

# IDEAL STRUCTURE OF RISK MITIGATION MODEL IN CREDIT INSURANCE INSTITUTIONS IN INDONESIA

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### Abstract

This study aims to review; 1) Why is the current risk mitigation model structure in credit guarantee institutions in Indonesia not ideal? 2) What is the ideal structure of risk mitigation model in credit guarantee institutions in Indonesia? The research method used is normative juridical research, which is research focused on examining the application of rules or norms in positive law. The results showed that; 1) The construction of risk mitigation models in credit guarantee institutions in Indonesia is currently not ideal due to several things in handling Failed Banks, such as the handling of Bank Century, namely; (a) Corruption related to Bank mergers; (b) Changes to the Regulations for the Disbursement of Short-Term Funding Facilities (FPJP); (c) FPJP BC that does not have complete collateral requirements; (d) Existence of Accounting Engineering, Fictitious Credit, and other Violations; (e) The embezzlement of foreign currency cash. 2) The ideal construction of risk mitigation models at credit guarantee institutions in Indonesia is carried out in stages; a) Identification of legal risks; (b) Legal Risk Measurement; (c) Legal Risk Monitoring; (d) Legal Risk Control; e) Credit Risk Control; (f) Legal Risk Management Information System; (g) Internal Control for Legal Risks.

**Keywords:** Ideal Construction, Risk Mitigation Model, Indonesian Credit Insurance Corporation.

## INTRODUCTION

### Background

The need for funds or capital for someone today is very important, to meet the needs of funds or capital, a financing institution is needed. Banks as financial institutions are not capable enough to cope with the needs of funds or capital needed by the community. This is due to the limited range of credit dissemination by the Bank, limited sources of funds, and other limitations that result in less flexibility in performing its functions<sup>1</sup>. Thus creating funding institutions that have been flexible, and in certain cases a higher level of risk known as financing institutions, which offer new forms of funding or financing.

The Bank is a business entity in the financial sector whose main activities are to collect public funds (*funding*), distribute them in the form of credit (lending), and provide services to the community. A bank is a financial *intermediary* institution. Bank activities are related to moving money, receiving and repaying customer money, buying and selling securities and providing bank guarantees.<sup>2</sup>

The bank has a role as a role for parties to excess funds and lack of funds whose main business is to provide credit and services in payment traffic and money circulation. Credit issued by banks can be classified into various types, both according to the nature of use, term of use, credit needs and credit guarantees. The smooth provision of credit depends on the role of the bank and the awareness of the customer to complete the credit as agreed.

The banking sector has a very vital role, among others, as a regulator of the lifeblood of the national economy. The smooth flow of money is needed to support economic activities. Thus, healthy and strong banking sector conditions are important to be the final target of banking sector policies. The role of the banking sector in development can also be seen in its function as a means of transmitting monetary policy. In addition, banking is a very vital tool in conducting payment transactions, both nationally and internationally. Given the importance of this function, efforts to become public trust in banking are a very important part to do.<sup>3</sup>

The banking business is a risky business. On the one hand, this business promises great profits if managed properly and carefully. On the contrary, it becomes full risk (*full risk business*) because its activities mostly rely on public entrustment funds, both in the form of savings, current accounts and time deposits.

The large role carried by the banking sector does not mean opening the faucet freely for anyone to establish, manage or run their bank business without being supported or backed up by good and healthy banking rules. The government through financial and banking authorities has the authority to set rules and responsibilities for supervision of banking businesses and activities.<sup>4</sup>

Risk can be defined in many different ways. For example, risk can be defined as an adverse event. Another definition that is often used for investment analysis, is the possibility of the results obtained deviating from the expected. In avoiding risks that may occur, banks need to have a part that plays a role in overcoming risks by using appropriate risk management. Risk management is a complete set of policies, procedures, that an organization has, to manage, monitor and control an organization's exposure to risk.<sup>5</sup>

Therefore, government policy in the banking sector must be directed at efforts to realize healthy, strong and robust banking. Savings and investment also play an important role in maintaining macroeconomic stability through their relationship with the effectiveness of monetary policy.<sup>6</sup>

A legal relationship in legal traffic, especially treaty law, involves at least 2 (two) parties bound by the relationship, namely creditors and debtors. Each party has rights and obligations born from the legal relationship in the form of achievements and counter-achievements that can be in the form of giving, doing, and not doing something.<sup>7</sup> The source of the emergence of rights and obligations between creditors and debtors is the existence of an engagement as Article 1322 of the Civil Code which reads; "Every engagement is born, either by consent, by law".

The provision of *personal guarantees* as collateral in the engagement of accounts receivable according to the view of utilitarianism theory that the ethical quality of an action is obtained by achieving the goal of common welfare. Good deeds are measured by beneficial results, if the results are not beneficial, then they do not deserve to be called good.<sup>8</sup> In the process of distributing funds (lending) to the public, banks must meet two main principles of banks, namely the principle of trust and the principle of prudence. The principle of trust pays attention to the bank's efforts to place the public (debtor customers) in a prime position in every banking activity so that the public (creditor customers) always believe in the role of banking as an investment vehicle.<sup>9</sup>

The provision of credit creates a legal relationship with all juridical consequences that can cause losses or risks to the bank as a creditor if basic matters are neglected. Risk is the potential loss due to the failure of the customer or other party (debtor) in fulfilling obligations to the bank in accordance with the agreed agreement. Failure to pay made by debtors can be divided into two types of default, namely: a) Those who are able (default intentionally), and b) Defaults due to bankruptcy, that is, unable to pay back their debts.<sup>10</sup>

### **Problem Statement**

1. Why is the current risk mitigation model structure in credit guarantee institutions in Indonesia not ideal?;
2. What is the ideal structure of risk mitigation model in credit guarantee institutions in Indonesia?

### **Theoretical Framework**

The main theory or *Grand Theory* that is the basis of the analysis knife in this study is the Theory of Banking Law. The definition of a bank according to Law No. 10 of 1998 concerning amendments to Law No. 7 of 1992 concerning banking is a business entity that collects funds from the public in the form of deposits and distributes them to the public in the form of credit and/or other forms in order to improve the standard of living of many people.<sup>11</sup>

And explained in Law Number 21 of 2008 which states that banks with conventional principles are banks that carry out their business activities conventionally whose activities provide services in payment traffic. In carrying out its activities, conventional commercial banks apply two methods, namely setting interest on selling prices and purchase prices on their products or known as spread based, and applying fees in other services known as fee based.<sup>12</sup>

Furthermore, *Middle Theory* in this study uses the Hierarchy Theory of Legislation. Hans Kelsen in the "General Theori of Law and State" translation of the general theory of law and <sup>13</sup> state elaborated by Jimly Assihiddiqie<sup>14</sup> under the title Hans Kelsen's theory of law among other things that legal analysis, which reveals the dynamic character of the system of norms and the functions of basic norms, also reveals a further peculiarity of law: law governs its own formation because one legal norm determines the way to create another legal norm, and also to some degree, determine the content of the other norms. Because,

one legal norm is valid because it is made in a way determined by another legal norm, and this other legal norm is the basis for the validity of the first legal norm.

Legal protection is all efforts that can ensure legal certainty, so as to provide legal protection to the parties concerned or who take legal action.<sup>15</sup> Legal protection is a protection given to legal subjects in the form of legal instruments both preventive and repressive, both written and unwritten. In other words, legal protection as an illustration of the function of law, namely the concept where law can provide justice, order, certainty, expediency and peace.<sup>16</sup>

Legal protection aims to integrate and coordinate various interests in society because in a traffic of interests, protection of certain interests can only be done by limiting various interests on the other hand. Legal interests are concerned with human rights and interests, so that the law has the highest authority to determine human interests that need to be regulated and protected. Legal protection is born from a legal provision and all legal regulations provided by the community which is basically an agreement of the community to regulate behavioral relations between members of the community and between individuals and the government that are considered to represent the interests of the community.<sup>17</sup>

Legal protection for every Indonesian citizen without exception, can be found in the Constitution of the Republic of Indonesia Year 1945 (UUDNRI 1945), for that every product produced by the legislature must always be able to provide legal protection guarantees for everyone, even must be able to capture the aspirations of law and justice that develop in society. This can be seen from the provisions governing the existence of equal legal position for every citizen.<sup>18</sup>

## RESEARCH METHODOLOGY

This research was prepared using a type of normative juridical research, which is research focused on examining the application of rules or norms in positive law.<sup>19</sup> Normative Juridical, which is an approach that uses a positivist legis conception. This concept views law as identical to written norms created and promulgated by authorized institutions or officials. This conception views law as a normative system that is independent, closed and independent of real community life.<sup>20</sup> In legal research there are several approaches, the approaches used in legal research are the statute approach, case approach, historical approach, comparative *approach*, and conceptual approach.<sup>21</sup>

Data sources in this study are divided into two parts, namely primary data sources and secondary data sources. A primary data source is a data source that directly provides data to the data collector; while secondary data sources are data sources obtained by reading, studying and understanding through other media sourced from literature, books, and documents<sup>22</sup>. The primary data sources in this study were interviews and observations. The results of interviews with informants that have been specified in the research plan have been carried out at the time of the study.

The research technique in this study is descriptive analytical, where the analysis is carried out critically. The data collected in this study will be analyzed descriptively with a *qualitative approach*, namely by providing a thorough and in-depth explanation and explanation (*holistic / verstelen*).<sup>23</sup>

## RESEARCH RESULTS

### Risk Mitigation Model of Credit Insurance Institutions in Indonesia Today

Mitigation is a planned and continuous action taken to minimize a loss / risk. Risk mitigation piltier is the process of identifying risks, measuring to mitigate risks. Mitigation is closely related to risk management, where risk mitigation strategies are considered as efforts made by the owner to reduce the occurrence of a risk that will arise or the impact of the risk. This preventive action requires identification first, especially what happens to companies related to the strategy carried out and the impact of the strategy. This is because these precautions aim to reduce risk.<sup>24</sup>

In terms of overcoming problematic financing, financing restructuring will usually be carried out. Where financing restructuring is an effort made by banks in resolving problematic financing through rescheduling, re-requirements, and realignment.

The bank is required to maintain the level of bank health in accordance with the quality of its assets, where this credit is an asset quality that is a factor and indicator determining the performance of a bank. So if this bad credit is not overcome properly, it will cause losses that must be borne by the bank and will affect the health level of the bank.<sup>25</sup> For this reason, an effort is needed to save the bank against bad loans, namely by *rescheduling*, *reconditioning* and restructuring.<sup>26</sup>

Lembaga Penjamin Simpanan (LPS) is an independent, transparent and accountable institution. In its implementation, LPS consisting of the Board of Commissioners and Chief Executive reports directly to the President. In Law Number 20 of 2004 concerning LPS which was later described in Government Regulation Number 32 of 2005.

On January 17, 2016, Law Number 1 of 2016 concerning Guarantee was established, which is one of the important milestones in the history of guarantee in Indonesia. The Guarantee Law can strengthen the legal basis for the implementation of guarantee activities so far and can integrate all regulations that have been governing guarantees. In addition to functioning to guarantee customer deposits in the banking industry, the Deposit Insurance Corporation is also expected to actively participate in maintaining the stability of the banking system.

LPS also has the obligation to prepare an annual consisting of work activity reports and financial statements. This annual report is submitted to the President and DPR, accompanied by the obligation to publish financial statements that have been audited by BPK in at least 2 (two) daily newspapers that have wide circulation.

The Law does have a duty both to formulate, determine and implement Failed Bank settlement policies that do not have a systemic impact or to carry out the handling of Failed Banks that have a systemic impact.

This becomes a question then, what if a customer has both a single account and a joint account. If so then both will be taken into account, taking precedence over a single account. So what is the value of the guarantee provided by the Government for each customer at a bank. Since its establishment until now, there has been a change in the value of the guarantee which means the change in the era of guarantee from blanket guarantee to *limited guarantee*. The occurrence of these changes can be caused by one or more criteria, namely if there is a withdrawal of large amounts of funds together and/or if there is considerable inflation in several years, and/or if the number of customers guaranteed by all funds decreases to not reach 90% of the total depository customers of all banks, or there is a threat of crisis that has the potential to cause a decline in public confidence in banking. And in every change, there must first be a consultation between the government and the DPR. If there is a customer account that amounts to more than the collateral value, the rest must be paid by the bank that has had its business license revoked through liquidation. However, it should be noted that not all can make claims.

Bank liquidation is the act of settling all assets and liabilities of the bank as a result of the revocation of the business license and the dissolution of the bank's legal entity. Immediately since liquidation, LPS again has the duty to take asset security measures, take over and carry out all rights and authorities of shareholders. And as a consequence of taking over the rights and authority of the GMS, LPS can decide on the dissolution of the bank's legal entity, the formation of a liquidation team, the determination of the bank's status as a Bank in Liquidation and the deactivation of all directors and board of commissioners. In addition, every activity and action carried out by the liquidation team must be submitted and accounted to LPS.<sup>27</sup>

The Deposit Insurance Corporation is responsible for the shortfall in bank handling fees after the old shareholders make capital deposits and all bank handling fees become the Deposit Insurance Corporation's temporary capital participation in the bank. The shortfall in handling fees can be deposited by the Deposit Insurance Corporation in one lump sum or gradually. If the conditions of the Deposit Insurance Corporation have not been met by the bank before the expiration of the period, the Deposit Insurance Corporation can make a preliminary deposit for the shortfall in the handling fee of systemic Failed Banks as high as 80 percent of the estimated handling fee.

The Deposit Insurance Corporation is also obliged to sell all bank shares within a maximum of three years since the shareholders and bank management transfer all rights, ownership, management and interests of the bank to the Deposit Insurance Corporation. The sale of shares must be carried out transparently while considering the optimal rate of return for the Deposit Insurance Corporation. If the optimal rate of return cannot be achieved within a period of three years, it can be extended at most twice with each extension for one year.

The decision to handle Bank Failure has a systemic impact without including existing shareholders stipulated in a decision of the Board of Commissioners of the Deposit Insurance Corporation notified to the Banking Supervisory Agency and the Coordinating Committee. The Deposit Insurance Corporation may announce the systemic Failed Bank on the Deposit Insurance Corporation's home page. All Failed Bank handling costs incurred by the Deposit Insurance Corporation become LPS's temporary capital participation in the bank. LPS is obliged to sell all bank shares in handling.

So if LPS wants to take actions such as handling failed banks with systemic impact in the case of Century or solving failed banks that do not have a systemic impact, LPS cannot simply disburse funds but must take into account the above. Handling systemic failing banks is a series of actions to save systemic failing banks submitted by the Coordinating Committee to LPS, by including (*open bank assistance*) or without involving shareholders.<sup>28</sup>

Handling systemic failing banks is a series of actions to save systemic failing banks submitted by the Coordinating Committee to LPS, by including or excluding old shareholders, the decision on handling systemic failing banks is determined in a Decision of the Board of Commissioners and notified to the Coordinating Committee and LPP. If the intention includes old shareholders, it is mandatory for old shareholders to have deposited at least 20% of the estimated handling costs, there is a statement from the bank's GMS effective from the date of bank handover by the Coordinating Committee to LPS, and submit documents to LPS regarding the use of funding facilities from BI, financial data of debtor customers, capital structure and composition of shareholders for the last 3 (three) years and other information related to assets, liabilities and capital of the bank. And all bank handling costs incurred then become the responsibility of LPS, unless the old shareholders are involved, LPS is only responsible for the remaining shortfall in handling fees, after first depositing capital by the old shareholders.

The construction of a risk mitigation model in credit guarantee institutions in Indonesia is currently not ideal due to several obstacles in handling Failed Banks as is the case in the following Bank Century; Since December 29, 2005, Bank Century has been declared as a bank under intensive supervision in accordance with BI letter No. 7/135/DPwB1/PwB11/Confidential. This is because foreign exchange securities (SSB) and credit distribution have the potential to cause problems. Among some issues that are still unresolved are;

- a) Corruption related to bank mergers;
- b) Changes to regulations for the distribution of short-term funding facilities (FPJP);
- c) FPJP BC that does not have complete collateral requirements;
- d) The existence of Accounting Engineering, Fictitious Credit, and other Violations;
- e) The presence of embezzlement of foreign exchange cash.

## **Ideal Construction of Risk Mitigation Model in Credit Insurance Institutions in Indonesia**

Legal Risk is the risk due to lawsuits and/or weaknesses in juridical aspects. Legal risks may originate, among others, from weaknesses in juridical aspects caused by weak engagements made by the Bank, absence and/or changes in laws and regulations that cause a transaction that has been carried out by the Bank to be inconsistent with the provisions, and litigation processes arising from third party claims against the Bank and the Bank against third parties.<sup>29</sup> The main objective of Risk Management for Legal Risk is to ensure that the Risk Management process can minimize the possibility of negative impacts from juridical weaknesses, absence and/or changes in laws and regulations, and litigation processes. The application of Risk Management for Legal Risk is applied both to individual Banks and to Banks in consolidation with Subsidiaries. The application of Risk Management for Legal Risk is adjusted to the size and complexity of the bank's business.<sup>30</sup> In implementing Risk Management through the process of identifying, measuring, monitoring, and controlling Risks, as well as Risk Management information systems for Legal Risks as follows:

### **1. Legal Risk Identification**

The implementation of identification for Legal Risk is to carry out periodic identification of all Risks, identify Risks in all products and business activities of the Bank, and The Risk identification process is carried out by analyzing all sources of Risk that are at least carried out against the Risk of the Bank's products and activities.

Banks must identify the legal risks inherent in all bank activities to carry out their businesses, namely in the form of credit, fund providers, treasury, investment, operations, services, information system technology, management information systems and human resource management. The Bank must record and administer every event related to legal risks including a number of losses caused by the events referred to in a data administration. The recording and administration of the data is compiled in a statistical data that can be used to project potential losses in a period and activity.<sup>31</sup>

### **2. Legal Risk Measurement**

Banks must have adequate Risk measurement methods for Legal Risk that are integrated with the Bank's Risk Management framework, both using quantitative and qualitative approaches. - In Measuring Legal Risk, the Bank may, among others, use indicators or parameters in the form of potential losses due to litigation claims, cancellation of agreements caused by weaknesses in engagements, changes in laws and regulations that cause the Bank's products to be not in line with existing regulations.

In this legal risk measurement process, the bank uses a combination of approaches in measuring legal risk, the Bank divides the activities inherent in the bank into 7 activities, namely: Credit, Treasury and investment, Operations and services, Financing and trading, Funding and debt instruments, Information system technology (TSI) and Management Information Systems, HR Management.



### 3. Legal Risk Monitoring

Furthermore, the process of managing risk, the risks that occur can be assessed / anticipated in many ways, for example avoiding risks, holding risks or transferring risks to other parties.<sup>32</sup> Banks must carry out several actions in order to carry out risk monitoring which includes 2 things, namely evaluation of risk exposure.

Evaluation of risk exposure is carried out by monitoring and reporting risks that are material or that have an impact on the bank's capital condition, among others, based on assessing potential risks using historical trends and improving the reporting process if there are changes in activities.

At this stage, the management has carried out data processing. The results of the processing have been described in the recommended form according to existing SOPs along with the consequences or influences that will arise. Marketing must be careful in analyzing customers during regular visits to see the development of the customer's business. Marketing must be able to place alternatives that exist if in the future unwanted things happen about risk.

Banks have systems or procedures in place to conduct risk monitoring. Monitoring is carried out by Islamic banks regularly and is periodically submitted to management to prepare several risk mitigation strategies if needed. Banks should implement effective procedures to prevent disruptions. In the process of monitoring risk, and checking and reassessing the system.

The implementation of monitoring for Legal Risk refers to the scope of application in general, namely establishing and establishing transaction approval mechanisms, including those that exceed the limits and authority for each level of position. The Bank monitors legal risks periodically in accordance with past experience of losses caused by legal risks. Management information systems must be able to provide complete, accurate and timely legal risk exposure reports in the framework of the management decision-making process.<sup>33</sup>

### 4. Legal Risk Control

All banks are required to take control measures against risks that may endanger the continuity of the bank's business. The establishment of risk control measures must always be in accordance with sharia principles, control measures are carried out by means of risk mitigation, including hedging and increasing capital to absorb potential losses.

The Bank has a control system and how to manage risk in accordance with the provisions and policies issued by the Bank. The risk control process must be in accordance with the exposure and level of risk that exists. Risk control can be taken by banks, among others, with risk mitigation methods in accordance with existing procedures. In controlling marketing risks must establish existing alternatives. The work unit or function subordinate to the legal field must periodically review contracts and agreements between the Bank and other parties, among others, by reassessing the effectiveness of the *enforceability process* to check the validity of the rights in these contracts and agreements.

In the event that the Bank issues guarantees such as *netting agreements*, *collateral pledges*, and *margin calls*, it must be supported by effective and *enforceable legal documents*.<sup>34</sup>

Implementation of legal risk control inherent in all functions of the organization both directly and indirectly handling activities related to legal risks, including:

- 1) The legal department periodically reviews contracts and agreements between banks and other parties outside the bank.
- 2) Issuance of bank documents such as bank guarantees, purchase agreements, cooperation engagements is supported by complete documents.
- 3) Ensure that legal risks are established against; The operational, organizational and internal control has been carried out in accordance with the provisions and regulations, codes of ethics and business strategies that have been determined.
- 4) Compliance with internal procedures and applicable regulations.
- 5) Financial statements of banks.
- 6) Risk management information system.
- 7) Organizers of communications related to the impact of legal risks on all employees and at every level of the organization.

## 5. Legal Risk Control in Credit

The provision of credit is carried out after there is a loan agreement between banks with the Debtor / Prospective Debtor which contains aspects of legality, credit agreements that contain the rights and obligations of the parties, including:

- 1) Credit Agreement
- 2) Credit Collateral Binding
- 3) Alternative Legal Risk Control to Insurance

## 6. Legal Risk Management Information System

The Bank must record and administer every incident, including litigation processes related to Legal Risk along with the amount of potential losses caused by the event referred to in a data administration. The recording and administration of the data is compiled in a statistical data that can be used to project potential losses of the Bank's business activities in a certain period.

## 7. Internal Control for Legal Risk

The implementation of the Internal Control System for Legal Risk must be complemented by a reliable internal control system. Effective implementation of internal control system can help Bank management safeguard Bank assets, ensure the availability of reliable financial and managerial reporting, improve Bank compliance with laws and regulations, and reduce the risk of losses, irregularities and violations of prudential aspects.

## CONCLUSION

Based on the results of research and discussion, several things can be concluded as follows:

- 1) LPS has the duty both to formulate, determine and implement Failed Bank settlement policies that do not have a systemic impact or to carry out the handling of Failed Banks that have a systemic impact, with the following conditions: (1) Failed Banks Do Not Have a Systemic Impact; a) The estimated cost of rescue is at most 60% of the estimated cost of not carrying out the rescue; b) The bank's business prospects with indicators: net NPL < 5% and no violations and The bank's health level is unhealthy with Composite rating 4 (Commercial Bank) and Less Healthy Rating 3 (BPR); c) A statement of the GMS willing to hand over the management, rights and authority of the GMS to LPS, a statement that there will be no prosecution of LPS or LPS's appointee in the event of rescue failure as long as the rescue action has been carried out in accordance with laws and regulations, and submit power of attorney from all shareholders; and d) The willingness of bank shareholders to submit bank settlements to LPS, including to submit the required documents. (2) failed banks have a systemic impact; a) Estimated handling costs < estimated costs of not handling, b) The bank's business prospects are still good, after being rescued, c) There is a statement from the bank's GMS that is willing to hand over the management, rights and authority of the GMS to LPS, d) The bank submits documents to LPS.
- 2) The construction of risk mitigation models in credit guarantee institutions in Indonesia is currently not ideal due to several things in handling Failed Banks, such as the handling of Bank Century, namely; (a) Corruption related to Bank mergers; (b) Changes to the Regulations for the Disbursement of Short-Term Funding Facilities (FPJP); (c) FPJP BC that does not have complete collateral requirements; (d) Existence of Accounting Engineering, Fictitious Credit, and other Violations; (e) The embezzlement of foreign currency cash.
- 3) The ideal construction of risk mitigation models at credit guarantee institutions in Indonesia is carried out in stages; a) Identification of legal risks; (b) Legal Risk Measurement; (c) Legal Risk Monitoring; (d) Legal Risk Control; (e) Credit Risk Control; (f) Legal Risk Management Information System; (g) Internal Control for Legal Risks.

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