banks after IDIC establishment. This behavior also indicates risk averseness in savers' behavior. The shift to savings deposits from time deposits and demand deposits in the immediacy of IDIC establishment reflects savers' desire to redefine their risk profiles by emphasizing safety over return as the new banking regime gets established. To a certain extent, such behavior manifests what some authors have termed the indiscipline of large savers wanting to shift risks, an effect that is corroborated by a lower decrease in savings deposits placed in state-owned banks compared to what occurs in national private, regional development, and foreign and joint venture banks. Such a hypothesis is backed by the fact that asset-weighted savings in state-owned banks remained higher than in national private banks, and regional development banks, but higher in foreign and joint venture banks in the immediate aftermath of IDIC establishment.

Moreover, the growth in banks assets in state-owned banks and regional development banks was higher than in private national and foreign and joint venture banks. This presupposes that state-owned and regional development banks were lending more, hence more trusted as sources of funds by economic agents than private national and

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extending beyond even June 2007, which shows the entrenchment of savers' behavior to transfer their money from relatively longer time horizon accounts (time deposits) to savings deposit accounts, which would be expected to occur in case of a significant change in risk expectations. Moreover, beyond the very short and intermediate term, findings indicate that IDIC establishment has not changed fundamentally the savings and borrowing functions in Indonesian banking system. Private national banks continue to control the lion share of bank assets, followed by state-owned, regional development banks and foreign and joint venture banks in that order. Private national banks still hold the highest percentage of savings in the Indonesian banking system, and there are no indications that a big dent will be made by state-owned banks and regional development banks in the foreseeable future. That said, foreign and development banks are increasingly becoming riskier takers compared to state-owned and regional development banks as shown by a reduction in working credit, but an increase in investment credit they make in the aftermath of IDIC establishment.

There is significant difference in asset-weighted bank credit channeled by state-owned banks, private national banks, and foreign and joint venture banks for working capital purposes, on one hand, and regional development banks, on the other. While private national banks disbursed larger working credit in the wake of IDIC establishment, regional development banks and foreign and joint venture banks, on the contrary, channeled lower credit levels during the same period.

Multiple regression results showed that deposits continue to have a significantly positive influence on the level of bank credit, while the level of Bank Indonesia

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working credit have to some extent shown higher fluctuation and credit risky sectors such as SMEs and agriculture than in trade and business services, and rising levels of Bank Indonesia certificates. Such risk, like any transaction that increases bank risk, given the structure of the deposit insurance, in the event it materializes, should therefore be borne not by banks, but by the insurance agency (IDIC). That underscores the need for both sound risk management and micro and macro credit insurance as a component of a more stringent prudential banking regime.

That said, the above argument is somewhat discounted by statistics on loans received and securities issued, which show a significant increase during the period. Moreover, by increasing the need for awareness on the soundness of banking institutions where they keep their funds, IDIC establishment has altered the way savers should make their saving decisions from being passive savers to being active, bank risk-sensitive rational investors, at least in the short term. While findings in this research showed some signs that could be interpreted as savers starting to factor in potential risk in their saving decisions in the short term, such behavior wanes in the long term, perhaps due to the restoration of their trust in the capacity of the banking system to safeguard thanks in part to IDC establishment. Such a change in attitude in fact vindicates the rationale for IDIC establishment as a vital factor that increases public confidence in the banking system as a custodian of their hard-earned savings. IDIC establishment, thus, by contributing to the restoration of financial stability, reduced the potential danger of future bank runs.

Nonetheless, beyond medium term, IDIC establishment increased moral hazard among savers, where savers are more likely to deposit their funds in banks, since IDIC is there to protect their funds. This is not seen in the long term, where the IDIC establishment has not been able to conduct its role in making savers more bank risk-sensitive. On the one hand, IDIC establishment has no longer been able to restore the trust of savers and unsound banking practices. In effect, the IDIC establishment has had a maximum value insurance effect on savers, given the maximum value of the insurance coverage.

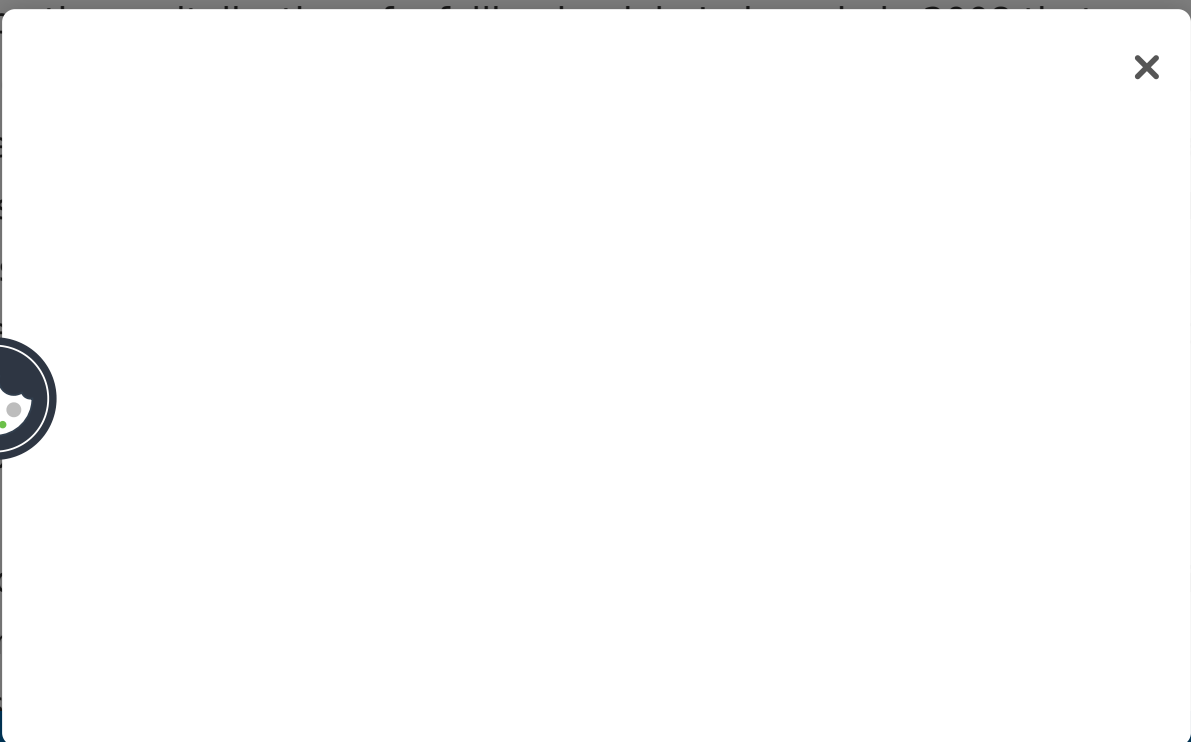


longer limited to limited liability (equity contribution), but is determined by IDIC and the banking supervisory agency (financial services supervisory agency), which is set at least 20% of the required cost of recapitalization for insolvent bank with systemic risk potential, and 10% for insolvent banks without potential systemic risk (IDIC regulation no. 5/PIDIC/2006, no. 4/PIDIC/2006, respectively), it is an onus on shareholders to ensure that banks where they hold shares do not engage in risky investment and financing behavior. And that serves as a vital invisible hand that from now on will complement the functions of the banking supervisory agency and IDIC for the good of a sound, prudent, sound banking industry. Moreover, there is need to note that IDIC and the Indonesian financial services authority (OJK) collaborate in monitoring risk profiles of banks on a regular basis for any signs of rising financial, investment, and operational risk. In the event of increase in liquidity risk, commercial banks face more frequent and stringent supervision, required to increase equity, face higher cost of loans from interbank market and Indonesian central bank in the event they opt for liquidity support, and are required to pay higher insurance premium on third-party deposits to participate in IDIC insurance program. Thus, IDIC, along with other institutional framework that has come into being during the 1998–2017 period, has laid a strong foundation for a sound banking sector, which has contributed to sustained financial stability.

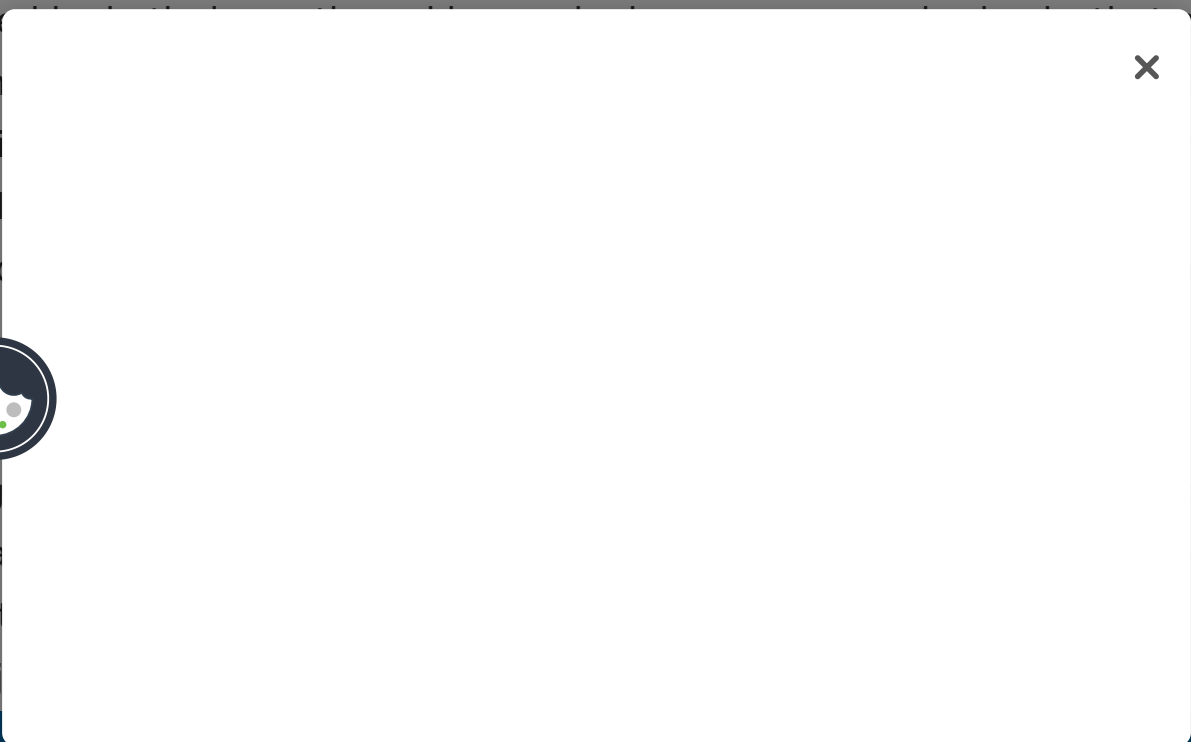
Nonetheless, IDIC establishment and its impact on the behavior of savers and banks have several policy implications. While the Indonesian banking sector has strong capital adequacy ratio (above 20% on average), there are signs that tighter scrutiny on bank risk has reduced bank appetite for disbursing loans in general and to sectors that have high potential. IDIC, by contributing to the stability of the banking sector during the 1998–2008 crisis, has helped to reduce the high risk of asset price bubbles such as in the late 1990s. Indonesia has witnessed a similar situation with the capitalization of the banking sector during the 1998–2008 crisis. Thus, the IDIC has helped to reduce the high risk of asset price bubbles such as in the late 1990s. Indonesia has witnessed a similar situation with the capitalization of the banking sector during the 1998–2008 crisis.



being a government institution is still subject to political pressure in its policymaking process, which if allowed to continue, poses danger of not only higher moral hazard but given forbearing, undermining its long term credibility (Dekle & Kletzer, [2004](#)). Apparently, the pretext of impending systemic risk continues to be a convenient bogey that policymakers may continue to use as a convenient ploy in future to justify, otherwise bad bank bailout decisions that are motivated by vested personal and group interests (Reza & William, [2005](#)). Strengthening resolution recovery mechanisms for not only systemic banks but also banks with branches that are spread in many regions as well as those that specifically provide services to risky sectors should be one of the ways to redress that problem. However, there is also need to strengthen and provide IDIC independence from political intervention by changing the way its management is appointed, reduce IDIC dependency on government funding in the event of major bailouts, by, for example, enforcing bail-ins by shareholders of troubled banks rather than dipping into state coffers using the pretext of systemic risk. Such measures should reduce moral hazard that has been associated with generous explicit deposit insurance programs (Cull, Senbet & Sorge, [2004](#)). It is also important for financial services supervisory authority, IDIC, the banking sector, and the Ministry of Finance to strengthen and scale up public financial literacy campaign to educate the public on the importance of sound financial management, keeping money in sound banks, and on what IDIC covers and does not cover (Schich, [2008](#)). What is also becoming evident is that as financial stability continues even the little disciplinary role of depositors diminishes, leaving IDIC and financial institutions supervisory authority to provide such a function. With regulatory officials susceptible to moral hazard practices as well, as proved by the 2008 financial crisis, it is necessary to have a more independent authority to discipline banks and their investors. One must also have a more effective bank resolution mechanism on a real-time basis to prevent systemic risk from spreading to other banks and financial institutions both in the developed and developing countries.



regular, timely, and multipronged coordination with the country's central bank (Bank Indonesia), which administers monetary policy, hence the linchpin of macroprudential policy, and the Ministry of finance, in its capacity as the implementor of fiscal policy. Not to mention the potential for political intervention in determining when to salvage a bank, which bank to salvage, and at what cost given the discretion that IDIC, which owes its authority to the government and the legislature to decide the fate of a bank that faces liquidity problems. The IDIC scheme was phased in such a way that it took 2 years for the limited deposit insurance scheme to take effect (September 2005–March 2007). The risk aversion that characterizes the short term is in part attributable to that format. Thus, a phased implementation of the deposit insurance scheme can pose risk of aggravating risk aversion in the short term but accentuating risk taking once the program is fully phased in. That underscores the importance of strengthening banking soundness, macroeconomic stability, and banking regulatory and supervisory institutions prior to implementing deposit insurance program. Implicit as well is the role that the maximum value of deposit the insurance program plays in influencing the behavior of depositors and banks. Barth, Caprio, Jr., & Ross (2001) and Demirgüç-Kunt, Karacaovali, Laeven (2005) provide sufficient information on best practices for policy makers in that respect. That said, setting the maximum amount that the deposit insurance program covers per individual account too high increases moral hazard among banks and savers, yet setting it too low may induce the perception of ineffectiveness. Moreover, the problem becomes more complicated considering the fact that setting the maximum value on an individual deposit account that the deposit insurance program covers is not only influenced by the state of the domestic macroeconomy, which in turn is affected by global economic conditions, but also by the global financial system that originates from other jurisdictions. To that end, the problem seems to be a global one. There is a need for research that should be conducted to isolate the factors that occurred almost a decade ago, such as the 2008 fuel price hike that led to the global financial crisis that started in 2006 and



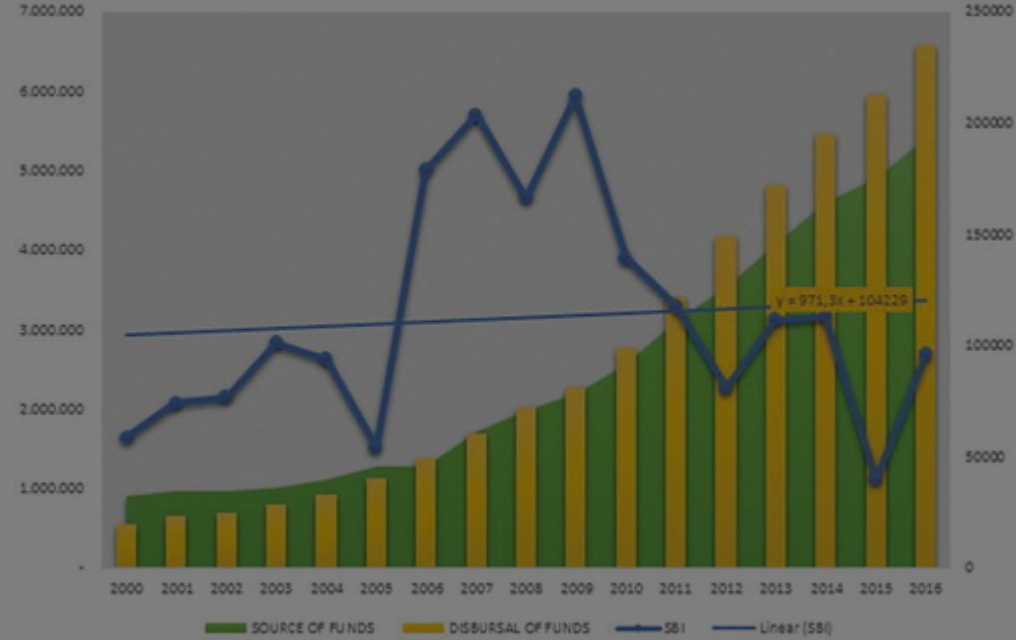
which employed a dummy variable to separate the ex ante and ex post regimes with respect to IDIC establishment, and variance between the means, though deemed adequate given the exploratory nature of the research has an inherent weakness that they are not good measures of variability. To that end, using a better measure of risk is one of the recommendations of this study for future research. Meanwhile, other limitations that range from unavailability of accurate time series data of sufficient length, and mistakes in data tabulation, while not deliberate, had impact on findings his research as well. The short duration the research covers though may help in identifying the likely trajectory of the impact of IDIC on the behavior of savers and commercial banks, and is not long enough to generate “generalizable” results to other deposit insurance programs elsewhere. The age of the DIA has been associated with high growth and volatility of bank intermediation. It is another research gap that, given the short data series used in research, it could not fill, and is therefore deferred to future research.

Research interests

The author has research interests principally in commercial banking management, financial stability, financial inclusion, poverty, and inequality. Previous research in the area includes participant in a research on fostering financial stability in APEC economies (2011); commercial credit and bank performance; management strategy in times of economic adversity; Bank Restructuring and Economic Recovery: A Critique of IBRA's p... as that have drawn in... forest fires and land... on; social capital a... research on the impa... e important... dence in a bank... by extensive



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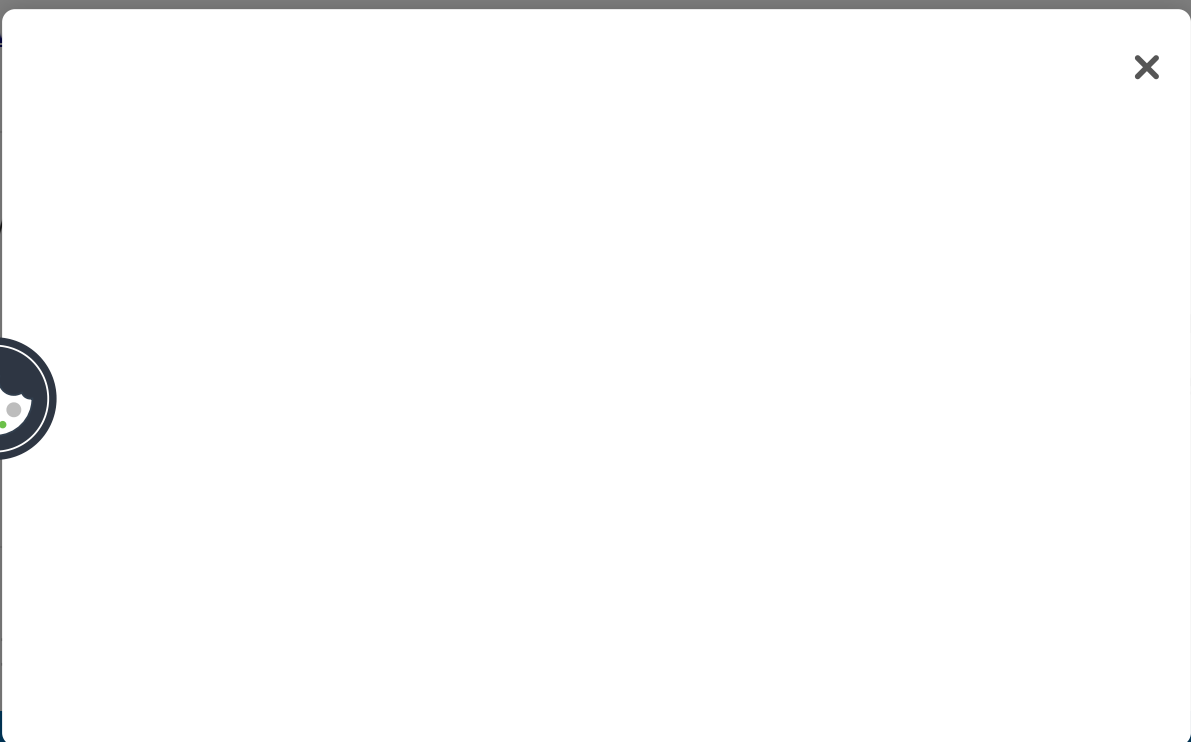
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Notes

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2. Depos <http://w>
3. Th
4. An ag and
informat wing and
controll
5. Brown banking

asset risk-weighted equity that was far below International capital adequacy requirements.

6. Brown ([1999](#)) gives an even higher NPL of 85% for 1998.

7. General banks that do not fulfill the above requirement besides facing stiff fines are supposed to scale down the scope and size of their operations.

8. Undang-undang Perbankan (UU No.10 Th. 1998), Cetakan Kedua, Sinar Grafika, 1999.

9. IDIC can conduct merger and acquisition of the bank in question, shake up or replace management, sell the bank, and cancel bank commitments to creditors.

10. In an effort to bolster public confidence in Indonesian commercial banks amidst the turmoil that has hit the global financial system, the IDIC raised the maximum insurable deposit per account to IDR2 billion as of October 2008.

11. www.IDIC.go.id.

12. CAMELS stands for the components of the condition of a bank that are assessed to determine its state of health or soundness. The CAMELS acronym stands for Capital adequacy; Assets quality, Management; Earnings; Liquidity; and Sensitivity.

13. Supposed to have been established in 2010 at the latest.

14. www.IDIC.go.id.

15. The brisk extension of consumption credit by commercial banks induced Bank

Indonesian NPL,

especial

16. Prior to the crisis, many countries

adopted measures for bringing public

confidence back in 1997/1998

economic conditions to reduce

potential risks. It was set at

IDR500 million per economic

condition during the crisis

induced by IDR2



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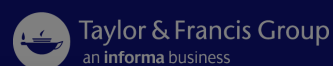
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