OJK Regulations Encourage Mergers between Banks

Following the enactment of Government Regulation in lieu of Law No. 1 of 2020, Indonesia's financial services authority, the OJK, has enacted several regulations designed to safeguard the stability of the financial system and deal with the threat of an economic crisis.

In our previous updates, we discussed some of these regulations in the context of the capital markets sector. In this update, we will discuss OJK Regulation No. 18/POJK/03/2020 on Written Order to Handle Problematic Banks ("**POJK 18/2020**") and OJK Regulation No. 12/POJK.03/2020 on the Consolidation of Commercial Banks ("**POJK 12/2020**") in the context of the banking sector. While POJK 18/2020 was issued in the context of the current coronavirus crisis, POJK 12/2020 has been on OJK's radar before the pandemic.

Incentive to Create a Holding Entity

As of January 2020, Indonesia has 110 commercial banks and 1,542 rural banks. With thin capitalisation and a minimum source of deposit, most banks are prone to liquidity and solvability issues that may even lead to their failure. In short, they are not well equipped to face an economic crisis that may result from the Covid-19 pandemic. If enough of these small and micro banks fail, it may trigger a systematic crisis to Indonesia's financial system.

Prior to the pandemic, the OJK was already planning to revise the single presence policy. Besides acting as a trigger, the pandemic also highlights the higher risk of the single presence policy. While this policy was initially introduced to weed out smaller banks that are vulnerable to economic crisis, it could also lead to the creation of banks that are 'too big to fail' or systematically important banks. An unexpected catastrophe, like this pandemic, could lead to the collapse of these big banks, which may result in the collapse of the overall economic system.

The OJK enacts POJK 12/2020 to reduce the risk posed by the single presence policy. Under POJK 12/2020, the OJK gives incentives to banks to form a holding bank entity. Here, consolidation of banks is not limited to only merger, but also acquisition, integration and split-off. A bank that already has one banking subsidiary can now acquire another bank while remaining a separate entity from its subsidiaries. As a result, the merger, acquisition, integration or split-off will not increase the business scale of the original bank (which then becomes the parent holding bank).

While the controlling shareholder of the parent holding can be a bank, non-bank financial institution, non-financial institution entity or an individual, only banks that can be the parent holding entity. If permitted by the OJK, the consolidated banks can also conduct the same business activities as the parent holding bank.

Leaning Away from Bail-Out

POJK 12/2020 indirectly supports Law No. 9 of 2016 on the Prevention and Resolution of Financial System Crisis by leaning away from bail-out as a resolution mechanism for troubled banks. This law promotes the bail-in method to save troubled banks and regulates three new resolution mechanisms for failed banks (which are banks having solvability issues that have passed the point of non-viability). These mechanisms are purchase and assumption, bridge bank and Indonesia Deposit Insurance Corporation (*Lembaga Penjaminan Simpanan*)'s open bank assistance.

There is no precedent on the implementation of any of the above resolution mechanism, and as such, we would need to conduct a comparative study of other countries that already implemented these mechanisms. For instance, the bridge bank resolution mechanism has been implemented in the United States back in 1987, and subsequently 10 times thereafter, resulting in the establishment of 10 bridge banks to resolve 114 failed banks.[1] However, based on practice, the bridge bank mechanism works best on big-scale banks with a holding structure, which can now be formed in Indonesia based on POJK 12/2020.

Increase of Core Capital

POJK 12/2020 also increases the amount of core capital for banks from IDR 1 trillion (for BUKU 1 and BUKU 2 banks) to at least IDR 3 trillion, which must be fulfilled by 31 December 2022. A parent holding bank must fulfil this IDR 3 trillion core capital.

But as part of the incentive to encourage larger banks to acquire smaller banks, OJK exempts the subsidiary banks from the above core capital requirement. Thus, the subsidiary banks can maintain a minimum core capital of IDR 1 trillion.

[1] FDIC Resolutions Handbook.

Can OJK Force Banks to Merge and Undermine Controlling Shareholder's Power?

To supplement POJK 12/2020 in light of the current coronavirus crisis, the OJK also issues POJK 18/2020, which gives an authority to the OJK to issue written orders to banks to merge; acquire another bank or become the subject of an acquisition; consolidate; and/or integrate (collectively, "**consolidation actions**"). But the OJK can only issue a written order based on the stabilisation action plan from the Financial System Stability Committee (*Komite Stabilitas Sistem Keuangan* or KSSK), which consisted of the Minister of Finance, the Governor of Bank Indonesia, the Head of OJK's Board of Commissioners and the Head of the Board of Commissioners of the Deposit Insurance Corporation (LPS).

Further, the OJK can only issue this order to banks that have liquidity or even solvability issues. These are banks that are under an intensive or specialised supervision by the OJK.

Essentially, POJK 18/2020 allows the OJK to 'force' the controlling shareholder of a bank to 'handover' the bank to OJK and either conduct a consolidation action towards another bank or accept a consolidation action from another bank for the purpose of producing a relatively healthy bank. But the OJK does not fully strip the controlling shareholder of its power as it allows the parties to a consolidation action to decide on the price or value of the shares and mechanism of the transaction.

Conclusion

The increase of banks' core capital under POJK 12/2020 will, by itself, limit the proliferation of small and vulnerable banks and contribute to the simplification of Indonesia's banking sector. We can also view POJK 12/2020 and POJK 18/2020 as OJK's follow-up mechanism to accommodate their other regulation on debts' restructuring and relaxation amidst the COVID-19 crisis, thus ensuring that the banks will still have enough solvability to conduct its services and implement this regulation. The forming of a bank holding structure also contributes to the strengthening of Indonesia's banking sector to face any threats of economic crisis, while maintaining diversification of banking services and products.

Contacts

Ibrahim Sjarief Assegaf
Partner

D +62 21 2555 7825
F +62 21 2555 7899
ibrahim.assegaf@ahp.id

Indira Yustikania
Partner

D +62 21 2555 7829
F +62 21 2555 7899
indira.yustikania@ahp.id

Our Regional Contacts

RAJAH & TANN | *Singapore*
Rajah & Tann Singapore LLP
T +65 6535 3600
sg.rajahtannasia.com

R&T SOK & HENG | *Cambodia*
R&T Sok & Heng Law Office
T +855 23 963 112 / 113
F +855 23 963 116
kh.rajahtannasia.com

RAJAH & TANN 立杰上海
SHANGHAI REPRESENTATIVE OFFICE | *China*
Rajah & Tann Singapore LLP
Shanghai Representative Office
T +86 21 6120 8818
F +86 21 6120 8820
cn.rajahtannasia.com

ASSEGAF HAMZAH & PARTNERS | *Indonesia*
Assegaf Hamzah & Partners

Jakarta Office
T +62 21 2555 7800
F +62 21 2555 7899

Surabaya Office
T +62 31 5116 4550
F +62 31 5116 4560
www.ahp.co.id

RAJAH & TANN | *Lao PDR*
Rajah & Tann (Laos) Co., Ltd.
T +856 21 454 239
F +856 21 285 261
la.rajahtannasia.com

CHRISTOPHER & LEE ONG | *Malaysia*
Christopher & Lee Ong
T +60 3 2273 1919
F +60 3 2273 8310
www.christopherleeong.com

RAJAH & TANN | *Myanmar*
Rajah & Tann Myanmar Company Limited
T +95 1 9345 343 / +95 1 9345 346
F +95 1 9345 348
mm.rajahtannasia.com

GATMAYTAN YAP PATACSIL
GUTIERREZ & PROTACIO (C&G LAW) | *Philippines*
Gatmaytan Yap Patacsil Gutierrez & Protacio (C&G Law)
T +632 8894 0377 to 79 / +632 8894 4931 to 32
F +632 8552 1977 to 78
www.cagatlaw.com

RAJAH & TANN | *Thailand*
R&T Asia (Thailand) Limited
T +66 2 656 1991
F +66 2 656 0833
th.rajahtannasia.com

RAJAH & TANN LCT LAWYERS | *Vietnam*
Rajah & Tann LCT Lawyers

Ho Chi Minh City Office
T +84 28 3821 2382 / +84 28 3821 2673
F +84 28 3520 8206

Hanoi Office
T +84 24 3267 6127
F +84 24 3267 6128
www.rajahtannlct.com

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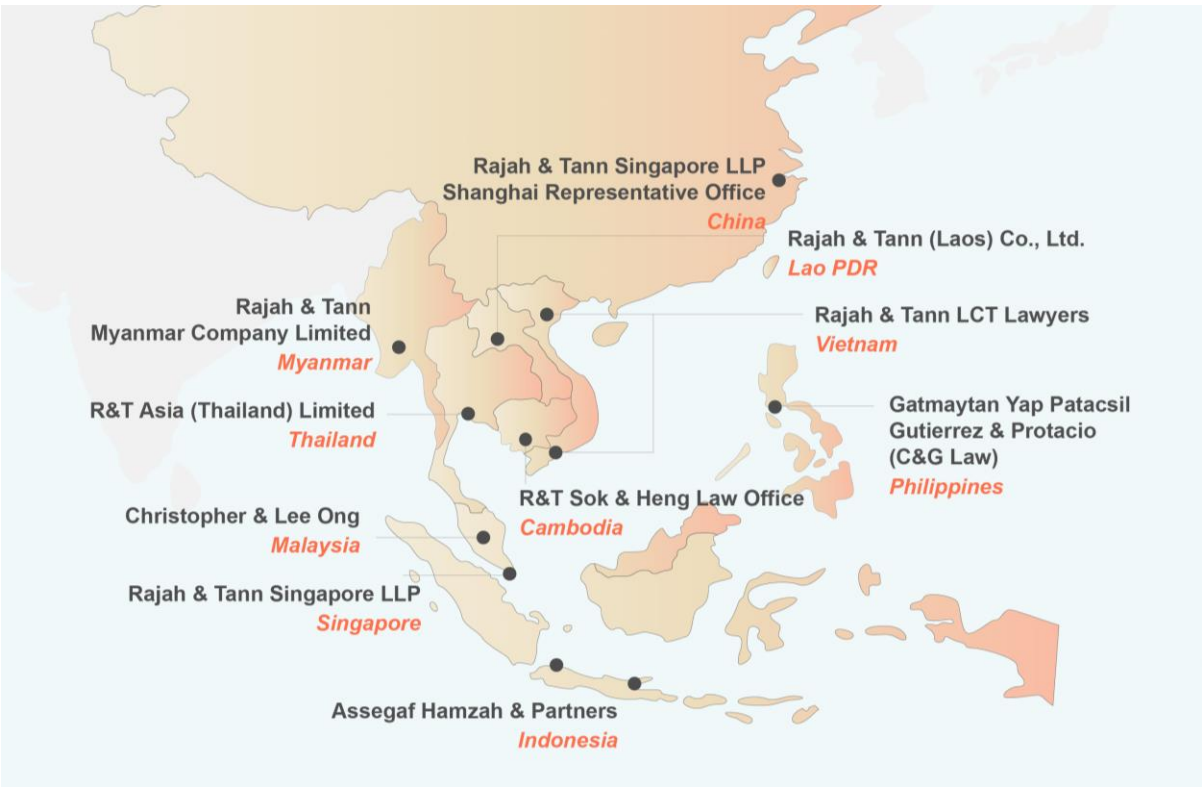

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