

Developing Policy Solutions for Four High Policy Priority Areas of the Indonesian Government

April 2010

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MINISTRY OF STRATEGY
AND FINANCE

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for Four High Policy Priority Areas
of the Indonesian Government**

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Institute

Preface

In the 21st century, knowledge is one of the key factors in determining a country's level of socio-economic development. From this recognition, Knowledge Sharing Program(KSP) was launched in 2004 by the Ministry of Strategy and Finance of the Republic of Korea and the Korea Development Institute(KDI) in an effort to contribute to the socio-economic development in the development partner countries by sharing Korea's unique development experiences. The most distinguishing characteristic of the KSP is that it is a demand-driven, participation-oriented consultation project aiming to tackle development issues from the partner country's perspective and provide policy implications that are not far-reaching but can be practically implemented in the environment of the partner country. For Indonesia, the Knowledge Sharing Program was initially launched when the Ministry of Finance of Indonesia sent a written Demand Survey Form concerning its areas of interests for the KSP in January, 2009.

Through an extensive survey of the Indonesian Government and agencies, the Ministry of Strategy and Finance of the Republic of Korea, KDI and the Ministry of Finance of the Republic of Indonesia, the counterpart organization, decided to tackle the issues of developing policy solutions for high policy areas of the Indonesian Government. These are: 1) Competition Policy, 2) Capital Market Development, 3) Financial Supervision, and 4) Medium-term Fiscal Expenditure Management.

I would like to take this opportunity to express my gratitude to the project consultants including the Project Manager, Dr. Okyu Kwon, Dr. Kwangshik Shin, Dr. Pil-Kyu Kim, Dr. Nowook Park and Dr. Joonhyuk Song for all their work in successfully navigating the KSP for Indonesia. I also thank Program Directors Dr. Wonhyuk Lim and Mr. Taihee Lee and Project Coordinator Ms.



Eun Hae Kim, all of whom are members of the Center for International Development at KDI, for their dedication and contribution to the project. Lastly my sincere thanks also go to the Ministry of Finance and all Indonesian officials and counterpart experts who actively supported the project.

Upon this occasion of publishing the findings of the KSP with Indonesia, I have a strong belief that the program results will be of great value for both Korea and Indonesia and I sincerely hope that through this Knowledge Sharing Program the Indonesian Government and relevant line ministry personnel could benefit from the Korea's experience. I also hope that our final report, which sets out policy strategies for the Indonesia's development from various perspectives, could be used as a catalyst in supporting Indonesia's leap to an advanced economy. The policy recommendations in this report, however, are based on the Korean experiences and are solely the opinions and recommendations of the authors.

Oh-Seok Hyun
President
Korea Development Institute

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Introduction

- 1_ Summary of the Research Findings
- 2_ Concluding Remarks

Introduction

*Okyu Kwon (KAIST Graduate School of Finance,
Former Deputy Prime Minister & Minister of Finance and Economy)*

As Morgan Stanly recognized Indonesia as a member of the BRICI, next group of emerging economies substituting the BRICs, Indonesia is taking a more important role in the global economy. Indonesia is a member of G20 like Korea and is showing a robust GDP growth of 4% in 2009 and expecting a 7% growth in 2010 in the midst of global financial turmoil stemming from subprime mortgage crisis. As the incumbent President Susilo Bambang Yudoyono was reelected in July 2009, political stability is being strengthened and as a result, reform policies are expected to be geared further. Development pace of Indonesia is now accelerating, thanks to its wide development potential with total population of 245 million, which is ranked the 4th largest population in the world, as well as abundant natural resources, and strengthened competitive export position based on labor cost, which is even lower than that of China or Vietnam.

As such, the Korean Government selected Indonesia as a strategic cooperative country in 2010 and pursued comprehensive cooperative relations. Even before the announcement of the 2010 strategic cooperative partner countries, the Ministry of Strategy and Finance of Korea has been engaging such cooperative relationship with Indonesia. With a theme of the “Tasks for Take-off toward an Advanced Economy,” four areas were selected for the 2009 Knowledge Sharing Program(KSP) with Indonesia: i) Developing Capacity for Effective Competition Policy, ii) Enhancing Financial Supervisory System, iii) Ways to Establish Securitization and Derivatives Market, and iv) Developing Medium-term Expenditure Framework and Performance Budgeting System.

This project was the third of its kind undertaken since 2005 for Indonesia and the main topics were selected after close consultation between the Korea Development Institute, the executing agency for the KSP program, and the Indonesian Government. The Ministry of Finance of Indonesia was designated as the coordinating institution for the Indonesian side.

Indonesia, in its accelerating development stage, is keen on minimizing trial and error and strengthening capacity building in structural reform policies in various areas. The KSP was evaluated to have comparative advantage over various cooperative programs of other countries or organizations. From the Korean side, Indonesia is a crucial cooperative partner country with vast market as well as natural resources, and it is very timely to decide to select Indonesia as a strategic partner for the multi-year comprehensive KSP. Indonesia also showed very strong interests in the program, as shown during the Final Reporting Seminar held in January 2010 in Jakarta, where a lot of high ranking government officials had attended and engaged in dialogues with the Korean counterpart experts during the discussions. As well, successful meetings were held with top decision makers of the Indonesian Government at the High Policy Dialogues, such as the Minister of Finance, Minister of Development and Planning, Fair Trade Commissioner, Vice Governor of Bank Indonesia (Governor position was vacant after the Governor was promoted to the Vice President of Indonesia), Chair of Financial Supervisory Office, and Head of Oil and Gas Office. Journalism also showed high interests as the interviews made with Indonesian journalists of major news media, including broadcasting stations were broadcasted at prime time news hour.

1. Summary of the Research Findings:

1.1. Developing Capacity for Effective Competition Policy of Indonesia

Indonesia benchmarked Korean competition law when it introduced competition policy in Indonesia in 2005, after the policy recommendation was made for Indonesia during the 2005 KSP at that time. Since then, Indonesia has been solidifying its foundation to strengthen its enforcement capacity of competition law.

Korea has successfully institutionalized its own competition law and policy for the last three decades. Korea's experience can offer valuable guidance for Indonesia in developing an effective and rational competition policy. Important implications of Korea's experience are as follows:

First, to develop a coherent competition policy, its purpose must be clear. Competition policy can become a rational public policy only when it strives for economic efficiency as the sole or at least the principal objective.

Second, to serve the goal of improving economic efficiency, competition rules should be shaped and enforced based upon sound economic theories. It is crucial for the competition agency to develop capacity to employ evolving economic theories of industrial organization.

Third, in addition to prohibiting anticompetitive business tactics, enhanced competition advocacy efforts are required to counter government regulations that hinder competitive processes.

Forth, Indonesia's competition law allows many exemptions. For a competitive market economy to be effective, exemptions from the competition law should be minimized to ensure the effectiveness of the law.

Fifth, adopting a leniency policy, which promises lenient treatment to those who disclose their cartel to the competition agency, can be of great help in anti-cartel efforts.

Sixth, it is appropriate to convert the current per se rule against business practices such as vertical restraints, differential pricing among buyers, and loyalty rebates to the rule of reason. These practices have the potential to enhance efficiency and consumer welfare.

Seventh, well-developed enforcement guidelines would not only increase predictability and transparency of the law enforcement but also enable competition agency to take more integrated approach to applying the law.

1.2. Enhancing Financial Supervisory System in Indonesia

Indonesia is yet to undertake comprehensive financial reform policies. For example, in case of commercial banks, around 80 banks are still doing a rather small scale business, showing weaknesses in terms of capital soundness, accounting transparency, and management accountability. Therefore it is imperative to strengthen financial supervision, but the institutional capacity is still weak. In addition, need for a better supervisory capacity has been highlighted by the recent financial turmoil originated from the U.S. subprime mortgage for both advanced and emerging countries. Faced with global trends of financial consolidation and liberalization, emerging market countries have increased their efforts to secure stability and soundness of their financial system by minimizing systemic risk potential with the enhanced financial supervisory structure.

Indonesian financial supervisory system stands at a crossroads. The architecture of financial supervisory system has the element that is more endogenous rather than exogenous. Financial supervisory system should be restructured in order to enhance the competitiveness and stability of financial markets in steps with the development stage of financial markets.

In retrospect, the outbreak of the 1997 economic crisis provided a decisive momentum for the immediate adoption of the integrated system of financial supervision in Korea. However, it is uncertain whether the current moment is the right timing for Indonesia to change its financial supervision structure. Considering the world-wide discussion on the reshaping of financial

supervision and the trend of integrating dispersed supervisory bodies, the financial supervisory system of Indonesia will eventually meet the need for reforms on overall regulatory and supervisory substances as well as governance structure. Whichever road Indonesia takes, it will face with many challenges to upgrade its current financial supervisory system. In this section, the authors do not suggest which road is the best for Indonesia, but to provide and share the lessons learned from past experiences after Korea has switched from a disintegrated financial supervisory system into an integrated one.

The fundamental lesson is that supervisory cooperation and checks and balances between public agencies responsible for the financial system are indispensable to efficient financial supervision and financial stability. This, the authors believe, is universally the case, irrespective of the specific type of institutional structure of financial supervision.

Indonesia has a similar financial supervisory system of Korea before it has undergone the changes in supervisory architecture in 1998.

The ultimate goal of restructuring financial supervision system is (to strengthen) and upgrade the soundness and competitiveness of financial industry. (In order to achieve these goals, the independence of financial supervision is essential). Under this condition satisfied, the accountability and efficiency of financial supervision becomes enhanced.

The second precondition for interagency supervisory cooperation and checks and balances is that there will be goodwill on the part of the heads of the public agencies responsible for the financial system. Since institutions are ultimately run by people, the institutional hierarchy seems to have been easily structured vertically according to the scope and strength of powers exercised by each of the public agencies involved. The Ministry of Strategy and Finance(MOSF) sits atop the institutional hierarchy, followed by the Financial Services Commission(FSC). MOSF and FSC are situated on the upper rungs of the hierarchical ladder, while the Bank of Korea(BOK) and the Korea Deposit Insurance Corporation(KDIC) are on its lower rungs.

As long as there are vertical hierarchical relationships among the public agencies, there is no room for interagency supervisory cooperation and checks and balances to be generated. Cooperation is not about order and obedience. Checks and balances are possible when the public agencies interact not in terms of powers, but in terms of functions. (Goodwill can be generated only when the relationships between the public agencies are functional and horizontal). In Korea where the cultural tradition widely prevails, much conscientious effort on the part of the public agencies over a long period of time will be necessary to nurture goodwill.

In these circumstances, the overlap of tasks and functions of the public agencies may serve as a substitute for goodwill. In advanced countries including the United States, the United

Kingdom, and Canada, some overlaps of supervisory powers and tasks between public agencies are in fact provided for in law, with a view to helping generate interagency supervisory cooperation and checks and balances in practice. In contrast, institutional structure of financial supervision in Korea, as envisaged by the 1997 Act for the Establishment of Financial Supervisory Organizations, leaves little or no room for such an overlap. The authors, therefore, suggest that powers be reallocated to bring about some overlaps of tasks and functions between public agencies. We have only to increase the degree of overlap up to a threshold beyond which each public agency begins to feel the need to cooperate with others for the accomplishment of its own tasks.

Examples of such partial overlaps may possibly include the following: First, BI could be legally authorized under certain conditions to perform an independent on-site examination of a bank, while the supervisory agency continues to be charged with financial supervision including on- and off-site examination. BI might use this limited authority simply as notional leverage by means of which it could win cooperation with the supervisory agency. Second, the mandate of the financial stability could be explicitly stated, in addition to the price stability, in the article of purposes of BI. In retrospective, BOK was deprived of its bank regulatory and supervisory functions when the BOK Act was revised in December 1997. At the same time, the mandate of financial stability was removed from the Act's article of purposes as well. Since then, there has been a widespread misunderstanding that BOK is no longer involved in financial stability. This kind of misunderstanding impeded interagency co-operations. To avoid the similar circumstances, the explicit statement of the financial stability mandate in the duties of BI, in the presence of a unified supervisory agency, would make it clear that the BI, together with other public agencies, should participate in the maintenance of financial stability.

In some sense, this could be considered as creating an effective overlap of the financial stability mandate among the public agencies. That would surely help enhance interagency supervisory co-operation and checks and balances. Third, the supervisory agency should be empowered with draw up draft legislation relating to prudential regulations in consultation with BI and the Ministry of Finance. Some extent of an overlap in the power to develop laws could then be created between the Ministry of Finance, the supervisory body and BI. The power to develop laws should not be monopolized.

In Korea, the Financial Policy Coordination Committee, which is attended by the Vice Minister of Strategy and Finance, FSC Vice Chairman, and BOK Vice Governor, is currently the only channel for communication between public agencies responsible for the financial system. The Committee, however, has no legal basis and it has been operated within the vertical institutional hierarchy. Due to the lack of legal basis and formal arrangements, the Committee's role as an interagency supervisory cooperation body has been very limited.

Based on the Korean experience, it is very important to introduce a variety of legal

arrangement for interagency supervisory cooperation and for checks and balances and, if necessary, to substantiate details in the form of MOUs or administrative agreements. These MOUs/agreements will help create stable relationships between the public agencies based on their respective functions on an equal footing. Also, the authors if Indonesia is to set up a coordination committee on interagency supervisory bodies, the committee should to be attended by heads of each supervisory agency to make the committee more operational and effective in agenda-setting and reaching agreements.

1.3. Ways to Establish Securitization and Derivatives Market in Indonesia

Securitization and derivatives markets are essential finance means to invigorate capital markets. A securitization market provides a firm or financial institution with a vehicle to raise funds backed by its assets. Meanwhile, this market offers investors investment products with high credit quality. A derivative product is a means to hedge various risks arising from underlying assets while it offers investors ways to invest according to diverse preferences.

Korea is the largest securitization market in Asia. Corporate and financial institutions have been active in funding secured on the back of assets. The exchange-traded market for stock-index derivatives is the most active in the world. Korea's experience in creation and development of securitization and derivatives markets will have implications for vitalizing capital markets in Indonesia.

In Indonesia, the securitization market has barely developed despite demand for securitization of consumer finance receivables and mortgage assets held by banks. The bank-centered financial system was obstacles to the invigoration of the securitization market. As well, the weak investor base is the primary reason behind the inactive securitization. In addition, the infrastructure surrounding ABS market is a constraint to the securitization market.

To make the securitization market active, ABS issuance offers various benefits to originators and investors. Above all, from the originator's perspective, the securitization market should enable originators to raise funds efficiently at low costs by issuing ABS. The bond market needs to be vitalized for the active securitization market. In addition to that, it is necessary to consider the adoption of securitization law, like Korea. Through the enactment of securitization law, it is necessary to establish systems which enhance confidence in securities and make possible the proactive participation and supervision of regulators. To invigorate such, the ABS market needs to have in place the infrastructure for asset valuation, asset transfer and the set-up of a special purpose company. Plus, key infrastructure, such as credit ratings and disclosure system, needs to be improved.

In Indonesia, inactive individual investors are stumbling blocks to invigorating the

derivatives market. The small size of the stock market is an impediment to the development of the derivatives market. The limit on price change gives a heavy constraint on the futures market which leads to the limited futures trades. An obstacle to the trading of stock options is automatic offsetting that is conducted immediately when the spot price changes 10% or more from the previous day's price. For that reason, stock options can play only a limited role in hedging the risk of price volatility in single stocks. Along with that, another constraint on the vitalization of the market is high tax rate.

The Indonesian government, among other things, needs to show its policy commitment to nurturing the capital markets with diverse policies aimed at boosting the derivative market. Moreover, to have the active derivatives market, the ways to expand the investor base needs to be considered. In Korea, the increased investments of individuals and companies in the capital markets and the expansion of such investors paved the way for the invigorating derivatives market. To expand the base of individual investors, it is necessary to actively educate individuals on the capital markets. To facilitate the Indonesian derivatives market, it needs to define and adopt market-friendly terms and conditions for derivatives trading, which will satisfy the needs of market participants. It is desirable to set the limit on price movement considering volatility in spot trade. What is more, an increase in the degree of price fluctuations could cause the depth of investors to be expanded by motivating investors with different purposes to participate in trades. In addition, if the current spot price is up or down 10% or more from the prior-day's price, offsetting transaction is automatically conducted immediately in case of stock options. Even in the stock option market, it is advisable to abolish the offsetting and, rather, strengthen measures to stabilize the market through margin and sidecar systems. Yet, it is necessary to establish options trading system in which ceiling and floor quote prices are set and quotes outside those prices are not accepted to prevent error trading. Moreover, the taxation of derivatives should be revamped. It is advisable to cut a derivatives trading tax at an early stage and not to impose tax on income arising from derivatives.

1.4. Developing Medium-term Expenditure Framework and Performance Budgeting System

In many emerging and developing countries, reforms in the budget process are in full swing by benchmarking best practices in advanced countries. Korea also has gone through major budget process reforms during early and mid 2000s. They are called as 4 major fiscal reforms in Korea. That is, medium-term expenditure framework(MTEF), top-down budgeting, performance-oriented budgeting and digital accounting system. MTEF and performance-oriented budgeting is selected as topics of the 2009 Knowledge Sharing Project(KSP) with Indonesia. This paper attempts to present brief theoretical overview of both initiatives, raises some issues from Korean experiences and developed recommendation for Indonesia who is in the process of introducing both reforms. It is stressed that capacity of government and cultural and political environment of the particular country concerned should be considered, in

designing and implementing the reforms. Based on the challenges that Korea had been facing in the process of reforms, practical recommendations that need to be considered for Indonesia are presented.

The purposes of MTEF are manifold: First, improve macro fiscal situation by introducing medium-term perspectives and fiscal discipline into budget process. Second, improve predictability of policy and funding to the program managers and the public by providing a picture of medium term plan. Third, improve the impact of government policy by linking policy priorities and performance to the budget allocation among sectors and programs.

To achieve these goals, some challenges need to be overcome. First, producing independent and objective macroeconomic projections and revenue estimates are crucial to give credibility of MTEF for decision makers, because the incumbent government tends to have too optimistic views on the economy. To make MTEF transparent, assumptions underlying medium-term macroeconomic forecasts should be made public. Second, costs and performance information of government policies should be credible and informative. Developing sound cost and performance information of existing policies and new policies creates a challenge of its own. It may take time to produce quality information, but it is a necessary procedure to realize full potential of MTEF. Third, the environments in which civil servants manage their policies need to be improved. Their line of responsibility should be clear and they need to have proper autonomy in managing their program. If their work environment is uncertain and they do not have proper incentives to manage their program effectively, performance of the government policies will not be improved even though MTEF.

Performance-oriented budgeting can be viewed as an infrastructure of MTEF, because it provides performance and costs information of government policies and enhances links between budget allocation and performance of spending programs. For the successful implementation of performance-oriented budgeting, some challenges need to be overcome. First, infrastructure of performance-oriented budgeting needs to be developed, which takes time and requires patience. The infrastructure refers to performance and cost information of spending programs, and program structure. Second, communications between the Administration and the Parliament is very important, particularly when outcome-oriented performance budgeting is introduced. The Parliament want to check the inputs and process of government programs, while outcome-oriented performance budgeting intends to give autonomy to program managers in the input and process management. Therefore, communication on the reform agenda with the Parliament is crucial for the successful implementation of budget process reforms. It is easy to introduce the appearance of budget process reforms, while meaningful implementation of the reforms is hard to come by. With careful and persistent efforts of involved parties and leadership of high level decision-makers, MTEF and performance-oriented budgeting will make budget process more efficient and disciplined by providing longer term perspectives, meaningful performance and cost information into budget process.

2. Concluding Remarks

With its vast domestic market, abundant natural resources, competitive edge based on labor cost stronger than that of China and Vietnam, Indonesia's presence in the global market is ever increasing. As the Asia Foundation under the Department of State of the United States designated Indonesia as the top priority cooperative partner country in Asia, Indonesia's role in the global economy, global financial market, even in geopolitics in Asia, is expanding.

On the contrary, despite that Indonesia also experienced financial crisis in late 1990's like Korea, restructuring effort in financial sector remains rather at the beginning stage. While Indonesia is enthusiastic about pursuing reform policies since it has achieved democratization in 2000, preparation for reform roadmap for that end seems to be insufficient. Considering these factors, the Korean Government's decision to select Indonesia as a strategic KSP partner is very relevant and timely. By focusing on policy implications of the Korea's successful reform experiences, Indonesia can minimize trial and error in its policy formulation, particularly in the areas of policy introduction process as well as implementation capacity building. In this regard, it is imperative for KSP to enhance visibility and to draw attention of the top decision makers of Indonesia.

In addition, in order to further support KSP, separate training opportunities were given to middle level core government officials to take financial MBA programs in an eminent graduate school in Korea. In the 2010 academic year, two Ministry of Finance officials were admitted and the number of officials admitted will be further expanded to the Central Bank, Financial Supervisory body, and Energy Ministry in the 2011 academic year.

The Strategic KSP for Indonesia is to be launched in 2010 including short-term job training programs. Three areas of sectors being considered are: financial market, energy and environment, and trade and investment. Thanks to high interests of both Indonesian and Korean Governments, future Strategic KSP for Indonesia will ensure successful implementation.

Developing Capacity for Effective Competition Policy of Indonesia: Lessons from Korea's Experience

- 1_ Purpose of the Study
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Developing Capacity for Effective Competition Policy of Indonesia: Lessons from Korea's Experience

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1. Purpose of the Study

Korea is one of the few newly industrialized countries that have successfully institutionalized its own competition law and policy. In December of 1980, Korea's general competition law, the Monopoly Regulation and Fair Trade Act (hereafter the MRFTA) was enacted, and competition policy and institutions began to emerge in a country with a strong tradition of extensive economic management by the government.

The MRFTA declares that its purpose is “to foster fair and free competition ... thereby stimulating creative business activities, protecting consumers and promoting the balanced development of the national economy.” Despite its multiple goals, the original Act lacked many crucial elements to be an effective competition law. Through a series of amendments in the last three decades, the MRFTA has gradually become a substantive and effective tool for the promotion of competition. There have been 19 amendments to the Act since the legislation, and the related law, regulations, and rules have developed quite rapidly.

The Korea Fair Trade Commission (hereafter the KFTC), an administrative agency with quasi-judicial authority, has exclusive responsibilities to enforce the MRFTA. While the Attorney General may prosecute violations of the Act, such an action is contingent on the KFTC's filing of a complaint. The KFTC, which was originally established within the Economic Planning Board, became a central, independent agency under the Prime Minister in December 1994, and the status of its chairman was elevated to the ministerial level in March 1996. The jurisdiction of the KFTC also has substantially broadened. At the beginning the KFTC administered only the MRFTA. Now it has jurisdiction over nine statutes,¹⁾ carrying out multiple missions of promoting competition, ensuring fair trade and protecting consumers. With its enlarged role and activities, the number of the personnel of the KFTC has increased from 75

in 1981 to almost five hundreds.

In the 1980s, the enforcement of the MRFTA was quite weak and limited. In 1987, for example, the KFTC issued 70 corrective orders.²⁾ Twenty years later, the number increased to 927. Until 1991 the KFTC had not imposed surcharges. In 2007, the KFTC imposed a total surcharge of KRW 423 billion on 414 enterprises, and made 48 requests for criminal prosecution. Nowadays, virtually no enterprise is free from the KFTC's enforcement activities.

Decisions of the KFTC can be appealed to the Seoul High Court and, ultimately, to the Supreme Court. Also, anyone injured by a violation of the MRFTA can bring an action for the recovery of actual damage. Active enforcement of the MRFTA coupled with the frequent imposition of heavy surcharges has triggered an increasing number of legal suits against the KFTC. Before 1996, the number of legal actions against the KFTC was less than 10 a year. The number jumped to 81 in 2007. The number of damage action has also increased. The increasing number of suits has expanded the role of the court in shaping antitrust doctrines and legal rules.

In Indonesia, the need for a competition law had been discussed for a long time by many scholars and NGOs, but a major factor contributing to its enactment was the financial crisis in 1997. IMF recommended Indonesia to enact a competition law, and in 1999 Indonesia passed "Law No. 5 of 1999 concerning the prohibition of monopolistic practices and unfair business competition" (hereafter Law No. 5/1999). There has been no amendment so far.

Chapter III of Law No. 5/1999 prohibits anticompetitive agreements among business actors, and Chapter IV prohibits certain individual activities such as monopolization, market control, and conspiracy. Chapter V proscribes abuse of a dominant position and anticompetitive mergers.

The Komisi Pengawas Persaingan Usaha (hereafter the KPPU) is the competition agency that enforces Law No. 5. It is an independent commission that reports directly to the President and the People's Legislative Assembly. It has the authority to enforce the law, to make implementing regulations and guidelines, to conduct research pertaining to Law No. 5, and to advise other governmental departments on competition policy. The KPPU began to step up its enforcement efforts from 2005. The number of cases handled, which remained less than 10 a year until 2004, increased to 22 in 2005 and 88 in 2008. As a competition agency which just started to apply the competition law, the KPPU faces a tremendous but challenging task of developing a sound competition policy.

1) The statutes enforced by the KFTC include Fair Subcontract Transactions Act, Consumer Act, Regulation of Standardized Contracts Act, Installment Contracts Act, Fair Labeling and Advertising Act, and Act Concerning Door-to-Door Sales.

2) The KFTC may recommend a voluntary correction for minor violations. For major violations, it may issue a corrective order (usually a cease-and-desist order) and may further impose a surcharge (an administrative fine). Complaints can be filed with the Attorney General for prosecution when the corrective order is not complied with or the violation is deemed serious.

Competition law covers a very wide range of business activities. The law is wholly prohibitory in nature as it is designed to stop business actions detrimental to the public welfare. The law also has an educational role in that it provides a code of business conduct, a description of what is fair business behavior and what is unacceptable. Given its scope and nature, the effects of competition law on the national economy will be enormous. The degree of competition is a key factor determining the growth of productivity and output in an economy. An effective and efficient enforcement of proper competition rules would significantly contribute to strengthening competitive market forces, thereby supporting economic development. However, if enforced in an inappropriate and arbitrary way, the law would be degraded to a convenient means of unnecessarily controlling businesses, thereby suppressing creative economic activities and destroying national wealth.

For a country that has recently enacted a competition law, it is critical to build a suitable competition policy framework based on a sound understanding of requirements for effective and efficient competition law and policy. That is not an easy task. Competition agencies with little experience of competition law enforcement can obtain important lessons from the experience of other nations with a history of developing competition law and policy. Korea enacted a competition law when it was a developing country, and for the last 30 years successfully institutionalized its own regime of competition policy.

This study will examine Korea's experience of developing competition law and policy for the purpose of drawing useful lessons for strengthening the capacity for effective competition policy of Indonesia. The next section deals with Korea's experience of competition law and policy, focusing on the evolution of substantive rules and enforcement tools. Section 3 discusses what Korea's experience implies for developing Indonesian competition law and policy.

2. Korea's Competition Law and Policy: History and Analysis

2.1. Goals of the MRFTA

To a large extent, the enactment of the MRFTA came from a strong need for a transition to a more market-based economy in coping with difficulties the Korean economy faced in 1980. The government's heavy and chemical industry drive coupled with extensive intervention in the economy during 1970s had severely hampered the price mechanism and created many distortions. This experience prompted a reappraisal of the way the economy was run and led the government to pursue a fundamental shift in policy orientation. The government enacted the MRFTA, while taking liberalization measures, abolishing direct price controls, and opening trade and investment. The idea that competition ensures the efficient functioning of the market underlay the enactment of the MRFTA.

Another important factor underlying the enactment of the MRFTA was a growing concern about excessive concentration of economic power on chaebols, which are large conglomerate business groups in Korea. Chaebols were presumed to possess and exercise special power associated with conglomerate bigness, posing a unique threat to the free market system and democratic values. They were also seen to engage in ‘unfair competition,’ having substantial advantages over small, independent enterprises in almost all aspects of business. Hence, it seemed necessary that the government establish an environment in which chaebols compete on equal terms with other economic agents.

These perceptions have had a profound impact on many aspects of Korea’s competition law and policy. The MRFTA proclaims that its objective is “to encourage fair and free competition by preventing the abuse of market dominating position and excessive concentration of economic power and by regulating undue collaborative acts and unfair business practices, thereby stimulating creative business activities, protecting consumers and promoting the balanced development of the national economy.” The law is aimed at the dual goals of promoting competition and promoting fairness and balanced development. Its stated purposes are broad enough to justify attacks on aggregate concentration and to support rules on competitive fairness and equity in bargaining relationships. Much of Korea’s competition policy stems from its stated purposes.

2.2. Preventing Concentration of Economic Power

Although the original MRFTA explicitly identified the prevention of the “excessive concentration of economic power” as one of its purposes, it did not provide measures to directly tackle the problem of concentration. Then the Act was amended in 1986 to contain chaebols’ expansion and thereby to mitigate the concentration of economic power.

The 1986 amendment of the MRFTA prohibited holding companies. It also required the KFTC to designate “large business groups” each year and subject them to special regulations. Direct cross-shareholdings between the subsidiaries of the same business group were banned, and financial subsidiaries were prevented from exercising their voting rights with shares in other subsidiaries of the business group. Also total equity investments by a non-financial affiliate of a large business group in other domestic companies were limited to 40% of its net assets. In 1993, the total amount of loan guarantees that a company could provide for its affiliated companies was limited to a maximum of 200% of its own equity capital, and in 1998 new intra-group loan guarantees were prohibited and all outstanding guarantees had to be cleared by March 2000.

When direct regulations on chaebols were first introduced in 1987, the focus of regulation was on preventing excessive concentration of economic power by limiting conglomerate expansion. Then chaebol regulations began to be used to pursue other goals such as dispersed

ownership, improved financial structure, and separation of ownership and management. To accommodate these diverse goals, many exemptions were created, undermining the effectiveness and predictability of the regulation. Increasing globalization of business activities is another factor that makes chaebol regulation ineffective and counter-productive. In a globalized economy, domestic regulations on chaebols inevitably place them at a competitive disadvantage.

Against this backdrop, chaebol regulations have been alleviated in recent years. Holding companies, which were banned from 1987, were allowed under some restrictive conditions by the February 1999 amendment. The investment limits, once eliminated in 1998 and reinstalled from 2001, were abolished again in 2008.

2.3. Competition Advocacy

Prohibiting anticompetitive practices by firms is not enough for protecting competitive market processes because governmental interventions often constitute the prime source of market power in many industries. This is true especially of a country like Korea where many legal barriers to competition were created by industrial policies up until the 1980s. To strengthen competitive processes by promoting an open and competitive environment, it is essential to reduce public restraints of competition.

The best way to do this is to empower some agency, which is not beholden to any particular industry, to question the merits of regulatory decisions and to represent consumer interests. This is why the KFTC is mandated under the MRFTA to advocate competition principles within the government.

The original MRFTA required government authorities to consult with the KFTC before they take any legislative or administrative measure that is likely to restrain competition. This provision serves as a major vehicle for the KFTC to oppose new regulations that unreasonably suppress competition and to advocate competition principles in the government rule making process. After gaining ministerial status in 1996, the KFTC has issued more opinions, and other ministries have accepted a larger proportion of its opinions. From 1998, the KFTC has played competition advocacy role by pushing its competition assessment opinion in the Regulatory Reform Committee of which the KFTC is a member. In 2008, the KFTC reviewed 827 proposed regulations and offered competition assessment opinions on 36 cases.

The MRFTA as amended in 1996 further empowers the KFTC to develop and implement plans for enhancing competition in markets where monopolistic structure persists for an extended period of time, and to offer its opinions on regulatory reform measures to relevant government authorities. To perform these tasks, the KFTC regularly publishes a report on industrial concentration and occasionally engages in industry studies. In 2008, for example, the

Commission took measures to mitigate impediments to competition identified in air transportation, broadcasting, telecommunication, financial service, and insurance sector.

Indeed, deregulation has taken place in many sectors through KFTC's competition advocacy efforts. The KFTC has successfully activated competition in many markets by easing or abolishing regulations that limit entry, pricing, or other competitive behavior. A good example is the enactment of the Omnibus Cartel Repeal Act in 1999, which removed 20 legalized cartels under 18 statutes.

2.4. The Coverage of the MRFTA

Since the enactment of the MRFTA, public corporations have been equally subject to the law as are private businesses, and have frequently been the target of the KFTC's enforcement action.

The coverage of the MRFTA has broadened considerably since its enactment. The original MRFTA confined its application to 12 KSIC (Korea Standard Industrial Classification) industries, explicitly exempting 5 KSIC industries including agriculture and forestry, fishery, mining, and public administration and defense. This statutory exemption was removed by the 7th amendment in 1999. The blanket exemption provided for financial and insurance companies in 1990 also was abolished in 1999.

From 2002, the KFTC started extraterritorial application of the MRFTA to anticompetitive practices by foreign firms that harm Korean consumers. The KFTC imposed corrective measures and surcharges against international graphite electrode cartel in 2002 and vitamin cartel in 2003. In 2005, the KFTC challenged Microsoft's design of its Windows operating system as an illegal tying and took corrective measures. The agency found Intel's conditional rebate scheme abusive in 2008, imposing corrective orders and surcharges.

Almost all profit-seeking enterprises are now within the jurisdiction of the MRFTA. Only legitimate actions taken pursuant to other laws and regulations, lawful exercise of intellectual property rights, and activities of cooperatives of small businesses or consumers³⁾ are exempt from the application of the MRFTA.

2.5. Prohibition of Undue Collaborative Acts

Article 19 of the MRFTA forbids concerted activities by "contract, agreement, resolution, or any other means" which would unreasonably restrain competition in any line of business. It

³⁾ For such cooperatives to be exempt from the law, conditions of voluntary membership and equal voting rights among members must be satisfied. Unfair trade practices and anticompetitive acts causing a price increase are not exempt.

specifies eight types of conduct that are subject to the prohibition. Two elements must be established to prove a violation: the existence of an agreement to engage in concerted action and unreasonable restraint of competition. An express agreement is not required to establish a violation; the existence of an agreement can be inferred from parallel behavior in appropriate circumstances. The reasonableness of an agreement is determined by its likely effect on competition, and the KFTC issued the Guidelines on Collaborative Activities in 2002, describing the way in which cooperative activities are to be assessed.

Article 26 extends the prohibition of undue collaborative activities and unfair trade practices to trade associations and their members. It also prohibits trade associations from limiting the number of firms and unreasonably restricting business activities of member firms.

As originally enacted, the MRFTA required parties to a restrictive agreement to register it with the KFTC for prior approval. There were 142 registered cartels during the period 1981 to 1986. Through subsequent amendments, however, legal rules and sanctions against collusive agreements have been substantially strengthened. The Act as amended in 1986 generally prohibited collaborative activities that “would substantially restrain competition,” while empowering the KFTC to grant discretionary exemptions. It also allowed inference of concerted action from circumstantial evidence. From 1993, proof of actual conduct became unnecessary to establish a violation. In 1999, the legal standard changed from “substantial restraint of competition” to “unreasonable restraint of competition,” which means that it is no longer possible to defend a restrictive agreement on the ground that it has insignificant actual effect. This new legal standard in effect establishes a per se rule against naked agreements to fix prices, limit output, rig bids, or allocate markets.

The offense of undue collaborative acts has been subject to the imposition of surcharges from 1987. The maximum amount of the surcharge was initially 1% of sales revenue of the product involved during the collusion period. It was raised to 5% from 1995 and to 10% from 2005. Colluding firms and individuals are additionally subject to criminal punishment.

From 1987, parties to a restrictive agreement may apply for prior approval of the agreement, and the KFTC can grant exemption if the proposed collaboration is deemed necessary for the purposes of rationalizing an industry, promoting research and technology development,⁴⁾ overcoming depression, facilitating industrial restructuring, rationalizing terms of trade, or enhancing the competitiveness of SMEs. Nine cartels had been exempted in 1987, but all were revoked by 1997. Many more cartels were legalized by various sector-specific statutes,⁵⁾ and the Omnibus Cartel Repeal Act of 1999 removed many of such legalized cartels.

4) Exemption of R&D cartels became available by the December 1992 amendment.

5) A 1991 survey by the KFTC revealed that there were 44 cartel-authorizing provisions in 35 statutes.

Several measures have been taken to facilitate the detection of cartels. Most important was the adoption in 1997 of a policy of according lenient treatment to cartelists who first disclose violations of which the KFTC is not aware. The leniency policy was expanded in 2001 to those who provide cooperation in the investigation. In 2005, amnesty plus was introduced which extends leniency to cartelists who disclose another collusion. Under the current program, the cartel participant who first discloses illegal collusion to the KFTC is entitled to complete exemption from punishment, and the second applicant is entitled to 50% deduction of surcharges. In 2002, the KFTC further adopted a program of giving pecuniary award to anyone who provides information and evidence on certain violations including illegal cartels. During 2002 to 2007, there were nine cases where the KFTC provided pecuniary award to informants of illegal cartel activities. In 2007, the KFTC was empowered to request other government agencies to provide bidding materials in public procurement.

The KFTC has toughened its enforcement against cartels from the mid-1990s. There has been a sharp increase in the number of corrective orders and the amount of surcharges imposed after the 1997 financial crisis. The number of corrective orders jumped from 4 in 1993 to 31 in 2006. The leniency program played a critical role in detecting and proving collusive behavior. The number of cartel cases where the leniency program was applied increased considerably from 2005. In 2007, 10 out of 24 cartel cases where surcharges were imposed were leniency cases, accounting for 72% of the total surcharges imposed on cartels in that year.

In many regulated industries such as insurance, financial service, and liquor, regulatory bodies sometimes informally guide pricing and other competitive acts of the regulated firms, thereby producing uniform conduct among competitors. The KFTC has consistently found such parallel behavior illegal if administrative guidance involved is not a legitimate action taken pursuant to relevant laws.

2.6. Prohibition of Abuse of Dominance

The MRFTA does not forbid monopoly per se but rather prohibits “market-dominating enterprises” from abusing dominant positions. Article 3-2 as amended in February 1999 forbids any “market-dominating enterprise,” defined as an enterprise which can exercise monopoly or monopsony power in a relevant market either unilaterally or in conjunction with others, from engaging in five categories of conduct:

- Unreasonably determining, maintaining or changing prices.
- Unreasonably adjusting supply.
- Unreasonably hindering business activities of other enterprises.
- Unreasonably hindering entry.
- Doing business to unreasonably exclude competitors, or acts that are likely to harm consumer interests significantly.

In general, abuse of dominance or illegal monopolization requires first, the possession of a dominant position or monopoly power in the relevant market and, second, the presence of abusive or exclusionary conduct.

Before the February 1999 amendment, the Act required the KFTC to designate each year “market-dominating enterprises” in accordance with two market share criteria: a single firm with a market share of over 50%, or two or three firms with a combined market share of more than 75% (as long as each individual share exceeds 10%), in a market with total domestic sales of more than KRW 100 billion (about 77 million US \$).⁶⁾ From 1997, a blanket exemption was provided for financial and insurance companies, and the KFTC was authorized to grant exemptions if a firm satisfied certain conditions and if the KFTC found the firm unlikely to engage in abusive conduct.⁷⁾

The designation of market-dominating firms amounts to making an irrefutable inference of dominance for those meeting one of the market share criteria, while ruling out a finding of dominance (and therefore the application of the law) for all other companies. It had the effect of putting the listed companies on notice that their behavior could be subject to special scrutiny. This statutory authority of the KFTC was repealed by the February 1999 amendment. The KFTC is now required to determine the presence of dominance on a case by case basis, considering such factors as market share, barriers to entry, and the relative size of competitors. In addition, the previous market share thresholds for designation were changed into those for a presumption of dominance.

The MRFTA proscribes not only exclusionary conduct but also ‘unreasonable’ monopolistic pricing and output restriction, and authorizes the KFTC to impose price and output directives as remedial measures. Until 1998, pricing by a dominant firm was regarded ‘unreasonable’ if its price changes were out of proportion to changes in market demand and supply or costs of supply, or if its sales expenses and general overhead expenses were excessive compared to the ‘normal level’ in the relevant or comparable market.⁸⁾ The second definition of ‘unreasonable’ pricing was dropped in the February 1999 amendment.

Intervention under the competition law to limit excess price increases reflects the perceived need for price controls in concentrated markets. But the application of the law involves the difficulty of determining the ‘proper’ level of prices and output and is incompatible with the belief that markets do better than administrators in determining prices and outputs. In fact, the

6) In 1998, 311 companies in 128 product or service markets were designated as market-dominating enterprises, of which 172 were affiliates of the top 30 chaebols.

7) To qualify for the exemption, the firm should supply in an open market with no entry barriers, have not increased prices, and have not committed the offense of abuse of dominance, collusion and unfair business practices, in the previous two years. About 20 companies applied for exclusion from the designation, but no firms were actually dropped from the list.

8) Until 1992, parallel price increases were also regarded as abusive pricing.

KFTC has been rather reluctant to control simple price or output changes. No case concerning monopolistic pricing is found since 2002.

In 2000, KFTC issued the Guidelines for Abuse of Market Dominance. The Guidelines explain the way relevant markets are defined and illustrate specific factors to be considered in determining market dominance and its abuse.

2.7. Merger Control

Article 7 of the MRFTA prohibits business combinations that “would substantially restrain competition in any line of business.” It not only covers acquisitions of stock or assets, mergers, and interlocking directorates, but also applies to the joint establishment of a new company as well. The Act also mandates the filing of a business combination report with the KFTC for transactions that meet certain thresholds,⁹⁾ and the KFTC has issued the M&A Notification Guidelines and relevant forms.

“Substantial restraint of competition” means the creation or enhancement of market power, i.e., the ability of a company or a group of companies to influence price and other important terms of trade in the relevant market. A merger is presumed to substantially restrain competition in the relevant market if the combined market share of the merging parties meets either of the definitions of a market-dominating enterprise, in addition to being the largest in the market and greater than that of the second largest firm by more than one-third of its share; or, if the merger involves a “large scale company” with assets or sales volume (including those of its subsidiaries) of over 2 trillion won, creating a firm with a market share of over 5% in a market where the combined share of the small and medium-sized firms¹⁰⁾ exceeds two-thirds. Once the presumption of anticompetitive effects is made, the burden to rebut falls on the merging parties. The presumption may be overcome by showing that other factors pertaining to competition in the market make adverse competitive effects unlikely or by demonstrating that the anticipated efficiency gains from the merger outweigh its likely competitive harm.

The law provides for statutory exemptions for anticompetitive mergers, and gives the KFTC substantial discretion in allowing a merger otherwise subject to challenge. Until 1998, Article 7 included a proviso that a merger may be exempt from the ban if the KFTC finds it necessary in order to rationalize an industry or strengthen international competitiveness. The provision was revised in 1999 to recognize specifically the efficiency-enhancing potential of a merger and the failing company defense. Hence, anticompetitive mergers will not violate Article 7 if the KFTC finds either that merger-specific efficiencies outweigh the harmful effects of reduced competition, or that it involves a failing company whose assets would be unlikely to be utilized

9) Business combinations involving a “large scale company” (with total assets or revenues on a consolidated basis exceeding KRW 2 trillion) must be reported to the KFTC before the completion of the transaction.

10) Small and medium-sized firms are those with less than 300 employees.

absent the merger, and less anticompetitive mergers are unlikely to occur.

The KFTC issued the Merger Guidelines in 1998, which set forth its merger enforcement policies. The Guidelines explain how the KFTC will define relevant product and geographic markets and conduct competitive effects analyses of a merger. The focus of analyses is on whether a merger is likely to substantially restrain competition in the relevant market.

In evaluating the likely competitive impact of a merger, the KFTC will first consider the post-merger market concentration and the increase in concentration produced by the merger, and then assess whether the merger, in light of market concentration and other factors set forth in the Guidelines, is likely to produce adverse competitive effects.

In the Merger Guidelines, the relevant product market is defined as “a group of products to which a significant portion of buyers of a certain product would turn in response to a significant price increase for a significant period of time.” The relevant geographic market is likewise defined as “a geographic area to which a significant portion of buyers of a certain product in a specific area would turn in response to a significant price increase for a significant period of time in that area.” Such definition of the relevant market is in line with the so-called SSNIP test, which focuses solely on demand substitution, i.e., likely consumer responses to a “small but significant and nontransitory increase in price (SSNIP).” Possible supply responses to a price increase are considered in the analysis of likely competitive effects of a merger.

The factors to be considered in assessing the likely reaction of buyers to a price increase when defining the product market include, inter alia, similarity of product use and price, buyers’ perception of product substitutability and actual purchasing behaviour, sellers’ perception of product substitutability and related business decisions. Factors that are considered for defining a relevant geographic market include, inter alia, the characteristics of the product such as ease of transshipment, the production and sales coverage of sellers, buyers’ perception of geographic substitutability and their actual geographic diversion, sellers’ perception of geographic substitutability and related business decisions, and ease of diverting purchases to different areas.

The Merger Guidelines identify two potential adverse competitive effects of a horizontal merger. Horizontal mergers may restrain competition (i) by increasing the likelihood of successful coordinated interaction (collusion) among rivals, and/or (ii) by enabling the merged entity to profitably raise prices or otherwise exercise market power unilaterally.

For horizontal mergers, the Guidelines as revised in 2007 provide for a safe harbour region based on the Herfindahl-Hirschman Index (HHI) of market concentration. This index is calculated by summing the squares of the individual market shares of the firms in the market. A horizontal merger that falls within one of the following regions will be presumed to produce no anticompetitive effects. Such a merger is subject to a “simplified review process,” requiring no

further analysis.

- (i) Post-merger HHI in the relevant market is below 1,200.
- (ii) Post-merger HHI in the relevant market is between 1,200 and 2,500 and the increased HHI produced by the merger is less than 250.
- (iii) Post-merger HHI is above 2,500 and the increased HHI produced by the merger is less than 150.

The Merger Guidelines state that market share and concentration data provide only the starting point for analyzing the likely competitive impact of a merger. For a horizontal merger outside the safe harbour, the KFTC will assess several other factors in addition to market share and concentration in evaluating the merger's likely competitive effects. These other factors include recent changes in market concentration, potential foreign competition, likelihood of entry, existence of similar products and adjacent markets, likelihood of unilateral effects, and likelihood of coordinated behaviour among competitors.

If the KFTC finds that a merger is likely to substantially restrain competition, it can block the merger, order a partial divestiture, or impose behavioral restrictions such as a price restraint or a market share ceiling to eliminate the merger's adverse effects. Less than ten mergers have been blocked so far. For most of the mergers that raised anticompetitive concerns, behavioral restraints were imposed as a relief measure.

2.8. Prohibition of Unfair Trade Practices

Article 23 of the MRFTA forbids business practices that are likely to harm "fair trade." While listing the following six categories of conduct that are subject to the prohibition, it also enables the KFTC to address "other practices that may harm fair trade."

- Unreasonable refusal to deal and discrimination.
- Unreasonable exclusion of competitors.
- Unreasonable inducement or coercion of competitors' customers to deal with oneself.
- Unreasonable exploitation of one's bargaining position.
- Transacting with others on conditions that unreasonably restrict their business activities, and hindering others' business activities.
- Unreasonable assistance of specially related persons or other companies by providing loans, assets, and manpower free or at preferential terms.

A wide variety of business practices, including refusal to deal, discrimination, sales below cost, abuse of superior bargaining power, and non-price vertical restraints, are covered by Article 23. Specific practices that fall within each of the categories of unfair trade practices are detailed both in the Presidential Decree of the Act and in implementing regulations.

The MRFTA declares the goal of enhancing competition and efficiency. At the same time, it

strives for the objective of fair trading conditions and balanced development. To support these dual goals, Article 23 of the Act covers not only anticompetitive practices but also unreasonable exercise of a superior bargaining position in business relations. In regards to the latter, the notion of unfair trade contains two elements: a position of economic strength in relation to one's trading partners, and taking advantage of such a position to the detriment of their welfare or viability. The application of such a concept concerns primarily the welfare of small businesses rather than that of consumers. What matters are not the anticompetitive potential or efficiency consequences of the practice in question but its possible harm to trading partners. Firm size, although not indicative of the ability to exercise market power, is important.

The KFTC issued in 1985 the Guidelines for Unfair Trade Practices in Large Scale Retailing, which specifies practices that may constitute unreasonable exercise of economic strength held by a large retailer vis-à-vis its small suppliers. Several specific laws which regulate certain business relations were also enacted to protect groups of small businesses vulnerable to exploitative practices by larger trading partners. Unreasonable exploitation of one's bargaining position in subcontract relationship, adhesion contracts, and franchise business are regulated, respectively, by the Fair Subcontract Transactions Act of 1984, the Regulation of Adhesion Contracts Act of 1986, and the Fair Franchise Transactions Act of 2002. Unfair practices in labeling and advertising are regulated by the Fair Labeling and Advertising Act. The KFTC has jurisdiction to enforce these laws. By the 2007 amendment to the MRFTA, the Korea Fair Trade Dispute Mediation Agency was established. Its primary mandate is to mediate disputes concerning business practices covered by Article 23 of the MRFTA and the Fair Franchise Transactions Act. Any business claiming damages from suspected violations of the law can apply for mediation, and the agency may recommend a settlement.

Non-price vertical restraints in general had been treated as per se illegal under Article 23 on the grounds that they cripple the freedom of dealers and restrain their ability to sell in accordance with their own judgment. This approach was abandoned when the KFTC issued in 2004 the Guidelines for Unfair Trade Practices. The Guidelines state that the illegality of exclusive dealing, vertical territorial restraint and customer restriction is to be judged by their competitive effects under a rule of reason, while providing a safe harbor for businesses with a market share of less than 10%. This change is in line with economic theories demonstrating the efficiency-enhancing potential of vertical restraints.

Resale price maintenance (RPM) of any kind had been expressly prohibited under Article 29 of the MRFTA until the Act was amended in 2001 to allow maximum RPM for justifiable purposes.¹¹⁾ The per se rule against vertical price fixing rests on the view that the practice is

11) The change in rule regarding maximum price maintenance was initiated by the US Supreme Court case, *State Oil Co. v. Kahn*, 522 U.S. 3 (1977), which "conclude[d] that there is insufficient economic justification for per se invalidation of vertical maximum price fixing" and that "vertical maximum price fixing, like the majority of commercial arrangements subject to the antitrust laws, should be evaluated under the rule of reason."

identical in effect to horizontal price fixing, and as such, as objectionable as horizontal collusion. However, two exceptions to the general ban exist: RPM can lawfully be applied for copyrighted articles and for products which are specifically entitled for the practice by the KFTC.

Unfair luring of customers, exploitation of a superior bargaining position, and unfair labeling and advertising account for the bulk of the actions against unfair practices. Article 23 has clearly thrust a heavy enforcement burden upon the KFTC.

2.9. International Contracts

Article 32 of the MRFTA prohibits domestic companies and trade associations from making international contracts that contain undue collaborative activities, unfair trade practices or resale price maintenance. Contracts for licensing industrial properties, copyright, know-how or franchise to domestic firms, joint research and development agreement, import distribution contract, and joint venture agreement are covered by Article 32. The KFTC issued the Guidelines for International Contracts in 1981, describing the types of potentially illegal practices and its enforcement standard.

The primary purpose of Article 32 is to protect domestic businesses from the abuse of a superior bargaining power by foreign counterparts in international contracts. Initially, domestic parties to a contract had been required to report the proposed contract to the KFTC, and the KFTC had been active in regulating international contracts until 1994. From 1981 to 1994, the number of the KFTC's corrective measures against unfair international contracts averaged 160 per year. Then the mandatory notification requirement was abolished in 1994, and domestic firms were entitled to request the KFTC for review of an international contract on a voluntary basis. From 1995, enforcement actions of the KFTC began to shrink dramatically. The number of corrective measures against international contracts dropped to two in 1997 and one in 1998, and there has been none thereafter. The progress in liberalization and globalization calls for nondiscriminatory application of competition law principles, bringing about such a dramatic change in the KFTC's enforcement policy toward international contracts.

2.10. Capacity for Economic Analysis

Since the late 1970s, the Korea Development Institute, a prominent think tank established by the Korean government, has been researching industrial organization and competition problems in Korea. It has played a significant role in developing Korea's competition law and policy by conducting empirical and theoretical research on competition policy issues and working closely with the KFTC.

In the private sector, the Korea Economic Research Institute founded by the Federation of

Korean Industries has contributed to the development of competition law in Korea by conducting critical research on the MRFTA and its enforcement.

The 1997 financial crisis led the KFTC to step up enforcement activities. Of the total surcharges of KRW 538 billion imposed during 1981 to 2000, about 94% was imposed during 1998 to 2000. Active enforcement of the MRFTA coupled with the frequent imposition of heavy surcharges has triggered an unprecedented number of legal suits against the KFTC. The number of legal actions brought by businesses and individuals has increased dramatically from less than 10 a year before 1996 to 64 in 1999.

Vigorous and stringent enforcement of the MRFTA has brought many changes. The awareness of the MRFTA by firms has heightened, and legal actions against the KFTC become more frequent, which in turn has induced many law firms to expand antitrust practices. Many universities are now offering courses on competition law and policy. More significant change is the increasing use of economic analyses in antitrust cases. Economic expert testimonies are often submitted to the KFTC and courts. Econometric studies are being utilized to analyze substantial competition issues. For example, in important merger cases, merging parties routinely retain economists to conduct empirical analyses for defining relevant markets and predicting its likely competitive effects. In 2005, the KFTC established an economic analysis division under its Market Structure Policy Bureau to enhance its economic analysis capacity.

3. Developing Indonesia's Competition Law and Policy

3.1. Pursuing Economic Efficiency

Competition laws may pursue the goal of maximizing consumer surplus or overall social welfare (i.e., economic efficiency). These laws may consider other economic goals such as increasing employment or international competitiveness of domestic industries. Competition laws may also pursue socio-political values such as fairness, economic democracy, and balanced development by preventing economic concentration and protecting SMEs. Historically, the goals of competition laws have been diverse across different countries and have changed over time within a country.

What should be the goals of the competition law? This is the main question that must be addressed by the competition agency. Everything else follows from the answer to this question. Is the competition agency to be guided by one value or by several? If by several, how is it to decide cases where a conflict in values arises? Only when the issue of goals has been settled is it possible to frame a coherent body of substantive rules and enforcement standards.

Korea's competition law stipulates that its purpose is "to encourage fair and free competition by preventing the abuse of market dominating position and excessive concentration of economic

power and by regulating undue collaborative acts and unfair business practices, thereby stimulating creative business activities, protecting consumers and promoting the balanced development of the national economy.”

Indonesia’s Law No.5 declares in Article 2 that “business agents in Indonesia will adhere to the principle of economic democracy and take into account the balance between the interests of business agents and those of the public,” and in Article 3 stipulates the purpose of the law as follows:

- a. to maintain public interests and promote national economic efficiency as one of the efforts to promote people’s welfare;
- b. to translate into reality a conducive business climate through the regulation of fair business competition so that there shall be a guarantee for certainty in equal business opportunities to major business agents, medium-scale business agents and small-scale business agents;
- c. to prevent business agents from resorting to monopolistic practices and/or unfair business competition; and
- d. to create effectiveness and efficiency in business activities.

The purposes declared in the competition law of the two countries are similar. They both declare promoting economic efficiency and consumer welfare as an important goal, and at the same time proclaim socio-political values like “the balanced development of the national economy” or the “guarantee for certainty in equal business opportunities.”

A competition law and policy with multiple goals may appear attractive. Most often, however, these goals contradict one another, and socio-political values such as fairness are rather vague and undefined. Contradictions in competing values have to be resolved in deciding specific cases, which can be done only in a very arbitrarily and unpredictable manner. Inevitably, multiple objectives lead to inconsistent and arbitrary application of the law as regulators try to reconcile and balance a range of often conflicting social, political and economic values on a case-by-case basis. This approach also invites lobbying by different stakeholders. To serve a variety of goals, greater political discretion is allowed. As a result, competition policy loses much in effectiveness, predictability and ease of administration, often protecting inefficient firms at the expense of competition and consumer welfare.

To develop a coherent competition policy, its purpose has to be clear. More importantly, competition policy can become a rational public policy when it strives for economic efficiency as the sole or at least the principal objective. Only when competition policy pursues this goal, can it have a sound intellectual basis of economic theory upon which to develop rational legal rules and systematic analytical frameworks. For these reasons, European countries which tended to pursue socio-political goals such as the individual right to engage in commerce and the dilution of economic power have altered enforcement standards over time to economic efficiency as the basis for competition law.

Indonesian competition law, like the MRFTA, employs values other than economic efficiency. Pursuing “the principle of economic democracy” and “equal business opportunities” will inevitably hinder the pursuit of economic efficiency and overall welfare. The practical challenge for the competition agency will be to recognize the problem of conflicting values in enforcing the law and to devise ways to minimize the problem. Korea mitigated the problem of conflicting goals in the MRFTA by enacting specific laws or regulations applicable to certain trading relations for the explicit purpose of protecting small businesses, but the conflict in values in enforcing the competition law still remains.

3.2. Strengthening Capacity for Economic Analysis

It is generally accepted that maximizing consumer welfare should be the sole or at least the main purpose of the competition law. Here, the term “consumer welfare” is just a synonym of people’s welfare or national wealth because everyone in the economy is a consumer.

The level of consumer welfare depends on how efficiently society’s economic resources are utilized. Consumer welfare is greatest when scarce economic resources are used in such a way that consumers are able to satisfy their wants as fully as technological constraints permit. Two types of efficiency in using scarce resources, allocative efficiency and productive (technical) efficiency, make up the overall efficiency that determines people’s welfare: (i) the assignment or allocation of the available productive forces and materials among the various lines of industry, and (ii) the effective coordination of the various means of production in each industry into such groupings as will produce the greatest result.¹²⁾ These two efficiencies “are necessary conditions for static, system-wide efficiency.”¹³⁾

Business behavior that creates or enhances market power harms consumer welfare by causing allocative inefficiency, while business behavior that creates productive efficiency necessarily increases national wealth and can benefit consumers by lowering the costs of goods or by increasing the value of the product offered.¹⁴⁾ There are many situations in which business behavior that may cause allocative inefficiency can also give rise to productive efficiency gains.

Competition law and policy is about the effects of business behavior on the overall efficiency of using resources and consumer welfare. The role of the competition law is to improve allocative efficiency without impairing productive efficiency so greatly as to produce either no gain or a net loss in consumer welfare, and the whole task of competition agencies is to identify and prohibit those forms of behavior whose net effect is welfare reducing, while

12) Knight(1933), p. 9.

13) Boner & Krueger(1991), p. 2.

14) Productive efficiency, like allocative efficiency, is a normative concept and is defined and measured in terms of consumer welfare. Productive efficiency is not a description of mechanical or engineering operation; it consists in offering anything that consumers are willing to pay for. The relative efficiency of firms is therefore measured by their relative success in the market. Economies of scale, specialization of function, ability to obtain capital, and management skill are elements that contribute to productive efficiency.

leaving beneficial or neutral behavior untouched. This task must be guided by sound economic theories.

An understanding of the relationship of business behavior to consumer welfare can be gained only through economic theory. Well-developed economic theory shows how firms can profit by interfering with allocative efficiency. Economic theory also demonstrates various ways in which businesses create productive efficiency. For business conducts likely to produce both allocative inefficiency and productive efficiency gains, economic theory provides the means of assessing the probable sizes of the gains and losses. Failure to count productive efficiency properly would result in destroying national wealth by condemning productive business organizations and practices.

For the competition law to serve people's welfare, it should be developed and enforced based upon economic concepts and theories. Otherwise the law works blindly, harming consumers and destroying national wealth. Developing a sound and effective competition policy further requires in-depth knowledge and information on the nation's industrial organization and competition problems. For this reason, competition agencies in many countries have an in-house economic analysis group of professional economists to support their competition policies.

The complexities of enforcing competition law arise because the law is designed to improve economic efficiency, with competition seen only as a means of promoting efficiency. Many kinds of ostensibly anticompetitive conduct may enhance efficiency. For example, horizontal mergers, while reducing the number of competitors in the market, often enable the merged entity to realize various forms of efficiencies. Vertical restraints imposed on dealers by a manufacturer restrain competition among dealers, but these practices may enable the manufacturer to distribute its product more effectively, thereby fostering interbrand competition. Hence, the competition agency must analyze likely competitive effects of a business practice before determining its reasonableness.

For competition agencies to have a high level of economic knowledge and expertise is a prerequisite for the effective and rational implementation of competition law and policy. In particular, for countries like Indonesia which began to develop competition rules and institutions, it will be a crucial task (i) to strengthen the research capability of analyzing industrial organization and competition problems in the economy and (ii) for the competition agency to build the capacity to employ evolving economic theories of industrial organization and perform case-specific economic analyses. Without this capacity, it would be impossible to frame and implement useful legal rules, to judge which market structures and practices are harmful and which beneficial to people's welfare, and to advocate competition principles effectively within the government.

There will be several measures that the KPPU can take in this direction. One option will be to have a public policy research institute which will support the development of Indonesia's

competition policy by producing requisite knowledge and information on the country's industrial organization and related policy issues. Korea's experience well illustrates what a competent policy research institute can do and how much contribution it can make to the development of competition policy in developing countries with little experience of competition law. The Korea Development Institute has systematically supported the formulation and development of the country's competition policy by producing and analyzing various data on Korea's industrial organization and concentration, by identifying competition problems in the economy, and by advocating specific policy measures. Its research and policy advocacy efforts heavily influenced the shaping of Korea's competition law and policy. A few of such cases are the adoption of measures to control the concentration of economic power, the adoption of leniency policy, the legislation of Fair Labeling and Advertising Act, and the expansion of the KFTC jurisdiction to consumer policy.

More direct and perhaps more effective way for building the capacity for economic analysis could be for the competition agency to establish an in-house team of competent economic analysts. The agency may also encourage and expand the involvement of outside experts in its rule-making process, support research and education program, encourage businesses to submit expert economic analyses by giving greater weight to economic evidence in deciding cases.

3.3. Strengthening Competition Advocacy

In general, governmental regulations that suppress competition are more prevalent in developing economies than in advanced ones. This heightens the importance of competition advocacy in the competition policy of developing countries.

In developing countries where government regulations often constitute the main threat to a competitive economy, an effective competition advocacy program is indispensable for establishing a more market-oriented economy and strengthening competitive forces. In addition to prohibiting anticompetitive business tactics by firms, systematic efforts are necessary to counter government regulations that hinder competitive processes. While the KPPU has increased its efforts to make sure that regulators have better understanding of competition principles, it would still be desirable for the KPPU to pay more attention and resources to its role of competition advocacy. Government regulations that have created and sustained monopoly should be its primary target.

Article 35 of Law No.5 empowers the KPPU to "provide suggestions and consideration concerning government policies related to monopolistic practices and/or unfair business competition." This provision does not seem to provide a sufficient legal basis for the KPPU to perform an effective competition advocacy role. The scope of "government policies related to monopolistic practices and/or unfair business competition" is unclear. Moreover, since other government authorities are not bound to consult with the KPPU on anticompetitive regulations,

the KPPU is likely to have difficulty in obtaining necessary information and cooperation from relevant government authorities. Korea's experience with competition advocacy suggests that competition advocacy efforts of the KPPU would benefit from making it mandatory for other government authorities to consult with the KPPU prior to adopting anticompetitive regulations, thereby making it easier for the competition agency to ask whether regulatory measures of other governmental bodies are in the consumer interest.

The prerequisite for successfully advocating competition principles within the government decision making process is the competition agency's superior capacity for cost-benefit analyses of regulatory measures. The KPPU should clearly spell out the welfare implications of anticompetitive regulatory measures so that government decision making takes them into account. Such efforts will also increase public awareness of the costs of anticompetitive regulations, thereby expanding public support for the open and competitive market economy.

3.4. Reducing Exemptions

Law No.5 provides for many exemptions. The law has three provisions which explicitly exempt certain business entities and activities, and the KPPU has issued several guidelines to clarify the boundary of such exemptions. These exemptions are the outcome of political decisions in Indonesia, and one can find valid and legitimate reasons for most of them. It is necessary and sometimes indispensable to limit the application of the competition law in order to accommodate various goals other than promoting competition. Nonetheless, areas exempted from the competition law need to be minimized for competition policy purposes.

First, horizontal price-fixing contracts based on the existing law are exempt under Article 5 of Law No.5. However, legalized cartels are very likely to have significant anticompetitive effects by shielding inefficient firms from competition. Price-fixing cartels directly hurt consumers as it supports supra-competitive pricing, and any gains realized by suppliers will be outweighed by consumer losses. Historically, Korea, Japan, and Germany had most often legalized cartels, but experience of such negative consequences led these countries to abolish cartels. The KPPU is better advised to step up competition advocacy efforts to reduce existing laws that legalize price-fixing contracts.

Second, Article 50 of the law excludes "entrepreneurs categorized as engaging in small scale business" and a number of acts or agreements from the reach of the law. Several of these exemptions need to be abolished or narrowed in scope. Giving a blanket exemption to small scale businesses runs counter to the goal of promoting economic efficiency. The exemption of "acts and/or contracts with the intention to implement the existing law" seems overbroad. It would be more appropriate to limit the exemption to legitimate actions taken pursuant to other laws and regulations. Exempting lawful exercise of intellectual property rights rather than "contracts related to intellectual property rights" would be more reasonable because even

legitimate intellectual property rights can be abused for anticompetitive purposes.

Third, as government control on strategic economic sectors is mandated by Indonesian constitution, such control by state-owned enterprises is exempt under Article 51 of Law No.5. The KPPU guidelines on Article 51 explain that the exemption only applies for the control, not covering the anticompetitive behavior of state-owned enterprises. Although public companies are subject to other regulations, they usually have a wide range of opportunities to exert market power and engage in anticompetitive practices because of their entrenched monopoly positions. This heightens the need for enforcement efforts against anticompetitive behavior of state-owned enterprises

3.5. Adopting Leniency Policy

Naked or hard-core cartels, which include agreements among competitors to fix prices, restrict output, divide markets or submit collusive tenders, have only pernicious effects on competition without any redeeming virtue. These practices cause significant harm to consumer welfare.¹⁵⁾ As such, hard-core cartels are treated as per se violations of competition law, and become the prime target of law enforcement by competition agencies. Indonesia is no exception. Law No.5 of Indonesia prohibits naked cartels, and the KPPU has focused its enforcement efforts on combating cartels.

The major obstacle in anti-cartel effort is the difficulty of detecting and proving the operation of a cartel. Cartel operators, knowing that their conduct is unlawful, try to conceal their arrangements. Indeed, it is estimated that only a small portion of cartels are actually caught and punished.¹⁶⁾ A leniency policy, which promises amnesty or immunity from sanctions to businesses or individuals who disclose their cartel to the competition agency, can be of great help in overcoming this obstacle. It can be an effective means of obtaining evidence of a cartel from insiders, or cartel participants. Experience of other countries including Korea has shown that a properly structured leniency program can dramatically increase the success of an anti-cartel effort.

For a leniency policy to be effective there must be a credible threat of severe sanctions for participating a cartel. Unless cartel operators are at risk for substantial punishment if their agreement is discovered and prosecuted, they will have little or no incentive to enter a leniency program. In situations in which cartel operators face potentially heavy sanctions for their conduct, a leniency program can provide them with a powerful incentive to defect from the conspiracy. If the KPPU is to introduce a leniency policy, it may refer the following elements of a successful leniency program suggested by OECD (2003).

15) An OECD survey of cartel cases by its members showed that the average cartel mark-up was 15-20%. See OECD(2002).

16) Bryant & Eckhard(1991) estimated the probability of cartel being caught at 13-17%.

- Complete immunity from sanctions should be awarded to the first applicant. This maximizes the reward for co-operation.
- Only the first to apply should receive complete immunity, and if the program is extended to subsequent applicants, the gap in the rewards should be substantial. This maximizes the incentive to be the first to defect, thus destabilizing the cartel.
- The program should have maximum transparency and certainty. Would-be applicants should be able to predict as accurately as possible what the outcome of their application will be.
- The program should be available in circumstances in which the competition agency has already begun an investigation.
- The competition agency should accord confidentiality to leniency applications and the information resulting therefrom to the maximum extent possible.

Two enforcement devices of the KFTC, the program of giving pecuniary award to anyone who provides information and evidence on illegal cartels and the authority to request bidding materials in public procurement from the government agencies, can also be instructive to the KPPU.

3.6. Expanding the Rule of Reason and Providing Enforcement Guidelines

Law No.5 prohibits vertical restraints such as resale price maintenance, tying, exclusive dealing, and territorial or customer restriction as a per se violation. The law also expressly proscribes price discrimination (price differences among buyers of the same good) and loyalty discounts. Economic theories, however, strongly suggest that the rule of reason, not a per se rule of unlawfulness, would be the appropriate standard to judge these practices.

The per se rule of illegality is appropriate only to practices that would always or almost always tend to restrict competition and decrease efficiency. But economics literature is replete with precompetitive justifications for vertical restraints, and there is a widespread consensus that vertical restraints, if imposed independently by a manufacturer, are likely to be efficiency-enhancing. Economic theories have shown that vertical restraints frequently represent an efficient reaction to market imperfections such as externalities, free-riding, and informational limitations, thereby enhancing efficiency and interbrand competition. Reflecting this economic knowledge, the United States Supreme Court overturned the per se rule against vertical territorial restrictions in its *Sylvania* decision in 1977, and overturned the per se rule against minimum resale price maintenance in *Leegin* decision in 2007.

Economic analyses also demonstrate that differential pricing and discounting can be legitimate means of competition, and per se rules against these practices will be counterproductive by prohibiting precompetitive conduct the competition law should encourage.

Business practices which have the efficiency-enhancing potential should be evaluated under the rule of reason.

Under the competition law, the illegality of a business conduct is to be determined by its effects on the overall economic efficiency and consumer welfare. Analyzing the competitive effects of a business practice usually involves complicated legal and economic issues, which makes it very difficult for business companies to judge the legal status of its business tactics. To improve the predictability and transparency of the enforcement policy and to make businesses aware of what constitute illegal actions, competition agencies have developed and pronounced guidelines which describe the analytical framework and specific standards to be applied in law enforcement.

The KFTC has 47 guidelines in place, and competition agencies in the U.S. and EU also released a number of guidelines on important issues and areas of their competition law. The KPPU has issued six guidelines concerning Article 22 (bid-rigging), Article 47 (sanctions), Article 50.a. (exemptions), Article 50.b. (exemption for intellectual property), Article 51 (exemption for state owned enterprises), Articles 28-29 (merger), and Article 19 (market control). The enforcement activities of the KPPU so far has centered on cartels. But gradually its enforcement actions will expand to other business conducts which involve a lot more complicated antitrust issues. Accordingly, the KPPU needs to develop more guidelines on substantive issues and enforcement standards based on sound antitrust economics, while taking into account specific market conditions of Indonesia. Well-developed enforcement guidelines would enable the KPPU to take more integrated and rational approach to applying the law.

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Enhancing Financial Supervisory System in Indonesia

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Enhancing Financial Supervisory System in Indonesia

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1. Introduction

Financial supervisory system of Indonesia is at a crossroads. The current fragmented financial regulation and supervision face greater challenges after the fracture of global financial system originated from the U.S. subprime mortgage meltdown, together with the blurred boundaries between the different types of financial institutions such as banking, securities and insurance companies. Beside, with the rise of the financial conglomerates, the fragmented supervisory system is conceived as less competent at assessing overall risk of financial conglomerates. Consequently, an integrated financial regulation and supervision in which banking, securities and insurance regulation and supervision combined within a single institution has emerged as an alternative choice to deal with a complex financial system.

Discussion on the establishment of an integrated financial supervisory system can be traced back to 1999 when the Central Bank Act no. 23 in May 1999 specified that Bank Indonesia will eventually surrender its role in bank supervision. In an amendment passed in December 2003, December 2010 is set as the target period for the separation of banking supervision authority from Bank Indonesia. As stated in Article 34 and 35 of the Act no.23/1999, a new independent financial supervisory institution will be established no later than December 31 2002, which has been postponed to December 2010.

The primary objective of this paper is to present the structure and operations of financial supervisory system of Korea after its transition from the multiple supervisory agency structure to the integrated system and the challenges Korea encountered during the transition. The experiences of Korea can offer some lessons to Indonesia for its effort to reform the current fragmented financial supervisory system. However, this paper is not meant to be exhaustive.

More considerations and studies should be conducted to embody the lessons learned from the Korean experience. There is no ‘one-size-fits-all’ approach for the shaping of financial supervisory system and each country should create its own optimal financial supervisory structure. Also, one needs to keep in mind that the establishment of a single supervisory agency will not resolve the problems that have observed in the multiple supervisory system without introducing the essential substances (i.e. supervisory principles and instruments) associated with an operational governance structure of financial regulation and supervision. The combination of the governance of supervisory system and supervisory substances should go in lockstep to achieve the ultimate goals of financial supervision, which is universally true. The Korean experience can be simply regarded as another episode proving this truth.

This paper will proceed as follows: The second section briefly reviews the current financial supervisory system in Indonesia and historical background. Section 3 presents the development of the financial supervisory system in Korean and the structure of the current integrated supervisory system.

2. Financial Supervisory System in Indonesia

2.1. History of Financial Supervision in Indonesia

In Indonesia, the relationship among the macroeconomic environment, structural changes, and objective monetary policy in a broad sense can be divided in three big periods, namely: before Asian Financial Crisis (AFC), during the AFC 1997~2000 financial crisis, and post July 2005 when Bank Indonesia decided to implement Inflation Targeting Framework (Goeltom, 2007: 257-265).

2.1.1. The Period Before Asian Financial Crisis (1969-1996)

This period is characterized by its growth around 6% annually, a reasonable level. Only during the period of 1969-1978 and 1989-1993 Indonesia experienced a booming economic growth, around 7-8% per year. The main drivers of economic growth were agriculture, manufacturing and mining sector. The incumbent government at that time, The New Order (Soeharto) Government, has been committed to the trilogy of development, i.e. growth, equity and stability. On the price development, before the financial crisis, inflation could be maintained in single digits (below 10% annually), with exception during the period of 1971~1982 when inflation was quite high around 16% (Table 3-1). The exchange rate was relatively stable due to adoption of a managed floating exchange rate system with a certain band.

Table 3-1 | Key Indicators, Indonesia 1971-1982, 1983-1990 (average annual percentage)

Indicator	Period	
	1971-1982	1983-1990
Real interest rate		
GDP growth rate	-4.55	7.24
M2/GDP	7.45	5.74
Money multiplier	15.85	28.02
Change in domestic credit	201	422
National saving/GNP	30.36	36.33
Investment/GNP	27.22	29.09
Change in GDP/investment	21.66	32.17
Inflation rate	34.74	17.46

Source: Calculated from International Monetary Fund (1992); World Bank (1992); Kuncoro (1996)

Note. Real interest rate is calculated from the following formula: $[(1+d/100)/(1+inf/100)-1] \times 100$, where d is 12 months deposit interest rate; inf is inflation rate, which is calculated from change in consumer price index.

M2 is M1(currency plus demand deposits) plus quasi money. Investment is gross capital formation. Money multiplier is M2/base money.

Key monetary indicators in Indonesia especially in the pre-reform period, show: (1) Indonesia began reforms with a shallow(on-shore) financial system, as M2 was less than 17% of GDP, a level below that many low income countries; (2) Indonesia had devalued the currency before launching reforms; (3) inflation, despite not being as low as in Malaysia, was under control, and internal and external accounts were near balance; (4) Indonesia already had a fairly high savings rate (as did Korea and Malaysia), moreover initial investment rate also was generally above those in Chile, New Zealand and Turkey (Kuncoro, 1996).

Credit reform began in 1983, when the artificial restrictions on the allocation of bank credit and state bank interest rate were eliminated, Bank Indonesia also reduced its significant role in refinancing bank loans and introduced the Bank Indonesia Certificates (SBI) and Money Market Securities issued and endorsed by banks (SPBU).

In the supervision and development of banks, up to 1992, Bank Indonesia (BI) remained abiding by Act No. 14 of 1967 concerning Banking Principles. Such duties prevailed and were reinstated in the new Act on Banking, namely Act No. 7 of 1992. In Chapter I, article 29 until article 37 of Act No. 7 of 1992, BI was responsible for the regulation, supervision, inspection and development, and imposing penalties over the breaches committed by the banks. In addition to those articles, BI was also authorized to regulate and supervise the activities carried out by the banks, as contained in Article 7 regarding the activities in foreign currencies, capital participation, and acting as the founder and management of pension funds. The fundamental differences in implementing the duties of BI based upon both acts were from its approach and implementation of the deregulation policies.

Table 3-2 | Financial Deregulation in Indonesia

REFORMS	SCOPE
Financial system reforms:	
Deregulation and Competition	Deregulation in June 1983 and October 1988. Since 1986, there has been some easing of restrictions on the scope of allowed business activities. In 1988, licensing of branching requirements was relaxed and public enterprises were allowed to place deposits with nonstate banks. Gross assets of the organized financial sector grew more than fourfold during 1983-89. At end-1989, Bank Indonesia (BI) and deposit money banks (DMs) held over 95 percent of total assets of the financial sectors. Financial market development
Management and supervision	Money and capital markets expanded, particularly with issuance of central bank and private papers, but remained small relative to financial institutions. In 1998, there was progress toward more uniform tax treatment of various financial assets. A new private stock exchange was licensed in 1988.
Management and supervision	In 1988, prudential regulations (lending limits for single borrowers) were strengthened, the components of capital and foreign exchange activities were defined, and capital adequacy requirements were extended to all banks. In 1989, the Bank Supervision Department of BI was expanded and reorganized. The supervision of nonbank financial institutions (NBFIs) was centralized in BI. A Bank Indonesia Supervisory Monitory System (BISMS) was established to recommend corrective measures and sound banking practices, e.g., improving the asset evaluation processes, strengthening capital adequacy requirements, and training supervisory personnel.
Monetary policy reforms:	
Open market operation	Auctions of central bank (SBIs) introduced in 1984. Issuance of repurchase agreements (SPBUs) began in 1985. Investments' house (FICORINVEST) created in 1985 to intermediate in money market.
Reserve requirements	Reduced from 15 percent to 2 percent of deposit liabilities in 1988.
Central bank financing	Liquidity credit facility, subsidizing priority sectors, reformed in 1983. General rediscount facilities introduced in 1984 to complement open market operations.

Source : Kuncoro (1996)

The reform in financial sector was taken one step further in October 1988 with what was referred to as Pakto 88 (October Package Policy 1988). Under Pakto 88, restrictions on the operations of foreign banks were eased, the procedures for establishing branch banks were simplified, and the requirements for becoming a foreign exchange bank were relaxed. The Pakto 88 also reduced the special privileges and responsibilities of the state-owned financial institutions and narrowed the differential tax treatment affecting various financial instruments. The bank reserve requirement was lowered from 15% to 2% on all deposits, successfully reducing the spread between borrowing and lending rates. The re-utilisation of the reserve requirement as indirect instrument of monetary policy is intended to control bank credit in the light of the surge in capital inflows. In addition, the new provision will strengthen the power of monetary policy to influence the bank's balance sheet.

2.1.2. The Period of Asian Financial Crisis (1997-2000)

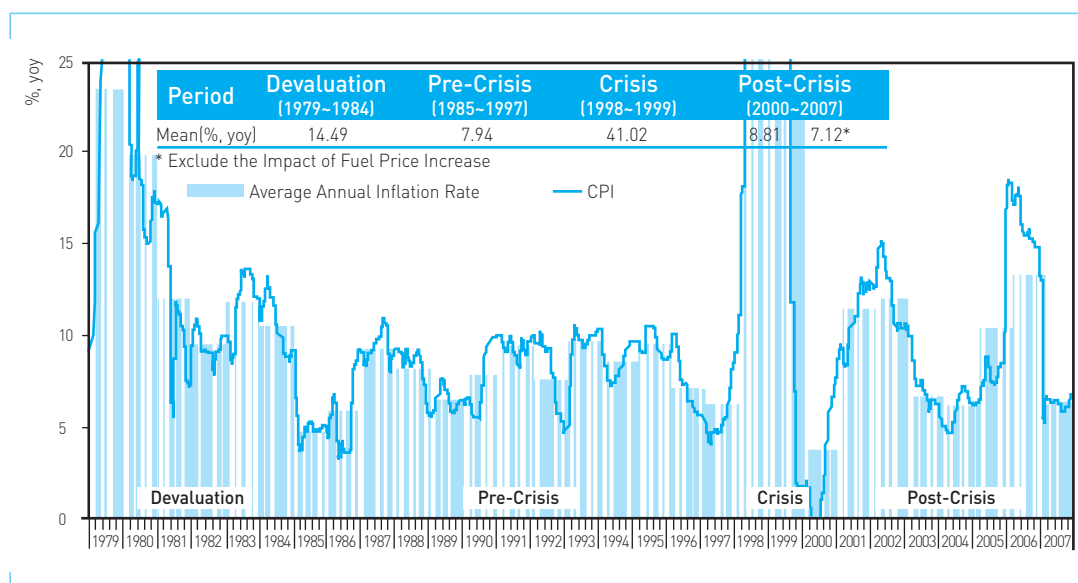
Between 1983 and 1999, the central bank was part of the government, and the Governor of Bank Indonesia was given the status of a Cabinet Minister. Under this structure, the central bank was only a member of the Monetary Board, consisting of several economic ministers with the Minister of Finance as the chairman. This board oversaw the overall conduct of monetary policy and financial sector supervision.

The crisis, which was triggered by an excessive depreciation of the rupiah, has resulted in the worst recession the economy has experienced. The economy shrank 13.68 percent during 1998 and the annual rate of inflation reached a very high figure, 77.6% at 1998 (year on year) basis. This was also followed by several large scale bank and business failures and a huge increase in unemployment rate. Figure 3-1 shows inflation rate has persisted about 7% during the last 30 years. Average of annual inflation rate was 14.5% (1979-1984), 7.94 (1985-1997), 41% (1998-1999), and 8.8% (2000-2007).

To cope with the battered rupiah, the government widened the trading band on the rupiah, and also intervened both in forward and spot markets. However, realizing the fact that defending the currency was futile under such a strong pressure on the rupiah, the government finally let the exchange rate float in mid August 1997.

To prevent further expansions of liquidity support, in April 1998, Bank Indonesia imposed a high penalty on the discount window facility and commercial banks' negative balance at Bank

Figure 3-1 | History of Inflation, Indonesia, 1979~2007



Source : DREKM BI (2008)

Indonesia. Furthermore, BI imposed a high penalty on the discount windows facility and commercial banks' negative bank balance at Bank Indonesia. In May 1998, BI placed a ceiling on deposit rates and the interbank rate guaranteed by the government. The policy aimed at preventing banks from adopting imprudent measures that could lead to self-reinforcing expansion on liquidity support.

2.1.3. Implementing New Monetary Policy Framework (Post July 2005)

During this period prior to passage of Law no.23/1999, the authority of Bank Indonesia to supervise and regulate the banking sector was severely limited. Bank Indonesia had the responsibility to review new proposals for bank licenses, but not to issue the permits (Djiwandono, 1999). Similarly, the central bank could comment upon or even suggest changes in policies affecting the banking sector, such as raising the compulsory reserve requirements, but the Monetary Board would eventually decide whether or not to fully implement the proposed policy change. The lack of independence and full authority for the central bank to regulate and supervise the banking sector also arguably explains the poor handling of the closure of 16 banks in late 1997 and destabilizing events that took place immediately after that (Siregar & Williams, 2004).

A major change in the conduct of monetary policy in the aftermath of the crisis was the Bank Indonesia Act that gives full autonomy in formulating and implementing policies. First, the objective of the central bank focuses on achieving and maintaining the stability of the rupiah (currency) value, meaning inflation and exchange rate. Second, the central bank has been given independence in both setting the inflation target (goal independence) and conducting its monetary policy (instruments independence). Third the decision on monetary policy rests on Bank Indonesia's Board of Governors, without any intervention from the Government and other parties. And fourth, a clear mechanism for accountability and transparency of monetary policy is outlined in the Act, among others by requiring Bank Indonesia to announce its inflation target and plan of monetary policy at the beginning of the year and to provide a quarterly report to The National Assembly on its conduct of monetary policy. Against this background, the most suitable framework of future monetary policy is inflation targeting. Two fundamental prerequisites for inflation targeting-i.e., the ability to conduct monetary policy with independence and absence of conflict with other nominal targets or policy objectives-are fulfilled.

Bank Indonesia has adopted a full-fledged inflation targeting framework (ITF) since July 2005. The framework has three primary characteristics: First, monetary policy is directed towards achieving an inflation target explicitly announced to the public for a specified time horizon. Second, monetary policy must be implemented with Bank Indonesia and on a forward-looking basis, responding to future development in inflation. Third, monetary policy is implemented on a transparent basis with measured accountability.

The monetary policy transmission mechanism illustrates how the monetary policy process influences inflation and the wider economy. Table 3-3 summarizes the transmission mechanism operates through six channels: exchange rate, asset price, interest rate, corporate balance sheet, credit, and expectation channel.

Table 3-3 | Summary of Transmission Mechanism in Indonesia

CHANNEL	BEFORE CRISIS			Crisis	After Crisis
	SBI/PUAB-Channel	Channel-Inflati	Total Effect	1997/1998-1999/2000	2000:01-2005:03
	Especially Exchange Rate and Interest Rate Channel			Especially Assets Price, Credit and Balance Sheet Channel	Especially Exchanges Rate, Assets Price, Interest Rate and Credit
Exchange Rate			Occurred but not strong	Strong via direct pt	The most strong channel for monetary transmission channel to CORE inflation via direct pt
(i) direct pt	Occurred	Occurred	8% variation inflation explained by rSBI after 25 months, and around 45% each explained by exchange rate and tradable prices	No comprehensive test	Occurring
				55% variation inflation explained by rSBI 15 after 15 months	59% variation inflation explained by shock SBI after 1 year
(ii) indirect pt	Occurred	Occurred	8% variation inflation explained by rSBI after 25 months, and around 45% each explained by exchange rate and tradable prices.	Not consistent with hypothesis	Not occurring (functioning well)
		Result not consistent:			The most strong channel for

Asset Price	Occurred	Shock SBI responded by increasing investment (others response variable as expected by hypothesis)	Not occurred (functioning well)	Start occurring (functioning) via investment channel (data 1996-2003)	monetary transmission channel to headline (CPI) inflation especially via investment channel 43% variability of inflation explained by shock SBI, 21% explained by deposit rate, and 17% by investment growth
Interest Rate			Occurred but not strong	Not occurring (functioning well)	Occurring (functioning) well especially via cost of capital channel
(i) cost of capital	Occurred through investment growth	No test in both investment deflator and CPI deflator	-2.9% investment growth explained by rPUAB after 1 year, 83% explained by itself	Result not consistent; at rPUAB increased, rKI declined so the investment growth also decrease	Occurring (functioning well)
				19% variation investment deflator explained by rPUAB, 41% explained by itself, 26% by investment growth	60% variability of inflation can be explained by shock SBI after 1 year
(ii) subst./income	Occurred	Occurs through consumption deflator	1.6% consumption on deflator explained by rPUAB after 1 year, 91% explained by itself.	Result not consistent: when rPUAB increased, rDEP decrease followed by positive consumption growth after 1 month	Occurring (functioning well)
				38% variation on consumption growth explained by rPUAB, 52% explained by itself	54% variability of inflation can be explained by shock on SBI after 1 year
Balance Sheet	Worsening debt/cap and short debt/fold debt, precisely increase investment		Not effective	Stronger, possibly due to extreme monetary	

Credit	Credit volume to the of SBI is low	Not occurred	Not effective	contraction and highly rupiah exchange rate depreciation	Occurring 41% inflation variability explained by shock SBI after 1 year
Expectation	No test due to lack of data			Not Effective Still backward looking (adaptive), 72% influenced by its self	-

Source : Goeltom (2007)

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

2.1.4. A Tale of Two Crisis

The global financial crisis (GFC) 2008 had not fully run its course at the time of writing, so it is possible that its impact on Indonesia will eventually be worse than has been observed so far. With that qualification noted, the differences between Indonesia's experience of the GFC and the Asian financial crisis (AFC) in 1997-98 are remarkable. Table 3-4 compares a number of the key economic variables during the two crises.

The indicator of most fundamental importance is the GDP growth rate, which plummeted below -18% in the earlier crisis, but has remained positive (4.4%) so far during the GFC. On most of the other measures the differences are equally striking: The depreciation of the currency from its strongest point just before each crisis to its weakest point was more than three times higher in the case of the AFC; the peak rate of year-on-year consumer price inflation was almost seven times higher; the peak interest rate on BI's open market operations instrument, the 30 day SBI (Sertifikat Bank Indonesia, Bank Indonesia Certificate), was more than six times higher; and the peak inter-bank seven-day borrowing rate was more than eight times higher. The loss of international reserves was only a little higher in absolute terms during the AFC, but well over twice as high in percentage terms. Only in relation to the rupiah market value of shares listed on

Table 3-4 | Crisis Comparisons

	Asian Financial Crisis	Global Financial Crisis
Lowest GDP growth rate (year-on-year % p.a.)	-18.3	4.4
(quarter)	Dec-98	Mar-09
Peak rupiah depreciation (%)	83.6	25.5
(period)	Jun-97-Jun-98	Feb-08-Nov-08
Peak CPI inflation		
(year-on-year % p.a.)	82.6	12.1
(month)	Sep-98	Sep-08
Peak SBI 30 day rate (% p.a.)	70.4	11.2
(month)	Aug-98	Nov-08
Peak interbank borrowing 7 day rate (% p.a.)	95.0	10.8
(month)	Jul-98	Dec-08
Decline in foreign reserves		
(\$ billion)	12.3	10.4
(%)	42.7	17.1
(period)	Jun-97-Feb-98	Jul-08-Nov-08
Decline in stock market capitalisation (%)		
(rupiah value)	52.2	55.1
(period)	Mar-98-Sep-98	Jul-08-Nov-08
(\$ value)	88.1	56.3
(period)	Jun-97-Jun-98	Jul-08-Feb-09

Note : The table is based on end of month data, except for GDP growth, which is based on quarterly data.

Source : Kuncoro, et al. (2009)

the stock exchange have the two crises been comparable in their impact, with declines of a little over 50% in both cases. If we focus on the percentage decline in the dollar value of shares, however, the impact of the AFC was again considerably more severe. As we shall argue below, these much more favorable outcomes reflect, to a considerable extent, the far greater skill with which the shocks to Indonesia's economy have been handled by policy makers the second time around.

Although most Asia's export-oriented economies were battered by the abrupt global downturn, the economic outlook for the Indonesia improved markedly during the first half of 2009 (Table 3-5). IMF (2009: 71-74) argued that the intensifying rebound in Asia can be linked to three factors: (1) expansionary fiscal and monetary policy, which has been very aggressive in some countries; (2) a rebound in financial markets and capital inflows, which eased financing constraints for smaller export enterprises and improved consumer and business confidence; and (3) the growth impulse for industry following large inventory adjustments.

Table 3-5 | Selected Asian Economies: Real GDP, Consumer Prices, and Current Account Balance (Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices ¹				Current Account Balance ²			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Emerging Asia	9.8	6.7	5.0	6.8	4.9	7.0	2.7	3.2	6.7	5.6	5.2	5.3
Newly industrialized Asian economies	5.7	1.5	-2.4	3.6	2.2	4.5	1.0	1.9	5.7	4.4	6.4	5.9
Korea	5.1	2.2	-1.0	3.6	2.5	4.7	2.6	2.5	0.6	-0.7	3.4	2.2
Taiwan Province of China	5.7	0.1	-1.0	3.7	1.8	3.5	-0.5	1.5	8.6	6.4	7.9	8.0
Hong Kong SAR	6.4	2.4	-3.6	3.5	2.0	6.5	-0.2	1.6	23.5	14.8	12.6	12.5
Singapore	7.8	1.1	-3.3	4.1	2.1	6.5	-0.2	1.6	23.5	14.8	12.6	12.5
Developing Asia ³	10.6	7.6	6.2	7.3	5.4	7.5	3.0	3.4	7.0	5.9	5.0	5.2
China	13.0	9.0	8.5	9.0	4.8	5.9	-0.1	0.6	11.0	9.8	7.8	8.6
India	9.4	7.3	5.4	6.4	6.4	8.3	8.7	8.4	-1.0	-2.2	-2.2	-2.5
ASEAN-5	6.3	4.8	0.7	4.0	4.3	9.2	2.6	4.6	4.9	2.6	3.3	2.0
Indonesia	6.3	6.1	4.0	4.8	6.0	9.8	5.0	6.2	2.4	0.1	0.9	0.5
Thailand	4.9	2.6	-3.5	3.7	2.2	5.5	-1.2	2.1	5.7	-0.1	4.9	2.7
Philippines	7.1	3.8	1.0	3.2	2.8	9.3	2.8	4.0	4.9	2.5	3.2	1.2
Malaysia	6.2	4.6	-3.6	2.5	2.0	5.4	-0.1	1.2	15.4	17.9	13.4	11.0
Vietnam	8.5	6.2	4.6	5.3	8.3	23.1	7.0	11.0	-9.8	-11.9	-9.7	-9.4
Other Developing Asia ⁴	6.5	3.9	3.3	4.1	10.1	12.8	11.6	8.3	0.0	-2.3	-1.0	-1.4
Pakistan	5.6	2.0	2.0	3.0	7.8	12.0	20.8	10.0	-4.8	-8.3	-5.1	-4.8
Bangladesh	6.3	6.0	5.4	5.4	9.1	7.7	5.3	5.6	1.1	1.9	2.1	1.0

1 Movements in consumer prices are shown as annual averages. December-December changes can be found in Table A7 in the Statistical Appendix.

2 Percent of GDP

3 The country composition of this regional group can be found in Table F in Statistical Appendix.

4 Includes Islamic Rep, of Afghanistan, Bhutan, Brunei Darussalam, Cambodia, Fiji, Kiribati, Lao PDR, Maldives, Myanmar, Nepal, Papua New Guinea, Samoa, Solomon Islands, Sri Lanka, Timor-Leste, Tonga, and Vanuatu.

Source : IMF (2009)

2.2. Key Regulation of Interest

2.2.1. Towards an Independent Central Bank

Under the former central bank law (Act No. 13 of 1968), Bank Indonesia's principal tasks were twofold: first, to assist the government in managing and maintaining the stability of domestic currency (Rupiah); second, to facilitate support for productive activities and efforts to bring greater prosperity to the population.

These were the concepts that became incorporated into the new Central Bank Act (CBA) in

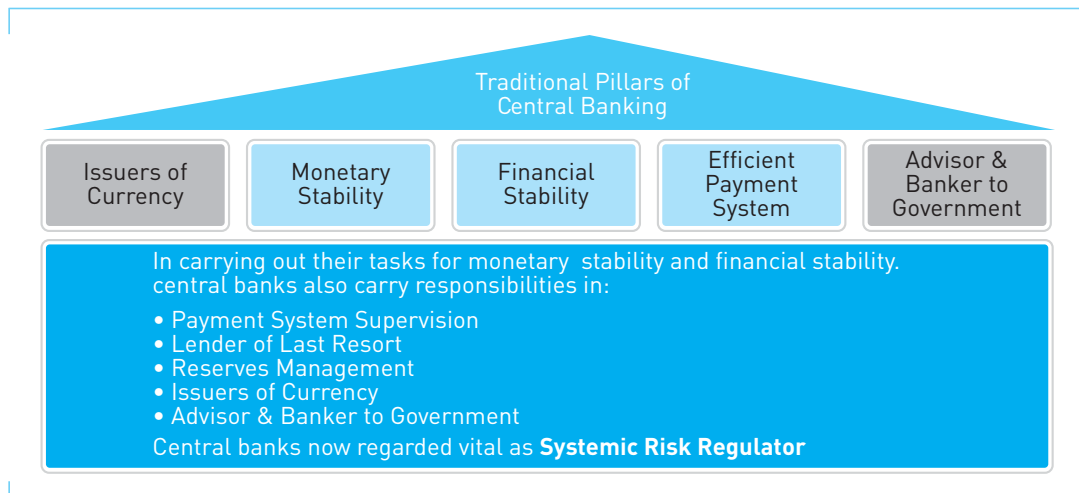
1999, establishing BI as an independent institution. First, as stipulated in the CBA the main objective for BI is to maintain the internal and external stability of Rupiah. Second, the CBA provides a more explicit foundation for the goal and instrument independence of Bank Indonesia. Third, the objective of maintaining stability in the Rupiah is defined by BI in its vision and mission statements. The BI vision is to achieve low, stable inflation and the BI mission is to maintain stability in the through monetary stability and improved financial system stability in support of sustainable long-term development. Fourth, in its design of a monetary policy strategy, BI would apply the base money indicative targeting approach under an agreement with the IMF.

Arguably, one of the cornerstones of the post-1997 crisis reforms on the regulation and supervision of the financial sectors in Indonesia is the enactment of the Central Bank Law no. 23 in May 1999 ---henceforth Law No. 23/1999--- and its subsequent amendments. As specified in Articles 7, 8 and 9 of Law No. 23/1999, its primary objective is to provide a legal structure whereby the central bank can act independently in carrying out its duties as the monetary policy maker (Figure 3-2).

The Law no. 23/1999 also clearly specifies that Bank Indonesia will eventually relinquish its role in bank supervision. BI is responsible for five role: i.e. as an issuer of currency, achieving monetary stability, achieving financial stability, achieving an efficient payment system, as an advisor and banker to government (Figure 3-2). First, Bank Indonesia safeguards monetary stability through the use of interest rates in open market operations, while also employing other instruments. Second, Bank Indonesia has a vital role in building the sound performance of financial institutions, particularly in the banking sector. Third, Bank Indonesia's powers include the maintenance of a robust payment system. Fourth, Bank Indonesia is able to tap its research and monitoring capabilities to access information on threats to financial stability. Fifth, Bank Indonesia operates the financial system safety net under the central bank lender of last resort (LoLR) function. BI now regarded as systemic risk regulator.

Presently, the functions of regulation and supervision of the financial sector in Indonesia are shared among different institutions (Siregar & Williams, 2004). The current Indonesia's regulatory structures are summarized in Figure 3-3. The central bank as stated in Article 8 of Law no. 23/1999 is responsible for the tasks of regulating and supervising the banking sector. The Ministry of Finance is responsible for the capital market sector and other financial institution. Both stock exchange and other financial institutions are under the direct supervision of its own Capital Market Supervision Authority (BAPEPAM). The new supervisory institution will undoubtedly alter the landscape of the financial safety net system of the country in the near future. The official target date for the establishment of the single supervisory agency is no later than December 2010.

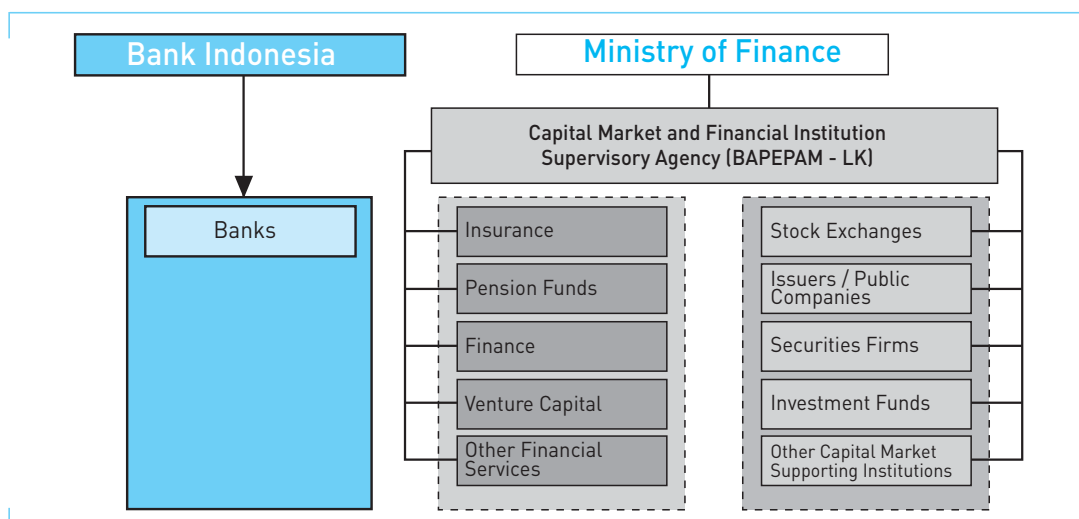
Figure 3-2| Roles of Central Bank



Source: Bank Indonesia (2009)

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

Figure 3-3| The Existing Indonesia's Regulatory Structures

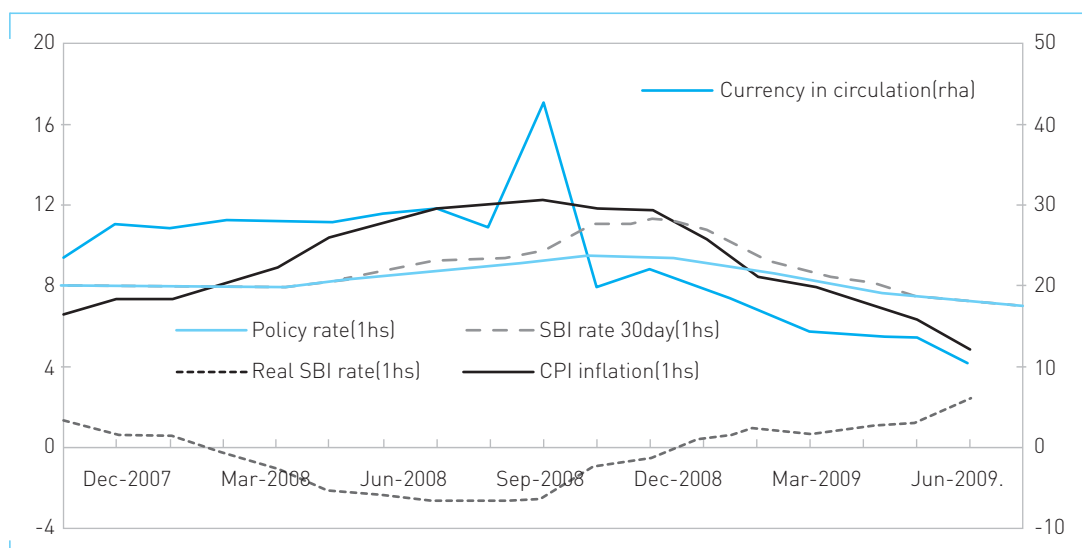


Source: Tandelilin (2009)

2.2.2. Inflation and BI Rate

The downward trend in consumer price inflation that first became evident at the end of 2008 continued through May 2009, by which time it was just below 5% per annum-less than half the peak rate recorded in Q4 2008 (Figure 3-4). Evidently the implementation of monetary policy has been considerably more successful in 2009 than it was in 2008. Bank Indonesia (BI) had been slow to respond to increasing inflation during 2008, and when it finally did begin to respond from May, the modest increases in interest rates it introduced were insufficient to slow the rate of growth of base money from an average of around 28% per annum, which is far too high to be consistent with sustained low inflation. Inflation continued to accelerate. It was not until the fourth quarter of 2008 that BI moved more aggressively to slow the growth of its monetary liabilities.

Figure 3-4| Monetary Policy Indicators and Inflation (% p.a.)



a The real SBI(Bank Indonesia Certificate) rate is the nominal rate less the contemporaneous rate of CPI (consumer price index) inflation.

Source: CEIC Asia Database; Kuncoro, et al. (2009c)

To achieve this end it would be necessary for BI to significantly increase the rate offered on its certificates (SBIs), but this created a political problem. Central banks are almost inevitably criticised when interest rates are on the rise. In this case, the economy was already slowing down because of the GFC, and this resulted in widespread calls for rate reductions. BI's solution to this problem was to turn its 'policy rate' into a fiction. Whereas in the past the policy rate had been the market yield on its one-month SBIs, from February 2008 the announced policy rate was de-coupled from the SBI rate (and, indeed, from any interest rate observable in the market)-without any announcement or explanation, so far as we are aware. At first the gap

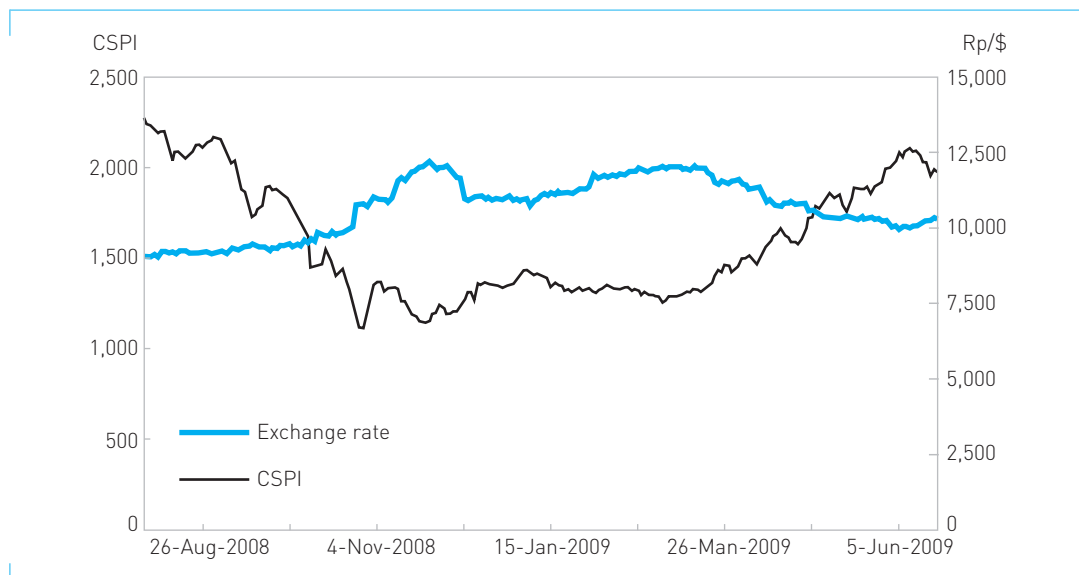
between the policy rate and the one-month SBI rate was very small, but in October 2008 it widened to almost 1.5%, increasing to about 1.75% in November. By making SBIs a more attractive investment, BI was able to reduce the rate of monetary expansion to only about 20% by October, without having to announce any significant tightening of monetary policy. Indeed, it sought to create the opposite impression, purporting to adopt a more expansionary policy by reducing the commercial banks' minimum reserve requirements in October, and by bringing an end in November to the series of small increases in its (fictitious) policy rate (25 basis points per month for the six months from May).

By tightening monetary conditions while purporting to move in the opposite direction, BI was able to put an end to the acceleration in inflation without generating significant protest. And once inflation began to decline significantly, nominal interest rates could be reduced without reducing the attractiveness of SBIs to investors. The real rates of return on SBIs recorded in the middle of 2008 were negative, but they turned positive in 2009, and have continued to increase, because inflation has declined more rapidly than the nominal SBI rate. The political imperative to maintain a fictional policy rate has disappeared, so that the policy rate is now once again identical with the one-month SBI rate. The experience of the last nine months or so has demonstrated - as was the case in 1998, when Indonesia began its recovery from the AFC-that it is perfectly feasible to bring high inflation to an end by tightening monetary policy, without having any significant negative impact on GDP growth (although of course it is possible that growth might have been higher still under a more expansionary monetary stance).

2.2.3. Financial Markets

Since Indonesia's stock market and foreign exchange market are integrated with the global financial system, it is not surprising that the GFC has had a noticeable impact on the financial sector. It has come as a pleasant surprise, however, that this impact has been quite restrained- especially by comparison with the previous crisis in 1997~98. After severe declines in the fourth quarter of 2008, both stock prices and the currency held relatively steady through Q1 2009 (Figure 3-5). In the next two months, however, previous losses in both markets began to be reversed. Stock prices increased by about 50% from mid-March through mid-June, while the rupiah appreciated by about 17%. The rapid increase in stock prices would appear to reflect a strong upswing in investor confidence and this provides some grounds for optimism in relation to Indonesia's near-term economic outlook. We may speculate that investors decided that the surge of pessimism that overcame the markets toward the end of 2008 had been excessive; alternatively, they may have been surprised by the confidence and competence with which Indonesia's monetary and fiscal authorities responded to the impact of the GFC. The strengthening of the currency is further evidence of the willingness of investors to increase or restore their exposure to Indonesian assets, not least because of the firmness of monetary policy and the corresponding decline in the inflation rate.

Figure 3-5| Composite Stock Price Index (CSPI) and Exchange Rate (Rp/\$)



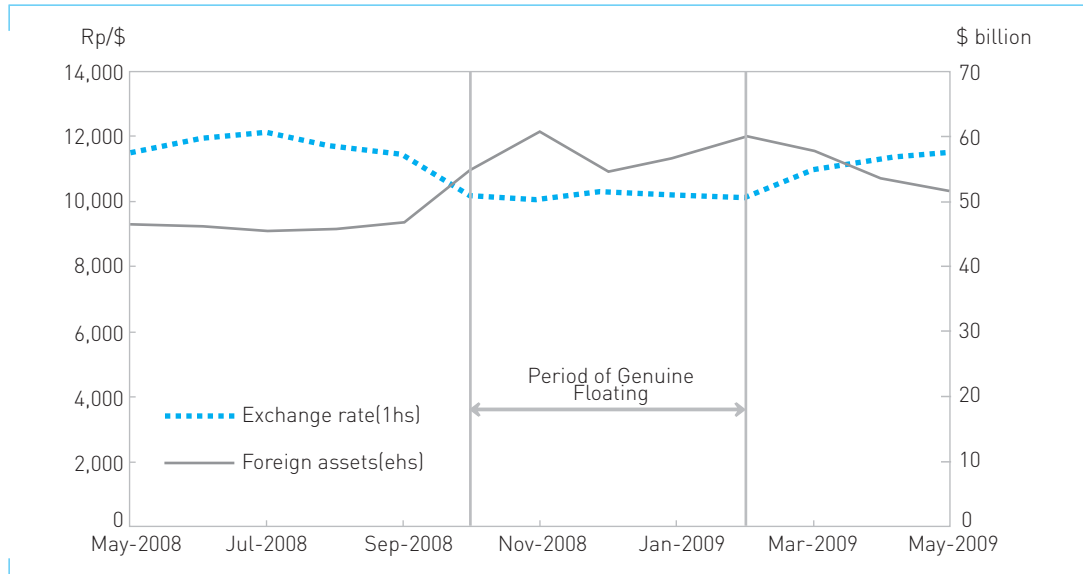
Sources : Kuncoro, et al. (2009)

These heartening outcomes in the financial markets provide useful background on the conduct of exchange rate policy and on the appropriate level for Indonesia's international reserves. Although the central bank 'floated' the rupiah at the outset of the Asian financial crisis in 1997, it has never been able to bring itself to allow a genuine float in which the value of the currency is determined solely by market forces. This can be seen by observing the level of BI's foreign exchange reserves, approximated by the level of foreign assets in Figure 3-6. In June and July 2008 BI's intervention in the foreign exchange market involved adding to its reserves so as to lean against the tendency for rupiah appreciation. In the next three months, however, with the GFC looming, it began selling off its reserves in an attempt to limit depreciation; during this period its foreign assets fell from almost \$61 billion to below \$51 billion, but even this was not enough to prevent the price of dollars rising by over 20%. Rather than continue to fight market forces, BI then changed its policy to something approximating a genuine free float. It largely withdrew from the market, allowing the currency to depreciate further to a little over Rp 12,000/\$. With BI sitting on the sidelines for the next three months, the exchange rate oscillated for the most part within the range Rp 11,000-12,000/\$. Subsequently, however, the urge to intervene again took over, with BI returning to the market as a buyer in order to restrain-although not prevent - appreciation of the currency back toward the Rp 10,000/\$ level.

Undoubtedly there is strong political pressure on the central bank to manage the exchange rate. The president himself 'ordered' the governor of BI to guard against further depreciation early in February 2009 after the exchange rate hit Rp 11,813/\$, although conceding that 'the rupiah is the domain of [the legally independent] Bank Indonesia, and not the government' (Maulia, 2009). In the event, conditions in the foreign exchange market began to improve, so

the governor was not forced to make a choice between his policy instincts and following the president's advice.

Figure 3-6 Exchange Rate Policy



Source : Kuncoro & Widodo (2009)

At other times, however, BI itself makes clear its preparedness to intervene in the market when circumstances dictate. It often draws attention to its success in building up its international reserves—the only purpose of which, of course, is to sell into the market to prevent depreciation (or to persuade potential speculators that it could do so on a scale so large as to defeat them); its withdrawal from the market in November 2008 was precisely to avoid a continuing loss of reserves. Even though reserves still amounted to over \$50 billion at the time, this suggests that it feared it would quickly run out of reserves otherwise. This raises an interesting question as to how much would be adequate for such intervention. BI itself does not regard \$60 billion as adequate; a figure of \$80 billion has been suggested by unnamed analysts (Suharmoko, 2009), but the basis for this seems arbitrary. By contrast, very few seem to argue that current reserves are sufficient - much less that they should be reduced to a low level.

Such a view is worth considering, however. Moving to a low level of reserves implies moving to a much more genuinely floating exchange rate. The experience of the three months through February 2009 shows how this would work in practice. At times when there is a loss of confidence in the rupiah and a corresponding outflow of capital, the rupiah depreciates in the absence of sales of foreign exchange by the central bank. The process is not open-ended, however. The more the price of dollars rises, the less reason there is to speculate: after all, speculation is the attempt to arbitrage between the low rate of the present and the higher rate of

the future, and once the spot (current) rate moves close to the expected future rate, the basis for further speculation no longer exists. Thus, with BI's withdrawal from the market in November 2008 the momentum of depreciation quickly dissipated. The reality is that what usually drives currency speculation is central bank intervention-and the belief on the part of market participants that ultimately this intervention will be unsuccessful.

In opposition to this view it might be argued that the experience of 1997~98 after BI 'floated' the rupiah was quite the opposite. At that time, withdrawal of BI from the foreign exchange market saw the exchange rate leap from less than Rp 2,500/\$ to over Rp 15,000/\$. The explanation for this is quite straightforward, however. On that earlier occasion, monetary policy was out of control. BI was lending massively to the banking system in its capacity as lender of last resort, and thus inadvertently financing the speculation against its own currency. By contrast, in late 2008 and early 2009, the rate of growth of BI's monetary liabilities was relatively low and declining, not high and accelerating. In short, the perils of floating the exchange rate appear to be greatly exaggerated, provided the float is accompanied by sound monetary policy.

There is another argument against accumulating a high level of international reserves. Purchasing dollars involves BI in injecting additional rupiah into circulation; if not offset, this is inflationary. To offset this effect it is necessary to issue an equivalent quantity of SBIs; BI's investment in higher international reserves is thus financed by borrowing from the public in this form. The implication is that in aggregate, entities outside BI must be 'going long' in rupiah-in effect, substituting rupiah-denominated liabilities of BI in their balance sheets for dollar-denominated liabilities of the US government. This means, roughly speaking, that the private sector becomes heavily exposed to the rupiah as a result of BI building up its reserves. Paradoxically, in building up its war chest to fight future speculation against the rupiah, the central bank causes private sector entities in aggregate to take on an exchange rate risk that is likely to precipitate precisely that speculation at any time there is some adverse shock to the economy. By March 2009, BI had issued \$34 billion of SBIs in order to finance its heavy investment in foreign exchange assets-implicating that the private sector collectively was exposed to the same extent to the danger of rupiah depreciation.

2.2.4. Banking

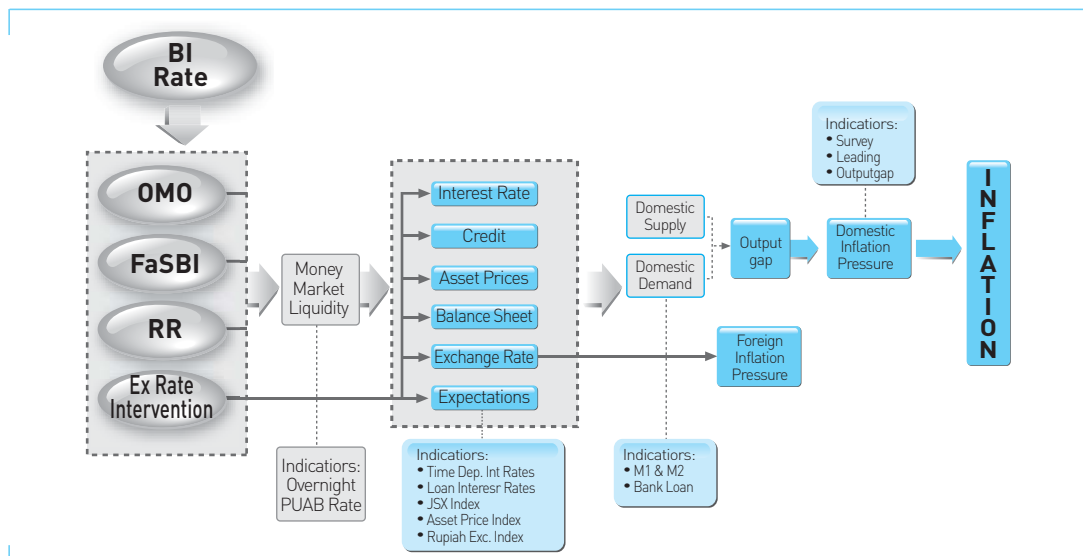
Several indicators continue to suggest that Indonesia's banking sector has been far less affected by the GFC than those of many other countries, and that the dangers noted by Gunawan and Siregar (2009: 24-5) have yet to materialise. There has been little indication of bank customers-either borrowers or depositors-shifting between rupiah-and dollar-denominated instruments. This suggests a reasonably high degree of confidence that the exchange rate is unlikely to change greatly in the near future. The average level of non-performing loans increased modestly from the post-AFC low of 3.8% recorded in December 2008 to 4.5% in

March 2009, but despite this the average capital adequacy ratio increased from 16.8% to 18.0% (over twice the regulatory minimum of 8%-during the same period (all data in this section are from CEIC Asia Database).

Bank interest rates peaked at the end of 2008, and then began to follow declining inflation and SBI rates. The average commercial bank rate for working capital loans declined slightly (by 22 basis points) through March 2009, while the average one-month time-deposit rate fell much more rapidly (by 133 basis points), such that the gap between them increased from about 4.5% to 5.6%. As an indicator of the gross margin on rupiah lending, this augurs well for banks' profitability (and thus their ability to strengthen their capital base). Lending growth rates continued to decline from the unsustainably high peak of almost 40% per annum recorded in October 2008 to about 26% in March, as banks applied much more conservative lending practices in order to strengthen their balance sheets (World Bank 2009). On the other hand, deposit growth continued to accelerate from a low of only 10% in August 2008 to over 21% in March. As a result, the loans-to-deposits ratio continued to decline from the peak of 79% recorded in August 2008 to 73% in March.

Bank Indonesia according the Inflation Targeting Framework, must achieve stability in the rupiah, or to control inflation. Therefore, it is crucial for Bank Indonesia to have a grasp on how monetary policy influences inflation through the transmission mechanism. This mechanism is known as the monetary policy process that influences the wider economy and inflation (Goelton, 2007). There are six transmission channels, i.e. the exchange rate, the asset price, the interest rate, the corporate balance sheet, the credit and the expectations channels. We can see how each of these channels influence inflation (Figure 3-7).

Figure 3-7 | Summary of Transmission Mechanism of Monetary Policy



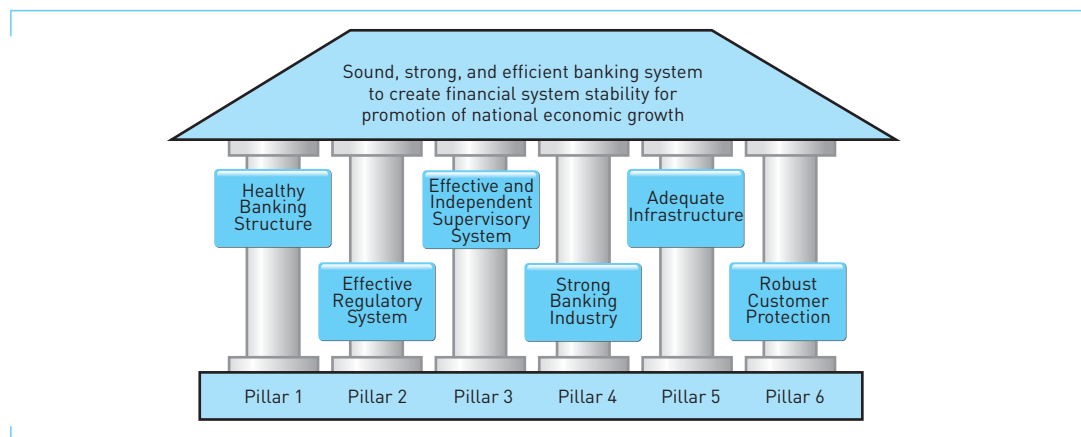
Source : Goelton (2007)

2.3. Current Issues on Financial Supervision

2.3.1. Indonesian Banking Architecture

The implementation of Indonesian Banking Architecture (API) in 2008 generally was congruent to the desired direction, with emphasis on reinforcing the national banking structure, widening access to credit and empowering consumers through financial education for the public. Since the launch of Indonesian Banking Architecture on 9th January 2004, significant achievements have been accomplished in terms of bolstering the national banking system. In accordance with the vision of Indonesian Banking Architecture to achieve a sound, robust and efficient banking system, which will help preserve financial system stability in support of national economic growth, the programs implemented were aimed at buttressing banking system resilience in order to contribute to the Indonesian economy. The programs that are contained under the umbrella of Indonesian Banking Architecture can generally be categorized into six main pillars, namely: (i) strengthening the national banking structure, (ii) improving the quality of banking regulations, (iii) establishing an independent and effective supervisory system, (iv) ameliorating bank management and operation, (v) building sufficient supporting infrastructure, and (vi) consumer protection and empowerment (Figure 3-8).

Figure 3-8 | Indonesian Banking Architecture



Source: BI (2009)

2.3.1.1. Reinforcing the Structure of National Banking System Program

The goal of bank consolidation is to establish a robust, sound and efficient banking industry, which can provide a greater contribution and added value to the national economy, as well as improve the ability of domestic banks to compete on a regional scale in anticipation of the inauguration of the ASEAN Economic Community in 2015 (BI, 2009). Still according to BI, Bank Indonesia set the minimum core capital for all commercial banks that operate in Indonesia

at Rp80 billion at the end of 2007, rising to Rp100 billion at the end of 2010. This is legislated through the issuance of PBI No 7/15/PBI/2005 and PBI No 9/PBI/2007 regarding Minimum Core Capital for Commercial Banks.

Although in principle all commercial banks have been able to conform to the minimum core capital requirement of Rp80 billion, national banking structure reinforcement is a continuous process conducted by improving the overall bank consolidation strategy. The ultimate goal of meeting the second stage minimum core capital requirement of Rp100 billion at the end of 2010 includes: (a) supervision for banks with a minimum core capital of less than Rp100 billion, (b) reformulating regulations related to bank consolidation, including the management of a commercial bank's minimum core capital and the provision of incentives for bank consolidation, and (c) other policies to improve the role of banks in contributing to economic growth. Over the subsequent few years the next consolidation strategy (post 2010) will be formulated with the overarching goal of achieving a sound, robust and efficient banking system that is able to support national economic growth and prepared for the ASEAN Economic Community (AEC) in 2015.

To support bank consolidation through mergers, Bank Indonesia provides incentives for banks that chose to merge as part of their consolidation strategy. In 2007, PBI No. 9/12/PBI/2007 regarding Incentives for Bank Consolidation was issued. Impetus for mergers among banks is also provided by the government through the Ministry of Finance and regulated by Finance Minister Decree No. 43/PMK/03/2008 regarding Book Value in Consolidation, Mergers and Business Expansion. Bank Indonesia cares about MSME development by improving the access of MSMEs to bank credit. In 2008, a range of activities was undertaken by Bank Indonesia. The activities were, among others, as follows: (i) technical assistance, (ii) institutional expansion, (iii) issuing policies and improving policies/regulations for bank credit, and (iv) increasing collaboration between the government and other relevant institutions.

Bank Indonesia also promote program to linkage between commercial and rural banks. The linkage program aims to build synergy between commercial and (Islamic) rural banks when extending credit/financing to the public. Throughout 2008, the linkage program facilitated by Bank Indonesia enabled.

The bank offices expanded steadily. As compared to the end of 2007, the numbers of total commercial banks offices increased by total 1,126 offices. The highest growth in the number of offices was for state-owned foreign exchange banks, namely 502 offices, followed by state-owned banks with 321 offices. Whereas the total numbers of overseas branch offices 17 offices (Table 3-6).

Domestic ownership of Indonesian banks far exceeded that of foreign ownership. The number of government and domestic banks is still greater than banks owned by a foreign party;

with 75 and 49 banks respectively. However, in terms of the percentage of asset value against total bank assets, domestic and foreign banks share similar percentages of 52% and 48% respectively.

Table 3-6 | Export Credit Commitment

Category of Bank	December 2007	December 2008
State Owned Banks		
Total Banks	5	5
Total Bank Offices	2760	3081
Foreign Exchange Commercial Banks		
Total Banks	33	32
Total Bank Offices	4673	5175
Non-Foreign Exchange Commercial Banks		
Total Banks	36	35
Total Bank Offices	742	842
Regional Development Banks		
Total Banks	26	26
Total Bank Offices	1241	1307
Joint Venture Banks		
Total Banks	17	16
Total Bank Offices	79	168
Foreign Owned Banks		
Total Banks	11	10
Total Bank Offices	131	179
Total		
Total Banks	128	124
Total Bank Offices	9626	10752
Number of Conventional Banks	125	119
Number of Islamic Banks	3	5

* Exclude BRI Rural Community Unit
Source: BI(2009)

Among the banks owned by a foreign party, the share of foreign acquisition banks was greater (Table 3-7). The share of foreign acquisition banks based on the total assets of foreign banks was 68.2%, which was relatively steady compared to its share at the end of 2007. Based on the number of foreign acquisition banks in terms of total assets over the last three years, the group of banks with total assets exceeding Rp50 trillion, the group of banks with total assets between Rp1 trillion to Rp10 trillion and the group of banks with total assets of less than Rp1 trillion all demonstrated significant improvements. In contrast, the group of banks with total assets between Rp10 trillion and Rp50 trillion tended to decline.

Table 3-7 | Share of Commercial Bank Assets Based on Ownership

Owner	December 2007			December 200		
	Total	Asset(T Rp)	Total Share	Total	Asset(T Rp)	Total Share
State Owned Banks ¹⁾	31	912	45.9%	31	1,033	44.7%
Local	52	238	12%	44	168	7.3%
Foreign ²⁾	45	836	42.1%	49	1,109	48%
Industry	128	1,986	100%	124	2,310	100%

1) Including State Owned Bank and Regional State Owned Bank

2) Including branch office of foreign bank, joint venture bank and foreign acquisition bank

3) Source: LBU

Source: BI (2009)

2.3.1.2. Improving Quality of Bank Regulations Program

The establishment of RBRI is intended to foster an active bank role in remote areas by developing the local economy and prominent business sectors through creating opportunities for local banks to play a more active role in developing the local economy and key business sectors through the utilization of RBRI research results. To the end of 2008, four RBRI had been founded as a result of collaboration between Bank Indonesia and the University of North Sumatera, the University of Brawijaya, the University of Andalas and the University of Hasanuddin. Since the establishment of RBRI in four provinces, no fewer than 13 research papers have been produced.

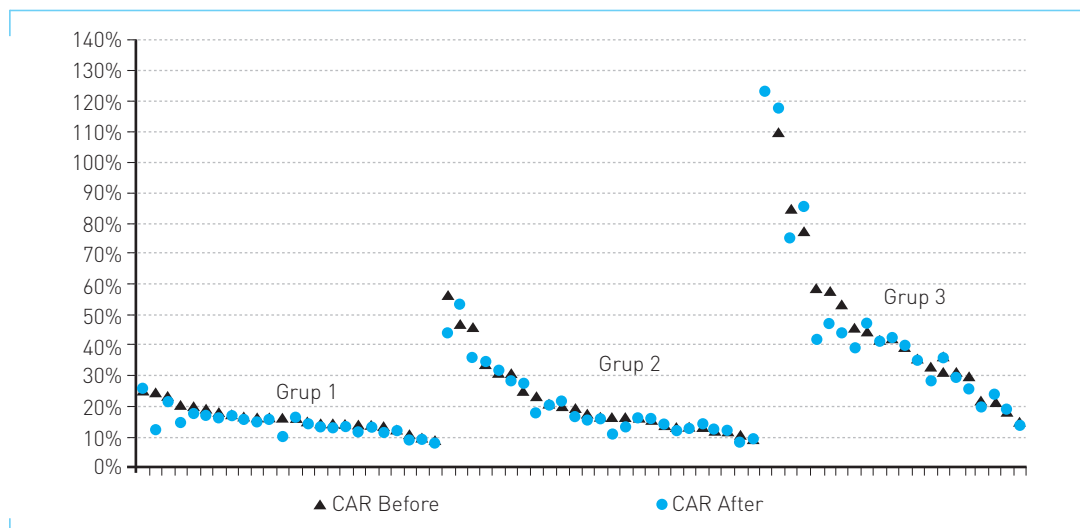
Periodically, Bank Indonesia and banks implement several task programs in collaboration to ensure Basel II implementation is successful. A number of programs were rolled out in 2008. The completion of Basel II in Indonesia requires elaboration, preparation, and planning by Bank Indonesia as the supervisory authority as well as banks and other related parties:

A. Calculation of Minimum Capital Requirement.

As an indicator of a bank's solvency level, capital is central in the implementation of Basel II in order to foster a sound banking system that is competitive nationally and internationally. To this end, Bank Indonesia refined the calculation of bank capital through the issuance of PBI No. 10/15/PBI/2008 regarding the Capital Adequacy Ratio (CAR) for Commercial Banks. Under this regulation, banks are obliged to calculate their risk-weighted assets based on credit risk, operational risk and market risk.

In addition, Bank Indonesia conducted studies to measure the influence of Basel II implementation on bank capital in order to avoid undermining bank performance through the implementation of Basel II. As such, Bank Indonesia has carried out Quantitative Impact Studies (QIS) on banks since 2005. In September 2008 Basel II implementation had caused an average decline in bank CAR of 1.92%, however, such a decline did not reduce bank CAR to below the benchmark level of 8% (Figure 3-9).

Figure 3-9 | Quantitative Impact Study (QIS)



Source: BI (2009)

B. Review Process by Supervisors

Bank Indonesia issued a Consultative Paper (CP) to banks that sets forth the direction of Bank Indonesia policy in implementing the four principles in accordance with risk-based supervision. In line with the CP, banks are requested to compile an Internal Capital Adequacy Assessment Process (ICAAP) to identify, monitor, measure and control all risks, including liquidity risk, concentration risk and interest rate risk, as well as the capital required by a bank in line with its risk profile. A number of the activities undertaken were designed to improve the risk-based supervision framework in order to emphasize supervisor judgment in the risk profile assessment and in determining a bank's rating. The amelioration of other supervisory tools is also required, including developing and fine-tuning SIMWAS to provide the supervisor with more accurate and timely information. Furthermore, Bank Indonesia also concluded a number of reviews in relation to the implementation of risk management for other risks in Indonesia's banks, such as interest rate risk in banking book, liquidity risk and concentration risk.

C. Market Discipline

In order for supervision performed by the public through the mechanism of market discipline to work well, banks must strive towards transparency by publishing information consistent with that obtained by bank officials in the assessment process and to manage risk.

2.3.1.3. Improving Bank Supervision Function Program

A number of training courses were held to raise the competence of human resources involved with supervision. Improvements to the banks' supervision function were made by building the competence of staff in the banking sector of Bank Indonesia through systematic, structured and continuous training carried out by the Banking Supervision School (BSS).

Education and certified training in 2008 was a continuation of that conducted in previous years in order to improve the proficiency of staff in the banking sector. Specifically, the goal of training and education in 2008 was to raise the aptitude of staff in the banking sector, especially in terms of preparing for Basel II implementation and PSAK 55 and 50. Since 2006, BSS has educated and trained validators including market risk specialists, information technology specialists as well as accounting specialists. Training in 2008 also aimed to achieve international accreditation such as through Certified Information System Auditors (CISA), Certified Financial Risk Management (CFRM) and Certified Anti Money Laundering (CAMS).

2.3.2. Banking Performance

Based on some key indicators, Indonesia commercial banking shows great performance according bank indicators (Table 3-8). From August 2008 until August 2009, Indonesia commercial banking succeeded to attain CAR above the Basel II accord, 8%. It also can be directly tracked from low loan to deposit ratios (LDR). A lower LDR is associated with lower intermediation activity, vice versa. Indonesia commercial banks are exposed to a higher risk due to high LDR from August 2008-August 2009. Unfortunately, excessive risk-taking is not accompanied by an increase in profitability but instead by an increase in the ratio of operating expenses, particularly in state-owned banks. The ratio of operating expenses to operating income in state-owned banks increased from 99.85 percent in January 2008 to 121.14 percent at the beginning of 2009(Soedarmono, 2009). The amount of operational losses in state-owned banks currently stands at Rp 1.91 trillion (US\$189 million).

Rural bank growth was congruent with the growth of commercial banks. Despite a relatively minor contribution as a whole, rural banks continue to maintain growth on a par with commercial banks. This is clearly demonstrated by the share of rural banks in the banking industry in its entirety (Table 3-9).

2.3.3. Questioning Stability of Indonesian Financial System

Once rocked by an embezzlement scandal, where a top executive allegedly skimmed hundreds of millions of dollars worth of bank assets into a personal account, yet it didn't prevent them from having another one. This time the effect is bigger, in the sense of who is indicated to be involved. Boediono and Sri Mulyani, two biggest names could provide a glimps into how severe Century Bank's problem was. The former is the vice president of Indonesia and the latter is the current minister of finance. Nonetheless, there were concerns last year that the country might need assistance from the International Monetary Fund (IMF) to stabilize its complex and loosely regulated banking system. Century Bank represents merger of three smaller banks (i.e. Bank Danpac, Bank Pikko and Bank CIC) whose balance sheets were combined and re-opened under a new banner in 2005.

Table 3-8 | Commercial Banks Performance

Indicators	2008			2009			
	Aug	Oct	Dec	Feb	Apr	Jun	Aug
CAR (%)	17.1	16.7	16.76	18.04	17.83	18.17	17.12
Capital	225,090	239,783	238,270	258,400	244,632	255,869	253,343
Risk Weighted Asset	1,316,241	1,435,941	1,421,448	1,432,301	1,371,985	1,407,974	1,479,671
Earning Assets Quality							
Classified Earning assets to Earning assets (%)	2.81	2.62	2.95	3.29	3.3	3.23	3.26
Classified Earning assets	55,002	57,653	66,144	75,753	75,030	74,718	76,286
Total Earning assets	1,959,251	2,200,681	2,242,282	2,300,867	2,272,105	2,316,641	2,342,796
Earning Assets Write-off Reserve / Mandatory Earning assets Write-off Reserve (%)	149.11	132.04	168.12	154.53	157.12	128.46	116.47
Earning assets Write-off Reserve	54.171	59.298	64.068	68.678	69.734	72.929	76.655
Mandatory Earning assets Write-off Reserve	36.33	44.909	38.108	44.442	44.384	56.771	65.816
Profitability							
ROA (%)	2.71	2.68	2.33	2.6	2.71	2.7	2.67
Profit	53,670	54,090	48,158	60,447	63,282	62,936	62,546
Average Assets	1,978,813	2,019,101	2,067,044	2,325,886	2,332,718	2,332,899	2,339,178
Operations Expenses / Operations Income (%)	83.42	85.41	88.59	96.54	89.16	87.77	87.23
Operations Expenses	134,469	183,958	232,170	51,549	93,113	134,702	177,206
Operations Income	161,193	215,376	262,061	53,398	104,433	153,476	203,147
Liquidity							
Activa against Passiva - Liquidity (%)	3.3	3.75	4.49	2.98	3.38	3.47	3.64
LDR (%)	79.02	77.48	74.58	73.5	72.86	73.2	73.95
Credits	1,205,846	1,297,860	1,307,688	1,301,844	1,297,635	1,335,033	1,365,942
Third Party Funds	1,526,025	1,674,994	1,753,292	1,771,098	1,780,918	1,823,803	1,847,038

Source: BI(2009)

It all began on 13 November 2008 when Century Bank failed to make bank clearance because of a technical mistake-late pre-fund depositing (Table 3-10). Therefore, Indonesia Stock Exchange (BEI) suspended Bank Century's stock activities for one day. At the next day, Century was available to make any bank clearance again. All offices and branches reopened and operated as usual. Meanwhile, Century's stocks were unsuspended. November 16th 2008, PT Century Mega Investindo and First Gulf Asia Holdings Ltd as the shareholder of PT Bank Century Tbk

Table 3-9 | Performance of Rural Bank and Commercial Banks

	2007					2008				
	Rural Bank	Islamic Rural Bank	Commercial Bank	Banking	% Rural Bank to Banking	Rural Bank	Islamic Rural Bank	Commercial Bank	Banking	% Rural Bank to Banking
Total Assets	27,741	1,203	1,986,501	2,015,445	1.4	32,533	1,693	2,310,557	2,344,783	1.4
Third Party Fund	18,719	708	975,462	994,889	1.9	21,339	570	1,152,700	1,174,609	1.8
Third Party Fund			1,510,834	1,511,542	1.2			1,753,292	1,753,862	1.2
Total Credit	20,540	877	791,605	813,022	2.5	25,472	1,257	1,054,289	1,081,018	2.4
Total Credit			1,002,012	1,002,889	2			1,307,688	1,308,945	1.9
Total SME Credit			20,493	502,796	524,166	3.9		25,262	633,945	660,464

Source: BI (2009)

signed the Letter of Intent (LoI) to acquire almost 70% stock issued by Century Bank. Four days later, the Financial Sector Stabilizer Committee (KSSK) which consist Central Bank (BI), Deposit Insurance Corporation (LPS), the Capital Market and Non-Bank Financial Institution Supervisory Board (Bapepam-LK), decided where the Century needs a bailout or not. At the second day of the meeting, KSSK decided to declare Bank Century as insolvent. Yet it is unclear whether there is a political motivation or not within the decision until this moment. Government will take over Bank Century through the State Deposit Insurance Corporation (LPS). November 23rd, the first injection due the bailout program was made. It cost Rp 632 billion from the LPS fund. Sunday 26 November 2008, Robert Tantular, the top executive who allegedly skimmed hundreds of millions of dollars worth of bank assets into a personal account was arrested. Early December, LPS made a second injection about Rp 2.201 Trillion to cover Bank Century's liquidity needs until Des 31th. In the middle of the month, 18 December 2009, Perppu JPSK was rejected by the house (DPR), though government claimed that the official letter from the head of house wasn't clear whether it is a rejection or not. This event thus became one of the polemics until now. 3 February 2009, LPS made a third injection because Bank Century's Capital Adequacy Ratio (CAR) is below 10%. LPS reinjected about Rp 1.55 Trillion. Then the last Rp 630 Billion injection was made on 21 July 2009, ballooned the total cost of bailout which erupted the Bank Century's controversy became Rp 6.76 Trillion in the end. It soared tenfold from the original estimate of Rp 600 billion(US\$60 million) proposed during the meeting on 20-21 November 2009.

According to Bank Supervision Report 2008 by Bank Indonesia (2009), BI had conducted a range of supervisory measures related to the risk profile of the Bank Century to ensure that bank activities run in accordance with prudential principles. The aspects of the bank deemed high risk by Bank Indonesia were communicated to the management and bank owners, followed by a request to produce a strategic action plan. However, in time the bank was unable to meet its commitments in accordance with the action plan agreed upon.

Global macroeconomics black outlook worsened Century Bank's problems. Bank Century's stock portfolio dropped significantly which had hard and direct impact on its liquidity. Moreover, the domestic stock market was tight, therefore, Century Bank was unable to seek and accrue funding to cover its outstanding short-term liabilities (Bank Indonesia, 2009). The preventive action to ease liquidity mismatch on Bank Century's daily balance sheet was unsuccessful. Therefore Century Bank was placed under special surveillance status. Worsening condition at Century Bank forced the government and BI through KSSK to declare bank century as a failing with a systemic impact. BI then conducted special supervision at Bank Century; also cooperate with other related institution to prevent any other embezzlement and to ensure a Good Corporate and Good Governance.

Government's bailout did not emerge without no reason. GFCs will not give a nice effect if the government let Bank Century failed. Minister of Finance, who is also acting chief

Table 3-10 | Bank Century's Debacle Chronology

Date	Event
13 November 2008	Century Bank failed to made bank clearance because a technical mistake-late prefund depositing
14 November 2008	Bank Century is available to make any bank clearance again. All offices and branch reopened and operated as usual. Meanwhile, Century's stock are unsuspended
16 November 2008	PT Century Mega Investindo and First Gulf Asia Holdings Ltd as the shareholder of PT Bank Century Tbk signed the Letter of Intent (LoI) to acquisated almost 70% stock issued by Century Bank
20-21 November 2008	Financial Sector Stabilizer Committee (KSSK) meeting to decide Century's bailout
21 November 2008	Bank declared as insolvent. Bank Century take over by the Government through the State Deposit Insurance Corporation (LPS)
23 November 2008	Rp 632 billion capital injection by Deposit Insurance Corporation (LPS) on Bank Century
26 November 2008	Robert Tantular arrested
5 December 2008	Second injection by the LPS as much as Rp 2,201 Trillion to cover Bank Century's liquidity needs until Des 31th.
18 December 2009	Perppu JSPK rejection by the house of representatives (DPR) . This rejection claimed as 'unclear' by the government. Sri Mulyani explained that official letter from the head of the house at 24 December 2008 only asked the government to propose draft on JPSK Act before 19 January 2009.
03 February 2009	Because Bank Century's Capital Adequacy Ratio (CAR) are below 10%, LPS reinjected Rp 1,55 Trillion
21 July 2009	LPS made an another injection as much as Rp 630 Billion
31 July 2009	By the end of July, The Century controversy erupted after the bank's bailout costs soared tenfold from the original estimate of Rp 600 billion (US\$60 million) proposed during the meeting.

Source : BNVP

economics minister, said the bailout was necessary to prevent the bank from failing and to maintain financial sector stability. When asked if the bailout was politically motivated, she replied, “Absolutely not. It was part of the government’s strategy to cope with the financial crisis.” She added that the only part politics played in the bailout was the positive side effect of allowing for a greater government role in supervision and control over financial institutions’ management (Guntensperger, 2009). BI has repeatedly argued the rescue was necessary to prevent a systemic threat to the banking sector, saying that 23 banks of the same size as Century would have been dragged down had Century been allowed to fold.

Time sensitivity added more debate on Century’s controversy. The decision by the Indonesian financial authority in November 2008 to bail out the bank was taken at the peak of the global economic crisis, as several large international banks were collapsing and there was no clear sign when the crisis would end (Wijayanto, 2009). This of course reminds people at the Asian Crisis 1998 where bank failures triggered a domino effect and create a defunct banking system. It is proven that now global economic situation also Indonesia financial and banking system improves, differ from 1998. But is unfair to judge when we criticized the authority decision to bail out Bank Century. If they had known what the situation would be like today, maybe the financial authority would not have taken the action it did, and instead would have moved to liquidation.

Furthermore, there would be capital run to Singapore where they would give full guarantee on the deposits. Indonesia already suffered capital out flight due the act of the foreign investors that tried to cut them lose on their US financial assets. If Century Bank is allowed to collapse, then it will bring panic to our banking system. It will bring a massive pain to our financial system. It is not impossible to imagine that the panic could be bigger than that of the Asian Crisis 1998.

Concerning about the government decision to increase the amount of bailout tenfold from the original estimate, it make sense when it is correlated to maintain Century’s ratio to a favorable condition. At table 1 we could see how LPS injected fund with reasons. For example, 3 February 2009, injection was made seeing the CAR of Bank Century is below 10%, as preconditioned by the central bank (BI).

Wijayanto (2009) believed that the decision-making process was proper, but not the data that was used as a reference. In addition to the criminal act by Bank Century’s owners and executives, the investigation should also have focused on those who provided the misleading data. Rp 1 trillion jumped to Rp 6.7 trillion that should be a big question. Garbage in, garbage out. “No matter how the decision-making process and how capable the person in charge, wrong data would lead to wrong-decision”, added Wijayanto.

Nonethelss, Wijayanto (2009) supports the government decision to bail out from the

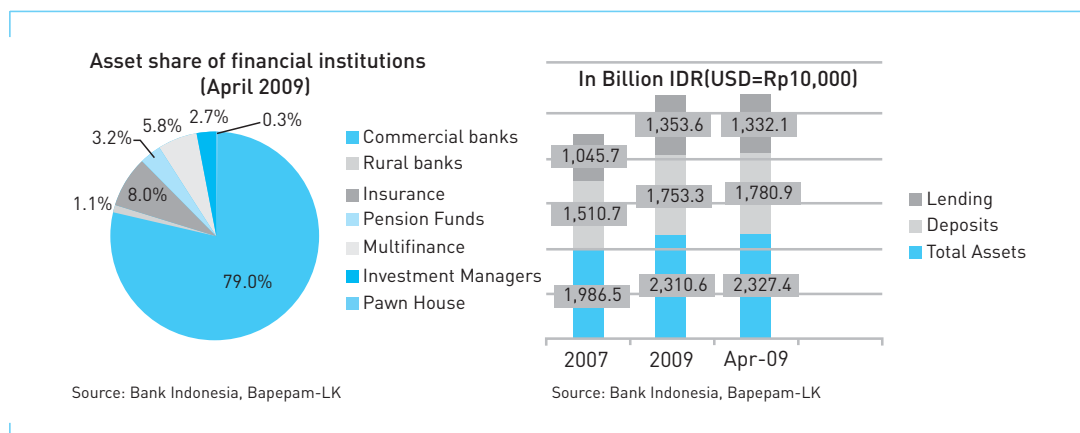
decision-making process and cost-benefit analysis. The cost is relatively uncertain and could be more than 6,7 trillion, but at least the result will be certain. On the contrary, liquidation would cost Rp 5,2 trillion but the result would be uncertain, with this uncertainty potentially representing enormous costs to the economy.

Late prefund depositing that Century had was normal. Corporate Secretary PT Bank Century Tbk Deddy Triana said that the incident of late prefund depositing could happen to any other bank. Moreover, mutation transactions in Indonesian banking were increasing at that time. Sigit Pramono, the head of Indonesia Banking Association (Perbanas) couldn't agree more: He added that the situation at that time was different; there was a liquidity crisis (Detik Finance, 2008).

Now Century Bank is regaining from their shattered name by rebranding themselves. With PT Bank Century Tbk letter, No. 1711/Century/DIR/IX/2009, Minister of Law and Civil Rights Decree AHU-41550.AH.01.02 2009, and Bank Indonesia Governor Decree, No. 11/47/KEP.GBI/2009, by 2 October 2009 PT Bank Century Tbk officially changed to PT Bank Mutiara Tbk, but still using BCIC as their listing name on Indonesia Stock Exchange (BEI). As post restructuring-program, they now are targeting to increase their asset for the next three years about Rp 12-13 trillions for the long run and Rp 8 trillions by the end of 2009. Until August 2009, their positions were CAR 9.52 percent, net profit Rp 201 billions, and NPL net 6.7 percent from 10.2 percent at the end of 2008.

Indonesian financial institutions asset share until April 2009 was mostly dominated by commercial banks by 79% (Figure 3-10). Others held little amount of shares as showed insurance 8.0%, multifinance sector 5.8%, pension funds 3.2%, investment managers 2.7%, rural banks 1.1% and pawn house 0.3%. It shows how Indonesian financial structure lacks diversification. From 2007 to April 2009, lending, deposits and total assets experienced an incremental movement. The only exception occurred on lending which it fell from 1,353.6 billion on 2008 IDR to 1,332.1 on April 2009.

Figure 3-10 | Structure of Indonesian Financial System



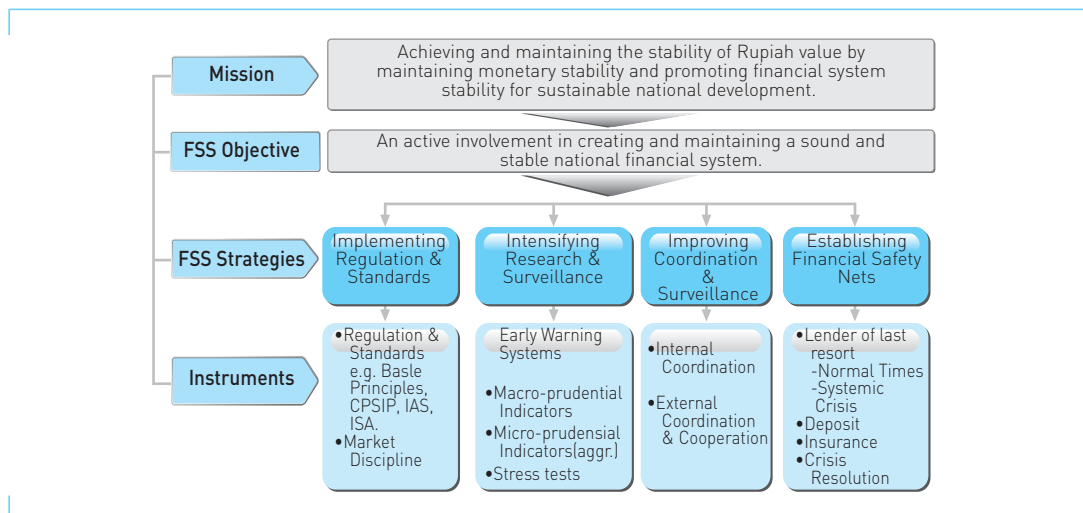
According to Sukarman (2009), society view regarding banking policies is divided into two different groups: The first group is those who demand broader bank transparency. The other one insist on limited bank transparency, implying that its liberties must be protected from its clients. These two perspectives have continued to influence formulation of banking policy as the central bank continued to compromise these two perspectives.

Those conflicting perspectives are followed by other contradicting perspectives that also related to matters of central bank transparency. The need for central bank independence, free from intervention from authorities, urged in 1980 to ensure that central banking policies would be oriented to the long term goals while government policies are commonly short term, influenced by political progress at that time.

Furthermore, Sukarman (2010) explained that the degree of central bank independence will follow its own political system. In an exoteric government environment, the question frequently arises as to whether the bank’s independence implies the return to banking esoterism. A question is when banks and other financial institutions improve transparency, will the central bank change to become an isolated institution immune from public transparency?

Bernhard (2002) suggests three formal aspects that define the central bank’s independence. The first aspect is control towards monetary policy instruments. There is a difference between “goals” with “instruments to achieve those goals”. The second aspect of making the central bank independent is the procedures in determining the management of the Central Bank. Third aspect is the capacity of the government to “sanction” the Central Bank by various means, for example by dismissing management, disapproving policies and budget reduction.

Figure 3-11 | Financial System Stability Framework



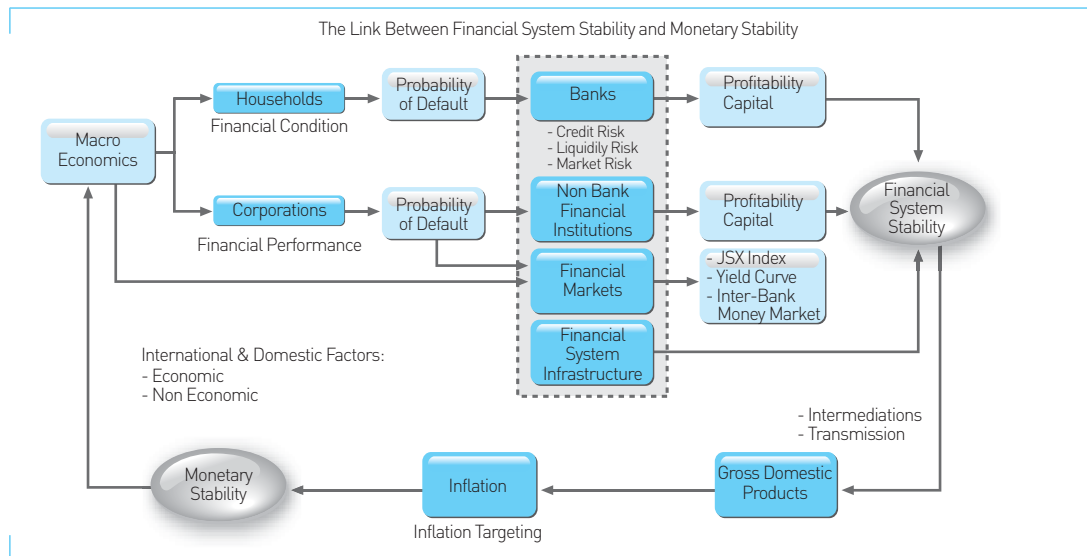
Source: BI (2009)

Financial System Stability (FSS) does not in fact have any standard international definition. Instead, multiple definitions are in use stating that a financial system becomes unstable when economic activity is hindered and the system is endangering the economy itself. The following are examples of definitions quoted from various sources: FSS means that the financial system has the capability to allocate funds efficiently and absorb shocks as they arise, thus preventing disruption of real sector activities and the financial system; FSS is a condition represented by a strong financial system capable of withstanding economic shocks, one that is able to ensure intermediary function, settlement of payments and diversification of risk; FSS is a condition in which the economic mechanisms of price formation, funds allocation and risk management operate properly in support of economic growth. FSS in Indonesia has its mission, objective, strategies, and instruments, as summarized in Figure 3-11.

Despite the absence of a uniform definition, a deeper understanding of FSS can be gained by looking at the factors likely to disrupt stability (Figure 3-12). Financial system instability can be triggered by turmoil and many other causes. In most cases, instability results from combination of market failures caused by structural factors or behavior of market players. Market failure itself can be brought on by external and domestic conditions. In a financial system built on markets, institutions and infrastructure, the predominant risks include credit risk, liquidity risk, market risk and operational risk.

As a rule, the sources of financial system instability are identified through a forward looking process to ascertain the potential risks that could influence the future condition of the financial system. Once identified, these risks are analysed for their potential for heightened threat, contagion effect and systemic impact that could devastate the economy.

Figure 3-12 | Monetary Policy and Financial System Stability



Source: BI (2009)

2.3.4. Reforms: A Change We Need

Progress of banking in a number of countries demonstrate a shift from esoteric to exoteric patterns, mainly ever since the emergence of globalization (Sukarman, 2009). Urges to open up esoterism appears due to the need to increase funding resources by opening up to foreign investment and strengthening the capital market. This strong need for liquidity causes segmentation policies and protectionism to be erased and policies moved towards deregulation of the financial system and universal banking that expands banking activities. Banks were no longer restricted of merely accumulating and distributing funds, however they were able to have access to the securities market, and were even active in the transaction of derivatives.

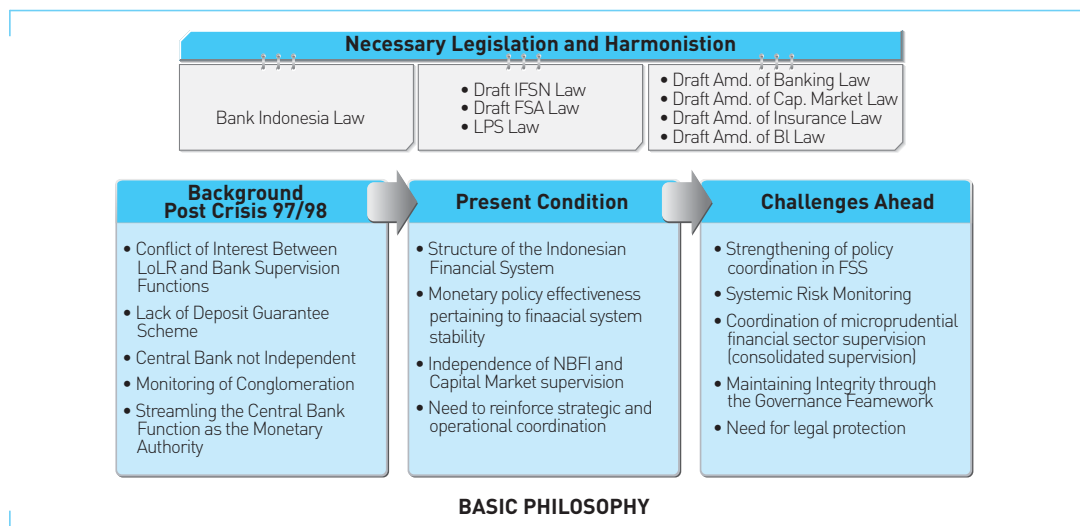
Indonesia banking policies have switched from estorerism to exoterism. Real conflicts that have recently occurred involve BI's independence and the establishment of Financial Services Authority (Otoritas Jasa Keuangan-OJK). Ideas to materialize BI independence are enacted by Law No. 23/1999 about BI, of which was amended with Law No. 3/2004. By this law, Indonesia policies return to its esoteric form, BI gains independence with a greater autonomy in managing banking sector. This may seem plausible because by definition, BI gains full independence in performing monetary policies, therefore bank monitoring must be released, as was done in England, Australia, and South Korea. Sukarman (2009) questions whether BI's absolute independence is the right choice for a developing country such as Indonesia, different from the German model that has been applied by European Union countries. Second, whether Financial Services Authority may perform its tasks efficiently without creating problems of coordination with BI, which remains to be a lender of the last resort in dealing with bank failure.

The first question that must be solved by examine other countries who have implemented central bank independence is whether absolute or partial independence suit Indonesia best or not. This implies that efficiency and effectiveness of BI performance in supporting economic development must become a priority. Establishment of the Indonesian Bank Supervision Body (Badan Supervisi Bank Indonesia-BSBI) based on Law No. 3 /2004 article 85 is one of the efforts to overcome existing weaknesses, although to clarify the tasks of BSBI, it requires an amendment of the current law as well as its elaborations.

Financial Services Authority is established based on international experience where banking activities, insurance, pension funds and capital markets have not been firmly differentiated. Because of this, monitoring towards financial institutions must be integrated. The tasks of Financial Services Authority is to integrate fragmented monitoring that was previously conducted by BI, Department of Finance and Bapepam, which will surely not be an easy task since different methods of monitoring, working culture, and staffing system are present. Therefore, in order to perform tasks of monitoring and regulation in the future, there is a greater degree of reformation that must be done. Potential problems including problems of coordination

with BI must be anticipated. And finally, based on conventional wisdom, each pragmatic-based policy decision must be monitored so that interventions may be applied for its own betterment, whether based on faulty designs or external factors that require changes to those regulations (Sukarman, 2009). Figure 3-13 highlight a framework for Financial Institution and Capital Market Supervision Structure from 1997/98, present condition, and some challenges ahead. Some changes on the current laws-including Banking, Capital Market, Insurance, and central bank Law-are required to cope with the challenges.

Figure 3-13 | Framework for Financial Institution and Capital Market Supervision Structure



Source: BI (2009)

3. Current Financial Supervisory Structure in Korea

3.1. Overview of Financial Supervision

In the aftermath of the economic crisis of 1997-98, the Korean government undertook a number of reforms in financial supervision. During this period policy-makers realized that the existing financial supervisory system lacked in the capacity to prevent financial crises and protect financial stability along with the growing convergence of financial services and ever-increasing importance of financial conglomerates. With the promulgation of the newly amended Supervisory Reorganization Act in early 1998, the Ministry of Finance and Economy (MOFE) was reorganized with part of its functions transferred to other public agencies. This reorganization was prompted by the criticism that MOFE's policy decision-making had become too concentrated and, thereby, undermines the checks and balances required for effective financial supervision and those attributes had contributed much to the outbreak of the financial crisis of Korea.

Until the end of 1997, the Korean financial supervisory functions were conducted by the MOFE. The MOFE had the authorities of licensing, legislation and most of supervisory policy-making. Under the leadership of the MOFE, each financial sector was supervised by a different entity. The Office of Bank Supervision, subordinate branch of the Bank of Korea, took the task of supervising banks. Other financial sectors, such as securities companies, insurance companies and non-bank financial institutions, were regulated and supervised by the Securities Supervisory Board (SSB), the Insurance Supervisory Board (ISB), and the Non-bank Supervisory Authority (NSA), respectively.

According to the structural reform of the Act on the Establishment of Financial Supervisory Organizations passed on December 1997, the new integrated financial supervisory body, known as Financial Supervisory Commission (FSC), was created in April 1998 and Financial Supervisory Services (FSS) was established in January 1999. This structural reform consolidated 4 financial supervisory agencies into a single unified supervisory body. The former (FSC) was created as an integrated supervisor of all types of financial institutions and markets while the latter (FSS) was established to function as an executive arm of the former. The FSC is a state agency whereas the FSS is a private corporation in the form of a special legal entity operating in the public domain. Although they are formally separate and independent in administrative perspective, the two agencies are supposed and expected to operate as a single supervisory authority.

Under this new system of integrated financial supervision, FSC and FSS are the sole supervisory agencies for banks and non-banks. Formerly, the Bank of Korea (BOK), the central monetary authority of Korea, and the Ministry of Finance and Economy (MOFE) shares the responsibility of bank and non-bank supervision. The monetary and credit policy functions, over which MOFE had a considerable leverage in the past, are not wholly vested in BOK with its autonomy to pursue the goal of monetary stability much strengthened. The Korea Deposit Insurance Corporation (KDIC), which was founded in June 1996 and started to operate in January 1997, became an integrated deposit insurance agency in April 1998, taking in as its latitude not only insured banks but also insured non-bank financial institution such as securities companies, insurance companies, comprehensive financial services companies, mutual credit banks, credit unions, etc.

Taken as a whole, the institutional reform on financial supervision structure was far-reaching and characterized by the division of powers and functions between FSC/FSS, KDIC, MOFE and BOK which are given more responsibility to keep the Korea's financial system stable and efficient.

With the inauguration of the current government, FSC subordinated the Financial Policy Bureau of the former MOFE and became the Financial Services Commission (FSC). FSC has the statutory authority to draft and amend financial laws and regulations and issue and abolish

regulatory licenses to financial institutions. Granted with the power of formulating laws, the new FSC stands as the principal supervisory authority and its statutory and independence has strengthened.

Figure 3-14 | Financial Supervisory System Before 1998

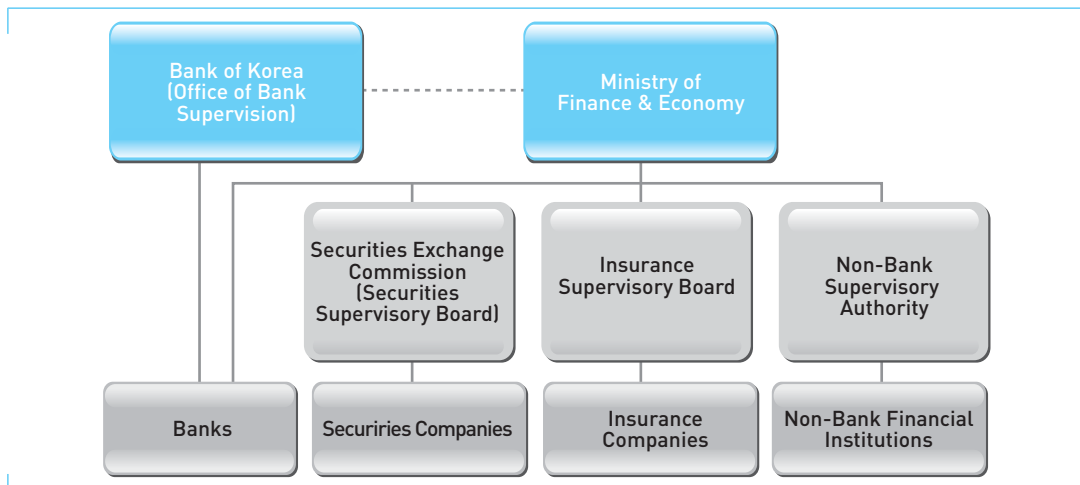
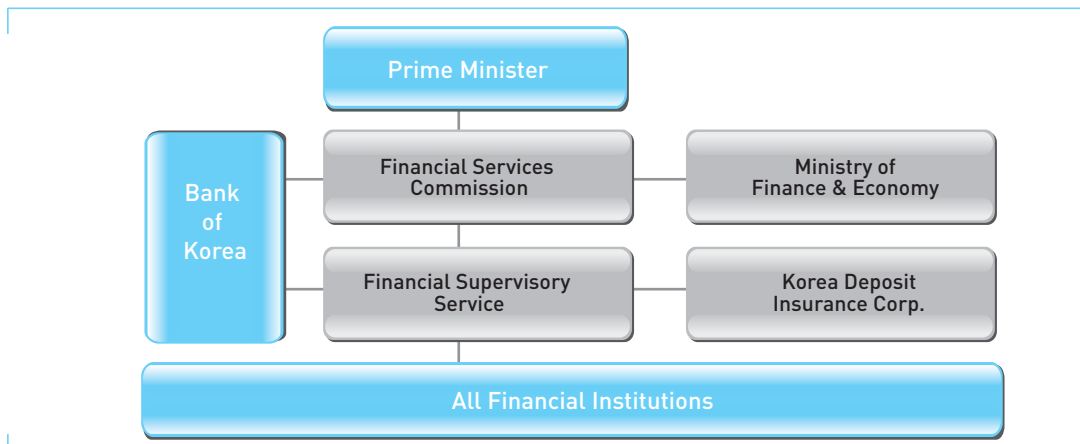


Figure 3-15 | Financial Supervisory System After 1998



3.2. Financial Supervision Organizations¹⁷⁾

3.2.1. Financial Services Commission (FSC)

The FSC was launched in April 1, 1998 under the Office of the Prime Minister, and currently consisting of the administrative committee of 9 members: Chairman, Vice Chairman,

¹⁷⁾ The following is based on *Financial Supervisory System in Korea*(2008).

the Vice Minister of Strategy and Finance, the Deputy Governor of the Bank of Korea, the President of the Korea Deposit Insurance Corporation, the Governor of the FSS, two members recommended by the Chairman of FSC and one recommended by the Chairman of the Korea Chamber of Commerce and Industry. The Chairman, appointed by the President with the recommendation of the Prime Minister, presides over the FSC meetings which is held twice a month, and exercises control over general affairs. The resolutions of the FSC meetings are adopted upon the concurrence of a majority of those present. The commissioner is appointed by the President for a 3-year term which can be renewed once.

The FSC is an independent government agency whose officers are barred from holding any political position or engaging in any commercial activity during his or her tenure on the Commission. The nine commissioners are also prohibited from participating in the resolution of matters that may raise conflict of interest.

As part of its regulatory oversight, the FSC deliberates and decides on policy matters relating to the inspection and supervision of financial institutions and the securities and futures markets. Matters relating to the securities and futures markets are largely delegated to the Securities and Futures Commission within the FSC. The FSC also has the authority to issue and revoke licenses from financial institutions. Legislation relating to the financial sector is drafted and submitted to the National Assembly by the FSC.

As its subordinate branch, the SFC is a special deliberation body. Five commissioners constitute the SFC, which is chaired by the Vice Chairman of the FSC. One standing commissioner and three non-standing commissioners are appointed with the recommendation of the Chairman of the FSC.

The principal function of SFC is to investigate market abuses, such as insider trading and price manipulation in the securities and futures markets and to establish authority to investigate unfair stock trading and seek prosecution with the amendment of the Securities and Exchange Act on February 1, 2002. In addition, the SFC conducts advance review of matters relating to the securities and futures markets to be deliberated by the FSC.

3.2.2. Financial Supervisory Service (FSS)

The FSS was set up in January 1999 to operate as an executive body subordinate to FSC. It is headed by the Governor. Under the law, up to four Deputy Governors and nine Assistant Governors and an Auditor may be appointed under the Governor. The Governor and the Auditor are appointed by the President with the recommendation of the Chairman of the FSC. The Governor recommends candidates for Deputy Governors to the FSC for appointment and directly appoints Assistant Governors. The Governor, together with Senior Deputy Governors, Deputy Governors and the Auditor each serves a renewable 3-year term.

The FSS is primarily responsible for supervision and examination of the regulated financial institutions in Korea. It also has the authority to order the submission of documents, records, or personal testimony necessary for investigation. Non-compliance or providing deliberately false statements in an FSS investigation constitutes an offence punishable under the law. Upon approval from the FSC, the FSS may also recommend dismissal of officers and managers of financial institutions who are found to be liable for violation of rules and regulations.

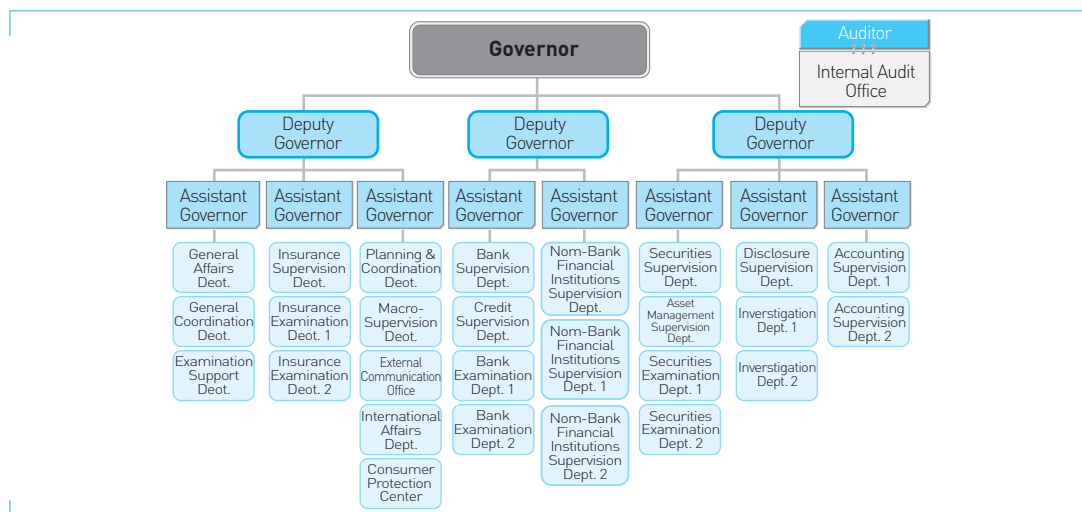
The FSS also serves as a mediator of disputes between financial institutions and investors and depositors and creditors. In order to carry out its broad responsibilities, the FSS maintains a staff of about 1,600 as of the end of 2008.

The FSS maintains twenty five departments and sixteen offices to carry out its operation. The departments and offices engage in five primary activities: consumer protection, supervision, examination, investigation, and supervision support and general affairs. One office separates from the others is the Internal Audit Office.

Fees collected from financial institutions and market participants cover most of the FSS budget. The Bank of Korea may also appropriate funding for the FSS. The FSS budget must be approved by the FSC. The principal sources of the FSS budget are 1) appropriations from the Bank of Korea, 2) Supervision expense sharing with the regulated financial institutions, 3) Issuance expense sharing with securities issuers, and 4) other revenues.

The ratio of supervision expense sharing for financial institutions is determined annually by the FSC and is based on the total liabilities as of the end of the previous year and subject to certain restrictions. The FSC takes into account the current funding level of the FSS and the total assets, deposits and credits, and other business characteristics in approving FSS budget.

Figure 3-16 | Organization Chart of the FSS



The issuance expense-sharing ratio is determined by the FSC based on the total amount of securities issues.

3.2.3. Related Organizations

A. Bank of Korea

The Bank of Korea (BOK) was established in 1950 under the Bank of Korea Act. The Act was amended in 1998 to give it greater independence over the monetary and credit policy and remove its responsibility for bank supervision. As the central bank of Korea, the primary role of the BOK is to 1) issue bank notes and coins, 2) formulate and implement monetary and credit policy, 3) act as banker to the banks, 4) act as banker to the government and its fiscal agent, and 5) conduct other duties, including managing the nation's foreign exchange reserves.

The BOK has the power to request the FSC to undertake its own or joint examinations with the FSS. On October 4, 2002, BOK and FSS signed an MOU to enhance cooperation and encourage joint examination of banks.

B. Korea Deposit Insurance Corporation

The Korea Deposit Insurance Corporation (KDIC) is a public deposit insurance corporation established in June 1996 under the Deposit Protection Act of 1995 for the purpose of operating the deposit insurance system prescribed by the Act. The KDIC, which had been the deposit insurance agency for the banking sector, was reorganized to operate as the integrated deposit insurance agency for both banking and non-banking sector after 1998.

The main body governing the KDIC is the Policy Committee, which is comprised of the President of the KDIC, the Vice Minister of MOSF, the Vice Chairman of the FSC, the Deputy Governor of the BOK, and the heads of the associations representing the banks, insurance companies and other financial institutions. The KDIC may request examinations or joint examinations with the FSS and information and documentation from each other, and such requests must be compiled with unless the agency has a good reason to refuse.

C. Korea Asset Management Corporation

The Korea Asset Management Corporation (KAMCO) was originally established under the Korea Development Bank Act and was commissioned by the government to manage and dispose of non-performing assets (NPAs) in the financial sector and state-owned properties. Since its foundation, KAMCO has been gradually expanding its functions. In November 1997, KAMCO was formally re-established to enhance and expand its role. At the same time, the Non-Performing Assets Fund was created to acquire, manage and dispose of NPAs to facilitate financial sector restructuring under the Act on Effective Management of Non-Performing Assets of Financial Institutions and Establishment of Korea Asset Management Corporation.

The new mission of KAMCO is to minimize financial sector restructuring costs while maximizing the recovery rate of NPAs and restoring soundness to the financial sector under the supervision of the FSC/FSS and MOSF. The primary functions of KAMCO are as follows: 1) management and operation of NPAs Management Fund, 2) acquisition and resolution of NPAs from financial institutions, 3) implementing work-out programs for acquired distressed companies, and 4) management of state-owned properties and resolution of tax arrears.

D. Self-Regulatory Organizations

A self-regulatory organization (SRO) is a non-governmental organization that has the power to create and enforce industry regulations and standards. Their priority is to protect investors through the establishment of rules that promote ethics and equality and complement the statutory financial supervision. The Korea Exchange (KRX) and the Korea Financial Investment Association (KOFIA) all assume self-regulatory functions to some degrees.

The KRX was created through the integration of the three existing spot and futures exchange committee, KOSDAQ committee and a sub-organization of Korea Stock Dealers Association with the following principal roles: 1) maintaining a fair and orderly organized market, 2) regulating and supervising the member firms, 3) setting listing requirements, 4) surveillance of securities transactions, and 5) regulating corporate disclosure.

The KOFIA was created through the integration of the Korea Securities Dealers Association, the Asset Management Association and the Korea Futures as a non-profit organization and became a legal self-regulatory entity under the Financial Investment Services and Capital Markets Act. The KOFIA is responsible for the following: 1) self-regulation to maintain sound trade practice among the member and to protect the interest of investors, 2) self resolution of disputes arising from the conduct of business of its members, 3) registration and management of experts, 4) over-the-counter transactions of stock certificates that are not listed on the securities market, 5) research and study of related regulations for financial investment services, 6) investor education and the establishment and operation of the foundation therefore, and 7) training business with respect to financial investment services.

4. Regulatory Measures to Enhance Financial Stability in Korea¹⁸⁾

4.1. Changes in Regulatory Measures after the Crisis in Korea

To improve the financial supervisory framework, the Financial Supervisory Commission (FSC), a unified body covering banking, insurance, non-banks and capital markets, was established. Key elements in strengthening supervision and regulation included a prompt corrective action (PCA) to deal with financial institutions failing to meet prudential standards and a new loan classification system based on forward-looking criteria (FLC). Other measures are summarized in Table 3-11. As a result, the supervision of domestic financial institutions has been made more sound by the adoption of advanced corporate credit evaluation standards and additional responsibility for credit decisions.

Because credit risks of the financial sectors depend upon corporate information, reforming measures have been taken on the corporate accounting standards. Transparent and responsible management can be made more likely through the obligatory publication of combined financial statements and institutionalizing the appointment of outside directors that aims at sweeping away obsolete dictatorial management practices.

Table 3-11 | Major steps taken to upgrade prudential supervision in Korea

- A unified supervisory body, the Financial Supervisory Commission, was created in April 1998.
- Accounting and disclosure standards were brought closer into line with International Accounting Standards.
- A "Prompt Corrective Action" framework has been introduced.
- A "forward-looking loan classification" system has been implemented.
- To supervise banks, the so-called "CAMELS" system has been put in place.
- The calculation of BIS capital adequacy standard has been improved.
- Exposure limits on banks' lending to individual companies and to chaebol were tightened.
- In the insurance sector, a solvency standard based on that used by the European Union was introduced.
- Mark-to-market valuation is now required for ITC funds.
- A partial deposit insurance scheme has been implemented.

4.2. Prompt Corrective Action

Financial institutions are exposed to systemic risks where solvent and sound banks are forced to confront contagious runs triggered by either the depositors' misconception or rational expectations on the possibility of their financial distress. In order to contain systemic risks,

¹⁸⁾ This chapter is heavily borrowed from Kang (2009).

many countries introduce deposit insurance system under which financial consumers are kept safe even on the verge of the outbreak of systemic crisis. Nevertheless, once a systemic crisis occurs, the deposit insurance fund is not sufficient enough to contain the costs incurred. It is often necessary for the government to intervene in distressed financial institutions with taxpayers' money. It has been known, however, that the government intervention might be costly due to regulatory forbearance, or policymakers' gambling in the course of crisis management, of which the example was shown in Savings and Loan Associations (S&L) Crisis in the United States in the 1980s and 1990s. Prompt Corrective Action (PCA) was instituted against this background for the purpose of minimizing the costs of taxpayers' money at the times of distress of insured financial institutions by partly eliminating regulatory forbearance. Therefore, PCA is directly related to deposit insurance system, which in turn has something to do with systemic risks.

Since April 1998, Korea has adopted PCA. When the BIS capital adequacy ratio or the overall evaluation result of a bank falls below minimum criteria, FSC takes necessary prompt and appropriate actions to correct the problems. As a result, banks that receive one of PCA shall submit a management improvement plan to FSC within two months after receiving the determination of PCA. PCA consists of three stages: Management Improvement Recommendation, Management Improvement Requirement and Management Improvement Order (See Table 3-12).

- *Management Improvement Recommendation*

Management Improvement Recommendations are issued by the FSC against a bank when (1) BIS ratio falls below, or (2) the rating for asset quality or capital adequacy is 4 (Deficient) or 5 (Critically Deficient) even though overall composite rating is 3 (Less than Satisfactory). Management Improvement Recommendations may entail organizational changes, new allowances against distressed assets, investment restrictions on fixed assets, entry restriction into new business areas, restrictions on new investments or dividend distribution, capital increase of reduction, and disposition of poorly performing assets.

- *Management Improvement Requirement*

Management Improvement Requirements are issued when the BIS ration of a bank falls below 6%, (2) the overall composite rating is 4 or worse, or (3) the bank fails to fully comply with FSC Management Improvement Requirements. Banks that are issued Management Improvement Requirements may be subject to business closure or consolidation of operating branches, a freeze on new investment, reduction of risky assets, restrictions on deposit interest rates, replacement of members of board of directors, officers, and external auditors, and suspension of certain businesses. A merger with or consolidation into another financial institution is also possible.

• *Management Improvement Order*

Management Improvement Orders are issued when (1) a bank is judged a distressed institution as stipulated under the Act Concerning the Structural Improvement of Financial Industry, (2) the BIS capital adequacy ratio falls below 2%, or (3) the normal operation of the bank is hindered, and the bank either does not or cannot implement its management improvement plan. Banks that receive Management Improvement Orders may be subject to, in addition to the measures from Management Improvement Requirement, capital write-down, suspension of top management, appointment of a receiver, merger with another financial institution, suspension of business within six months, or revocation of banking license.

In addition to the formal enforcement actions, FSC may also take informal supervisory actions to force banks to exert autonomous and preliminary efforts through an agreement between the FSC/FSS and banks to improve banking operations. The FSC may require a bank to submit a management improvement plan, a letter of commitment, or a memorandum of understanding with FSC/FSS in the likelihood of further deterioration in the CAMELS ratings or management guidance ratios (BIS capital adequacy ratio, domestic currency liquidity ratio, etc.) of banks.

Table 3-12 | Prompt Corrective Action Enforcement Criteria

Type of PCA	Criteria
Management Improvement Recommendation	<ul style="list-style-type: none"> • BIS capital ratio < 8%; or • 4th grade for capital adequacy or asset soundness with an overall rating of 4th (Deficient) grade, or 5 (Critically Deficient) even if overall CAMELS rating is 1(Strong), 2(Satisfactory), or 3 (Less than Satisfactory).
Management Improvement Requirement	<ul style="list-style-type: none"> • BIS capital ratio < 6%; or • 4th grade or 5th of CAMELS rating
Management Improvement Order	<ul style="list-style-type: none"> • BIS capital ratio < 2%; • Category of distressed financial institutions; or • Normal operations are hindered and bank does not or cannot implement improvement plan, even though it has been urged to do so

Theoretically, credit card business as one of credit-specialized financial business, is not directly connected to systemic risks, for credit card companies (CCCs) do not have a deposit taking function. The financiers towards CCCs are financial professionals like large financial institutions or institutional investors, which are not necessarily protected by public financial safety net. In fact, they should not be protected in the sense that market discipline helps sound management of financial system. Despite the theoretic rationale, Korea introduced PCA even in credit card businesses on July 1, 2002, in order to put an emphasis on the soundness of CCCs.

The PCA for CCCs is triggered based on BIS capital adequacy ratio. If a CCC does not meet 8% BIS ratio, management improvement recommendation is imposed by FSC. Under this

measure, it may be subject to organizational changes, specific allowances, restrictions on investments on fixed assets, entry into new business area, new investments and dividend payment, reduction or increase of its capital, or disposition of non-performing assets. When its BIS ratio becomes lower than 6%, harsher PCA measure, or management improvement requirement, is automatically triggered. With this measure, it may be subject to consolidation of operating offices, a freeze on new investments, a reduction of risk assets, control of interest rates, replacement of senior management and external auditors, suspension from some business areas, dissolution, or merger or consolidation with other financial institutions. Once CCC's BIS ratio hovers below 1%, it receives management improvement order, under which it is subject to a partial or complete cancellation of equity capital, suspension of the top management, appointment of a receiver, merger with or consolidation with other financial institutions, suspension of business up to six months, or revocation of business license.

To attain public awareness, CCCs are required to disclose their annual reports, including the balance sheets and the income statements for each fiscal year. The disclosure must cover financial information relating to the asset soundness, profitability, productivity, and the sources and uses of their capital. Furthermore, to receive supervisory data on CCCs, FSC and FSS conduct on-site examination and off-site surveillance.

4.3. Forward-looking Criteria

Banks are required to appropriately classify their assets and ensure their soundness. In classifying assets, borrower default risk is a major consideration. The FSC has revised the Regulation on Supervision of Banking Business to introduce new asset classification standards called Forward-looking Criteria (FLC) for banks to take into account the future debt-servicing capacity of borrowers as well as past debt service and credit history. The FLC went into effect on December 31, 1999. Changes in asset classification standards before and after the introduction FLC is summarized in Table 3-13.

Under the new standards, the FSC provides for only minimal guidelines for asset classification and provisioning, and banks must establish their own specific standards for asset classification in evaluating the debt-servicing capacities of borrowers.

In order to calculate BIS risk-adjusted capital adequacy ratio, the assets held by financial institutions should be classified and corresponding loan loss provisioning made. The assets are classified into (1) normal, (2) precautionary (3) substandard, (4) doubtful, and (5) estimated loss under the forward-looking criteria (FLC). Here is the definition of the above classification:

- Normal: credit exposures to borrowers who maintain a certain level of credit standing as well as sound business standards and borrowers whose loans are less than on month overdue, but whose debt-serving capacity is sufficient.
- Precautionary: credit exposures to borrowers whose banking transactions and credit status

Table 3-13 | Changes in Asset Classification Standards

	Pre-FLC	Post-FLC
Overall Comparison	<ul style="list-style-type: none"> • Uniform standards for all banks • No individual standards for banks 	<ul style="list-style-type: none"> • Minimum guidelines • Banks establish their own standards
Assets subject to classification	<ul style="list-style-type: none"> • Limited to 13 items including loans and guarantees 	<ul style="list-style-type: none"> • Expanded to all the assets banks need to classify, including lease assets
Classification of Loans	<ul style="list-style-type: none"> • Based mainly on past borrower credit history 	<ul style="list-style-type: none"> • Based primarily on the borrowers' future capacity to repay and past credit history
Classification of Foreign Bills Bought	<ul style="list-style-type: none"> • Separate standards are applied 	<ul style="list-style-type: none"> • In principle, the same loan standards are applied, except when necessary due to guarantors' different credit, etc.
Classification of Securities	<ul style="list-style-type: none"> • Primarily based on valuation and credit risks of issuers • Securities subject to mark-to-market, or equity methods are exempt from classification 	<ul style="list-style-type: none"> • Based on issuers credit ratings (by banks' own credit rating model, or credit rating agencies) • All securities are subject to classification without exemption
Restructured Loans	<ul style="list-style-type: none"> • No separate standards for restructured loans 	<ul style="list-style-type: none"> • Separate standards for restructured loans

call for lender attention; in particular, credit exposures to borrowers whose loans are overdue at least one month but less than three months or whose borrowings exceed the volume of their sales

- **Substandard:** credit exposures to borrowers with unfavorable pattern of banking transactions or credit status and exposures to borrowers who must agree to a definite repayment schedule with the lender; this can include exposures to borrowers who have been in arrears for over three months but no less than six months, or for whom a suspension of serving or reduction of interest has been granted.
- **Doubtful:** credit exposures in excess of the amount expected to be collected from customers classified as substandard that is expected to be a loss, but has not yet been realized as such; normally the overdue restriction on doubtful assets is the same as substandard, but they are deemed more risky

Table 3-14 | Minimum Loan Loss Provisions

(Unit: %)

	Credit Card Company		Bank		
	Loan assets	Credit Card Loans	Corporate Loans	Housing Loans	Credit Card Loans
Normal	0.5	1	0.5	0.75	1
Precautionary	1	12	2	8	12
Substandard	20	20	20	20	20
Doubtful	75	60	50	55	60
Expected loss	100	100	100	100	100

- Estimated loss: credit exposures in excess of the amount expected to be collected from customers classified as substandard that must be accounted as a loss because collection is not possible in a foreseeable period; in the case of credit card companies, more than six months overdue assets are classified as estimated loss

Financial institutions must accumulate minimum loan loss provisions for their assets according to the asset classifications. The minimum ratio of loan loss provisions varies depending on whether the asset is a loan or credit card asset. For example, the minimum ratio of a normal loan asset is 0.5% but the minimum ratio of a normal credit card asset is 1%. The difference is more vivid in the case of precautionary asset: minimum requirement for the loan loss provisions of normal loan is just 1%, but precautionary credit card assets should accumulate at least 12%. This strict provisioning requirement also reflects the high likelihood of distress and loss rates after default of the classified credit card assets during the so called plastic bubble in 2003 and 2004.

5. The Korean Experience of Integrated Financial Supervision

5.1. Constructing the Integrated Supervisory Agency

The financial crisis of 1997 left Korea with many valuable lessons. Of the many lessons learned from the crisis, none may have been more important than understanding the need to strengthening prudential regulation in order to promote financial stability. Supervisory negligence deteriorated not only overall functions of financial market but also the health of the economy. Amid the growing convergence of financial services and blurring of distinctions among various financial sectors, the adoption of a new regulatory regime was urgently needed to restore market discipline and to ensure the proper functioning of market mechanism.

There has been a long history of conflicts between the MOFE and BOK over independence of BOK and banking supervision authorities. Academic communities demand that financial supervisory structure should be reformed to meet the following demands: 1) growing convergence of financial services, 2) poorly supervised business areas due to fragmentation of supervisory functions, 3) government and politics may affect financial supervision, and 4) lack of effective supervision especially for non-banks. In those times, the complicated and fragmented supervisory structure was criticized to hinder the development of financial markets. In this recognition, the Korean government initiated the Presidential Committee on Financial Reform in January 1997 to look into the feasibility of a unified financial supervisory body in Korea. After a series of in-depth studies and analysis, the committee submitted a number of recommendations that eventually led to the reform of the central bank and the financial supervisory structure in Korea. Based upon the committee's recommendations, the government

proposed a bill to consolidate the four existing financial supervisory authorities - the Office of Bank Supervision (OBS), the Securities Supervisory Board (SSB), the Insurance Supervisory Board (ISB), and the Non-bank Supervisory Authority (NSA)-into a single unified supervisory agency. The plan along with other reform-related draft bills including the amended Bank of Korea Act separating the function of bank and the Act on Establishment of Financial Supervisory organizations, was submitted to the National Assembly on August 23, 1997. This ignited heated debates on the idea of taking away the central bank's supervisory function. The BOK at that time strongly opposed such government's plans for the following reasons: Firstly, as lender of last resort, the central bank had to be in a position to monitor the insolvency and liquidity status of banks. This was also necessary for BOK to secure the stability of the payment and settlement system. Therefore, they argued, it was essential for the BOK to keep bank supervisory function. Secondly, it stressed that the politically neutral central bank should carry out bank supervision, a process that should be isolated from political pressure. It was also more efficient if bank supervision remained entrusted to the BOK, which already possessed the adequate human and physical resources.

The government, for its part, advocated that bank supervision had to be separated from the BOK because of conflicts of interest that might arise between monetary policy and supervisory policy. For example, if the central bank eased monetary policy to maintain financial stability, this could damage price stability which was the core goal of the central bank. Furthermore, the government pointed to worries that the central bank might become overly powerful, if it were to retain the right to supervise banks while being granted independence in monetary policy.

In spite of elevated tension and confrontation between the BOK and the MOFE, the Act on the Establishment of Financial Supervisory Organizations was passed on December 29, 1997 in a special session of the National Assembly as the situation took a new turn in the outbreak of the financial crisis and the IMF recommended the establishment of an integrated financial supervisory agency to the Korean government.

On the basis of the Act, the FSC was established on April 1, 1998 as Korea's first integrated financial supervisory body, which immediately took on the task of reforming domestic financial institutions and large business groups and oversaw restructuring in the corporate and financial sectors in the wake of the financial crisis. Subsequently the OBS was separated from the Bank of Korea and renamed as the Banking Supervisory Authority. The Securities and Exchange Commission was dissolved and the Securities and Futures Commission (SFC) was established under the FSC to oversee the securities and futures markets. Finally, on January 1999, the OBS, SSB, ISB, and NSA were consolidated into a single supervisory body as the Financial Supervisory Service (FSS), the executive arm of the FSC, thus creating an integrated financial regulatory and supervisory system in Korea, and this framework is still preserved as of this writing.

5.2. Issues Related with Integration

5.2.1. Pros and cons

Strengthening regulatory capability is more important than the institutional structure of regulation and supervision. In the following, we will enumerate the merits and demerits of integration described in the literature.

The rationale for establishing the integrated body is well provided by Briault (2002):

- ① Market development such as the increase in the number of financial conglomerates and the blurring of the boundaries between financial products make sector-based regulation increasingly less viable;
- ② There are economies of scale and scope available to an integrated regulator, and there is value in being able to allocate scarce regulatory resources efficiently and effectively;
- ③ There are benefits in setting a single regulator clear and consistent objectives and responsibilities, and in resolving any trade-offs among these within a single agency; and
- ④ There are advantages in making a single regulator clearly accountable for its performance against its statutory objectives, for the regulatory regime, for the costs of regulation and for regulatory failures.

On the other end of the spectrum, there are counter-arguments on the unification of financial supervision which are well summarized by Abrams and Taylor (2000):

- ① It will be difficult for them to strike an appropriate balance between the different objectives of regulation-ranging from guarding against systemic risk to protecting the individual consumer from fraud;
- ② A single unified regulator may also suffer some diseconomies of scale due to X-inefficiencies associated with monopolies as well as the tendency for unified agency to be assigned an ever-increasing range of functions;
- ③ The synergy gains from unification will not be very large since differences of style and culture among banking, securities and insurance regulation will remain for a long time;
- ④ It will extend moral hazard concerns across the whole financial services sector because the public will tend to assume that all creditors will receive equal protections; and
- ⑤ The change process itself may be poorly managed or become politicized, thereby leading to unpredictable and possibly undesirable outcomes.

These arguments raise many points to think before choosing which type of financial supervisory structure a country will take. Each country has different stages of financial development and political and cultural endowments. There is no one-size-fits-all instrument for regulatory and supervisory structure. In-depth study on the interdependence among financial institutions and supervisory agencies should be taken prior to supervisory reforms.

5.2.2. Architecture of an Integrated Agency

If one favors the creation of a unified authority, issues on how to structure, organize, manage and make a transition toward an integrated agency ought to be considered.

A. Scope of Regulatory Power and Responsibility

The structure of an integrated agency can be categorized into two models: a fully integrated model and twin peaks model. A fully unified model seeks to a single national financial regulator that has a wide range of supervisory power across the whole financial sector.¹⁹⁾ Under the twin peaks model suggested by Taylor (1995), regulation is broken down between agencies specializing on prudential regulation on the one hand and consumer protection on the other. This type of regulatory structure is based on the argument that there is a fundamental incompatibility between conduct of business and prudential regulation or at least they are best undertaken by separate regulatory agencies.²⁰⁾

Proponents of a twin peaks model argue that two objectives could not coexist without conflict within a single organization and that the consumer protection goal will tend to dominate because consumer losses make headlines and upset politicians. It is also noted that consumer protection regulation tends to be relatively resource-intensive. Hence, its separation may allow the agency charged with prudential oversight to focus more explicitly and efficiently on the detection and management of risks to financial system. The ability to adopt a narrow focus is especially important in countries, which are prone to periods of financial instability.

However, Briault (2002) points out that experience at the FSA (Financial Services Authority) in the United Kingdom has demonstrated that in most cases there is no conflict between conduct of consumer protection and prudential regulation. Even when conflicts arise, a single regulator can find solutions internally as the way the solutions can also be reached between separate regulators. He argues that the latter may involve inefficiencies if information does not flow properly between different regulators. Hence, due to the large content of information in the case of the former, a single regulator can find better solutions than the latter.

B. Relationship with Central Bank

There have been arguments about the benefits of combining banking supervision and monetary policy-making. Several of them are: 1) the central bank's need to be concerned about banks' financial soundness as a precondition for an effective monetary policy; 2) the synergies between information required for the conduct of monetary policy and the supervision of banking sector; 3) the central bank's need to assess the credit-worthiness of participants in the payment system; 4) the central bank's need to have access to information on the solvency and liquidity of individual banks in order to exercise its lender of last resort functions.

19) Denmark, Hungary, Iceland, Korea, Sweden, UK, Japan, Latvia, Estonia, Norway, Austria, and Germany have adopted this type of structure.

20) Australia, Canada and Holland have adopted this structure. s.

Hence, the real issue seems to be whether the benefits in doing so are greater or less than the alternative benefits arising from the creation of a single financial regulator.

It should also be stressed that even if supervisory function of banks is separated from the central bank, close cooperation between the integrated supervisor and the central bank is essential in dealing with systemic risks. It is common for an integrated regulatory regime that there is a certain kind of mechanism through which the integrated regulator and the central bank can share information and cooperate with an aim to ensure the soundness of financial system and the effectiveness of monetary policy. The central bank is typically positioned in the center of payment system and it holds the intrinsic function of the lender of last resort. Faced with the danger of systemic risks or actual occurrences of those risks, the roles of a central bank and an integrated supervisory body should be clarified to contain the adverse of effects from the shocks. It is usually suggested that central banks should provide liquidity to the temporarily illiquid banks whose solvency is not questioned. However, in reality, neither central banks nor regulatory authorities can differentiate illiquidity from solvency. In the traditional model, forced sales of opaque and illiquid assets lead to the insolvency of initially solvent but illiquid banks. Central banks will be involved in providing liquidity regardless of the solvency of troubled banks, hence, the roles of central bank as a crisis fighter should be clearly stated and understood a priori.

Table 3-15 | Comparison of Arguments to the Role of Central Bank on Financial Supervision

Relationship between	Comparison of two arguments	
	The central bank should not perform banking - supervision function.	The central bank should perform - banking supervision function.
Monetary -stability	(1) Regarding the possibility of conflicting interests between the monetary authority's goal- (macroeconomic stability) and the supervisory authority's goal(banking system stability)	
	<ul style="list-style-type: none"> ①When the monetary authority performs banking supervision, there could be conflicts between anti-cyclical monetary policy and procyclical supervisory policy. ②When the monetary authority performs banking supervision, there could be conflicts between the restriction of the monetary growth rate (the high-interest rate policy of the monetary authority) and the consideration of bank balance (the low-interest rate policy of the supervisory authority). ③The monetary authority that performs banking supervision is likely to provide excessive amount of reserve money in order to stabilize the banking system ④There could be conflicts because financial liberalization and innovation are disturbing 	<ul style="list-style-type: none"> ① The supervisory authority separated from the monetary authority with macroeconomic perspectives may excessively cling to the prudence of banking system and therefore undermine the sound risk-taking performance of banks for a long time. ② The separation between the monetary authority and the banking supervision authority could cause administrative problems of communications between the two authorities.? ③ The additional provision of reserve money can be completely offset by open market operation. ④ The more monopolistic the banking

	<p>factors for the monetary authority that performs banking supervision but those factors improve financial efficiency in terms of banking supervision.</p> <p>⑤ If the recent emergence of large financial groups expands the regulation scope of the monetary authority that performs banking supervision, the monetary policy is more likely to be exposed to political pressure.</p> <p>⑥ When the supervisory authority and the monetary authority are separated and they are against each other as to policy direction, they may try to find their own supporting evidences and this process could maximize the production of information, eventually leading to better understanding of the market.</p>	<p>system is, the lower the possibility of conflicting interests between the two goals is.</p> <p>⑤ Because conflicting interests between the two goals are different from conflicting issues caused by proxy problems, it is more necessary to complement legal guidelines to solve conflictions than to separate functions through streamlining the restructuring.</p> <p>⑥ The supervisory authority separated from the monetary authority is likely to be overly exposed to political influences.</p> <p>⑦ The monetary authority that does not perform banking supervision may treat lightly the effects of its monetary policy as to the prudence of the banking system.?</p>
	<p>[2] Regarding the possibility that when the monetary authority performs banking supervision, the public's confidence on the monetary policy could be undermined.</p>	
<p>responsibility and Banking supervision function</p>	<p>① Supervision failure by the monetary authority that performs banking supervision erodes the reputation and independency of the monetary authority.</p> <p>② Because a continued inflation at a moderate level increases banks' profit from low-interest rate savings through the rising nominal interest rates, the monetary authority that performs banking supervision has the inflation tendency.</p> <p>③ The monetary authority that does not perform banking supervision focuses on the monetary policy, making it possible to improve the outcomes of inflation.</p>	<p>① Supervision failure may erode the reputation of the monetary authority that performs banking supervision, but there are few empirical evidences that the failure actually harm the public's confidence on the monetary policy.</p> <p>② The potential risk to the reputation makes the monetary authority perform banking supervision function more carefully.</p> <p>③ The outcomes of inflation are more related to the monetary policy's dependency on government than on whether the monetary policy handles the supervision responsibility or not.</p>
	<p>[3] Regarding the possibility that the monetary policy efficiency could be enhanced through the monetary authority's performing banking supervision function</p>	
	<p>① If there are aspects that are of help to the monetary policy, they could be obtained</p>	<p>① The efficiency of the monetary policy may be improved when the monetary authority reflects information (various monetary policy channels and banks' movements) gathered by supervision and inspection on the planning and execution of the monetary policy.</p>

	<p>through the reports written by outside supervisory authority.</p>	<p>② Empirical evidences exist that classified information about supervision has improved the FRB's predictive power for macroeconomic developments.</p> <p>③ Empirical evidences exist that outside reports does not help improve the efficiency of the FRB's monetary policy because of their problems with quality, quantification, promptness, and bias.</p>
<p>Financial stability responsibility and Banking supervision function</p>	<p>(1) Banking supervision, central bank's lender of last resort and risk management</p>	
	<p>① When translating the central bank's lender of last resort as the provision of emergency advance, it is groundless to argue that the central bank act more effectively in selecting subject banks for provision than the interbank market does.</p> <p>② When translating the central bank's lender of last resort as a policy to stabilize interest rates, this becomes equal to the open market operation, leaving no need for the central bank to perform banking supervision.</p> <p>③ In the case where a bank that was running short of liquidity at an early stage became insolvent later, the final responsibility falls to government that provides public assistance made of tax funds.</p>	<p>① Considering the instability of the interbank market and the possibility of conflicting private interests within the market, the central bank's function as lender of last resort is still critical.</p> <p>② In a country without mature foundations for open market operation, the function of lender of last resort through rediscount is still very important.</p> <p>③ In order for the central bank to act as emergency source of funds in time of crisis, it is necessary that the central bank should be mindful of not only the entire banking system but also various information and status of individual banks by performing banking supervision function at usual times.</p>
	<p>(2) Banking supervision, central bank's function to maintain the stability of the payment and settlement system</p>	
<p>① Central bank's participation of the payment and settlement system is different from country to country, so the need of banking supervision by the central bank could be different depending on the country. For instance, in the UK where its payment and settlement system is made focused on commercial aspects, the need of banking supervision by the central bank is not that strong because the central bank is not the system operator.</p>	<p>① Due to the rising settlement risks caused by the efficiency of the payment and settlement system, it is now necessary for the central bank to participate in operating the system and to supervise banks directly and indirectly.</p> <p>② Since the payment and settlement system is the channel of the monetary policy, the intervention of the central bank that promotes the system's efficiency and stability contributes to the enhancement of the monetary policy.</p>	

In the case of Korea, the BOK is allowed to exercise some limited supervisory functions in relation to those businesses falling within their particular areas of competence. The BOK has the right to request individual banking institutions to submit materials about their business to check their actual management status. It may also require the FSS to examine banking institutions or to have its own staff participate on a joint basis in such examinations. Another connection is that the Deputy Governor of the BOK serves as an ex-officio member of the FSC. As a consequence, the BOK has a channel to take part in the decision-making process concerning financial supervisory policy.

C. Transition towards an Integrated Agency

Even if a government decides to transform toward an integrated regulatory regime, two important issues should be addressed for the successful implantation. First, the transition for the individual specialized agencies to the integrated agency should be managed effectively. Once the decision has been made to make the transition to an integrated regulatory regime, it is vital to set up a transition implementation plan. Second, once the integrated agency is established many administrative and personnel matters as well as cultural clashed must be addressed and dealt with. Handling staff relocation, dislocation and changing the culture would be a very demanding task. These should be done through a well-managed transition program.

Besides, the pace of transition to the new integrated agency is an important factor to the success of the transition. Two contrasting approaches have been taken reflecting differences in organizational culture and state of economy: gradual approach²¹⁾ and big-bang approach.²²⁾ While a long lead time may help ensure that an effective plan has been put in place and that all the details of the transition process itself have been ironed out in advance, it may mean that the individual agencies lose vigor as its regulatory power become weak in the meantime. Hence, one needs to consider the optimal pace of transition to maximize the effects of integration.²³⁾

D. Regulatory Governance

In order to achieve the increased efficiency of financial regulation, regulatory policy with good substance is certainly primary importance, whereas good regulatory governance is of second-order importance (Goodhart et al. 1998). However, the order of importance may be reversed in countries where institutional distortions are huge enough to prevent good regulatory policy from achieving the objectives of regulation. The issue that are covered under the heading of institutional structure of financial regulation and supervision include the optimal allocation of functions and power among the public agencies responsible for financial stability and the interagency arrangements for information sharing and cooperation and for checks and balances in normal circumstances and in crisis situation. Discussions on regulatory governance are based

21) Denmark, Norway and Sweden etc. belong to this category

22) United Kingdom and South Korea etc. adopt this approach.

23) Siregar and James(2004) are in favor of gradual approach as banks dominate the financial sector in Indonesia. They claim the strengthening of respective supervisory agencies should be achieved before integrating those agencies into a single body.

on the proposition that the efficiency of regulators and supervisors in achieving their objectives may be influenced by the particular institutional structure in which they operate (Goodhart et al. 1998). Regulatory efficiencies depend on regulatory culture as well as the skills and experiences of regulatory staffs, all of which in turn depend on governance structure at least in the long run.

Regulatory governance becomes the main perspective that the theme of institutional structure offers, especially when it is applied in the context of emerging market economies like Indonesia. Regulatory governance refers to the interdependence and accountability of the public agencies responsible for financial stability. Quintyn and Taylor (2002) consider that weaknesses in regulatory governance were a significant factor that invited the East Asian financial crisis in the late 1990s.

Emerging economics can benefit much, in terms of regulatory efficiencies, from improving upon regulatory governance. In emerging economies in East Asia, there is a strong cultural tradition in which people tend to identify their own social status with that of the institution where they work. There, less independence of the supervisory agency seems directly linked to lower quality or weaker achievement motives of staffs. Hence, to capitalize the benefits of an integrated regulatory agency and attain institutional cooperation and checks and balances, strengthened arrangements with institutional independence and accountability based on explicit legal bases should be provided. The credit card fiasco of Korea occurred in 2003 is a good example to signify the importance of regulatory governance which will be discussed in detail shortly.

6. Functional Independence and Horizontal Checks and Balances between Supervisory Agencies: a Case Study

In this section, we will provide the recent case of the credit card fiasco to signify the importance of functional independence and horizontal checks and balances among the respective public agencies responsible for the stability of financial stability.

The prudential problems of credit-card companies and of households, along with high arrearage ratios and huge number of credit defaulters, was believed to be related to the policy stance of boosting domestic demand which the Ministry of Finance and Economy (MOFE) firmly maintained over four years from mid-1998 until the first half of 2002. Considering the economic situation that ensued the outbreak of the economic crisis in 1997, the adoption of such a policy stance at that time was appropriate to some extent. The problem is that, although some adverse side effects had soon begun to emerge and build up, MOFE didn't pay enough attention to their developments for too long, adhering to its own policy stance strongly all along. During this period of over four years, other public agencies such as FSC/FSS and BOK could not

respond to these side effects adequately and flexibly. Supervisory policy of FSC/FSS and that of BOK were effectively constrained by, or even subordinated to, economic policy of MOFE.

This can be ascribed to the policy dominance of MOFE over FSC/FSS and BOK. This phenomenon is mainly due to the existence of a vertical institutional hierarchy among the public agencies in Korea. Thus there was little room for interagency supervisory cooperation and checks and balances. It was not until the latter half of 2002 that MOFE gave up its policy stance of boosting domestic demand. Upon the sudden turnaround of MOFE's policy stance, FSC/FSS and BOK began to wholeheartedly voice their concerns about the prudential aspects of credit-card companies and of households and to take full-scale supervisory measures. But it was all too late. Those measures simply added to the regulatory burden that already fell on credit-card companies and on households, rather than mitigating their prudential problems. Financial market instability eventually broke out in the middle of March 2003. Although financial markets soon returned to normal as a result of market intervention promptly undertaken in concert by the public agencies, the same problems have not gone away but lingered on since that time. We recount below how the public agencies set the policy environment during 1998-2003 and how important the functional independence and horizontal checks and balances count to ensure the overall stability of financial system.

6.1. The Development of Credit Card Crisis

In 1998, the government (MOFE in particular), with a view to settling the 1997 economic crisis, centered its economic policy on stabilizing the foreign exchange market and on restructuring the real and the financial sectors of the economy. With the foreign exchange market having stabilized by the second quarter of 1998, MOFE turned around to ease its macroeconomic policy to cope with economic contraction and credit crunch. However, private consumption and investment kept on plummeting, since wholesale restructuring was rapidly under way. Thus, in the third quarter of 1998, the government began to strengthen its effort to boost the economy by means of fostering the real estate boom (BOK, 1999). In addition to promoting exports, MOFE solidified its focus on boosting domestic demand during 1999, when the world economy was expected to grow low. MOFE increased fiscal spending and executed the government budget early to compensate for the contraction in private consumption and investment. Further, it took de-regulatory measures to promote the use of credit cards as well as housing and construction booms. Regarding the credit-card promotion policy, for example, MOFE removed in April 1999 the ceiling (60%) that had been imposed on the proportion of non-core credit-card businesses (i.e., cash advances and card loans) to both core (i.e., settlement of credit-card payments) and non-core credit-card businesses, and further removed the monthly credit limit (a little over US\$ 600) on cash advances in May 1999. It introduced tax breaks for credit-card purchases in August 1999. MOFE also offered tax credits for a certain category of consumption goods in December 1999 (MOFE, 1999). By around the end of 1999, the boosting of domestic demand had been on the rails as the core element of the macroeconomic policy.

Henceforth, the policy of boosting domestic demand became the macroeconomic policy stance of MOFE until the first half of 2002. The Bank of Korea detected upswings of such variables as cash advances and household debts as early as in September 1999 and in January 2000, respectively. Such surges certainly reflected MOFE's aggressive pursuit of the boosting of domestic demand.

In January 2001, MOFE, as part of its credit-card promotion policy, began to require firms to use corporate credit cards to pay for corporate entertainment expenses. As MOFE had vehemently kept on enforcing its policy of boosting domestic demand since 1998, some adverse side effects began to manifest themselves by early 2001. For example, FSC/FSS recognized in February 2001 that the credit-card industry was in excessive competition. In the same month, BOK pointed out the continued upswings of household debts. Later in May 2001, FSC/FSS diagnosed the credit-card companies as suffering from the prudential problems. Rather than taking standard measures to mitigate excessive competition among credit-card companies, FSC/FSS focused instead on consumer protection. In particular, FSC/FSS strengthened monitoring of how credit-card companies conducted business with their customers. They attempted to reduce the number of individual credit defaulters directly by means of, say, tightening the requirements for credit defaulter registration. An analysis regarding the prudential problems of credit - card companies, together with a comprehensive package of measures, was released by FSC/FSS on May 3, 2001, in a public document titled "Plans to Enhance Competitiveness in Credit Card Industry." However, core elements of the package were hushed up in fact, since the revision of relevant laws and regulations required for the enforcement of some measures met with the strong opposition from MOFE. Regarding the continued upsurge of household debts, BOK took a cautious but optimistic view, saying that the upsurge did not currently warrant much concern. During the latter half of 2001, MOFE expanded the scope of tax breaks for credit-card purchases in August 2001 and introduced further tax credits for another category of consumption goods in November 2001. These measures may have added strength to boosting domestic demand. BOK kept its cautious optimism about the continued upsurge of household indebtedness. Although FSC/FSS hinted at their concern about the phenomenon, nonetheless they chose to be bystanders during the course of development. It is to be noted that the Financial Policy Coordination Committee attended by MOFE Vice Minister, FSC Vice Chairman, and BOK Vice Governor, failed to take a balanced view of what was happening in the economy throughout the entire year. When the Committee was held in October 2001, for example, it regarded the up surge of household debts simply as a factor that might adversely affect the smooth flow of funds to small - and medium-sized firms. The Committee approached the issue of excess competition from the standpoint of consumer protection only, ignoring the ever-worsening prudential aspects of credit-card companies.

In short, MOFE was exerting its all-out efforts to pursue the policy of boosting domestic demand over the three years from mid-1998. Meanwhile, other public agencies such as FSC/FSS and BOK generally continued to take their reserved positions all along, though they

detected potential signs of problems by around early 2001. Consequently, supervisory environment produced during 2001 by the public agencies responsible for the financial system such as MOFE, FSC/FSS, and BOK, was lax enough to encourage moral hazard on the part of both credit card companies and households and to mass-produce credit defaulters.

The side effects of the boosting policy had reached huge proportions by around the end of 2001. For example, the prices of residential housing especially in Seoul and its metropolitan area were soaring. The number of credit defaulters kept on increasing. The credit-card related arrearage ratios were on the remarkable increase. In response, MOFE made it clear that it would combat all these problems. In January 2002 and in March 2002, MOFE took a series of market-stabilizing measures that focused on encouraging the supply of residential housing and on suppressing the speculative demand. Also, the Financial Policy Coordination Committee held in February 2002, released its first analysis of household indebtedness, together with the comprehensive set of supervisory policy measures, in a public document titled “Short-and Long-Term Measures on the Growing Household Debts.” Note, however, that these responses never implied a reversal or weakening of the policy stance of MOFE. MOFE was straightforward about this point by stating that there would be no change in its policy of boosting domestic demand at least until the first half of 2002 (MOFE, 2002a). A series of market - stabilizing measures taken by MOFE early in 2002 was soon followed and neutralized by another series of measures taken by the same Ministry in April/May 2002, to induce a real estate boom. Further, the Financial Policy Coordination Committee held in March 2002, stated in its public document that it was concerned lest household lending, if excessively regulated, should lead to a contraction in private consumption and thus to a delay in economic recovery. These remarks were explicit enough to be received by the market as a signal that the supervisory policy measures agreed upon in the Committee held one month earlier had in fact been constrained effectively by MOFE’s policy stance of boosting domestic demand.

During the first half of 2002, both FSC/FSS and BOK showed inconsistent and ambiguous attitudes towards the prudential problems of credit-card companies and of households. For example, FSC/FSS made a public statement in April 2002 that they would strengthen their prudential supervision of credit-card companies, whereas in the same month FSC Chairman virtually reaffirmed in a public lecture the Financial Policy Coordination Committee’s March 2002 position that supervisory policy measures to combat the prudential problems of credit-card companies and of households could be preceded by considerations of economic recovery. BOK intermittently expressed its concern about the prudential problems of households, whereas it strongly put forward arguments for the need to boost domestic demand. What made FSC/FSS and BOK keep to their inconsistent and ambiguous attitudes in the face of the already huge prudential problems during the first half of 2002? The answer relates directly to the fact that MOFE held fast onto the policy of boosting domestic demand all through the years from mid-1998 until the first half of 2002. MOFE, being preoccupied with its macroeconomic policy to boost domestic demand, was afraid lest supervisory policy measures to restrain the upsurge of

household indebtedness should harm its golden rule by any chance. Since MOFE was at the summit of the vertical institutional hierarchy, its policy perspective as such dominated the Financial Policy Coordination Committee where it was made clear in March 2002 that regulatory measures against the upsurge of household lending would be enforced only as long as they would not stand in the way of MOFE's boosting of domestic demand. Between MOFE, FSC/FSS, and BOK, there was no interagency supervisory coordination process to speak of. As supervisory policy was inherently and effectively constrained by economic policy, FSC/FSS and BOK were not able to take independent policy positions of their own, but were subject to policy dominance of MOFE. This was the reason why FSC/FSS and BOK were seen inconsistent and ambiguous in their attitudes. In May 2002, MOFE finally agreed, via the Ruling Party - Administration Coordination Committee, to pursue a comprehensive set of the full-scale policy measures to combat the prudential problems of credit-card companies. In fact, it was none other than the same set of measures that FSC/FSS came up with in May 2001. By accepting the original policy measures that it had rejected a year before, MOFE signaled to the markets that it essentially gave up its long-maintained policy stance of boosting domestic demand. With the formal procedures for revising relevant regulations completed, the set of measures was finally put into practice in July 2002. Subsequently, a series of measures to stabilize real estate markets and to curb real estate speculation was announced in the latter half of 2002.

With the turnaround of MOFE's policy stance in May 2002, other public agencies suddenly outgrew their yearlong inconsistency and ambiguity. In the latter half of 2002, FSC/FSS began to carry out an additional series of supervisory measures of their own to combat the prudential problems of credit-card companies. In particular, FSC/FSS enforced the strengthened prudential measures of their own in November 2002. BOK also raised the target level of the call rate by 0.25%p in May 2002 out of concern over the continued upsurge of household lending and the resulting excess liquidity in the market. Throughout the latter half of 2002, BOK repeatedly announced in public its explicit concerns about the prudential problems of credit-card companies and of households and about potential financial instability.

Heavily affected by mounting uncertainties such as the outbreak of war in Iraq, North Korea's nuclear threats, the rampancy of SARS, and the obscure outlook for the world economy, etc., the domestic demand of the Korean economy plummeted during the first half of 2003. To make matters worse, the accounting fraud of SK Global was revealed on March 11, 2003. That incident inflamed already widespread concerns about the prudential problems of credit-card companies and of households, triggering financial market instability immediately. BOK promptly intervened in the market as a crisis manager, supplying emergency liquidity. The Financial Policy Coordination Committee held in March and in April, presented the financial markets with a couple of policy packages. One package consisted of self-rescue measures for credit-card companies to improve their prudential conditions, while the other was a financial lifeboat plan for the financial sector as a whole to rescue credit-card companies.

These policy packages, which constituted public intervention, certainly pacified the markets. Nevertheless, financial market instability has not gone away but has lingered on since then. The prudential problems have continued to be the most serious threat that may disturb the markets at any time. For example, the number of credit defaulters had been steadily increasing month by month throughout 2003, to be over 3.7 million by the end of 2003. That is, the year 2003 has seen a dramatic increase in the number of individual credit defaulters of over one million. The arrearage ratio relating to credit-card companies has continued to show its upward trend during 2003. Finally, the LG Card predicament occurred in November 2003 and lasted for about three months until its bailout was agreed upon in January 2004. The case of LG Card reminds us of the grim reality that the outstanding prudential problems of credit-card companies and of households have proven to be a potentially serious de-stabilizing factor.

6.2. Assessment

What can we get away with the case study investigated above in terms of financial regulation and supervision, especially supervisory governance?²⁴⁾ As we have discussed earlier, both FSC/FSS and BOK recognized certain symptomatic movements of some variables that related to the prudential aspects of credit-card companies and of households. In particular, in May 2001, FSC/FSS went so far as to put forward a comprehensive package of measures to combat the prudential problems of credit-card companies. Nevertheless, both FSC/FSS and BOK remained reserved and inconsistent in their analyses and views, dealing with apparent problems in an indecisive manner. This is because the public agencies were not able to go through the process of supervisory cooperation and coordination on an equal footing with each other. If each public agency is given a unique mandate of its own, interagency cooperation must be functional. Also, checks and balances are required for policy coordination in the real sense of the term. Thus, in theory, function-based horizontal relationships between the public agencies greatly contribute to mutual cooperation and coordination. In practice, however, vertical hierarchy has been more entrenched among the public agencies in Korea. It has long been taken for granted that economic policy of MOFE takes precedence over both the micro-prudential approach of FSC/FSS and the macro-prudential approach of BOK. Faced with aggravating signs of the prudential problems for several years, FSC/FSS and BOK, being under the leadership of MOFE, came to act in unison as if they were guided by “disaster myopia.”²⁵⁾

24) Kang(2009) describes that the Korean experience of credit-card crisis symbolizes the significance of separation of credit card companies from systemic risks. According to him, credit card policies should not be influenced by macroeconomic policies like a tool of expansionary policy in a period of recession. Regardless of business cycles, stringent risk management system should be built in and the soundness of credit card companies thoroughly monitored by professional supervisory staffs based on timely and accurate information. He also stresses that policymakers should remind of the purpose of introducing and regulating credit card business. The policy objectives depend on the level of economic and financial market developments. If efficient resource allocations are the purpose like in Korea, privacy protection could be a secondary concern. But even in this case the government should seriously consider systemic risks, for which are related to consumers' welfare in the end.

25) BIS(2001) defines “disaster myopia” as “[t]he tendency for investors, entrepreneurs and financial institutions to become overly optimistic in booms ... placing too little weight on low-probability adverse events.” Based on the recent experience that has led to the current prudential problems of credit-card companies and of households in Korea, one may not be too presumptuous to say that all the public agencies as well as credit-card companies and households were severely imbued with disaster myopia.

If any of the public agencies felt the need for supervisory cooperation and policy coordination, it should have put the issue before the Financial Policy Coordination Committee. Upon recognition of the prudential problems, however, neither FSC/FSS nor BOK brought up the issue to the Committee. While the competent authorities such as FSC/FSS and BOK kept silent about the issue, MOFE, which played the leading role in the Financial Policy Coordination Committee, let the problem rolling out too long to spur the domestic demand. MOFE was well aware of possible tradeoffs between its current policy stance of boosting domestic demand and standard supervisory policy measures to be taken, if ever, against the prudential problems. Even if the Financial Policy Coordination Committee had discussed the issue, FSC/FSS and BOK would have been subject to the apparent limitation that they should not run counter to the policy perspective of MOFE even within their proper domains of operational activities. Due to such flaws in institutional structure of financial supervision, the Financial Policy Coordination Committee could not provide a practical channel for communication and consultation amongst public agencies nor produce flexible and timely responses. In a nutshell, the current prudential problems of credit-card companies and of households and the consequent upsurges of credit defaulters, the hikes of arrearage ratios, and the recent lapses into financial market instability, are all attributable to supervisory failure and to the resultant absence of interagency supervisory cooperation and checks and balances. It follows as a matter of course that MOFE, FSC/FSS, and BOK are all directly to blame for the supervisory failure. This is the vivid evidence for the importance of institutional independence and mutual checks and balances between supervisory bodies.

7. Recommendations Based on Korean Experiences

The need for a better supervisory management has been highlighted by the recent financial turmoil originated from the U.S. subprime mortgage for both advanced and emerging countries. Faced with global trends of financial consolidation and liberalization, emerging market countries have increased their efforts of to secure the stability and soundness of their financial system by minimizing systemic risk potential with the enhanced financial supervisory structure.

Indonesian financial supervisory system stands at a crossroads. The architecture of financial supervisory system has the element that is more endogenous than exogenous. Financial supervisory system should be restructured in order to enhance the competitiveness and stability of financial markets in steps with the development stage of financial markets.

In retrospect, the outbreak of the 1997 economic crisis provided a decisive momentum for the immediate adoption of the integrated system of financial supervision in Korea. However, we are not sure whether the current moment is the right time for Indonesia to change its financial supervision structure. Considering the world-wide discussion on the reshaping of financial supervision and the trend of integrating dispersed supervisory bodies, the financial supervisory

system of Indonesia will eventually meet the need for reforms on overall regulatory and supervisory substances as well as governance structure. Whichever road Indonesia chooses, it will face with many challenges to upgrade its current financial supervisory system. In this section, we are not going to suggest which road is the best for Indonesia, but to provide and share the lessons we learned from our past experiences after Korea has switched from a disintegrated financial supervisory system into an integrated one.

The fundamental lesson is that supervisory cooperation and checks and balances between public agencies responsible for the financial system are indispensable to efficient financial supervision and financial stability. This, we believe, is universally the case, irrespective of the specific type of institutional structure of financial supervision.

Indonesia has a similar financial supervisory system of Korea before it has undergone the changes in supervisory architecture in 1998.

The ultimate goal of restructuring financial supervision system is to strengthen and upgrade the soundness and competitiveness of financial industry. In order to achieve these goals, the independence of financial supervision is essential. Under this condition satisfied, the accountability and efficiency of financial supervision becomes enhanced.

The second precondition for interagency supervisory cooperation and checks and balances is that there will be goodwill on the part of the heads of the public agencies responsible for the financial system. Since institutions are ultimately run by people, the institutional hierarchy seems to have been easily structured vertically according to the scope and strength of powers exercised by each of the public agencies involved. MOFE sits atop the institutional hierarchy, followed by FSC. MOFE and FSC are situated on the upper rungs of the hierarchical ladder, while BOK and KDIC are on its lower rungs.

As long as there are vertical hierarchical relationships among the public agencies, there is no room for interagency supervisory cooperation and checks and balances to be generated. Cooperation is not about order and obedience. Checks and balances are possible when the public agencies interact not in terms of powers, but in terms of functions. Goodwill can be generated only when the relationships between the public agencies are functional and horizontal. In Korea where the cultural tradition widely prevails, much conscientious effort on the part of the public agencies over a long period of time will be necessary to nurture goodwill,

In these circumstances, the overlap of tasks and functions of the public agencies may serve as a substitute for goodwill. In advanced countries including the United States, the United Kingdom, and Canada, some overlaps of supervisory powers and tasks between public agencies are in fact provided for in law, with a view to helping generate interagency supervisory cooperation and checks and balances in practice. In contrast, institutional structure of financial

supervision in Korea, as envisaged by the 1997 Act for the Establishment of Financial Supervisory Organizations, leaves little or no room for such an overlap. We, therefore, suggest that powers be reallocated to bring about some overlaps of tasks and functions between public agencies. We have only to increase the degree of overlap up to a threshold beyond which each public agency begins to feel the need to cooperate with others for the accomplishment of its own tasks.

Examples of such partial overlaps may possibly include the following: First, BI could be legally authorized under certain conditions to perform an independent on-site examination of a bank, while the supervisory agency continues to be charged with financial supervision including on- and off-site examination. BI might use this limited authority simply as notional leverage by means of which it could win cooperation with the supervisory agency. Second, the mandate of the financial stability could be explicitly stated, in addition to the price stability, in the article of purposes of BI. In retrospective, BOK was deprived of its bank regulatory and supervisory functions when the BOK Act was revised in December 1997. At the same time, the mandate of financial stability was removed from the Act's article of purposes as well. Since then, there has been a widespread misunderstanding that BOK is no longer involved in financial stability. This kind of misunderstanding impeded interagency co-operations. To avoid the similar circumstances, the explicit statement of the financial stability mandate in the duties of BI, in the presence of a unified supervisory agency, would make it clear that the BI, together with other public agencies, should participate in the maintenance of financial stability.

In some sense, this could be considered as creating an effective overlap of the financial stability mandate among the public agencies. That would surely help enhance interagency supervisory co-operation and checks and balances. Third, the supervisory agency should be empowered with draw up draft legislation relating to prudential regulations in consultation with BI and the Ministry of Finance. Some extent of an overlap in the power to develop laws could then be created between the Ministry of Finance, the supervisory body and BI. The power to develop laws should not be monopolized.

In Korea, the Financial Policy Coordination Committee, which is attended by the Vice Minister of Strategy and Finance, FSC Vice Chairman, and BOK Vice Governor, is currently the only channel for communication between public agencies responsible for the financial system. The Committee, however, has no legal basis and it has been operated within the vertical institutional hierarchy. Due to the lack of legal basis and formal arrangements, the Committee's role as an interagency supervisory cooperation body has been very limited.

Based on the Korean experience, it is very important to introduce a variety of legal arrangement for interagency supervisory cooperation and for checks and balances and, if necessary, to substantiate details in the form of MOUs or administrative agreements. These MOUs/agreements will help create stable relationships between the public agencies based on

their respective functions on an equal footing. Also, we suggest that if Indonesia is to set up a coordination committee on interagency supervisory bodies, the committee should to be attended by heads of each supervisory agency to make the committee more operational and effective in agenda-setting and reaching agreements.

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Ways to Establish Securitization and Derivatives Market in Indonesia

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Ways to Establish Securitization and Derivatives Market in Indonesia

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1. Necessity of Securitization and Derivatives Market

Capital markets development is a very important factor for the growth of innovative firms and development of economy. Capital markets enable companies and financial institutions to raise large funds and offer investors diverse investment instruments.

Securitization and derivatives markets are essential finance means to invigorate capital markets. A securitization market provides a firm or financial institution with a vehicle to raise funds backed by its assets. Meanwhile, this market offers investors investment products with high credit quality. A derivative product is a means to hedge various risks arising from underlying assets while it offers investors ways to invest according to their diverse preferences.

It is necessary to stimulate securitization and derivatives markets to ensure sound development of capital markets in Indonesia. Indonesia is at the early stages of introducing institutional framework and building securitization and derivatives markets. So far domestic ABS issuance was done in accordance with the BAPEPAM's guidelines. Although a derivatives market has been created for individual stock options in Indonesia, its trading volume is low. Therefore, Indonesia needs to invigorate capital markets by establishing securitization and derivatives markets.

Korea is the largest securitization market in Asia. Corporates and financial institutions have been active in funding secured on the back of assets. The exchange-traded market for stock-index derivatives in Korea is the most active in the world. Thus, Korea's experience in creation and development of securitization and derivatives markets will have implications for vitalizing capital markets in Indonesia.

This study is designed to look for ways to invigorate securitization and derivatives market in Indonesia by assessing development of such markets in Indonesia. To that end, this study looks at the background in creation of securitization market in Korea, as well as the current state of this market and key factors in the market development. Moreover, the study examines how the exchange-traded derivatives market has developed, and key factors in such market development. It also assesses conditions for the introduction of asset-backed securities and the creation of a derivatives market through analysis of finance conditions in Indonesia. Based on the assessment of the aforementioned conditions, this study mulls over ways to design institutional framework for the development of securitization and derivatives markets in Indonesia. Korea's experience and the analysis of Indonesia's market conditions provide the basis for reviewing legal and regulatory framework for securitization and derivatives suitable for financial market in Indonesia. Furthermore, this study provides ways to build infrastructure for efficient establishment of securitization and derivatives markets.

2. Current State of Securitization Market in Korea

2.1. Basic Concepts in Asset Securitization

Asset-backed securities (ABS) refer to the securities issued by a corporate or financial institution based on standardized and pooled assets according to specific conditions. Cash flows from the underlying assets are used to repay the principal and interest of the securities.

ABS have special characteristics that differ from other types of securities because ABS are the securities backed by assets. In essence, ABS are issued based on the creditworthiness of underlying assets. Therefore, both the quality of underlying assets and credit enhancement have decisive effects on the credit quality of securities to be issued. In the same sense, the concept of "bankruptcy remoteness" is also introduced to ensure legal separation of securitized assets from an originator's assets in terms of creditworthiness.

ABS provide benefits in various aspects to originators, investors and financial markets. For originators, high quality securities can be issued based on the characteristics of underlying assets, cash flows and credit enhancement, which are insulated from the credit quality of an issuer. Accordingly, issuers can benefit from ABS issuance, such as reduction in funding costs, improvement in financial structure, security of a new funding sources and improvement in risk management techniques. The merit of ABS issuance is funding at relatively low costs. Meantime, ABS can also be a new funding source for originators. Furthermore, since assets can be moved off balance sheets through ABS issuance, financial institutions, in particular, choose asset securitization as a way to strengthen the management of shareholders' equity.

ABS also provide investors with diverse benefits. Various types of ABS can be issued to

reflect investors' different preferences for risk, maturity and more. For that reason, the scope of invest instruments is broadened by the adoption of ABS. Moreover, another benefit of ABS for the investors is relatively higher profitability arising from initial liquidity premium and premium in the structure than other bonds with the same credit quality.

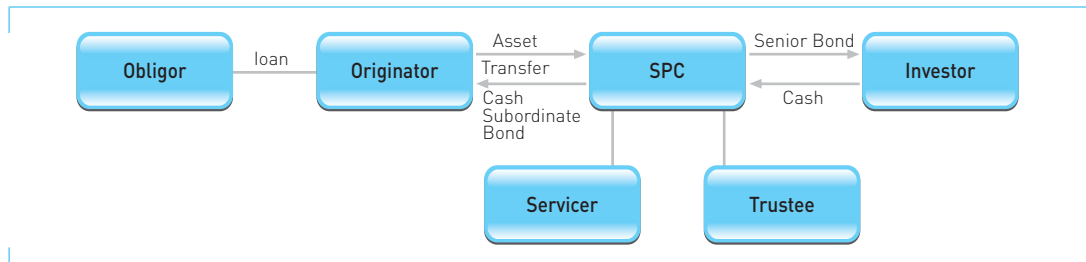
Securitization also helps arrangers to enhance an ability to analyze underlying assets and gain know-how in new types of securities, thereby contributing to the development of financial markets. Offering a new revenue stream to various stakeholders is also one benefit of ABS.

2.2. Securitization Structure

2.2.1. Basic Structure

ABS, in general, have the issuance structure as described in Figure 4-1 below. Key participants in ABS issuance process are an originator, a servicer, an issuer, an administrator, a trustee and a credit enhancement provider. An originator sets up a special purpose company (SPC) specialized in ABS issues and transfer its assets to the SPC. The SPC issues ABS securitized by the transferred assets. After ABS issuance, underlying assets are managed by a servicer. Where the assets are cashed in on, cash proceeds are put into the SPC account of a trustee and used to pay the principal and interest of ABS at maturity.

Figure 4-1 | Basic Structure of ABS



2.2.2. Key Participants

Key participants in ABS transactions include an originator, a SPC, a servicer, a trustee and a credit enhancement provider. An originator is an entity that owns the assets engaged in the transaction. It can be seen as an actual beneficiary of securitization. Keeping the quality of underlying assets independent from the originator's creditworthiness is the key to ABS issuance. Therefore, relatively little attention is paid to an originator.

A servicer means an entity that is responsible for management of underlying assets and cash flows from those assets. Although many parties are involved in ABS issuance, only a servicer, an administrator and a trustee are involved in the principal and interest payments of ABS. That

said, a servicer is an entity decisively affecting the payment of ABS principal and interest. A servicer has to build a separate system for management of underlying assets, and conduct servicing activities such as request for underlying asset, repayment and debt collection. In addition, a servicer is responsible for reporting the management of the underlying pool and furnishing the pool-related information and conducts major activities in relation to ABS payment.

Meantime, an issuer refers to a special purpose company (SPC) that is established to smooth out ABS issuance and separate underlying assets from an originator's.

A SPC undertakes activities necessary for ABS issuance and repayment according to its securitization plan. Generally, a SPC is a paper company formed to implement a securitization plan. Therefore, its overall activities are contracted out. In addition to the servicing, a SPC is responsible for closing and keeping the books, accounting audit and tax affairs. Those activities are entrusted to an administrator.

The major role of a trustee is to monitor servicing activities on behalf of investors and manage cash flows from underlying assets and accounts. Plus, it plays the role of a custodian in a predefined manner under a servicer's instructions on management while serving as a payment agency for the principal and interest of ABS. Although in the past a trustee functioned as a payment agency in the beginning, its role has been gradually expanded as the financing structure became complicated, various types of issuers emerged, and increasing number of bonds defaulted.

2.2.3. Securitization Structure

Securitized assets are important in that they determine the creditworthiness of ABS and affect securitization structure according to their features. In general, diverse asset classes, such as mortgage loans, auto installment receivables, loans, credit card receivables, property-secured loans, lease receivables and securities, can be underlying assets of ABS. Identification characteristics of asset class and analysis of cash flows from assets have great impacts on designing securitization structure.

Generally, securitized assets can be divided into two categories: amortization assets and non-amortization assets. For amortization assets, cash flows from assets are fixed or standardized. On the other hand, in case of non-amortization assets, cash flows from assets are not fixed or standardized. Traditional amortization assets are mortgage-backed securities (MBS), auto installment receivables, corporate loans and bonds. Typical non-amortization assets are credit card receivables and trade receivables. Securitization structure varies depending on the characteristics of such asset classes.

The roles and functions of participants in a securitization deal are defined in advance, on the basis of various contractual agreements. Thus, the roles of participants, the function of risk controls and so forth must be clearly pre-described in contracts to control diverse risks. Basically, when reviewing such contractual documents, one must take into consideration whether the roles and functions of participants in the transaction are clearly defined based on securitization laws and regulations, and whether risks associated with the transaction are clearly controllable under the relevant.

As well, whether the control of various risks, and the clear control of the risk associated with the true sale of underlying assets that are stated under the contracts need to be closely examined.

Essential elements to consider in relation to ABS structure are whether securitization constitutes a true sale, ways to separate and manage underlying assets from an originator's estates, account transfer methods and whether other risk factors in the securitization structure are controlled. A true sale is a basic structure that makes a SPC bankruptcy remote even though an originator or servicer goes bankrupt. To make a deal constitute a true sale, assets must be sold at a reasonable value according to an appropriate procedure. The control and risks of assets sold are properly transferred to a SPC. With regards to such true sale in the United States and Europe, a legal council presents legal opinions based on analysis of various terms and conditions of the sale. In Korea, Asset-backed Securitization Act (the ABS Act) has provisions concerning the true sale, which differ greatly from securitization laws in other countries.

Meanwhile, credit enhancement is provided on the back of asset analysis to improve the credit quality of securities. The most important determinant of credit enhancement level is uncertainty over cash flows from underlying assets. Such risk is measured by assessment of individual obligors, if possible, where the number of clients is small and the related information is available. Where the number of clients is large and the credit information of clients is difficult to be obtained, as in the retail banking sector, historical loss data and risk management attitude of a financial institution are taken into account to gauge the risk.

There are two types of credit enhancement: internal credit enhancement through cash flows from underlying assets and external credit enhancement. Subordination is one of internal credit enhancement in which several tranches of ABS with different priorities of payment are issued and cash flows from underlying assets are used to pay the principal and interest of senior tranches. Such senior/subordinated structure helps increase the likelihood of payment of senior class of securities.

External credit enhancements are a line of credit, a guarantee and a letter of credit. A credit enhancement provider can be seen as one of very important infrastructure to animate a securitization market. As a rule, in the United States or Europe, a monoline insurer acts as a provider of credit enhancement. In Korea, there is no monoline insurance company. Therefore,

a guarantor created by the government or a bank plays the role of a credit enhancement provider.

Table 4-1 | Cash Flow Elements

Contents	Assumptions for Analysis
Details of securitization assets	Principal, transfer price, and appraised value of bonds concerned, and analysis of basic statistics Weighted-average interest rate Weighted average residual period
Date of asset transfer	Dates for cutoff and transfer of underlying asset how to treat the principal of and interest on underlying assets collected before the date of asset transfer
Collection schedule for principal of and interests on underlying assets	How to collect the principal of and interests on underlying assets and how to make repayment, according to the term to maturity and weighted-average interest rate Whether to change the collection schedule where prepayment is reflected
Loss rate and monthly recovery rate	Analyze the characteristics of assets reflected as loss. Estimate applied loss rate and base net loss rate recovery rates and methods over time (for each period)
Interest rate on late payment	Whether weighted-average late payment interest rate of underlying assets is applied and reflected.
Prepayment rate	whether historical prepayment of an originator are incorporated

2.3. Current State of Securitization Market in Korea

2.3.1. Background and Progress

In Korea, legal and regulatory framework for asset securitization was introduced pursuant to the Asset-Backed Securitization Act (the ABS Act). Such framework paved the way for the securitization market to become active. In the wake of the 1997 financial crisis, financial institutions possessed plenty of non-performing loans. Subsequently, demand for securitization mounted. Diverse types of financial institutions faced pressure for efficient financing using their assets. However, ABS issuance was difficult because there was no legal and regulatory framework. For that reason, the ABS Act was enacted. This act includes special treatment and exceptions to address existing institutional obstacles to ABS issuance as well as regulatory mechanism for ABS issuance.

As for key securitization laws, the enactment of the ABS took place in September 1998 provides grounds for the adoption of ABS which includes ABS issuance procedures as well. Subsequently, Special Purpose Companies for Mortgage-Backed Securities Act (the MBS Act) was enacted in January 1999, which laid the institutional groundwork for MBS issuers. Following the enactment of the MBS act, Korea Housing Finance Corporation Act was enacted in December 2003.

The introduction of institutional framework for securitization and the development of the securitization market in Korea suggest that the adoption of new structures were accelerated by the needs of market participants and changes in the government's policy and regulation stemming from the economic and financial development.

A chain of bankruptcies among Daewoo subsidiaries and affiliates (Daewoo Group) in the second half of 1999 caused a big stir in the Korean financial market. As Daewoo Group went bankrupt, investors increasingly restless about investment funds sold by investment trust companies that held a large volume of bonds issued by Daewoo Group. Subsequently, massive redemptions in investment funds occurred, which, in turn, intensified unrest in the financial market. To remove the skepticism of investors, investment trust firms strived to clean up their funds by issuing secondary collateralized bond obligations (CBO) secured by a pool of investment-grade bonds and Daewoo Group bonds from the investment funds. Key features of secondary CBO are as follows: a mixed pool of normal assets and non-performing assets is created and based on this asset pool, senior, mezzanine and subordinated tranches are issued. Among tranches, mezzanine tranche is mixed with other highly profitable assets to create a high yield and high risk investment fund consisting of subordinated debt. Main credit enhancement for CBOs issued by investment trust companies were subordination, bank credit facility and reserve.

In the second half of 2000, primary CBO structure was introduced to address a liquidity squeeze in the corporate sector. This securitization structure was designed to provide liquidity support for companies by underwriting the bonds issued by lower-rated companies and issuing CBO backed by a pool of those bonds. Prior to the 1997 financial crisis, the bond market in Korea was dominated by secured bonds. However, a flurry of corporate bankruptcies occurred due to the financial crisis. As a result, private guarantee insurance providers faltered. Guarantors including securities companies and Seoul Guarantee Insurance Company lost their ability to provide guarantees, especially for bonds issued by large corporates. Under these circumstances, a large volume of bonds, issued before and after the 1997 financial crisis, matured, beginning in the second half of 2000. During the restructuring of ailing financial institutions and corporates, sparked by the financial crisis, creditor banks ceased new lending to viable firms thus continued such a credit crunch. Therefore, the government's proactive market intervention became increasingly necessary. Thus, ABS were issued based on the pools of bonds issued by companies grappling with a liquidity crunch and underwritten by securities companies. To

enhance the creditworthiness of ABS, high-rated banks provided credit facilities and Korea Credit Guarantee Fund guaranteed bank credit facilities. This primary CBO structure resulted in the active issuance of high yield bonds by companies with lower credit quality. The expected benefits of this type of the structure were easy funding for small and medium-sized companies, stabilization of capital markets for companies through active long-term bond issues, stabilization of bond coupon rates thanks to the invigorating bond market, and a broader range of investment products for investors. For that reason, the Korean government pushed for primary CBO issuance backed by a pool of privately issued new bonds partially guaranteed by Korea Credit Guarantee Fund in a bid to support the corporate funding. Consequently, the relevant market grew rapidly.

In addition to the primary CDO structure, revolving structure was introduced. In the revolving structure, long-term bonds are issued based on a pool of short-term assets. This structure enabled companies to issue ABS secured by trade receivables.

As consumer delinquencies began to rise in 2002, credit card companies started to experience deterioration in asset performance. Worse, a rise in delinquency rate and a decline in assets triggered the early amortization of credit card ABS in 2003. Accordingly, new ABS structure was used to tackle the liquidity shortage of credit card companies in 2004. To ease the funding crunch of LG Card Co., Ltd., which was acquired by creditor banks due to the failure to raise capital, credit card ABS started to be issued using the master trust structure. Plus, securities companies were allowed to engage in credit derivatives dealings in 2005. Consequently, synthetic CDOs backed by credit derivatives were issued. Likewise, ABS were used for various purposes. Changes in market conditions and originators' issuance needs were main driving forces behind the adoption of new structures.

2.3.2. Characteristics of Securitization in Korea

One of the most notable characteristics of securitization in Korea is that the introduction of legal and regulatory framework for securitization was initiated by the enactment of a securitization law, called the "Asset-Backed Securitization Act (the ABS Act)." The ABS Act consists of the basic concepts of asset securitization, securitization procedures, and special treatment and exceptions for promotion of securitization.

One of the fundamental features of the legal regulatory framework for securitization in Korea is that entities which are able to push for a securitization deal are restricted by limited originator eligibility. Eligible entities are financial institutions including banks, state-owned companies, such as Korea Land & Housing Corporation and Korea Housing Finance Corporation, and corporates with strong credit quality. The rationale behind the limited definition of an originator at the early stage was the government's view that special treatments, including tax benefits, and exception to the registration of mortgage or title, under the ABS Act

could be misused. In addition, a corporation authorized by the Financial Services Commission or by Presidential Decree is eligible to become an originator. When an eligible entity securitizes its assets, it is entitled to special treatments and exceptions under the ABS Act.

Securitized assets refer to the assets that underlie securitization transactions. Under the ABS Act, securitization assets are defined in a broad sense to mean claims, immovable property and other property rights.

A special purpose vehicle (SPV) means the vehicle that is created to issue asset-backed securities. The ABS Act defines three types of SPVs: a special purpose company exclusively engaged in securitization, called “securitization specialty company”; a trust company established in accordance with the Act on Trust Business; and a foreign corporation specializing in the business of securitization. To make the setup of a special purpose vehicle easier, the ABS Act allows a securitization specialty company to be created in the form of a limited company that is easy to be established with relatively low minimum capital stock.

ABS issuance procedures include the registration of a securitization plan, the transfer of assets, the registration of the asset transfer, the issuance of ABS and the payment of principal and interest. A securitization plan has to be registered with the Financial Services Commission before ABS issuance. On behalf of the Financial Services Commission, the Financial Supervisory Service grants approval for the securitization plan submitted only if that plan does not violate the ABS Act and other related laws. Especially, the ABS Act stipulates requirements for a true sale. Only ABS that meet the true sale requirements are permitted to be issued under the protection of the ABS Act.

Furthermore, the ABS Act contains exceptions to the perfection of claim transfer, registration, the application of the Act on Trust Business and otherwise in order to smooth over securitization.

In case of general claim transfer, perfection is accomplished only when a party that transfers claims notifies a borrower of the transfer or the borrower gives a consent to the fact of the transfer in case of general transfer. However, in case of claim transfer under a securitization plan, perfection against the borrower is effective even when a party that purchases claims notifies the borrower of the transfer. Where making a notification is not possible, a public notice may substitute a notification to the borrower.

Moreover, if the transfer of claims is registered with the Financial Services Commission according to a securitization plan, perfection against third parties comes into force at the time of the registration under the Civil Law.

Plus, for smooth ABS issuance, the ABS Act has a variety of provisions for special treatment and exceptions, including procedure for fixation of collateral security claims

mortgage, registration, tax benefits and exception to the application of restrictions on types of trust assets under management upon management of excess funds.

2.3.3. Current State of ABS Market in Korea

After the first issuance in 1999, ABS issuance grew substantially from 2000. The issuance volume reached KRW 50,900 billion in 2001. In 2003, credit card ABS issuance showed a drastic downward trend due to an increase in default rates in the credit card sector. After all, serious liquidity problems confronting credit card companies caused the ABS market to freeze up drastically in the second half of 2003. This situation continued into 2004. ABS issuance was recorded at KRW 27 trillion in 2004, down significantly from a year ago. From 2005 onwards, the issuance volume for popular ABS asset class plunged, leading to a sharp drop in the size of the ABS market.

Table 4-2 | ABS Issuance Volume

(in trillions of KRW, number of deals)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Issuance Volume	6.8	49.4	50.9	39.8	39.9	27	28.6	23.2	19.8	20.6
No. of Issuance	32	154	194	181	191	170	236	183	106	81

Source: Financial Supervisory Service

Yearly ABS issuance by asset class suggests marked changes in the breakdown of underlying asset classes over time. The ABS Act lists immovable property, claims and other property rights as securitization assets. At the early stage of securitization, non-performing loans (NPLs) were the most popular underlying asset. Therefore, NPL ABS constituted the largest portion of total ABS issuance. However, the emergency of diverse asset classes brought bid change to the composition of underlying assets.

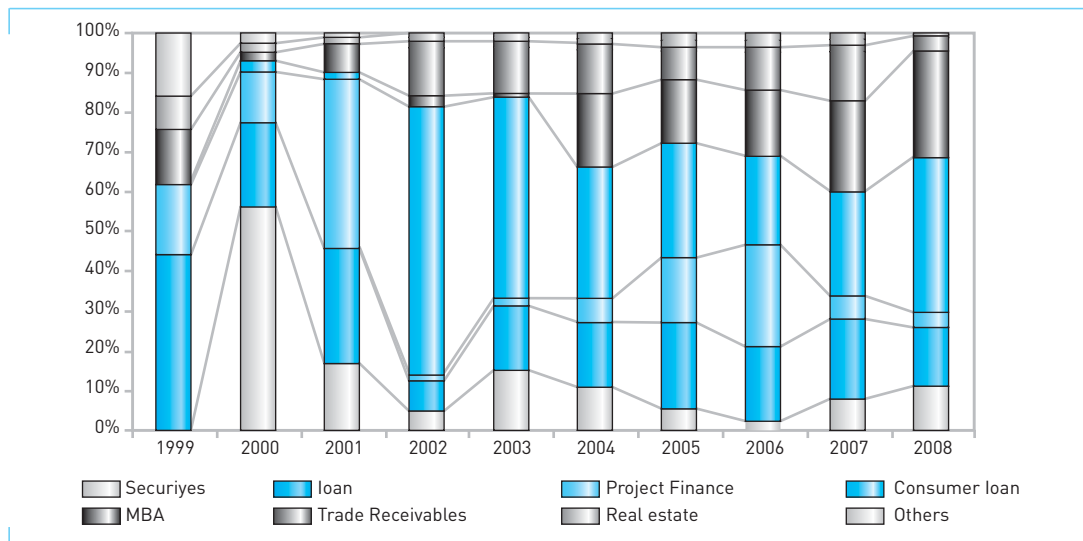
In 2000, a securitization structure was introduced for the clean-up of non performing assets in investment trust companies. Subsequently, bonds became one of popular asset classes. Moreover, when primary CBO was issued for smooth corporate funding, ABS backed by new corporate bonds took up a high portion of total ABS issuance.

From 2001 onwards, credit card receivables and consumer finance receivables were major asset classes as credit card companies, leasing companies and other finance companies, called “specialized credit finance companies” in Korea began relying on ABS as a stable funding vehicle. However, in 2003 and beyond, credit card assets plummeted due to liquidity problems at credit card companies. As a result, credit card ABS as a percentage of total ABS issuance declined. Meanwhile, from 2007 onwards, specialized credit finance companies became active again in securitization transactions backed by auto finance receivables and more. Thus, consumer finance ABS represented an increasing portion of the total issuance volume.

In terms of property development finance, the securitization of project finance (PF) loans started to gain steam in 2003. PF loan ABS as a proportion of total ABS issuance continued to rise. However, a slump in the construction market since 2006 resulted in a sharp fall in the portion of PF loan ABS.

In the meantime, mortgage-backed securities (MBS) constituted a small portion of ABS issuance until 2003. However, since the establishment of KHFC in 2004, MBS as a percentage of ABS issuance went up considerably. The reason is that after KHFC was created, it originated more and more long-term fixed-rate mortgage loans through banks and securitized those mortgage loans, leading to rapid growth in the market.

Figure 4-2 | ABS Issuance by Asset Class



Source: Financial Supervisory Service

There have been obvious changes in leading originators over the course of ABS market development. At the early stage of the market, a major originator was KAMCO that was responsible for the resolution of NPLs purchased from financial institutions. At the time when institutional framework for securitization was introduced, one of the most important goals was to clean up NPLs in the financial sector through securitization. In the United States, the securitization market grew dramatically when securitization was used as a means to resolve the NPLs acquired by Resolution Trust Corporation (RTC) during the restructuring of savings and loan (S&L) industry. However, what is different of the Korean case is that MBS was mostly issued in relation to the resolution of non-performing mortgage loans in the United States. The resolution of NPLs is almost complete in Korea. And the period for which the Non-performing Claim Resolution Fund could buy NPLs is restricted to December 2002. Thus, KAMCO represents an insignificant portion of the ABS market.

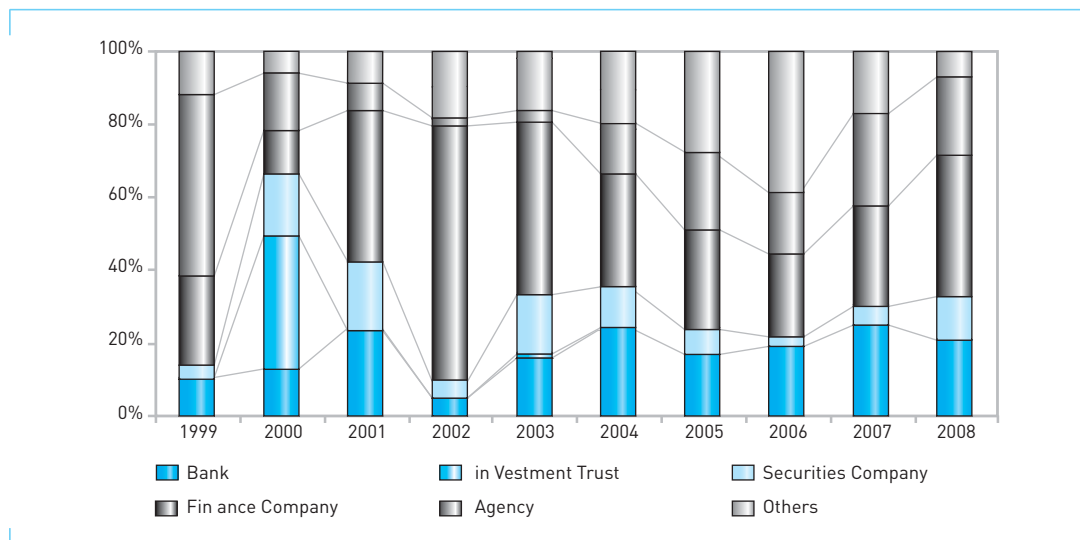
In 2000, investment trust companies became a leading originator because they utilized securitization to deal with the bonds issued by Daewoo subsidiaries and affiliates. In 2001, banks emerged as a major originator while resolving NPLs through CLO issuance.

Specialized credit financial companies as a proportion of total originators rose greatly until 2002. However, after the credit card debt crisis in 2003, their proportion dropped sharply.

As the securitization market developed, corporate as a percentage of total originators have continued to rise. Especially, as the securitization of project finance (PF) loans to construction companies was invigorated in 2004 and beyond, the portion of corporates increased consistently until 2006. However, the construction market fell into a slump, concerns about creditworthiness of PF loan ABS were intensified in the market. Consequently, PF loan ABS deals dwindled sharply. Thus, corporate as a percent of total originators, appeared to decline.

Meantime, the establishment of KHFC in 2004 helped to vitalize the MBS market. Since 2004, KHFC as a proportion of total originators rose markedly.

Figure 4-3 | ABS Issuance by Originator



Source: Financial Supervisory Service

Asset-backed commercial paper (ABCP) is a short-term financial instrument issued to raise money in the form of commercial paper backed by future cash flows or various assets held by a company or financial institution. Due to the simpler issuance procedure than that of bonds, commercial paper is used as a source of prompt funding. Traditional commercial paper is issued based on credit without collateral whereas ABCP is issued based on assets held by a corporation or financial institution. Especially, the majority of ABCP are not based on the ABS Act. Under

the Commercial Law, a special purpose company is created for the purpose of issuing commercial paper. This special purpose company acquires assets and issue ABCP.

Participants in the ABCP market are an issuer, a program manager, a commercial paper broker, a liquidity provider and a credit enhancement provider. An issuer of ABCP primarily takes the form of a conduit or special purpose company that uses commercial paper proceeds to purchase assets from an originator. A program manager is responsible for overall ABCP program activities. In general, a commercial bank serves as a program manager, and at the same time becomes a de facto entity issuing and repaying commercial paper. A commercial paper broker sells ABCP to investors. In general, an investment bank or securities company acts as a commercial paper broker. Where commercial paper is issued but not underwritten in the market, a liquidity provider purchases the unsold commercial paper under commercial paper purchase (credit protection) contract to ensure the continuity of ABCP program. By doing so, it helps improve the liquidity of ABCP. In addition, it is responsible for permits and approvals and oversight. A credit enhancement provider offers credit facility to strengthen the credit quality of assets.

In the Korean ABCP market, there are two types of ABCP: ABCP issued under the ABS Act and ABCP issued under the Commercial Law. As for ABCP under the Commercial Law, a corporation is created for commercial paper issuance. This corporation purchases assets and issues commercial paper several times. The merit of this structure under the Commercial Law is the ease of issuance without undergoing regulatory procedures, including the filing of a securitization plan. For that reason, the market for this type of ABCP became robust.

As regards to the ABCP market in 2006 and beyond, the total ABCP issuance rose from KRW 14.7 trillion in 2006 to KRW 21 trillion in 2007. However, the ABCP issuance volume declined to KRW 15.2 trillion in 2008, down year over year. ABCP issued by the SPCs created under the Commercial Law reached KRW 13.5 trillion, representing 88.8% of total ABCP issuance in 2008.

The majority of ABCP transactions were the securitization of construction firms’ PF loans. In 2008, PF Loan ABCP stood at KRW 8.3 trillion, 61.5% of total ABCP issuance.

Table 4-3 | Current State of ABCP Issuance

(in trillions of KRW)

Issuance Volume	2006	2007	2008
ABCP	14.7	21.0	15.2
ABCP Under Civil Law	11.5	18.0	13.5
PF ABCP	9.2	9.6	8.3

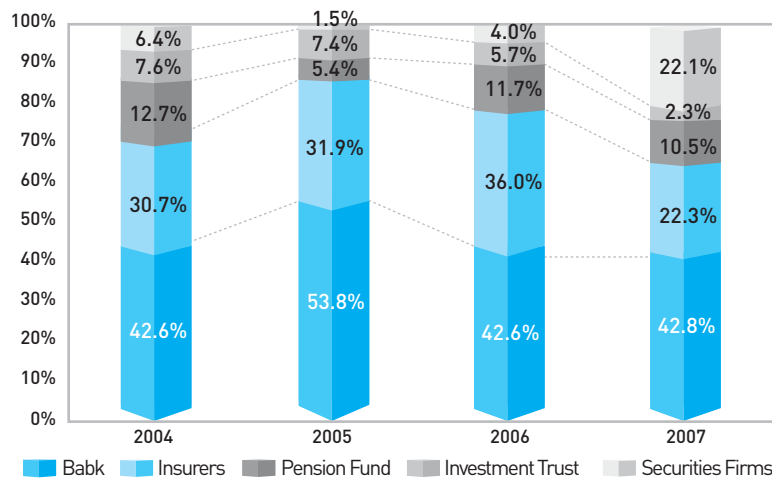
Source: Korea Ratings

2.3.4. Infrastructure for Securitization

A. ABS Investors

Major ABS investors are banks, investment companies, insurance companies, mutual/investment funds and pension funds. Financial institutions in Korea have a preference for relatively high credit quality securities. Therefore, higher-rated ABS have become a target for vigorous investments.

Figure 4-4 | Breakdown of KHFC MBS Investors



As for investors in MBS issued by Korea Housing Finance Corporation (KHFC), banks are the largest investor, followed by insurance companies. The main reason why banks and insurance companies constitute the large portion of MBS investors is gradual growth in demand from financial institutions for high quality long-term securities. Meanwhile, in 2007, securities companies as a percentage of MBS investors rose considerably. A temporary liquidity crunch of banks limited the sales of MBS, of which securities companies made outright purchases. Subsequently, securities companies saw a momentary rise in MBS holdings. Pension funds represented about 10% of MBS investors as demand for long-term bonds climbed up gradually.

Mutual/investment funds as a proportion of MBS investors was 7.6% in 2004 but continued to decline every year to 2.3% in 2007. It was primarily attributed to a substantial drop in demand for bond funds amid the bullish stock market. Such low MBS demand from mutual funds/investment funds is likely to limit the development of secondary MBS market.

B. ABS Disclosure

Given the unique features of ABS, the ABS Act prescribes requirements for registration and disclosure. Publicly issued ABS are subject to corporate disclosure system.

ABS issuance involves such procedures as the registration of a securitization plan, the registration of asset transfer, and the filing of registration statement for securities issuance. When an issuer issues securities, it should submit a registration statement for issuance as well as submit and publish periodic reports, including a business report.

Article 3 of the ABS Act stipulates as follows: “when a special purpose company, or a foreign corporation or a trust business entity specializing in the business of asset-backed securitization proposes to be governed by this Act in relation to asset-backed securitization, it shall register with the Financial Services Commission an asset-backed securitization plan containing the scope of securitization assets, classes of asset-backed securities, the methods of management of securitization assets, etc.” Article 4 of the ABS Act lists what should be included in a securitization plan. Article 6 prescribes the registration of asset transfer. With respect to disclosure after issuance, Article 27 prescribes as follows: “the issuance of asset-backed securities pursuant to an asset-backed securitization plan shall be in accordance with the Commercial Act, the Capital Market and Financial Investment Business Act, and other relevant Acts and subordinate statutes unless otherwise provided in this Act.” Accordingly, for publicly issued ABS, a securitization specialty company has to submit periodic reports, including a business report, pursuant to Article 186.2 of the Capital Market and Financial Investment Business Act. Details of ABS registration and disclosure are described in the Financial Supervisory Commission’s Regulation on Supervision of Asset-Backed Securitization Business, and the Financial Supervisory Service’s securitization filing forms and guidelines for securitization activities.

Beginning in March 2000, disclosure documents can be filed with the Data Analysis, Retrieval and Transfer System or DART via the Internet. When these documents are submitted, investors and other users can access them immediately.

C. Bond Pricing

Background to the introduction of bond pricing system in Korea is as follows: there was almost no valuation or pricing of bonds held by investment trust companies due to the lack of concrete valuation and application principles. Therefore, the price of redemptions in mutual/investment funds could not be determined based on the fair value of bonds. Thus, the bond pricing/valuation system was adopted in 1999. From May 2000, three providers of bond pricing service were created in the form of a subsidiary of a credit rating agency and were registered with the Financial Services Commission.

Bond pricing companies provide pricing data of all non-marketable bonds. Based on such pricing information, financial institutions measure the value of the bonds held. Or bond prices are used as primary source for bond trading.

Table 4-4 | Overview of Bond Pricing Companies in Korea

	Korea Bond Pricing & KR	KIS Pricing	NICE Pricing Services
Month of Establishment	May 2000	June 2000	June 2000
Headcount	60	50	40
Capital Stock	KRW 5 billion	KRW 3 billion	KRW 5.55 billion
Parent Company	Korea Ratings	Korea Investors Service	NICE

D. Credit Ratings

A credit rating is a rating agency’s opinion on the likelihood that principal and interest on a specific security or debt will be paid according to issuance terms and conditions. Such opinion is based on the assessment of factors affecting the debt repayment. Credit rating agencies use symbols to express relative creditworthiness. Ratings information is used as an objective indicator of creditworthiness by investors when they decide to buy, hold or sell assets in their portfolios. Moreover, credit ratings are used for increasingly diverse purposes in addition to bond issues. Especially, more and more regulators around the world use credit ratings in financial supervision and oversight.

It was in 1985 that a credit rating system was introduced for the first time in Korea. Commercial paper ratings began at that time. The Asian Financial Crisis in 1997 brought sweeping changes to capital markets in Korea. Along with that, the bond market underwent a rapid change from the secured-bond-dominated one to unsecured-bond-dominated one. Further, awareness about the importance of credit ratings began increasing.

Issuance and secondary market regulations have been the strong foundation for the creation and maintenance of the credit rating market in Korea. Currently, there are three full-service rating agencies, including Korea Ratings (KR), NICE Investors Service (NICE Rating) and Korea Investors Service (KIS), and Seoul Credit Rating & Information (SCI), which offers only CP and ABS ratings.

Credit rating agencies in Korea have provided a broader range of rating services and have functioned more actively due to the shift of the bond market toward the unsecured bond-dominated market, and the broader scope of entities and financial instruments subject to credit ratings resulting from the adoption of institutional framework for securitization.

Korean rating agencies have strived to enhance their analytical capabilities and external credibility by capitalizing on capital participation from or business alliance with global rating agencies. In 1998, Moody's Investors Service purchased a 50% stake plus one share in KIS and has maintained managerial ownership in that agency to date. KR formed business alliance with Fitch Ratings Limited in 1999. In 2007, Fitch Ratings became the largest shareholder of KR in 2007. NICE Rating have formed and sustained business alliances with Japan's R&I and China's Dagong Global Credit Rating.

Table 4-5 | Overview of Credit Rating Agencies in Korea

	KR	KIS	NICE Rating	SCI
Date of Establishment	1983. 12. 29	1985. 02. 26	1986. 09. 11	1992. 04. 23
Date of Rating Service Commenced	1987. 11	1985. 09(98. 08)	1987. 06	2000. 01
Rating	All types of bonds	All types of bonds	All types of bonds	CP, ABS
Shareholders	Fitch Ratings(64.2%), Korea Value Asset Management(9.3%), etc.	Moody's, NICE	NICE	SB Partners, SB Restructuring Investment Cooperative No. 1
Capital Stock	KRW 24.3bn	KRW 5bn	KRW 23.7bn	KRW 13.7bn
No. of Analysts	63	56	64	-
Affiliation with Foreign Rating Agency	Fitch(99. 1. 20)	Moody's (98. 08. 18)	R&I (2000. 04. 25)	JCR(Japanese rating agency)
Ratings Revenue(2008)	KRW 21.4bn	KRW 20.8bn	KRW 19.7bn	KRW 0.4bn

Rating agencies primarily rates bonds, commercial paper and asset-backed securities. Along with that, they also assess the financial strength of financial institutions and assign issuer ratings. Rating agencies rate more diverse entities and financial instruments owing to market demand or development of new rating services. Especially, as transactions linked to credit have increased, the scope of the rating universe has expanded.

The rating market in Korea has grown gradually in size as unsecured bonds became dominant in the bond market after the financial crisis and the securitization market became active. Plus, the adoption of Basel II resulted in an increase in the use of ratings information to measure credit risk.

Credit ratings are also utilized as a means to regulate the quality of securities issues, as seen in mandatory credit rating requirement for unsecured bonds and ABS to be underwritten by a securities company, and restrictions on the rating level of commercial paper handled by a full-

service financial company. In addition, securities companies are allowed to underwrite only bonds that are rated by at least two rating agencies. Moreover, securities companies are allowed to underwrite ABS that are rated by one rating agency. If an unlisted firm wants to issue ABS, it must receive an investment-grade rating.

And credit ratings are also used in the risk management of banks, the asset management of asset management companies, and regulation on the financial strength of financial institutions, such as required net capital ratio of a security company.

Nevertheless, the depth and width of the bond market are limited. Unlike other countries, credit risk transfer is not active. The use of ratings information is limited compared to that in the United States or Europe.

The credibility of credit ratings assigned by rating agencies in Korea can be measured by default rates. The ratings performance of Korean rating agencies shows statistically significant difference in default rates between investment grade and speculative grade ratings. Given that, the appropriateness of credit ratings is high. Above all, despite relatively short history of the rating market, historical default rates published by rating agencies exhibit the solid discriminative power of their rating systems to distinguish investment-grade and speculative-grade ratings.

2.4. Factors for Success of ABS Market in Korea

2.4.1. Adoption of securitization through enactment of securitization law

The government's strong legal support, among other things, was the biggest driving force behind the active use of ABS as a very effective means of restructuring to overcome the financial crisis. Legal and regulatory obstacles to securitization were removed by the enactment of the ABS Act, which laid the institutional framework for smooth securitization.

The ABS Act in Korea differs from the existing legal mechanism designed to regulate the financial sector. With special treatments and exceptions to various stumbling blocks to securitization, the ABS Act contributed greatly to growth in the securitization market.

2.4.2. Clarification of "true sale" concept

The core to asset securitization is to provide legal and regulatory framework under which an issuer issues securities based on its own credit by insulating the credit risk of assets from that of an originator's (bankruptcy remoteness). Article 13 of the ABS Act clarifies what constitutes a true sale.

Moreover, Article 12 of the ABS Act stipulates that underlying assets must be isolated from a servicer’s bankruptcy to improve the reliability of ABS.

In this way, the requirements associated with the ‘true sale’ are clarified through the ABS Act, so as to remove uncertainties. Accordingly, the clarification of the true sale concept helped to invigorate ABS Transactions.

Table 4-6 | Cumulative Default Rates of Korean CRA

Agency	Rating	1st yr	2nd yr	3rd yr	4th yr	5th yr	6th yr	7th yr	8th yr
KR	AAA	-	-	-	-	-	-	-	-
	AA	-	-	-	-	-	-	-	-
	A	-	-	-	-	-	-	-	-
	BBB	0.30	0.52	0.89	1.30	1.77	1.77	1.77	1.77
	BB	3.89	6.82	8.57	9.17	9.59	9.82	10.07	10.42
	B or lower	11.19	13.89	15.59	15.59	15.59	15.59	15.59	16.60
	Investment	0.14	0.24	0.42	0.63	0.88	0.88	0.88	0.88
	Speculative	6.45	9.30	11.03	11.45	11.75	11.91	12.10	12.62
Total	1.84	2.73	3.40	3.68	3.94	4.01	4.08	4.28	
KIS	AAA	-	-	-	-	-	-	-	-
	AA	-	-	-	-	-	-	-	-
	A	-	-	-	-	-	-	-	-
	BBB	0.13	0.42	9.58	0.94	1.14	1.14	1.14	1.14
	BB	4.49	6.95	8.52	9.21	9.44	9.70	10.00	10.87
	B or lower	8.18	9.70	10.23	10.23	10.23	10.23	10.23	10.23
	Investment	0.05	0.17	0.31	0.47	0.57	0.57	0.57	0.57
	Speculative	5.71	7.88	9.14	9.63	9.80	9.98	10.20	10.82
Total	1.52	2.21	2.69	2.96	3.08	3.16	3.24	3.48	
NICE Rating	AAA	-	-	-	-	-	-	-	-
	AA	-	-	-	-	-	-	-	-
	A	-	-	-	-	-	-	-	-
	BBB	0.36	0.62	0.90	1.54	1.90	1.90	1.90	1.90
	BB	3.29	5.95	7.51	8.41	8.89	8.89	8.89	9.27
	B or lower	8.98	11.52	13.43	13.43	13.43	13.43	13.43	13.43
	Investment	0.15	0.26	0.39	0.69	0.87	0.87	0.87	0.87
	Speculative	5.34	7.95	9.62	10.25	10.61	10.61	10.61	10.88
Total	1.52	2.33	2.92	3.33	3.51	3.57	3.57	3.68	

Note: from 1998 through 2008

Source: Three domestic rating agencies

2.4.3. Regulatory direction to promote securitization

In Korea, regulators strived to form a securitization market swiftly whereas preventing related institutions from being operated beyond their capacity. These efforts contributed to the higher credibility of ABS and subsequent brisk investments. In Korea, a securitization plan has to be registered with the Financial Supervisory Service for ABS issuance.

The transfer of assets must also be registered to have perfection in place. The securitization documents filed are promptly published via the electronic disclosure system, thereby gaining public trust in ABS to be issued and enables investors to obtain securitization-related information smoothly and quickly.

Such efforts of the regulators have contributed to the active ABS market by helping ABS to gain public trust and enhancing information efficiency.

2.4.4. Introduction of flexible securitization structure in response to a funding squeeze in the corporate sector

When corporate faced a funding squeeze, the government implemented policy measures quickly and effectively to tackle the liquidity crunch in the market through CBO. This is one of success factors for the corporate restructuring.

Companies with low credit quality relied mainly on bank loans secured by collateral or guarantee. Due to low credit quality, they had limited access to the capital markets. In a tight money situation, even companies with high credit quality suffered a funding difficulty. Primary CDO, designed to improve this corporate funding structure, provides companies in funding difficulties to raise funds in the capital market using the securitization structure.

3. Current State of Derivatives Market in Korea

3.1. Basic Concepts of Derivatives

A financial derivative refers to a financial contract whose value is derived from the price fluctuations of an underlying financial instrument such as currency, bond and stock. Derivatives include forwards, futures, swaps, options or various combinations thereof. In addition, by type of underlying asset, derivatives can be divided into currency derivatives, interest rate derivatives and equity derivatives. And depending on where trading takes place, derivatives can be classified into exchange-traded derivatives and over-the-counter derivatives. Exchange trading refers to the trading of products listed on an accredited exchange. In the exchange, financial products whose trading terms and conditions are standardized are traded. Furthermore,

counterparty's creditworthiness is not the issue. Meantime, an OTC derivatives transaction refers to the transaction that does not involve the exchange. OTC derivatives trading between two parties takes place within the limits set for their respective counterparty. Products being traded and trading terms and conditions are not standardized. A flexible transaction is available in the OTC market but counterparty risk exists in this type of transaction.

A futures contract is a contract to buy or sell a specific financial instrument at a certain time in the future and at a pre-determined price. In general, a futures contract is a contract containing standardized terms and traded on a formal exchange. On the other hand, a forward contract is an agreement between two parties made directly or indirectly through a dealer or broker on an OTC market.

An option contract is the right to sell (for put option) or buy (for call option) underlying commodity at a specified price at a specified date or during a specified period in the future. An option contract has an asymmetric payoff pattern. It differs from a forward or futures contract in that premium is paid upon trading.

A swap contract is, in general, an agreement between two parties to swap future cash flows from two financial assets or debt. Swaps include currency swaps and interest rate swaps. A currency swap is a contract between two parties to exchange the principal and interest of a loan/debt in one currency for the same in another currency. An interest rate swap is an agreement between two parties to exchange a fixed interest payment for a floating interest payment.

Derivatives markets grew greatly as larger global capital movements resulted in a rise in the degree of price fluctuations in financial instruments, and, thus, the need for hedging the risks of such price fluctuations increased. On the supply side, the emergence of a futures exchange led to the standardization and generalization of derivatives trading, making derivatives trading easier for all economic entities including individuals. Rapid advances in IT technology helped to make easy the assessment, separation and transfer of risks arising from underlying assets. Accordingly, diverse derivative products could be developed.

3.2. Current State of Derivatives Market

3.2.1. Current State of Global Derivatives Market

Global derivatives trading on exchanges continued rapid growth in 2000's. However, the growth rate of the trading volume dropped considerably due to the global financial crisis in 2008.

The global trading of exchange-traded futures and options stood at 17, 653 million contracts

in 2008, up 13.7% year on year. About 8,292 million of futures contracts were traded while 9,361 million of option contracts were traded. Financial derivatives that are based on stock index, single stock, interest rate or currency represent 90% of the derivatives markets. Derivatives based on physical assets, such as agricultural goods, energy products and metals, accounted for the remaining 10%.

In terms of trading volume by region, exchanges in North America made up approximately 40% of the aggregate derivatives trading volume in the world. Exchanges in Asia Pacific and in Europe represented about 28% and about 24%, respectively.

In terms of trading volume by exchange, CME Group that recently merged with the Chicago Board of Trade (CBOT) and the New York Mercantile Exchange (NYMEX) was the largest derivatives exchange with about KRW 3.3 billion of contracts, followed by Eurex with about KRW 3.2 billion of contracts and Korea Exchange (KRX) with about 2.9 billion of contracts. KRX posted the largest trading volume of derivatives in the world until 2006. However, it slipped down to third place recently due to the mergers and acquisitions of overseas large exchanges, and the stagnant trading of KOSPI200 options.

Table 4-7 | Global Trading Volume of Exchange-traded Derivatives by Product

(contract)

Product Type	2008	2007	Change
Stock indices	6,488,620,434	5,499,833,555	18.0%
Single stocks	5,511,194,380	4,400,437,854	25.2%
Interest rates	3,204,838,617	3,745,176,350	-14.4%
Agricultural goods	888,828,194	640,683,907	38.7%
Energy products	580,404,789	496,770,566	16.8%
Currencies	577,156,982	459,752,816	25.5%
Precious Metals	180,370,074	150,976,113	19.5%
Metals	175,788,341	106,859,969	64.5%
Others	45,501,810	26,140,974	74.1%
Total	17,652,703,621	15,526,632,104	13.7%

Note: based on futures and options traded on 69 exchanges on the globe

Source: Futures Industry Association, Annual Volume Survey, 2009

3.2.2. Current State of Derivatives Market in Korea

KOSPI200 stock index futures are the first derivative product in Korea. Starting with the market for KOSPI200 stock index futures opened in May 1996, stocks, bonds, currency futures and options contracts are listed on the exchange. Stock derivatives include KOSPI 200 futures, KOSPI200 options, KOSDAQ STAR futures, and 15 stock futures and 33 stock options. As for derivative products based on assets other than stock, there are interest rate products, including

Table 4-8 | Trading Volume of Derivatives by Exchange

(million contracts)

Ranking	Exchange	2008	2007	YoY Change
1	CME Group (including CBOT and Nymex)	3,278	3,158	3.80%
2	Eurex (including ISE)	3,173	2,704	17.30%
3	Korea Exchange	2,865	2,777	3.20%
4	NYSE Euronext	1,676	1,525	9.90%
5	Chicago Board Options Exchange (including CFE)	1,195	946	26.30%
6	BM&F Bovespa	742	794	-6.60%
7	Nasdaq OMX Group	722	551	31.00%
8	National Stock Exchange of India	590	380	55.40%
9	JSE South Africa	514	330	55.80%
10	Dalian Commodity Exchange	313	186	68.70%
11	Russian Trading Systems Stock Exchange	238	144	65.50%
12	Intercontinental Exchange	234	195	20.40%
13	Zhengzhou Commodity Exchange	223	93	139.20%
14	Boston Options Exchange	179	130	37.60%
15	Osaka Securities Exchange	164	109	50.30%
16	Shanghai Futures Exchange	140	86	63.90%
17	Taiwan Futures Exchange	137	115	18.70%
18	Moscow Interbank Currency Exchange	132	85	54.50%
19	London Metal Exchange	113	93	21.80%
20	Hong Kong Exchanges & Clearing	105	88	19.30%

Source: Futures Industry Association, Annual Volume Survey, 2009

3-year KTB futures, 5-year KTB futures, 10-year KTB futures and currency stabilization bond futures. And currency derivatives traded on the exchange are US dollar futures, US dollar options, Japanese yen futures and Euro futures. Commodity futures such as gold futures and lean hog futures are listed and traded on the KRX.

When it comes to trading volume in the Korean exchange-traded futures market, the trading volume of KOSPI200 options has been somewhat flattened recently. The trading volume of KOSPI200 futures, 3-year KTB futures and US dollar KTB futures has been on the rise.

KOSPI200 options represented 96.5% of total derivatives trades on the exchange in 2008. KOSPI200 futures accounted for 2.3%.

Meantime, since 2008, single stock futures, 10-year KTB futures and port futures were listed from 2008 onwards, but their trading volume, except for individual stock futures, has been sluggish.

Table 4-9 | Derivative Products listed on KRX

Date	Product Name	Underlying Asset	Classification
May 1996	KOSPI 200 futures	KOSPI 200	Stock price index(SPI)
July 1997	KOSPI 200 options	KOSPI 200	SPI
Apr. 1999	Won/dollar futures	US dollar	Foreign Exchange(FX)
	Won/dollar options	US dollar futures	FX
	CD rate futures	CD rates	Short-term interest rates(delisting)
	Gold futures	Gold	Precious Metal
Sep. 1999	3-year Korea Treasury Bond futures	3-year KTB	Mid-term interest rate
Jan. 2001	KOSDAQ 50 futures	KOSDAQ 50	SPI(delisting)
Sep. 2001	KOSPI200 futures spread	KOSPI200	SPI
Dec. 2001	KOSDAQ 50 options	KOSDAQ 50	SPI(delisting)
Jan. 2002	Stock options	7 stocks	Single stock
May 2002	3-year KTB options	3-year KTB	Mid-term interest rate
Dec. 2002	Currency stabilization bond futures	Short term(CS) bonds	Short-term interest rate
Aug. 2003	5-year KTB futures	5-year KTB	Mid-term interest rate
Sep. 2005	Stock options	23 stocks	Single stock
Nov. 2005	KOSDAQ STAR futures	STAR	SPI
June 2006	Japanese yen futures	Japanese yen	FX
	Euro futures	Euro	FX
Feb. 2008	10-year KTB futures	10-year KTB	Mid-term interest rate
May 2008	Single stock futures(15 issues)	Individual stocks	Stock
July 2008	Lean hog futures	Lean hog	Agricultural good

Source: KRX

Table 4-10 | Daily Average Trading Volume and Amount of Major Products on KRX

(contracts, in ten millions of KRW)

	Trading Volume			Trading Amount		
	2007	2008	Change(%)	2007	2008	Change(%)
KOSPI200 Futures	194,139	267,927	38.0	214,343	251,744	17.4
3-year KTB futures	55,102	64,325	16.7	59,150	68,830	16.4
US Dollar Futures	23,383	26,892	15.0	10,839	15,076	39.1
Futures Total	274,684	406,568	48.0	285,339	336,501	17.9
KOSPI200 Options	11,015,626	11,165,638	1.4	8,877	11,597	30.6
Total	11,290,310	11,572,206	2.5	294,216	348,098	18.3

Source: KRX(2009)

The breakdown of trading volume by investor type suggests that individuals constituted an increased portion of futures trades due to higher spot volatility following the global financial crisis. On the other hand, foreign investors as a percentage of KOSPI200 options trades rose greatly thanks to the adoption of algorithm trading.

As regard to 3-year KTB futures, securities companies and individuals as a percentage of trades increased 6.0% and 1.8% year on year, respectively, owing to a rise in interest rate volatility. Dollar futures saw a 4.3% yoy increase in the proportion of individual investors in total trades as foreign exchange rates became more volatile. However, dollar futures experienced a 8.3% drop in the portion of investment trust companies due to the sales of hedge positions associated with overseas investment funds.

3.3. Trading Structure of Derivatives Market in Korea

3.3.1. Characteristics of exchange-trade derivatives

In case of exchange-traded derivatives, contract specifications, which include trading unit, contract months and settlement methods, are standardized as the exchange's rules (business regulation for futures market). And the stability of transactions is high because the exchange acts as a central counterparty (CCP). Plus, safeguard measures such as daily settlement, reverse trading and margin have been put in place to mitigate the settlement risk arising from large gaps between the time a contract is made and the time settlement is made. Reverse trading is a trading system to make a buyer free from an initial binding contract even before the final day of trading to reduce trading losses. Daily settlement is a system in which futures are repriced daily to reflect the market's closing price, and the gain or loss resulting from this repricing is realized daily to make settlement amount smaller. This system ensures secure settlement. Margin is a cash collateral deposited by an investor with a trade or exchange, corresponding to the level of risks in a futures or options transaction when the investor submits an order. The exchange requires its members to keep the margin above a certain level all the times, given the risk level of that member's open interest.

3.3.2. Derivatives Trading System in Korea

A. Overview of Trading System

The Capital Market and Financial Investment Service Act requires the matters necessary for trading in the futures market to be prescribed as the exchange's business regulation for the derivatives market and compliance requirements for members upon derivatives trading to be stipulated as basic rules for a derivative contract. Enactment of or modifications to those regulation and rules are subject to the approval of the Financial Services Commission.

The business regulation for the derivatives market details derivatives trading methods and procedures, including trading volume, trading hours, final delivery date and method for execution of agreement for trades. On top of that, it sets forth the matters related to derivatives settlement, including method of settlement between the exchange and its member, member margin and margin payment method, and how settlement failures are handled. Furthermore, it also contains entrustment rules. These rules describe the method and procedure for entrustment of futures trading between a member and a customer, including the opening of derivatives account, entrustment terms and method, customer margin and margin payment method.

B. Membership

Under the Capital Market and Financial Investment Service Act, eligible members for derivatives trading are futures companies or securities companies that obtain an intermediary license for derivatives trading. Before the adoption of this act, securities companies were allowed to engage only in trading futures based on stock or stock indices. However, the new act allows financial investment companies licensed for derivatives trading and intermediary service to engage in all types of derivatives trades.

The derivatives exchange has two types of membership: clearing member and non-clearing or trading member. A clearing member refers to the membership of a clearing house that clears for its own account as well as on account of its client, trading member. A trading member refers to a member who entrusts a clearing member to clear their futures trades.

C. Derivatives Trading Procedure

Derivatives trading process is as follows:

Table 4-11 | Derivatives Trading Process

Process	Description
Opening of Account	An investor opens a futures and options trading account at a security company or futures company, apart from a stock (spot) trading account. A member provides the investor with leaflet describing the overview of futures and options trading and the related risks.
Payment of Margin	The investor must pay margin in advance to submit an order for futures and options trading after opening the account. Eligible institutional investors may pay margins after the trade is executed. Initial deposit must be paid for trading stock-related products. Substitute securities may be used to pay the initial deposit in full and may be used to pay member margin. Yet, no initial deposit is necessary for an ex-post margin account, option buying account or KTB account.
Submission of an order	The investor submits an order in writing, by telephone or via electronic communication tools to the member, and then, the member passes it to the exchange.

Trade execution and notification	The order of the investor passed to the exchange(quote) is executed by the exchange's trading execution system according to the principles of trade execution, price priority, time priority and others. The results of the trade execution are immediately notified to the member securities company or futures company. The member passes the results to the investor.
Daily mark to market settlement	Once the market closes, the securities company or futures company conducts daily mark to market settlement based on the closing price that day. Gain or loss arising from daily settlement is reflected in the deposit of the investor. The deposit amount falls below the level of maintenance margin, the investor must pay variation margin by the next day.
Offsetting and final settlement	Offsetting sale or purchase refers to the method of settlement intended to offset a previously established long or short position by selling or buying the same type and number of securities before the last trading day. Where the investor has open interest in an expired contract, the trading process is completed when final settlement is made for the open interest via predetermined cash settlement or physical delivery.

D. Details on KRX Derivatives Trades

When a derivative product is listed, a basic contract size is set to expedite the trading of such a product. The contract size of derivatives being traded on KRX is as follows:

Table 4-12 | Underlying Asset and Trading Unit of KRX-listed Derivatives

		Underlying Asset	Trading Unit
Stock products	KOSPI200 futures	KOSPI200	KOSPI200 × KRW 500,000
	STAR index (KOSTAR) futures	STAR index	STAR index × KRW 10,000
	KOSPI200 options	KOSPI200	KOSPI200 × KRW 100,000
	Stock options	30 listed stocks	underlying stock price × 10
Interest rate products	3-year KTB futures	Standard KTBs with a par value of KRW 100, a maturity of 3 years, an annual coupon rate of 8% and semi-annual interest payment	Par value of KRW 100 mil.
	5-year KTB futures	standard KTBs with a par value of KRW 100, a maturity of 5 years, an annual coupon rate of 8% and semi-annual interest payment	Par value of KRW 100 mil.
	Currency stabilization bond futures	364-day currency stabilization bonds issued by Bank of Korea	Par value of KRW 200 mil.
	CD futures	91-day certificates of time deposits	Par value of KRW 500 mil.
	3-year KTB futures options	3-year KTB futures	1 3-year KTB future contract
	USD futures	US Dollar	USD 50,000
	Yen futures	Japanese Yen	J ¥ 5 mil.

Currency products	Euro futures	Euro	EUR 50,000
	USD options	US Dollar	USD 10,000
Commodity products	Gold Futures	gold bar of 99.99% purity	1Kg

Source : BNVP

Contract month means a month in which a futures contract matures as the final day of trading arrives. It is also called delivery month. KOSPI200 futures have four delivery months; March, June, September and December. Each futures contract is traded for one year till the contract month arrives. When the last trading day arrives and the trading of an expiring futures contract is completed, a new futures contract is listed to ensure that KOSPI200 futures have four contract months.

There are two types of trading hours for futures and options contracts: trading hours on weekdays and trading hours on the last trading day. After the adoption of one futures market, weekday trading hours for derivative products, except for stock products, are extended 15 minutes. As a result, the trading hours are between 9:00 and 15:15, the same for all derivatives. Yet, futures spread trading hours are between 9:00 to 15:05 because only multiple price auction is allowed. Quotes can be submitted from 60 minutes before the trading begins until the trading hours are over. The trade is executed at a single price between 8:00, the time when the submission of quotes starts and 9:00, and between 15:05, the time when the market closes and 15:10. The trade is executed at multiple prices between 9:00 and 15:05. On the final day of trading, each derivative product has different trading hours, given the characteristics of that product, depending on the settlement method and the processing time after the market closes. The trading hours for stock products on the last trading day are between 9:00 and 14:50. The trading hours for other products are between 9:00 and 11:30. Meanwhile, trading hours for futures spread trades are the same as multiple-price auction hours for products whose final trading day arrives. Trade execution at the time when the market closes on the last trading day, is completed in the form of multiple-price auction for products, such as stock and interest rate products, settled by an exchange of cash, or in the form of a single-price auction for products such as currency and commodity products, settled by physical delivery.

Table 4-13 | Trading Hours by Product

		Weekday	Final Trading Day
Stock products		09:00~15:15	09:00~14:50
Interest rate, currency and commodity products			09:00~11:30
Stock products	Stock products	09:00~15:05	09:00~14:50
	Interest rate products		09:00~11:30
	Currency and commodity products		09:00~11:20

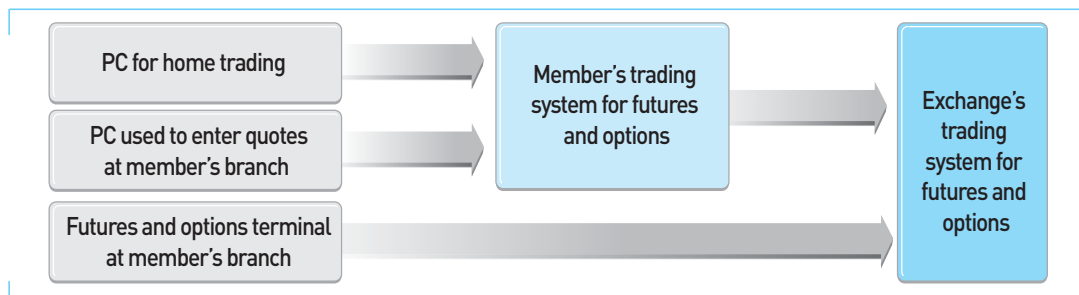
Note: 1) Quotes are received between 60 minutes before the trade begins and the end of the trading hours.

E. Hours for spread trading are the same as those for quote submission.

A quote or quotation refers to the behavior of a member to express its intention to buy or sell on the exchange. It is in contrast to the concept of an order made by a client to express its intention to buy or sell to a member. The quote submitted is considered effective from the receipt of the quote until the trading closes the same day. Quotes can be submitted between 60 minutes before the start of the trading hours and the end of the trading hours.

A quote can be submitted in the following three ways: ① an investor enters a quote into the exchange's trading system for futures and options via home-trading PC linked to a member's trading system for futures and options; ② an employee of the member puts a quote in the exchange's trading system for futures and options via PC used for quote submission in the member's trading system for futures and options; or ③ a quote can be entered directly into the exchange's trading system for futures and options via the member's terminal for futures and options. When entering a quote, it is not necessary to indicate if it is intended for selling, liquidation, buying or redemption. Only bid or offer needs to be indicated.

Figure 4-5 | Method of Entering Quotes



Quote price unit or tick size refers to the minimum price value and quote quantity unit or lot size refers to the minimum quantity to be ordered. The exchange determines tick size and lot size, considering the convenience of trade and the speed of trading execution. The smaller the tick size is the more sophisticated and detailed investment strategy an investor can employ. However, the smaller tick size could give rise to inefficiency in the operation of the market, such as a delay in trade execution via the system.

KRX set price limits on quotes by product to promote fair futures market prices, prevent investors from suffering damage or loss due to sharp price fluctuations, and avoid error trades. For futures trading, upper and lower price limits are set relative to base price (limit price in case of interest rate, currency and commodity products). Base price is the theoretical value consistent with tick size on the day when the trade commences for the first time. Once the trade takes place, the base price is the prior day's settlement price.

Table 4-14 | Tick Size, Lot Size by Product

	Tick Size	Lot size	Limit on Quote Quantity
KOSPI200 futures	0.05p	1 contract	1,000 contracts or less
STAR index futures	0.50p	1 contract	1,000 contracts or less
KOSPI200 Options	Less than 3p: 0.01p	1 contract	5,000 contracts or less
	3p or higher: 0.05p		
Stock options	KRW 10 in case where quote price is less than 1,000;	1 contract	5,000 contracts or less
	KRW 50 in case where quote price is higher than		
	KRW 2,000, but less than KRW 1,000;		
	KRW 100 in case where quote price is higher than		
Interest rate futures	KRW 5,000, but less than KRW 10,000; and KRW 200		
	in case where quote price is higher than KRW 10,000		
Interest rate futures	0.01	1 contract	1,000 contracts or less
3-year KTB futures options	0.01	1 contract	5,000 contracts or less
Currency futures	KRW 0.1(KRW 0.1 per JPY 100)	1 contract	1,000 contracts or less
US dollar options	KRW 0.1	1 contract	5,000 contracts or less
Gold futures	KRW 10(the price is quoted in KRW per gram)	1 contract	1,000 contracts or less
Futures spread	tick size of futures contracts making up futures spread	1 contract	N/A

In case of options trading, no price limit range is set because an option price fluctuates tens or hundreds times during the day. Yet, limit price is set to prevent error trading. Thus, the quote, which is not within the limit price, is not received.

F. Management of Derivatives Market

The exchange stops trades at its own discretion if normal trading activities are impeded by failure occurring on the exchange's trading platform for futures and options, its member's system or the stock market's IT infrastructure. It is called "Discretionary Halting of Trade".

The exchange may suspend or cease all the trades of the issue associated with any of the following:

- trades cannot be normally executed because of the failure of the exchange's trading system or the member's trading system for futures and options.
- it is not possible to trade more number of constituents of stock price index than the number specified (100 issues for KOSPI200 and 15 issues for STAR Index) because system failure in the stock market lasts for 10 minutes or more
- Trading of underlying asset is suspended in case of stock options;
- Trading of any of two futures contracts constituting futures spread is suspended in case of futures spread trading.

The exchange may resume the trading when the cause of a trading halt or suspension has been resolved. An initial price upon the resumption of the trading is determined by individual auction at a single price.

There is also compulsory halting of trading (circuit breaker system) in place to ensure balance between spot and futures prices. Circuit breakers refer to a system that temporarily suspends all the trading in the market in order to provide investors with a cooling-off period to help them to make a rational investment decision where stock futures price fluctuates excessively.

Where the execution price of a futures contract, of which prior-day trading volume is the largest (take the first month contract if there are more than two issues) 5 minutes after the time for single price quotation on the stock market ends, continues to be 5% higher than base price in case of KOSPI200 futures, 6% higher or lower than base price in case of STAR futures, or 3% higher or lower than the theoretical value for one minute or longer, the trading of the that futures contract is suspended for five minutes (the suspension of trading KOSPI200 futures includes KOSPI200 options, and KOSPI200 futures spread, and the suspension of trading STAR index futures includes STAR index futures spread).

A circuit breaker can be triggered only once a day. Yet, if the trading on the stock market is suspended after suspending or resuming trades due to a steep rise in futures price, the trading is halted again. However, the circuit breaker is not triggered after 14:20 the same day.

G. Settlement of Derivatives Trades

Final settlement is made between a clearing member and an exchange or between a trading (non-clearing) member and its designated clearing member for open interests that have not been closed out by the end of trading hours on the final trading day. Cash settlement or physical delivery is used as set out in each product. In cash of cash settlement, open interests that are valued at the settlement price on the final trading day (the closing price of futures) through daily mark to market settlements are measured again to produce the final settlement price on the final trading day. Gain or loss arising from such revaluation is the final settlement difference. In case of physical delivery, the amount of final settlement, which is calculated based on final settlement price (settlement amount on the last trading day), and underlying asset (currency futures: foreign currency, gold futures: gold bar) are delivered and received.

H. Member Margin

Member margin is the amount of money that is deposited with an exchange by a clearing member to guarantee contract fulfillment related to proprietary trading of derivatives trading (including those of a trading member and customer). It is collected and deposited ex-post and is computed based on all open interests. Therefore, the method of calculating such margin is the same as that of computing member margin for net exposure of open interest in futures or

options. Part of customer margin can be used to pay a member margin.

A clearing member shall deposit with the exchange a margin per account which is no less than the maximum net loss to be suffered in the event that the price or quantity of underlying asset fluctuates by a certain level. Each account is considered as one portfolio to measure its total risk. A margin is calculated to cover the total risk. In this way, a member margin is computed via composite optimized margin system (COMS), which adopts portfolio risk-based approach.

By product, margins include margin for option premium, margin for price movement in futures or options, margin for futures spread, and margin for physical delivery. Unlike customer margin which is paid upon making an order, member margin is ex-post margin that needs to be paid by 12:00 the next day after margin calculation is done. Substitute securities or foreign currency may be used instead of cash to meet the margin requirement.

KRX's COMS (Composite Optimized Margin System) is a portfolio risk-based margin system used to compute potential risks arising from open interests in futures and options trading. Its features are as follows: i) automatic deduction of open interest while selling and buying of the same issue (having both long and short open interests of the same contract is no longer allowed), ii) offset of margin on the open interests of the same underlying asset; and iii) partial offset of margin on the open interests of different types of underlying assets in the same product group [given offset ratio between different types of underlying assets in the same product group].

3.3. Factors Invigorating Derivatives Market in Korea

3.3.1. Factors Invigorating Derivatives Market in Korea

In general, the degree of volatility in underlying assets is the most critical success factor because it determines the need to hedge risks from a derivatives market and the level of market attractiveness to speculative traders. High volatility in the Korean stock market is one of driving forces behind the growth of the KOSPI200 futures and options markets into an internationally competitive market.

Furthermore, the size of the underlying asset market is also vital. If a derivatives market is created in a rush despite an immature spot market, it is difficult for such market to come to stay. Korea has an active market for stock derivatives. The introduction of rational trading system helped to vitalize the derivatives market.

The qualitative level of market participants is very important in the process of introducing derivative products. The level of financial market development is judged by the proportion of institutional investors participated in the market. In this sense, one of the factors determining the success of a derivative product is the market participation of producers and consumers who have substantial interests in such a derivative product. In Korea, there are a wide range of investors with various appetites, including speculative traders. This contributed greatly to stimulating the derivatives trading.

The level of market liquidity is also critical to the derivate product in its early phases. Existence of market maker function, speculative trades as a percentage of total trades and more are the basic elements underpinning the stable growth of that derivative product in the market. In addition, product diversity that can meet the needs of different investors is another success factor of a derivative exchange. In case of Korea, the active and liquid stock market gave a boost for stock derivatives trading. In other words, there are various needs for stock trading risk or speculative trading. Such needs ultimately provided large liquidity to the market.

In practice, a minimum trading requirement can be satisfied when the economic risks arising from the production and consumption process are created and commercialized as an exchanged-traded product.

The last factor essential to the success of a derivatives market is a financial regulator's commitment to a derivatives market. Only if the financial regulator has positive views on the economic function of a derivative market, it is possible to see market-friendly improvement in institutional framework for the market.

3.3.2. Challenges facing Korean Derivatives Market

The biggest challenge confronting the Korean derivatives market is that the trading volume of exchange-traded derivatives in Korea has been stagnant since 2003 whereas derivatives trading volume in developed and emerging markets have shown continued growth. And another challenge is that among exchange-trade derivatives, except for KOSPI200 futures and options, other derivatives markets are not active. Plus, in terms of product diversity, the Korean derivatives exchange offers a very limited range of derivative products compared to other derivatives exchanges. Thus, with the adoption of diverse derivatives, criteria for weeding out sluggishly traded products need to be established.

4. Ways to Establish Securitization Market in Indonesia

4.1. Current State of Capital Markets in Indonesia

4.1.1. Capital Market Conditions

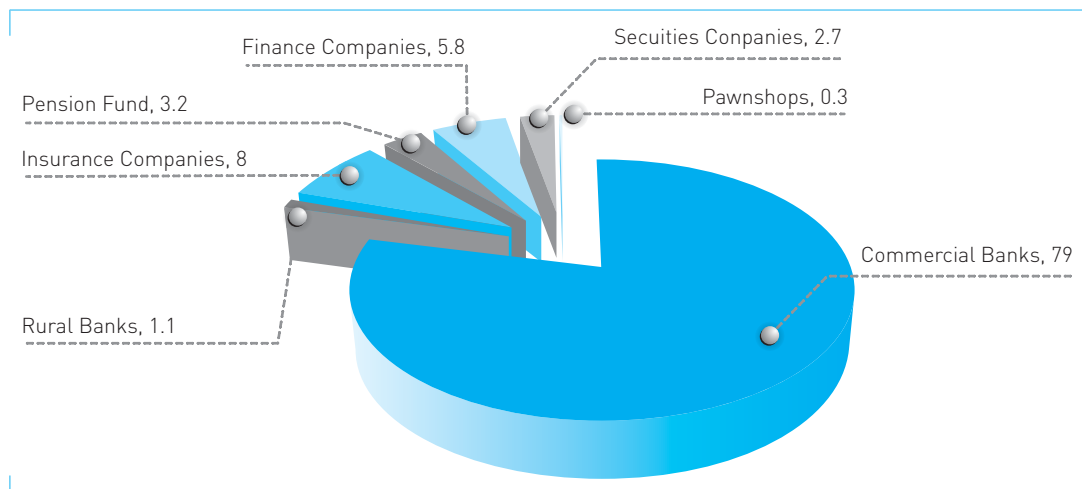
As with other Asian countries, Indonesia has a bank-centered financial system. Under the Law of the Republic of Indonesia No. 14 of 1967, banks are classified into commercial banks, development banks, depository banks, co-operative banks and rural banks by business activity. Meantime, under the Law of the Republic of Indonesia No.7 of 1992, banks are classified into commercial banks and rural banks by function, and sharia banks by business activity.

A non-banking institution is defined as a corporate entity that mobilizes funds from the public through securities issues and channels them to invested companies. Non-banking institutions can raise funds directly from the public by issuing the certificates of deposit and expand investment in invested assets and companies.

Regulations on capital markets in 1995 laid the regulatory groundwork for capital markets in Indonesia. These regulations require all securities trades to be conducted by securities companies.

Banks' assets stood at USD 232.7 billion as of March 2009, representing 80% of the country's financial assets. Top 10 banks in Indonesia showed high market shares, measured by banking assets. Before the Asian financial crisis, banks exhibited strong growth in Indonesia. However, the financial crisis produced a run on bank deposits, leaving them in a liquidity shortage. Many banks underwent restructuring.

Figure 4-6 | Assets of Indonesian Financial Institutions



Source: Bank Indonesia, Financial Stability Review, March 2009

The loan portfolios of banks in Indonesia suggest that loans are primarily originated for the purpose of investment in working capital, investment or consumption. Consumer lending recorded the highest growth rate. Also, corporate lending displayed large growth but smooth money supply to the corporate sector is deemed to be limited.

In the financial regulatory structure of Indonesia, Bank Indonesia (BI) has the authority to regulate and supervise the banking sector while BAPEPAM has the power to regulate the non-banking sector.

4.1.2. Current State of Bond Market

In general, asset-backed securities (ABS) are issued in the form of bonds or beneficiary certificates. For that reason, bond market development provides an important impetus for ABS market development. In a well-developed bond market, ABS can be issued and sold in the form of bonds backed by various types of assets. Furthermore, a CDO market backed by a pool of bonds can also be developed.

The Indonesian bond market consists of two components: government bond and corporate bond markets. Further, the government bond market is comprised of government securities and government Sukuk.

The Indonesian bond market was created as the issuance volume of government bonds grew. Since then, the government bonds have continued to dominate the market. When the bond

Figure 4-7 | Outstanding Bonds in Indonesia



Source: Indonesia Stock Exchange (IDX)

issues increased substantially in 2002, outstanding government bonds reached IDR 398 trillion. By the end of June 2009, the outstanding balance of government bonds was IDR 553 trillion.

Meantime, the corporate bond market grew gradually from 2003 onwards and stood at IDR 86 trillion at the end of 2008.

In the secondary bond market, the trading volume of bond decreased 22.45% from IDR 68.57 trillion in 2007 to IDR 53.18trillion in 2008. The average daily trading volume of government bonds and corporate bonds were IDR 3.9 billion and IDR 0.2 billion in 2008.

As described above, the Indonesian bond market has seen a drastic increase in issuance since 2002. However, the secondary bond market is relatively weak.

4.2. Current State of Securitization Market in Indonesia

4.2.1. Legal Grounds for Asset Securitization

Legal base for issuing asset-backed securities (ABS) was established by the adoption of BAPEPAM-LK Rules concerning ABS issuance. The established legal grounds are as follows:

- Rule No. IX.K.1: Guidelines for Asset Backed Securities Collective Investment Contracts
- Rule No. V.G.5: Guidelines concerning ABS investment
- Rule No. IX.C.10: Guidelines of Form and Content of Prospectus for a Public Offering of Asset Backed Securities
- Rule No. VI.A.2: Functions of Bank Custodians Related to Asset Backed Securities
- Rule No. IX.C.9: Registration Statement for Asset Backed Securities Public Offering

As seen above, rules concerning contracts, investment, prospectus and asset custody exist with respect to ABS issuance. For public offerings of ABS, ABS issuance is required to be registered. Meantime, there are rules regarding loan delinquency and bad debt loss in the Indonesian bankruptcy law in relation to the treatment of an obligor's bankruptcy and delinquency. However, unlike Korea, comprehensive securitization rules are not yet to be established.

When essential procedures for bond issuance are taken care of, the next step is a company which desires to issue bonds registers with the stock exchange. BAPEPAM conducts a listing eligibility review on that company. If the company gets a green light from BAPEPAM after the eligibility review, it should file an issuance registration statement and goes through a listing process. Then, it can issue bonds.

As for the regulatory framework for the bond market, BAPEPAM is a securities regulatory authority responsible for supervision and oversight of bond issuance. Especially, BAPEPAM set

standards for the registration of an issuer and the listing of bonds and put them in place. As well, it established regulations on trustees and credit ratings. Regulatory mechanisms and tools are put in place for all issuance-related activities in the Indonesian bond market.

Major laws and regulations concerning the bond market include the Capital Market Act (1995), which is a basic law for the securities market, the Government Securities Act (2002) regarding government bond issuance, and the Bonds Transaction Tax Regulation (2009) under which 15% tax is levied on interest income on bonds. In addition, regulations on the secondary bond market include the Bonds Transaction Reporting Regulation (2006), under which transaction details should be publicly disclosed within one hour after such a transaction is made, and the Primary Dealers Regulation (2007), which provided the legal basis for the adoption of primary dealer system. Under this law, 18 primary dealers are required to provide the market with two-way quotation for government bonds. In addition, there are also rules for clearing and settlement of bonds.

The characteristics of the bond market in Indonesia are that government bonds are issued in three forms of fixed rate bonds, floating rate bonds or zero coupon bonds, as well as in the form of Islamic bonds (sukuk). As for corporate bonds, bonds have maturities of one or more years. However, the corporate bond market is small in size. Meanwhile, central bank policy rates and government bond interest rates are used as base rates, in the corporate bond market.

4.2.2. ABS Issuance in Indonesia

In 2008 in Indonesia, there was one ABS issuance of IDR 91 billion and the originator was PT bank Rakyat Indonesia. The underlying assets of the deal were mortgage loans and the Moody’s Indonesia rated that ABS deal.

In Indonesia, there were several securitization transactions, backed by auto installment receivables and credit card receivables held by finance companies and banks, from 1996 through 1997. As the performance of some underlying assets deteriorated after the Asian

Table 4-15 | Cross-border ABS Issuance

Company	Loan type	Year
Citibank NA	Credit card	1995-1997
PT. Astra Sedaya Finance	Auto loan	June 1996
PT. Bunas Finance	Auto loan	Feb 1997
PT. Astra International Tbk.	Car loan	June 1997
PT. Bank Bira, Tbk.	Auto loan	March 1997
PT. Bank International Indonesia	Credit card	July 1997
PT. Putra Surya Multidana Tbk.	Auto loan	Oct 1997

financial crisis, overseas investors showed less preference for ABS deals in Indonesia. Consequently, there was almost no cross-border ABS issuance after the Asian financial crisis.

As the legal and regulatory framework for securitization established and the securitization market develops, consumer finance receivables are highly likely to become a popular asset class.

4.2.3. Challenges Facing Securitization Market in Indonesia

In Indonesia, the securitization market has barely been developed despite demand for securitization of consumer finance receivables and mortgage assets held by banks.

In order to vitalize the securitization market, it is important to keep diverse investors and institutions, which have assets beyond a certain level.

On the originator's side, the asset size of individual financial institutions is relatively small in Indonesia. Except for commercial banks, other financial institutions are small in size so that they do not have sufficient quantity of assets to undertake a securitization transaction. This result only a handful of financial institutions could enjoy the effect of lower funding costs through massive ABS issuance. What is more, due to the bank-centered financial system, corporate and financial institutions rely on banks for funding. These create obstacles to the invigoration of the securitization market.

A primary reason behind the inactive securitization market is the weak investor base for the bond market. Vitalizing the securitization market requires the presence of investors with diverse appetites for risk and yield. However, in Indonesia, the bond investor base is not substantial in size, which undermines the development of the securitization market.

Along with that, the lackluster underwriting operations of securities companies are an impediment to the market development. Securities companies are not relatively large in size and their investment banking operations are not robust. Accordingly, these circumstances make them difficult to provide services to meet various issuance needs, which creates a major obstacle to the vitalization of the securitization market.

In addition, the infrastructure surrounding ABS acts as a constraint to the securitization market. Accumulated data on asset performance is not sufficient. Further, there is no disclosure system.

Highly volatile asset performance presents yet another constraint to ABS issuance. As asset performance such as delinquency rate fluctuates sharply depending on financial market conditions, the prospect of drastic change in the creditworthiness of ABS is increased.

Accordingly, excessive credit enhancement is demanded, which may cause a problem.

Despite the existence of BAPEPAM's securitization-related rules, there are no legal grounds to provide a futile foundation on which the securitization market can grow, which limit the securitization market to become active. The existence of securitization law would help greatly reduce the legal risks associated with securitization. Therefore, the formal articulation of legal grounds may be very critical to invigorate the securitization market.

Financial institutions in Indonesia have plenty of mortgage assets. Accordingly, demand for securitization is high down the road. Among other things, the necessity of funding via securitization structure is on the rise due to the robust consumer finance and housing finance sectors. Plus, there is a need for adopting CDO structure as a way to introduce the funding structure for smooth SME funding.

4.3. Ways to Stimulate Securitization Market in Indonesia

4.3.1. Precondition for Active Securitization Market

To make the securitization market active, ABS issuance offers various benefits to originators and investors. Above all, from the originator's perspective, the securitization market enables originators to raise funds efficiently at low costs by issuing ABS. In case of Indonesia, there is no efficient market because the bond market is underdeveloped. For that reason, the bond market needs to be vitalized for the active securitization market.

And securities companies need to improve their expertise in ABS issuance. Securities companies play the role of measuring asset performance, designing securitization structures based on such performance assessment, and selling ABS to market participants. In Indonesia, securities companies are engaged primarily in stock brokerage business. Therefore, they need to secure staffs specializing in the design of securitization structures, asset analysis, and so forth.

Moreover, they must enhance their advisory capability for efficient funding by expanding their business volume and beefing up intermediary service. On top of that, the bond investor base needs to be widened. Large institutions such as banks should be encouraged to make active investment in bonds. Long-term institutional investors, including pension funds, need to get bigger in size and become more active in bond investment. They will provide are the ways to expand the demand base for ABS.

The larger size of originators and the need for diversification of funding sources are emerging as key factors fostering the ABS market. Especially, if financial institutions specializing in consumer finance grow in size, the need for diverse funding sources will increase, which, in turn, will give a boost for the securitization market.

4.3.2. Policy Improvement

To create and nurture the securitization market in Indonesia, it is necessary to consider the adoption of securitization law, like Korea. Through the enactment of securitization law, systems which enhance confidence in securities and enable the proactive participation and supervision of regulators will be established. Securitization law should encompass the basic concept of asset securitization, the issuance structure, the roles of participants, the issuance procedures, the characteristics of ABS and the disclosure structure. If securitization law is enacted, various obstacles to securitization could be overcome and efficient regulatory system for the securitization market could be put in place. Also, legal risks would be markedly mitigated thanks to higher predictability of regulations on securitization, thereby contributing greatly to animating the securitization market.

Plus, the adoption of the securitization market needs to be prepared by enacting laws to improve the existing financial market system. To establish regulatory mechanisms for the securities market, it is necessary to enact law concerning financial supervision on the securities market and securities companies, in addition to the existing laws such as the Central Bank Act, the Act on Audit of Government Agencies. In terms of securities exchange, it is necessary to introduce laws on the adoption of collective investment vehicles, securitization, registration of securities, and regulation of securities companies, in addition to the implementation of the securities exchange-related law that Indonesia is pushing for.

For the securities market infrastructure, it is necessary to adopt law on protection of financial consumers and investors as well as strengthen provisions about securities transactions in the existing civil law, commercial law and bankruptcy law.

Better taxation system such as income tax on bonds can be one of key factors fostering the securitization market. In Korea, various tax benefits were given at the early stage when the institutional framework was introduced. That measure contributed to the development of the market. It would provide significant implications for the invigoration of the securitization market in Indonesia.

4.3.3. Establishment of Securitization Infrastructure

Invigorating the ABS market requires the infrastructure for asset valuation, asset transfer and the set-up of a special purpose company. Additionally, key infrastructure, such as credit ratings and disclosure system, needs to be improved.

For efficient ABS issuance, investors' exclusive rights to the assets transferred to the SPC have to be recognized. However, there are no legal grounds for such recognition in Indonesia. Thus, it is necessary for Indonesia to introduce the legal framework for the efficient creation of a SPC and the bankruptcy-remoteness of transferred assets.

With respect to valuation, it is necessary to collect enough data on various characteristics of asset classes in order to accurately estimate cash flows from underlying assets and issue securities based on such estimation. To that end, financial institutions that own assets should have more sophisticated risk management systems as well as the disclosure system for those assets.

Furthermore, sophisticated credit ratings are required. For ABS, the role of a credit rating is very important. In Indonesia, there are credit rating agencies that were set up as a joint venture with foreign rating agencies. However, their experience in rating ABS deals seems to be insufficient. Thus, they need to learn diverse analytical techniques through alliances with global rating agencies.

Disclosure system fitting the features of ABS should be introduced to vitalize ABS issuance. For Indonesia, electronic disclosure system needs to be improved. Among other things, establishing a system for disclosure of asset performance, along with the adoption of institutional framework for securitization would ensure the efficient disclosure of asset characteristics, securitization structure, tranche, credit enhancement, asset pool performance and more.

If credit enhancement providers exist, high quality securities issues can be created. A credit enhancement provider may be a public guarantee company or a monoline insurance company. In a country with an active ABS market, monoline insurance companies act as a credit enhancement provider. However, it is more efficient to have public guarantors as a credit enhancement provider in a still maturing securitization market. Therefore, new measures are required to encourage public guarantors to improve their ability to analyze ABS and participate in ABS deals as a credit enhancement provider.

5. Ways to Stimulate Derivatives Market in Indonesia

5.1. Necessity of Derivatives Market Condition

5.1.1. Necessity of Active Derivatives Market

A derivatives market enhances efficiency in the financial market and has large ripple effects on other financial segments. Derivatives markets in the world have shown dramatic growth with ceaseless technology innovations. However, proper regulatory framework for derivatives, market climate for market participants and investor training are preconditions to allow a derivatives market to take root in the financial system and contribute to the financial market development.

The sound development of a derivatives market requires the establishment of effective oversight mechanism. Efficient approach to market oversight is necessary to create a reliable derivatives market and broaden an investor base for derivatives.

5.1.2. Current State of Derivatives Market in Indonesia

Milestones in the history of the Indonesia Stock Exchange are as follows: In 1995, Surabaya Stock Exchange (SSX) and Jakarta Stock Exchange (JSX) were recognized as a self-regulatory organization by Indonesia’s Capital Market Law No. 8. JSX introduced the automated trading system in 1995, scripless trading in 2001 and remote trading system in 2002. Such improvement in trading systems resulted in remarkable growth. In late 2007, JSX and SSX were merged and reborn as the “Indonesia Stock Exchange (IDX).”

Table 4-16 | Futures Contract Terms in Indonesia

Code of Contract	LQ 45 contract shall be LQFSX-YYMM YY is the symbol of year, MM month.
Underlying	Underlying applied shall be LQ 45 Index that is calculated and published by Jakarta Stock Exchange.
Multiplier	LQ 45 contract shall be Rp 500,000.00 (five hundred thousand Rupiah) per index point.
Price Fraction	0.05 (zero point zero five) index point
Contract Month	Spot Month, Second Month
Trading Hours	Monday-Thursday Session I : 09.15-12.00 WIB Session II: 13.30-16.15 WIB Friday Session I : 09.15 - 11.30 WIB Session II: 14.00 - 16.15 WIB
Last Trading Day	The Last Trading Day shall be due date of the contract that constitutes the last Exchange Day for contract trading.
Transaction Cost	Transaction cost shall amount to Rp 8,000.00 (eight thousand Rupiah) per contract, and clearing cost shall amount to Rp 7,000.00 (seven thousand Rupiah) per contract.
Daily Settlement Price	Daily Settlement Price of Securities Future Index Contract shall be calculated from the average of 12 (twelve) prices, consisting of 6 (six) prices of Securities Index at Underlying market and 6 (six) prices of Securities Future Index Contract at the Exchange resulting from the price/figure within the last 60 (sixty)minutes of trading at Underlying market and regular futures market.
Final Settlement Price	Final Settlement Price shall only be calculated based on the average of Securities Index within the last 30(thirty) minutes on the last Trading Day at Underlying market, by taking Securities Index every 5(five) minutes to obtain 6 (six) index points.
Max Daily Fluctuation	6 point index from the previous settlement price
Initial Margin	Rp 3.000.000,00 (three million Rupiah) per open contract

Stocks, bonds and derivatives are currently traded on IDX. 396 firms were listed on the Indonesian stock market as of the end of 2008. The market capitalization of listed companies stood at IDR 1,064 trillion. IDX composite index reached a record of 2830 in January 2008, but fell to 1111.39 in October 2008 due to the global financial crisis. The derivatives listed on the exchange are single stock options, but their trading volume is low. The trading volume was merely IDR 585 million in 2008.

As described above, the lack of exchanged-traded derivatives in Indonesia is primarily attributed to the fragile base of investment in stock and derivatives in the capital markets, the low awareness of such products among market participants and the weak function and role of securities companies.

70 to 80 percent of the Indonesian stock market relies on foreign-owned securities companies as the market is dominated by foreign-owned investment banks. The number of stock investors is about 300,000, which indicates the narrow investor base. 120 securities companies are IDX members. And investment instruments are not diverse.

LQ45 Index futures are traded in Indonesia. LQ45 is the simple average price of 45 representative stocks listed on IDX. LQ45 contract shall be IDR 0.5 million per index point with tick size of 0.05 point. As for LQ45 Index futures trades in Indonesia, the upper price limit is 6 points above base price and the lower price limit is 6 points below base price. Historical data shows that fluctuations exceeding 6 points have been frequent in the Indonesian stock market. This implies that , the futures market has not been functioned well as a hedging tool. As a result, the trading volume of the futures market is very poor.

In Indonesia, American-style stock options are traded. Underlying assets are 20 stocks. Contract size is 10 shares and settlement by physical delivery is carried out. In the stock option market, when the price of underlying instrument is up or down 10% from the prior-day price, a stock option is exercised through automatic offsetting transaction.

This constraint has caused the stock option market in Indonesia to record a continued decline in trading volume. The trading volume of stock options dropped from 5,772 contracts in the second quarter of 2007 to 1,843 contracts in the third quarter of 2008.

5.2. Constraints to Introduction of Derivative Product in Indonesia

5.2.1. Investor Base

In Indonesia, the financial market is bank-dominated and Individual investors are not active players in the stock market. These are stumbling blocks to invigorating the derivatives market.

When it comes to the investor base, 60% of population in Indonesia is concentrated in Java Island, with Jakarta as the most densely populated area. Nevertheless, only 1 million people participate in trading on IDX.

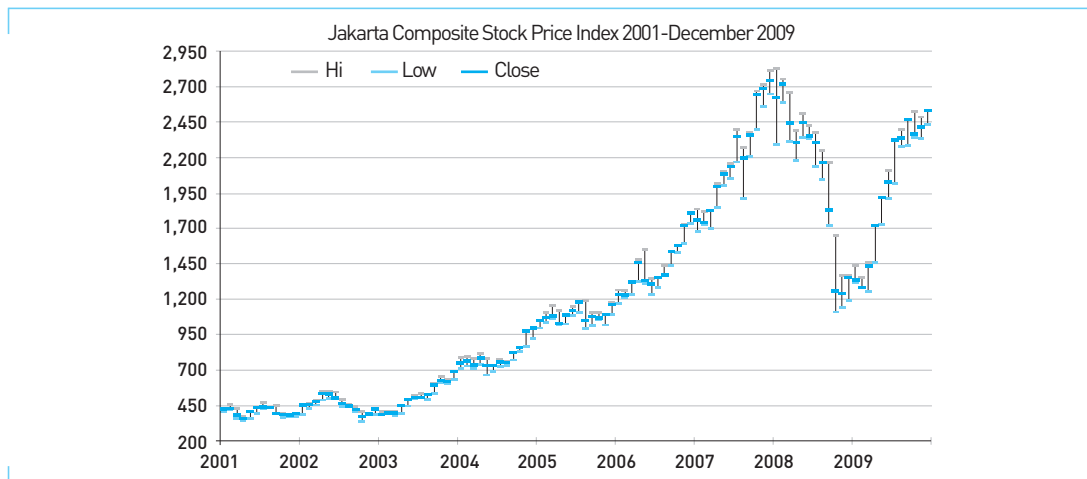
In terms of institutional investors, financial institutions do not actively invest in stock and derivatives which acts as a constraint on the expansion of the investor base for the derivatives market. This limited investor base is seen as one of major obstacles to the vitalization of the derivatives market.

5.2.2. Trading Volume of Underlying Instruments

To energize the derivatives market, the underlying assets trading should be active. However, the stock market is not active in Indonesia. The stock trading volume is low and the trading base is fragile. These give constraints on derivatives trades. The stock market cap was recorded at IDR 1076 trillion at the end of 2008, down 45.9% from the previous year due to repercussions from the global financial crisis. This market cap represented measily 0.2% of stock markets around the world. What is more, the average daily trading volume of the stock market is IDR 4,440 billion, which is lower than that of the major developed countries. The small size of the stock market is an impediment to the development of the derivatives market which is based on the stock market.

Meantime, the stock volatility is very high. Therefore, the need for hedge trades using derivatives is high.

Figure 4-8 | IDX stock market index



Source: Indonesia Stock Exchange (IDX)

5.2.3. Constraints on Market Systems

For LQ45 Index futures contracts, the limit on six points or more volatility of the index has been adopted in 2001. This limit still exists. The limit on price change could help to prevent speculative trades from being occurring. However, it also gives a heavy constraint on the futures market to grow.

In addition, an obstacle to the trading of stock options is automatic offsetting that is conducted immediately when the spot price changes 10% or more from the previous day's price. For that reason, stock options can play only a limited role in hedging the risk of price volatility in single stocks.

Along with that, another constraint on the vitalization of the market is high tax rate levied on derivatives trades. 2.5% tax rate is applied to initial margin for derivatives trading in Indonesia (the Indonesia Government Rule Number 17, 2009).

5.3. Ways to Vitalize Derivatives Market in Indonesia

5.3.1. Wider Market Base

The Indonesian government, among others, needs to show its policy commitment to nurturing the capital markets with diverse policies aimed at boosting the derivative market. In developed countries, various derivative products have emerged through the voluntary participation and understanding of market participants. However, in the countries that have relatively underdeveloped capital markets, the government's policies to build market systems and foster the capital markets are very important. In Korea, the government took the initiative to create a derivatives market and implemented various policies to vitalize it.

Moreover, to have the active derivatives market, the ways to expand the investor base needs to be considered. In Korea, the increased investments of individuals and companies in the capital markets and the expansion of such investors paved the way for the invigorating derivatives market. Especially, more investors with different appetites are necessary as an increase number of investors looking for hedging and a rise in speculative investors are critical to boost the derivatives market. In addition, the market for collective investment schemes should become active to have more institutional investors. Derivatives investments with diverse purposes should be created through the emergence of derivatives investment funds.

To expand the base of individual investors, it is necessary to actively educate individuals on the capital markets. In Korea, Korea Council of Investor Education was set up to beef up the investor training to offer programs to educate students and individuals on the capital markets. In case of Indonesia, educational programs for diverse groups should be developed and provided.

As well, it is advisable to adopt a policy to strengthen the explanation of products in the capital markets.

Furthermore, banks should be allowed to invest in derivatives. Since asset quality is vitally important to a bank's survival, it is necessary to allow banks to invest in stock and derivatives for hedging purposes.

5.3.2. Improvement of Market Systems

In order to facilitate the Indonesian derivatives market, it needs to define and adopt market-friendly terms and conditions for derivatives trading, which satisfy the needs of market participants.

Current price limits on LQ45 index futures need to be expanded. It is advisable to adopt new expanded price limits of 20% up or 20% down from the base index. However, it is important to remember that the very purpose of derivatives is to gain a tool to hedge against high volatility in spot trade. Given that, it is desirable to set the limit on price movement considering volatility in spot trade. An increase in the degree of price fluctuations could cause the depth of investors to be expanded by motivating investors with different purposes to participate in trades. Yet, if the price limits on futures are expanded, some speculative traders are likely to incur more losses. Future trades are likely to give rise to higher volatility in spot trades arising from price change. These potential problems could be addressed by the risk management system of individual investors. The problem of non-fulfillment of contract, which results from a rise in the degree of price movement could be mitigated by the margin system. For that reason, the higher degree of futures price changes is expected to create more positive impacts on the invigoration of the derivatives market than negative impacts.

In addition, if the current spot price is up or down 10% or more from the prior-day's price, offsetting transaction is automatically conducted immediately in case of stock options. Even in the stock option market, it is advisable to abolish the offsetting and, rather, strengthen measures to stabilize the market through margin and sidecar systems. Yet, it is necessary to establish options trading system in which ceiling and floor quote prices are set and quotes outside those prices are not accepted to prevent error trading.

Moreover, the taxation of derivatives should be revamped. It is advisable to cut a derivatives trading tax at an early stage and not to impose tax on income arising from derivatives.

6. Ways to Build Infrastructure for Capital Markets

6.1. Establishment of Institutional Framework

One of elements necessary to vitalize the securitization and derivatives markets is policy support. As for securitization, among other things, the enactment of securitization law is required to facilitate ABS issuance. It is important to lay the foundation for companies and financial institutions to raise funds without difficulties by formulating a law that governs securitization procedures, special exceptions for ABS issuance, special exceptions for the setup of a SPC, disclosure and so forth.

Furthermore, it is necessary to build the groundwork for due diligence and asset transfer. It is also essential to have in place simplified and streamlined procedures for perfection of asset transfer for ABS issuance. Due diligence is very important to identify the existence of assets to be securitized and assess the likelihood that cash flows will be generated by such assets. Thus, it is necessary to adopt a policy to define requirements for due diligence providers such as an accounting firm and strengthen their due diligence capability.

Meanwhile, an effort should be made to gain higher market efficiency for underlying instruments of derivatives. It is critical to create an environment in which the capital markets can be used as key investment tool by enhancing efficiency in the stock market and expanding the investor base. Moreover, the introduction of derivatives that are based on many different assets, other than stocks, may be considered. For instance, the diverse types of underlying assets that can be considered are foreign currencies, interest rates and commodities. The most significant elements in building such market are market efficiency and information transparency in the markets for underlying instruments.

6.2. Establishment of Infrastructure for Capital Markets

It is very important to have disclosure system in place to establish an efficient market. In Korea, the Financial Supervisory Service established the Data Analysis, Retrieval and Transfer System, DART, an electronic disclosure system in 1999 to enhance information efficiency with regards to the issuance of stocks, bonds, ABS and other securities. It is a comprehensive disclosure system that allows companies to submit disclosure information online while it becomes immediately available to investors and other users. DART has been firmly established as the efficient disclosure system, with the broader scope of securities subject to disclosure and better search system.

In addition, there is also ABS disclosure system in Korea. Detailed disclosure requirements were established regarding originators, SPCs, securities to be issued, and credit enhancement.

The ABS disclosure system allows users to know which originator has transferred assets to what structure and which type of securities have been issued. Plus, the ex-post performance of asset pools is also published. Thus, this ABS disclosure system enables investors invest in ABS based on disclosed information.

In Indonesia, the derivatives market is regulated by limits of price changes in derivatives. Instead of relaxing such limits, it is desirable to adopt monitoring system for unusual derivatives trades down the road. As for derivative products, various disclosure systems in relation to market conditions have been established while detection system for unusual trading activity has been in place to prevent market disturbance. Especially, there are monitoring system for arbitrage trading and unusual trading detection system in place.

For the sound development of securitization and derivatives markets in Indonesia, it is very important to promote sound trading in the markets and to establish disclosure system to enhance transparency at the same time.

When it comes to securitization, it is necessary to introduce securities filing system that provides accurate information on the characteristics of ABS and the likelihood of repayment. For the derivatives market, it is necessary to adopt system for ongoing monitoring of self-regulatory organization to detect abnormal trades and improve the security of trades.

Plus, settlement and clearing system and margin system need to be established to ensure more secure trading. It is necessary to build the systems to ensure that trading is executed based on the different preferences of investors and traders are held accountable for their trades. Such systems will help to strengthen confidence in the market and expand market participants.

6.3. Expansion of Market Participants

Indonesia is the country with the largest number of islands in the world. Thus, it is vitally important to come up with measures to enhance customers' access to the derivatives market. In Korea, investors enter orders into the exchange's trading system for futures and options, using home trading PC which is linked to their securities company' trading system for futures and options. The securities company's employee is commissioned to trade derivatives on behalf of investors. Direct quotation entry into the exchange's futures and options trading system is also available using the securities company's terminal for futures and options trading. Especially, the increased penetration of home trading system is deemed to have contributed greatly to broadening the retail investor base.

In case of Indonesia, the spread of home trading system could be considered as a way to expand the investor base. At an early stage, it is advisable to build home trading system for stock trades. Then, with the widening investor base, the scope of trading products needs to be

expanded gradually. Ultimately, home trading system for derivatives trading should be established.

When using the home trading system, investors sometimes make mistakes in the order entry process or execute the trades exceeding limits. Therefore, it is also important to put in place controls to prevent them.

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Developing Medium-term Expenditure Framework and Performance Budgeting System: Lessons from Korea and Their Application to Indonesia

- 1_ Introduction
- 2_ Medium-Term Expenditure Framework (MTEF)
- 3_ Performance Budgeting (PB)
- 4_ Summary and Concluding Remarks
- References

Developing Medium-term Expenditure Framework and Performance Budgeting System: Lessons from Korea and Their Application to Indonesia

Nowook Park (Korea Institute of Public Finance)

1. Introduction

1.1. Background of the Paper

Budget process reforms have been implemented among many OECD countries from mid-1980s up to present and they include introducing medium-term perspectives to fiscal planning and performance information into budget formulation. These reform efforts have been spreaded to emerging and developing countries under the auspices of international organizations, such as the World Bank, IMF and regional development banks. In many countries, budget process reforms are introduced in response to fiscal crisis, such as unsustainable growth of government spending accompanied by increasing public debt. These efforts are intended to impose fiscal discipline based on long-term pictures of fiscal situation in the country and to maintain quality of public services while restraining or decreasing government spending.

In Korea, budget process reforms consisting of medium expenditure framework, top-down budgeting, performance budgeting and digital accounting system have been introduced in response to the increasing public debt after the 1997/1998 Asian financial crisis. Indonesia also had gone through aggressive budget reforms by developing modern legal framework for budgeting, establishing unified and more comprehensive budget, massive fiscal decentralization, and assigning highly assertive role for the Parliament. In continuation of these reforms, medium term expenditure framework and performance budgeting have been introduced recently.

Although many countries strive to reach common goals of these reforms, their implementation is quite diverse due to social, economic and political characteristics of each country. While it is easy to introduce appearance of budget process reforms, it is hard to

introduce meaningful reforms that improve decision-making in budget allocation and program management. Since there are many challenges to the successful reforms, it is worthwhile to look at other countries' experiences and avoid mistakes. Korea can be a useful case to draw lessons for Indonesia which has just embarked on medium-term expenditure framework and performance budgeting, because these reforms have been carried out within a very short period of time when Korea had little infrastructure and capacity to implement the reforms.

1.2. Recent Budget Process Reforms in Korea and Indonesia

In this section, brief overview of recent budget process reforms in Korea and Indonesia will be discussed to give background information on this paper. Korea has introduced comprehensive budget process reforms during mid 2000s. In response to the 1997/1998 Asian financial crisis, Korea started ambitious reform initiatives in budget process with strong support from President. They are MTEF, top-down budgeting, performance budgeting and digital budget & accounting system.

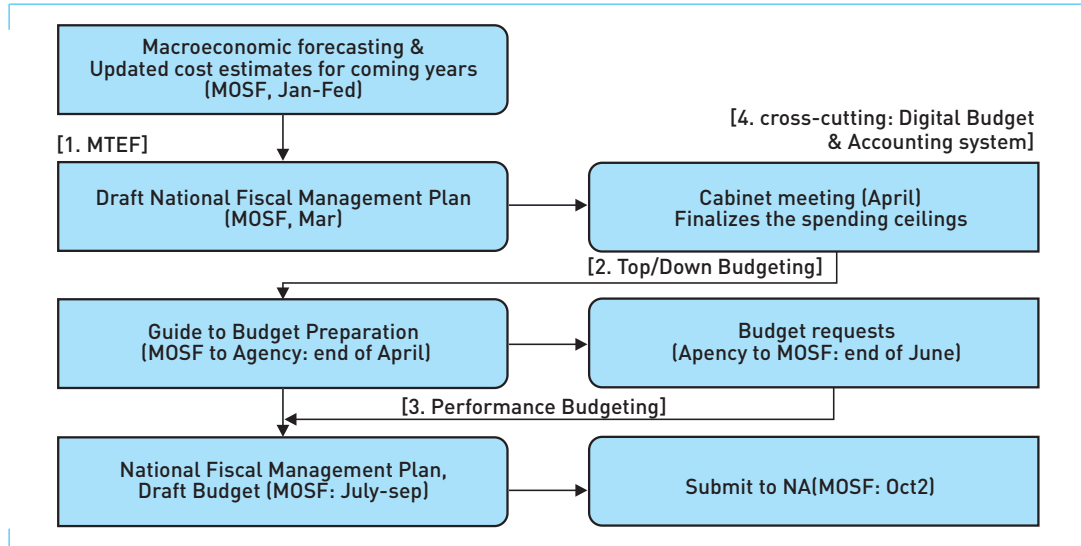
Their location in budget process is illustrated in Figure 5-1²⁶⁾. MTEF is called National Fiscal Management Plan in Korea and designed to provide 5 year fiscal plan. In order to give more autonomy in budgeting to the line ministries, top-down budgeting is introduced by limiting the involvement of the central budget authority in budget formulation at the program level. In return for giving more autonomy to the line ministries, performance budgeting is implemented to improve accountability and budget allocation by developing outcome-based performance information. Digital budgeting & accounting system consists of developing program structure, cost accounting and IT system and are designed to provide infrastructure for budgetary reforms.

Korea took a big bang approaching by introducing all the reforms within a very short time span. All these reforms were introduced from 2003 to 2007. MTEF was pilot projected in 2003 and fully implemented in 2005. Top down budgeting was introduced as a pilot project in 2003 and fully implemented in 2005. Performance budgeting was introduced to a limited number of agencies and fully implemented in 2005. Program budgeting was fully introduced in 2006 and IT system was developed in 2007, but cost accounting has not been fully implemented yet. Allocation of indirect costs is yet to be planned and accrual accounting will be fully implemented from 2010. To provide legal foundation for these reforms, the National Finance Act was enacted in December, 2006. It is important to give stability to the reforms because the budget process reforms are often subject to the shift of political regime. That is partly because introducing the budgetary process reforms are attractive to politicians but improving and using it in decision making process is not.

26) If we use broader definition of MTEF, MTEF process includes every elements of budget process in Figure 5-1 (See Figure 5-6). MTEF in Figure 5-1 refers only to the process for estimating available resources for the medium term and developing the draft of National Fiscal Management Plan.

Advantage of a big bang approach is that it can make reforms irreversible, while its drawback is that it may overload public sector and hinder effective implementation of reforms due to lack of capacity. Korean experience shows both sides of big bang reforms: comprehensive reforms are introduced without strong resistance from civil servants, but there are some limitations of reforms occurred due to capacity issues among civil servants.

Figure 5-1 | Budget Process and Its Reforms in Korea



Indonesia also started budget reforms in response to 1997/1998 Asian financial crisis and successfully recovered from the shock. The government debt rose dramatically in 1997 and 1998-reaching almost 100% of GDP in 1999-, but declined to 35% of GDP in 2008. This involved a new legal framework for budgeting, unified and more comprehensive budget and massive fiscal decentralization and the empowerment of local governments. Also the role of the legislature was strengthened with the transformation of budgeting system.

Prior to the crisis there was no effective legal framework for budgeting in Indonesia. Following the crisis and the transition to democracy, a strong emphasis was placed on reforming the legal framework for budgeting. A series of laws were adopted. They are State Finances Law 17/2003, State Treasury Law 1/2004, State Planning Law 25/2004, Regional Governance Law 32/2004, Fiscal Balance Law 33/2004, and State Audit Law 15/2004.

The second major transformation was to have a more comprehensive and unified budget. Previously, there were separate routine (operating) and development (capital) budgets and significant off-budget activity. The Indonesian government had merged the separate routine and development budget as of 2005. It also took on the difficult task of bringing various activities that were a previously off-budget on to the budget to make more comprehensive.

The third major reform was drastic decentralization program, which began in 2001, and involved giving unprecedented political autonomy to the regional government as well as the transfer of significant functions from the central government. The fiscal transfer arrangements between the central government and the local governments are composed of three key elements: Revenue sharing, general allocation grants and specific allocation grants.

The fourth major pillar of the post-crisis transformation was the highly assertive role of the new democratic parliament in the budget process. Previously, there was no active role for the Parliament in the budget process. All the aforementioned legislation was passed with the unanimity from the Parliament. Therefore, further budget process reforms should be pursued with the cooperation of the Parliament.

In continuation of the budget process reforms, MTEF and performance budgeting has been introduced to upgrade the budget process under the auspices of the World Bank. Program structures have been developed among selected agencies, and MTEF is in the process of development and plan to be announced to the public in 2010.

These new initiatives are at the early stage of development and in the process of developing program structure with performance indicators and MTEF draft. Operational strategy is not set yet. Therefore, this report may serve as a reference for coping with various challenges of implementing budget process reforms.

2. Medium-Term Expenditure Framework (MTEF)

2.1. Overview and Framework of MTEF

The failure to link policy, planning and budgeting is the single most important cause of poor budgeting outcomes in developing countries. The implementation of a MTEF is increasingly being accepted as an appropriate response to the problem. In many respects, MTEF has become the new panacea of public expenditure management. It is proposed as a cure not only for the inadequacy of planning and budgeting system but also for the broader performance problems of government.

It is not surprising that MTEF should receive universal support. It is rational to plan and manage finances in an integrated manner with a medium term perspective. Yet there are dangers in applying MTEF as a repackaged solution to diverse countries' budget problems.

This section defines MTEF and explains steps of developing MTEF. It also discusses issues involved in developing and using effective MTEF.

MTEF is a set of the government's strategic policy and expenditure framework, which balances what is affordable in the aggregate against policy priorities of the government.

In defining a MTEF as an operational concept, it is useful to distinguish three levels of development:

Medium Term Fiscal Framework (MTFF) is the first and necessary step towards an MTEF. It typically contains a statement of fiscal policy objectives and a set of integrated medium term macroeconomic and fiscal targets and projections. MTFF estimates available resources for the next year and medium-term, that is, usually 3 to 5 years in the future. Based on the estimation, the government develops top-down resource envelopes for each sector and line ministry.

Medium Term Budget Framework (MTBF) builds on this MTFF by developing medium term budget estimates for individual spending agencies. The objective of an MTBF is to allocate resources to the nation's strategic priorities and ensure that these allocations are consistent with overall fiscal objectives. This gives some degree of budget predictability to spending agencies, while ensuring overall fiscal discipline. MTBF estimates current and medium-term expenditure for extant and new policies. It gives information on the required resources for maintaining existing and new policies. In fact, MTBF is the most basic type of MTEF.

Medium Term Expenditure Framework (MTEF) develops the approach further by adding elements of activity and output based budgeting to the MTBF framework. These methods seek to improve the value of money for public spending, in addition to reinforcing fiscal discipline and strategic prioritization.

MTEF matches program costs with available resources in budget formulation process for the next fiscal year. By going through these steps, MTEF is expected to shift the psychology of budgeting from "needs" to an "availability of resources" mentality.

The main objectives of MTEF can be illustrated in the following way: First, it intends to improve macro-fiscal situation, which is lowering budget deficits and improve economic growth. In many countries, it is adopted as a rational approach to retrenchment and economic stabilization. Second, it intends to improve the effect of government policy by developing better way of allocating resources to strategic priorities between and within sectors. By developing information on the available resources and required costs for government policy, it can provide better framework for making decisions on resource allocation; Third, it intends to enhance predictability of government policy and its funding. The provision of information not only on the coming fiscal year but also on the medium-term fiscal year enables parties related to policy making and implementation to have reasonable expectations for medium-term; Fourth, it improves program performance and impact when combined with increased managerial autonomy and effective performance management. It will shift civil service from administrative

to managerial culture and allow greater room for managerial flexibility and innovation.

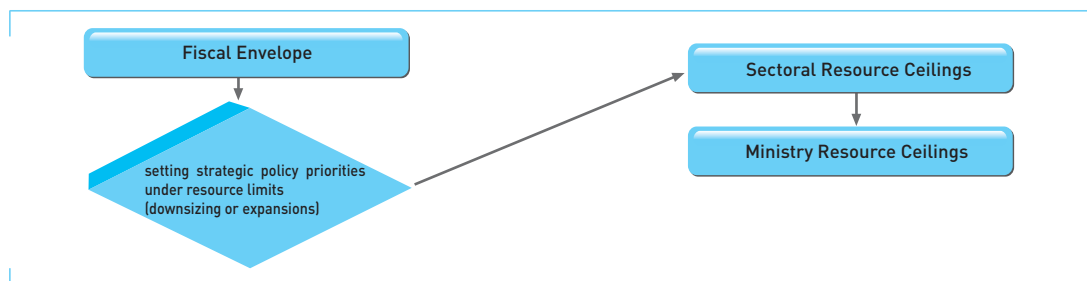
More detailed description of each element of MTEF is discussed in the following. MTEF begins with developing macroeconomic framework to get the sense of available resources. Macroeconomic framework builds upon predictions of main macroeconomic indicators, such as GDP, inflation, balance of payment, unemployment rate, wages and so on. Estimates on them should be conservative and assumptions lying behind should be transparent. It should take into account fiscal policy objectives and their impact on the economy.

Revenue and expenditure estimates are usually developed for two scenarios, that is, optimistic and conservative, with the former reflecting a high probability of macro stability and the later a more uncertain macroeconomic environment where these estimates could be quite low. Revenue estimates are mostly about taxes and other non-tax revenues and developed in line with the macroeconomic framework. Before calculating fiscal space for public expenditure, deficit target should be set an appropriate level taking into account the current macroeconomic situation to achieve economic stability. Based on revenue estimates and deficit target, maximum fiscal space for government spending is derived.

Forecasts for macroeconomic variables and revenues are the starting point for MTEF and their accuracy and credibility is one of the key factors for the successful MTEF. Improved predictability, that is expected benefit of MTEF, relies on reducing the gap between estimates and actual revenues, thereby reducing the need to cut expenditures during the budget year. Technical improvements to revenue and debt forecasting are therefore the key to giving public sector managers the budget predictability they need to manage effectively. They can also highlight situations where revenue estimates are being inflated in order to avoid hard budget decisions.

Aforementioned maximum fiscal space means top down resource constraints, also known as fiscal envelope. After developing fiscal envelope, the next step is setting strategic policy priorities under resource limits and deciding the direction of fiscal management, that is, expanding or decreasing one. Then depending on the policy priorities, resource ceiling for sector and ministry level is decided.

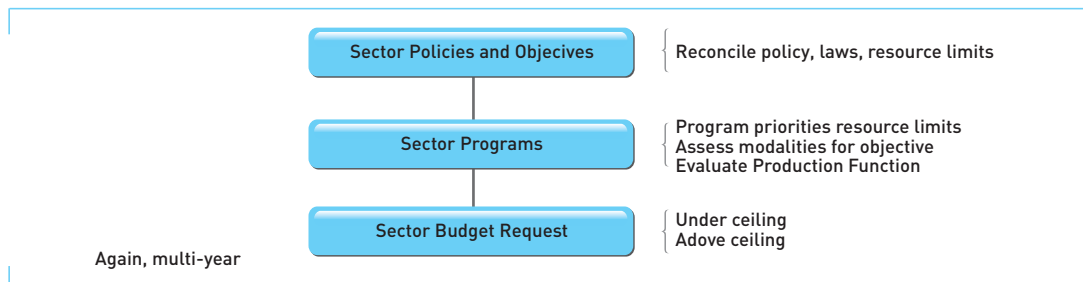
Figure 5-2 | High level policy priority setting under top down resource constraints



Policy priorities by sector are decided by the President and cabinet. Different expenditure growth rates are attributed to different priorities to their importance. For example, education sector gets an increase from 3% to 5% of GDP. Sector strategies are formulated to link budget allocations with expected policy achievements at each sectoral level. To establish such a link, key performance measures need to be developed to measure expected policy achievements and sector spending should be classified into mandatory versus discretionary spending. Mandatory spending is usually defined by laws where spending is automatic when specific conditions are met.

So far, resource ceilings are determined by the macroeconomic estimates and policy priorities at the sectoral level. The next step of MTEF is developing estimates of costs of current government policies. These cost estimates are developed to establish baselines for resource allocation and for each line ministry to estimate fiscal impact of current policies. This baseline provides information on future costs of current policies. Changes in policies are not taken into account for this baseline and only changes in cost drivers, such as prices, quantity, workload and so on, are included for future cost estimates. Alternative baseline scenarios can be developed to estimate budgetary impacts of policy changes.

Figure 5-3 | Linking policy, resources and means by sector



These expenditure baselines for the sectors would be different from budget allocation. They are supposed to indicate whether current policy or policy changes are sustainable and are in line with the budget in medium term. Line ministries are responsible for preparing expenditure baselines. The role of central budget authority in the process of cost estimates is to provide the methodological support and critically review the expenditure baselines. The central budget authority will reconcile budget request to ceiling given to sectors and line ministries. Then it will be used in the annual budget formulation.

Improvements in the costing of policies and programs will take long to achieve. They require a fuller information base and cannot be delivered without the active involvement of sector ministries.

Figure 5-4 | Reconciling resources with means

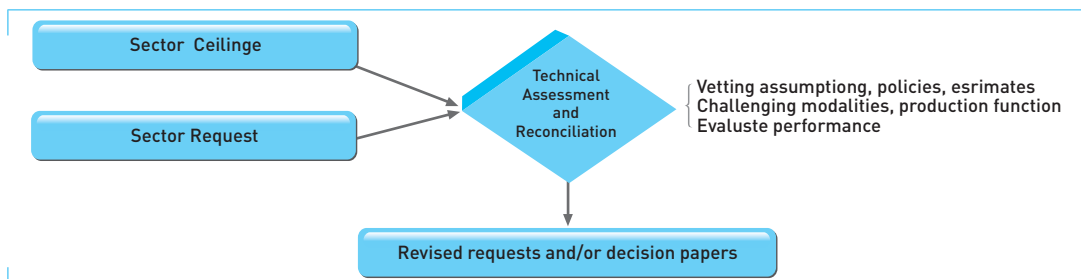
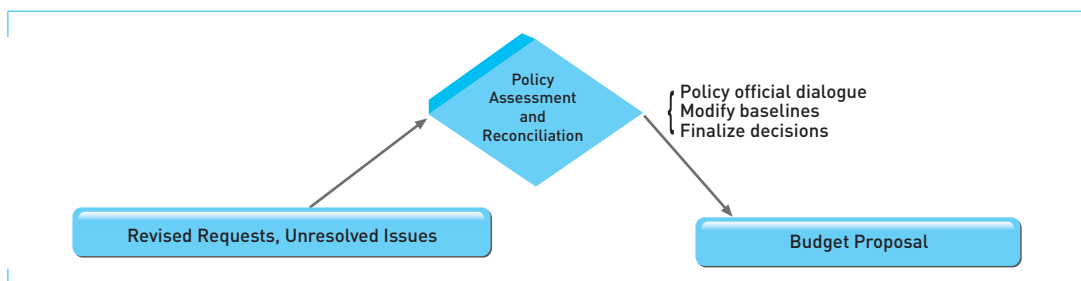


Figure 5-5 | Reconciling strategic policy and means



This section concludes by summarizing the key characteristics of MTEF and important issues for the successful implementation of MTEF.

IMF (2007) summarizes the key features of MTEF in the following way:

- A statement of fiscal policy objectives;
- Integrated medium-term macroeconomic and fiscal forecasts;
- Estimates of expenditure and receipts of ministries and agencies for two to four years beyond the budget year;
- Formal “forward” or “out-year” estimates—the first out-year estimate of expenditure becomes the basis of budget negotiation for the following year; and
- Hard budget constraints in the form of ministries’ and agencies’ budget appropriations.

IMF (2007) also suggests the following issues are important for the successful implementation of MTEF:

- Fiscal policy objectives and quantitative fiscal targets need to be articulated and defended at the highest level of government;
- Robust revenue forecasts are critical and the target levels of expenditure must be rigorously related to the macroeconomic prospects over the medium term;
- Budget and forward estimates are better set in nominal terms to ensure that program managers respond to price changes;
- The framework should be based on clearly defined and fully costed policy proposals; and

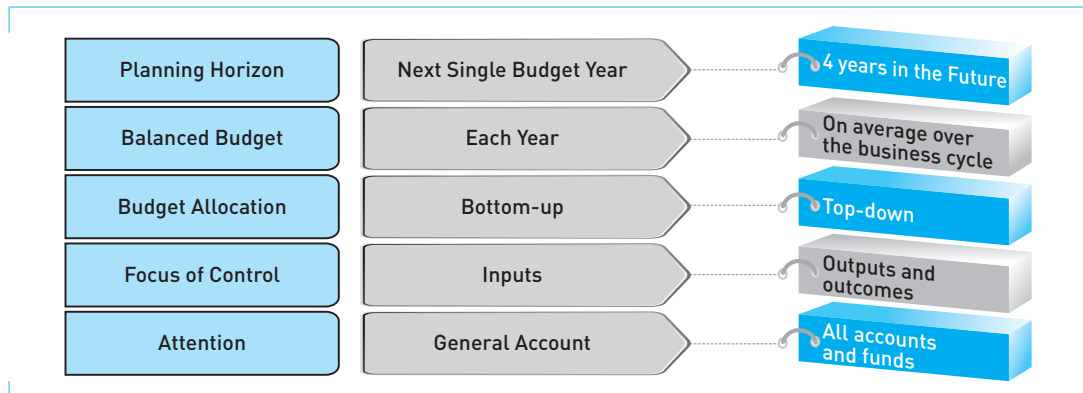
- The medium-term budget framework should be accompanied by strengthened measures to review individual expenditure policies and their institutional delivery mechanisms.

2.2. Challenges of MTEF: Observations and lessons from Korea

In this section, observations and lessons from Korean experiences with MTEF will be discussed. Particularly, it focuses on the challenges of MTEF, since there are some preconditions for the successful implementation in Korea. MTEF was introduced in 2003 with the publication of the National Fiscal Management Plan for 2004-2008.

It covers 4 years in the future including the next fiscal year, while traditional annual budget process covers only the next fiscal year. If the government pursue balanced budget, it is calculated on average over the business cycle under MTEF, while it focuses on annual budget balance under the traditional annual budget process. Under the MTEF, fiscal discipline is strengthened by setting ceiling by top down approach, while the traditional annual budget process usually starts from the bottom and focuses more on the need rather than resource availability. Focus of control shifts from input to outputs and outcomes under MTEF. Coverage of budget tends to be comprehensive by including not only general account but also other accounts and funds. Figure 5-6 summarizes the comparison between traditional annual budgeting and budgeting under the National Fiscal Management Plan.

Figure 5-6 | Framework of the National Fiscal Management Plan compared to Previous Annual Budget Process



Source: Koh, Youngsun (2009)

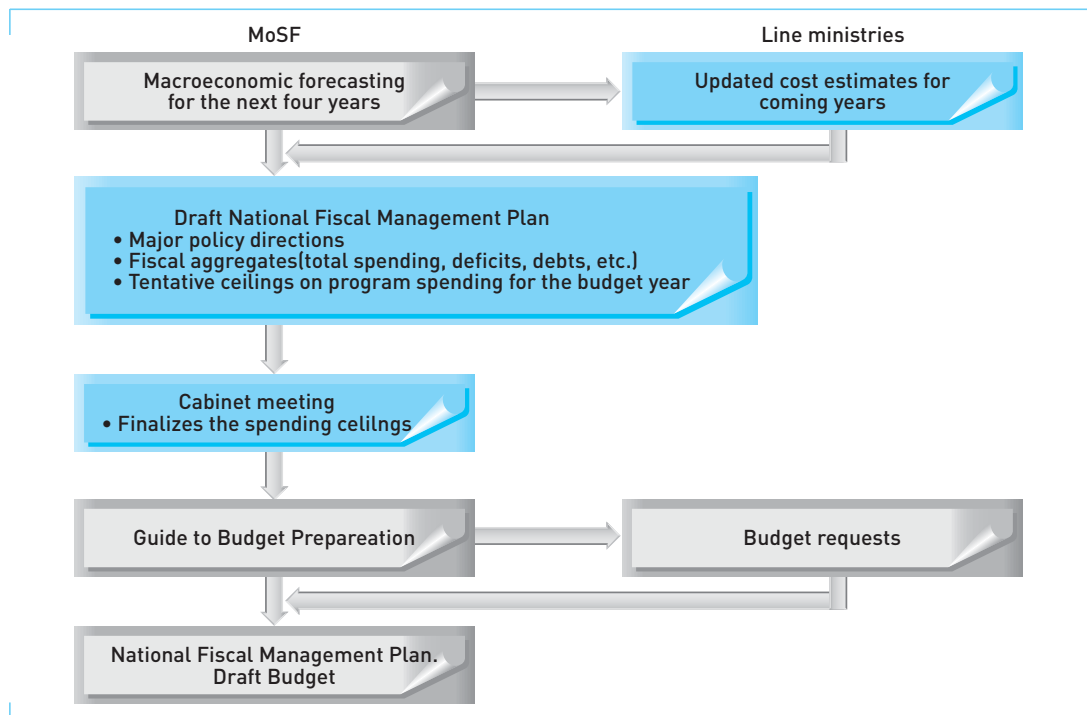
Figure 5-7 shows how the National Fiscal Management Plan is developed. Ministry of Strategy and Finance (MOSF) forecasts macroeconomic variables for the next four years. Line ministries are responsible for the cost estimates of their programs. Based on the projections on the macroeconomic variables, revenues and program costs, MOSF develops the first draft of the National Fiscal Management Plan consisting of major policy directions, fiscal aggregate and

tentative ceilings for line ministries. For the development of policy directions, expert panels are convened to identify major agenda of each sector. Also regional meetings are held to discuss important issues in local governments.

Although the expert panels and regional meetings help to communicate and identify important policy agenda in each sector and region, it is not clear how they are used in setting policy priorities and budget allocation. There is criticism that they may be a just publicity tool rather than information used in decision making process. It is, however, fair to say that they serve as a communication channel between the central budget authority and line ministries/local governments/the public.

With the draft of the National Fiscal Management Plan, cabinet meeting is held to finalize the spending ceilings for line ministries. Based on the finalized spending ceilings, the guide to budget preparation is issued to line ministries. By following the guidance, line ministries submit their budget request to MOSF and the National Fiscal Management Plan and budget draft is finalized after negotiation between line ministries and MOSF.

Figure 5-7 | MTEF process in Korea



Source: Koh, Youngsun (2009)

In Korea, the National Fiscal Management Plan (NFMP) covers 5 years, that is, current year, budget year and 3 out-years. It consists of two main parts: macro fiscal policy and sectoral fiscal

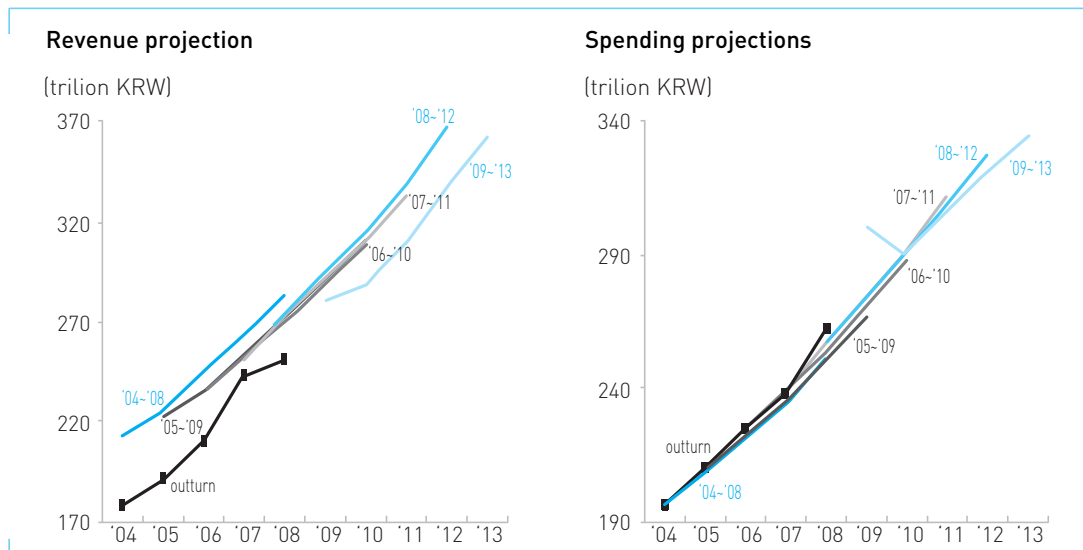
policy. Macro fiscal policy includes projections on spending, revenue, balance and debts. Secotral fiscal policy contains major policy directions and sectoral spending allocations. NFMP is prepared by MOSF each year. Sectoral working group consisting of experts is organized to discuss major policy issues that will be addressed in NFMP. NFMP is submitted to the National Assembly together with the annual draft budget and used only for an informational purpose. Some movements are emerging from the National Assembly to have a voice in the NFMP, but the legislature have not involved in the drafting of NFMP.

NFMP has been showing positive effects on the following areas: It plays a role of medium for dialogue between government and the public on medium-to-long-term policy issues and to inform the public about the government’s fiscal strategy. It also facilitates communications between the central budget authority and line ministries on fiscal situations and policy priorities.

However, there are remaining problems: First, it lacks consistency across successive NFMPs. There have been frequent changes to accommodate changing circumstances. Second, fiscal targets have been unclear. It is unclear whether target is debt or deficit and how firm the spending ceiling is. Third, macroeconomic scenario tends to be too optimistic. Actual economic growth tends to be often lower than what was expected.

In early years, there have been large revisions in fiscal projections. Little effort has been made to reconcile the difference between projections and outturns. Figure 5-8 shows the revenue and spending projections of NFMP. Revenue projections in early years show bigger discrepancy between projections and outturns, while spending projections and actual spending do not show such discrepancy. The latter implies good spending control is in place.

Figure 5-8 | Projections of revenue and spending in each NFMP



Source: Koh, Youngsun (2009)

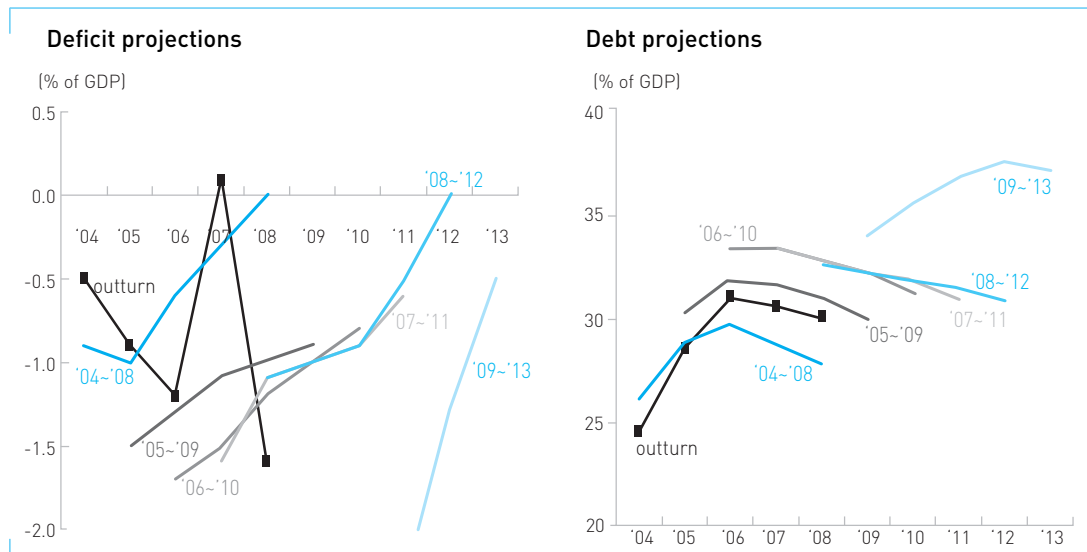
The gap between revenue projections and outturns are decreasing as MOSF accumulates experiences. It may suggest improved accuracy of forecasts as well as stable economic conditions.

Now let's look at the discrepancy between projections of deficit, debt and their outturns, which are exhibited in Figure 5-9. The gaps between projections and outturns in deficits and debts clearly exist. Due to unexpected changes in the economy, revenue forecast can be different from the outturn. In contrast, deficit and debt are more likely to be influenced by the government decision in response to shortfalls in revenues or increases in spending.

The Lack of consistency across successive NFMPs lowers their effectiveness as a medium for policy dialogue between government and the public by undermining their credibility. While it is inevitable to have discrepancy between projections and outturns, it is important to explain the gap in the next NFMP and make clear the underlying assumptions for the projections. Without them, it is hard to know whether the discrepancy is due to unexpected external factors or due to government's overspending.

In Korea, since underlying assumptions are not made public and the discrepancy between projections and outturns are not explained in the next year's revised NFMP, it is close to developing new NFMP each year rather than revising it from previous NFMP in response to policy changes or environmental changes. It may undermine disciplinary role of NFMP and its credibility to the public.

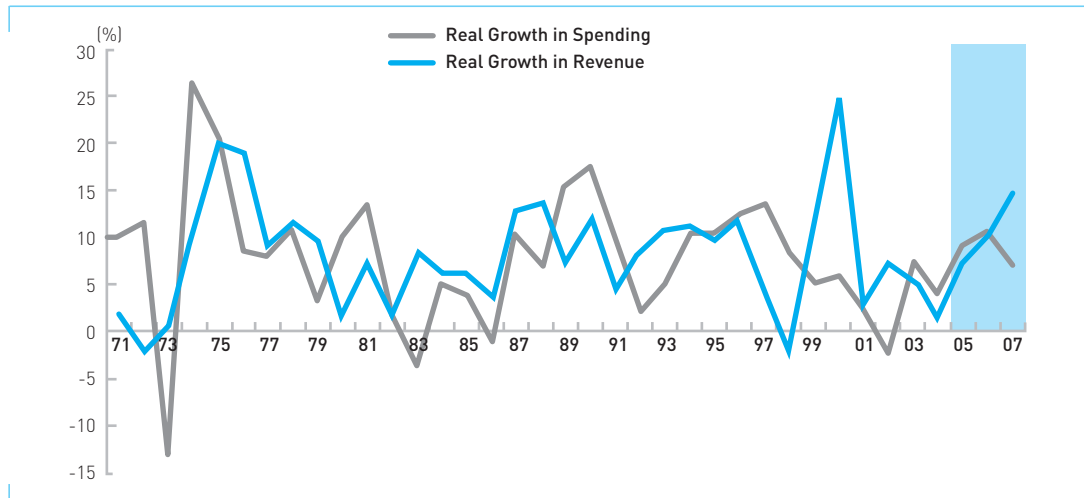
Figure 5-9 | Discrepancy Between Projections of Deficit and Debt and Outturns



Even after the introduction of NFMP, spending growth still shows pro-cyclivity. Figure 5-10 shows the tendency that spending growth moves together with revenue growth. One of expected benefits of MTEF is an enhanced role of public spending as an automatic stabilizer of the economy. Figure 5-10 indicates a limited role of NFMP in stabilizing the spending. The reason appears to lie in the inconsistency across successive NFMPs. NFMP becomes more like ritual for annual budgeting rather than annual budgeting is affected by NFMP.

In this respect, Indonesia may suffer the same transparency issue in developing MTEF. Currently, Indonesia does make public the underlying assumptions of revenue forecasts, although underlying macro-economic models are not made public. The Ministry of Finance, after consultation with the Parliament, presents a narrow range of revenue forecast.

Figure 5-10 | Real growth in spending and revenue of the central government

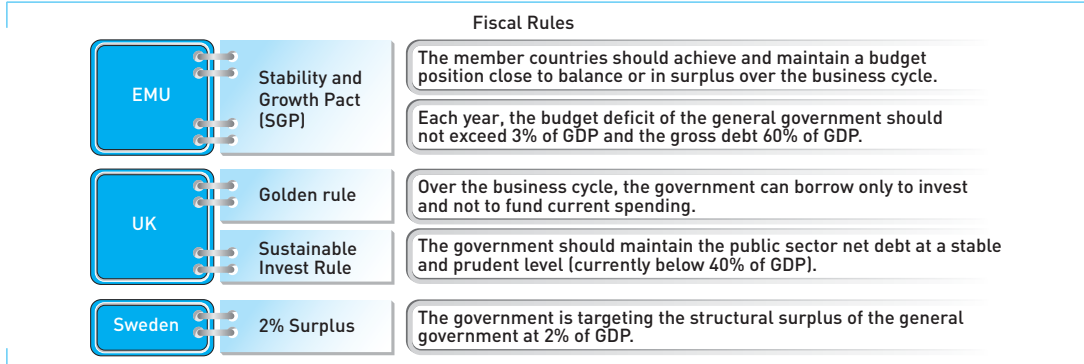


Source: Koh (2009)

Korean NFMP also suffers from unclear specification of fiscal strategy. Some countries rely on specific fiscal rule, i.e. budget balance or surplus over a medium-term. Without these specific fiscal rules, NFMP’s fiscal policy directions can be unclear to the parties involved. Some countries use specific fiscal rules to introduce fiscal discipline into fiscal management. Figure 5-11 illustrates some examples from other countries.

Korean NFMP presents projections on major fiscal aggregates, and does not explain the underlying fiscal strategy. For example, what can be construed from the 2009’s NFMP is that the government will try to ‘balance the budget by 2012’. A natural question is “what will happen if the economy turns worse than expected? Would the government let the deficit grow or reduce the spending to meet the target?” Ideally, the government should set targets in terms of spending and not deficits. The former has advantage over the latter in terms of controllability (therefore, credibility) and short-term stabilization.

Figure 5-11 | Examples of Fiscal Rules



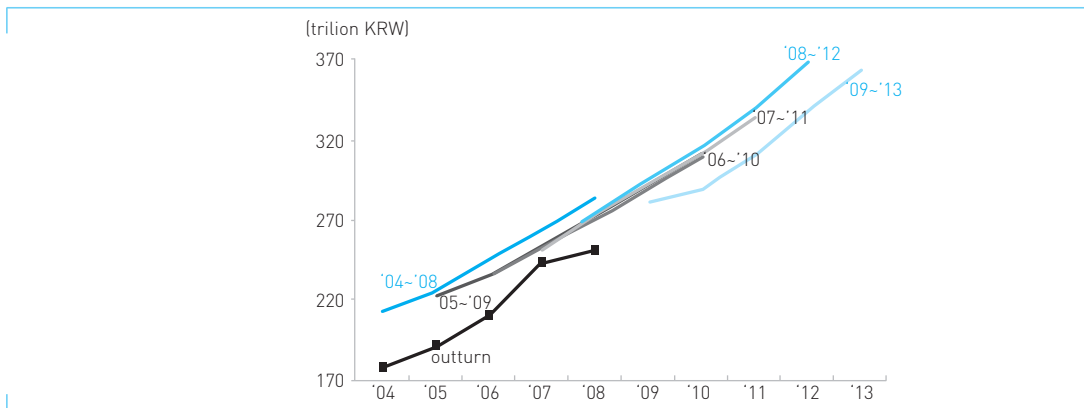
Source: Koh (2009)

Interestingly, Indonesia already adopted fiscal rules, that is, public debt should be limited to 60% of GDP and annual budget deficit should less than 3% of GDP. This fiscal rule is adopted in 2003 and budget deficit was 1.7% of GDP and public debt was 57% of GDP at that time. Since then budget deficit and government debt were always under the rule and, therefore, the caps have never been tested.

The last danger of MTEF is that optimistic projections from the incumbent government. Government tends to prefer optimistic macroeconomic scenario rather than conservative one. This is observed in NFMP and it directly affects the revenue projections of NFMP. Figure 5-12 shows that in early years, revenue projections are optimistic.

Indonesia, however, may not suffer from the same problem. Since 26% of government revenues should be transferred to local governments in the form of the general allocation grants and the reference is not realized revenues but projected revenues, central government does not have incentive to make optimistic forecast. In an interesting way, the Indonesian budgeting process has a built-in mechanism to prevent optimistic macroeconomic forecast.

Figure 5-12 | Optimistic revenue projections



Observations from NFMP calls for the following actions. First, ideally, set a medium-term targets in terms of deficits and debts, while set annual target in terms of total spending. Second, prepare annual budget within the spending ceiling, which means fiscal discipline should be strong by enforcing the spending ceiling. Third, let the automatic stabilizer work in full scale when revenue goes above or below the projected level. Fourth, explain the difference between projections and outturns to the public through NFMP. Transparency of underlying assumptions on the NFMP is crucial to gain credibility and enhance fiscal discipline.

2.3. Policy Recommendations for Indonesia

According to the maturity and comprehensiveness of MTEF, there are three types of MTEF: Type 1 refers to the situation in which a macroeconomic framework and an expenditure framework are used to allocate resources between sectors, developed within the central budget authority. Type 2 refers to the situation in which, in addition to Type 1 element, there is improved sector budget process to focus more on meeting objectives and targets through integrated activity-based budgets. Type 3 refers to the situation where, in addition to Type 2, there are enhanced autonomy and incentives to line ministries to manage their resources in a responsible way. As MTEF matures, it is better to move to type 3 to maximize the benefits of MTEF.

To have a valid and credible MTEF, some issues need to be addressed: (1) credible estimation of resource availability, (2) credible estimation of policy costs, (3) enhanced link between policy priority and budget allocation, and (4) relevant incentives and discipline to line ministries.

To develop credible estimates of resource availability, technical capacity, transparency of estimates and independence of estimates are needed. It is necessary to build capacity to provide objective projections for the future macroeconomic indicators and revenues.

Currently, the Indonesian Ministry of Finance plays a role in establishing the level of financial resources available. The Fiscal Policy Office prepares the economic assumptions and revenue forecasts for the budget, thus establishing the maximum level of expenditures given the government's deficit target.

The Fiscal Policy Office relies on a committee of technical experts to prepare the economic assumptions and revenue forecasts. Its members represent the Ministry of Finance, BAPPENAS-National Development Planning Agency, the National Statistical Agency, the Central Bank, the Ministry of Energy and Mineral Resources, and the coordinating Ministry of the Economy. This committee is chaired by the Ministry of Finance, which has final responsibility for the economic assumptions and revenue forecasts.

This committee will meet on numerous occasions. Several of the bodies have an independent forecasting capacity and will come to the meetings with their internal results.

Interestingly, this committee proposes a range rather than fixed points for each variable—economic growth, foreign exchange, interest, inflation, oil price and crude oil production. Fixing the exact variables within the range is subject to negotiations between the government and Parliament.

The budget documentation makes explicit the key economic assumptions and provides sensitivity analysis for some of them. However, there is no independent scrutiny of the assumptions nor formal comparison with private sector and other forecasters. The underlying macro-economic models are not made public.

It is crucial for the credibility of the projections to make underlying assumptions public and explain the differences between projections and outturns. Indonesian government doing fairly well in this part for their annual budgeting process, but it may need to improve the consistency and transparency of MTEF by making macro-economic models public and make comparison of its forecasts with other forecasters.

Lastly, independence of institutions that produce the projections is also important. It is desirable that revenue estimation is done by the independent unit. Without independence, there will be a tendency for over-optimism. If there are already credible institutions producing the projections, their estimation can be utilized: for example, average of multiple projections produced by the institutions can be used.

Too optimistic economic assumptions create the government's principal fiscal risk. In OECD experiences, nothing derails the government's annual budget more than the use of inaccurate economic assumptions. The greatest risk is for them to be too optimistic, thus making more resources seemingly available than are in reality. In OECD countries, the focus is to ensure the independence of those responsible for the calculation to insulate them from political pressure.

In some countries, it is a political tradition of the economics departments within finance ministries to have this independence. This is for example the case in the Nordic countries. In other countries, separate and independent government bodies exist to calculate the economic assumptions, which is the case of the Netherlands with the Central Planning Bureau. In Australia, there are expert panels drawn from the relevant institutions that are responsible for the economic assumptions. In the United States, the independent, non-partisan Congressional Budget Office plays a leading role in ensuring the accuracy of the economic assumptions. In other countries, non-government organizations play a leading role in calculating the economic assumptions. Canada, for examples, bases its assumptions on an average of leading private

sector forecasts. Chile uses an independent non-governmental panel of experts to determine the economic assumptions. This serves to place safeguards against the use of unrealistic, or “optimistic,” economic assumptions.

The Indonesian practice of politically negotiating the economic assumptions-albeit within calculated ranges-between the government and the Parliament is not observed in OECD countries. Although the built-in incentives-that is, revenue sharing mechanism between the central and local government-may prevent too optimistic revenue forecasts for now, establishing independence forecasting unit need to be done in the future.

Cost information on existing policies needs to be developed, but it will take time. It is better to start with direct costs on the policy, then developing distribution scheme for the indirect/overhead costs. There are two approaches for the indirect cost distribution: rule of thumb scheme and activity based costing method. It is best to avoid the situation requiring distribution of indirect costs, but if it is inevitable, rule of thumb approach is often used. Rule of thumb refers to the situation where the number of staff, size of budget or size of office is utilized as criteria of indirect cost distribution. In some areas, activity based costing method can be used and it tends to provide better cost information. For cost information, consider introducing accrual concept to the selective areas, such as pension, loan and guarantee.

In Indonesia, program structure is developed without distributing indirect costs by establishing separate administration program. Korea also adopted the same approach to avoid technical difficulties at the early stage of budget process reforms. It contributed to speed up the reform process, but it also made the scope of budget process reforms limited to direct costs. As a result, big shares of budgets from agencies that directly delivers services to the public are exempted from MTEF and performance budgeting. In the long run, distribution of indirect costs needs to be considered for some areas where the share of indirect costs is significant.

One of the purposes of MTEF is to enhance a link between policy priority and budget allocation. In addition to these priorities, performance information and political priorities should play a role in linking priority and sectoral budget allocation. In other words, expressing political priority in terms of performance targets and linking required resources to the targets are needed. In this respect, MTEF and performance budgeting are complementary.

Other precautions can be suggested in the following way: First, ensure that the MTEF follows the same format and detail as the budget. This makes the linkages between the two natural and fosters the use of the MTEF. This has a major implication for Indonesia as the current practice of keeping a detailed budget documentation may need to be significantly simplified in order to successfully implement MTEF. Second, to ensure that they are always up-to-date, some OECD countries update them every week, following the Cabinet meetings. Any decision with a fiscal impact made at the Cabinet meeting would immediately be incorporated

in the MTEF. Otherwise, they run a risk of becoming obsolete and require a new MTEF each year, rather than having an updated rolling one in place. Third, to locate the responsibility for the MTEF with the same unit that deals with the regular budgeting responsibilities. They will have the most ready access to the information and have an incentive to keep it up to date because they see value for themselves in doing so. Having a special MTEF unit separate from the Budget Office almost guarantees the failure of an MTEF.

Implementing a rigorous MTEF is a significant challenge, particularly for an emerging country. It absorbs a large amount of technical and human resources, and runs the risk of distracting attention from other reform efforts. Therefore, the basic type of MTEF needs to be developed as a starting point and then further enhancement of MTEF should be considered.

3. Performance Budgeting (PB)

3.1. Overview and Framework of PB

Performance budgeting is one form of performance management movement in the public sector. It can be defined as procedures to enhance link between spending and outcomes/outputs through the use of formal performance information. The purposes of PB can be listed in the following: accountability, management and budgeting tool. It can be used to enhance accountability of government spending programs. As participatory democracy advances, public sector is under heavier pressure to explain what it achieved with public money. In response to the pressure, government use PB as a medium to communicating with the public and making program managers accountable. PB is also used as a management tool to improve government programs' performance. Lastly, PB is an attempt to use performance information for the purpose of budget allocation.

Recent global resurgence of PB is witnessed in many countries. In many OECD countries, PB has been introduced as a key element of budget process reforms since late 1980s. Recently it is gaining renewed momentum in some OECD countries, such as Canada and the United States. Other countries, such as Austria, Korea, France, Mexico, Spain, Portugal, and Russia are joining the movement. In some emerging and developing countries, such as Brazil, China, Chile, and Columbia, PB is also adopted.

Characteristics of recent PB in OECD countries can be summarized as follows. Outcome-oriented PB is widely adopted rather than output-oriented PB. Particularly, New Zealand, Australia and UK that adopted output-based approach moved towards outcome-oriented PB. Advantages of outcome information are ease of communication with the public and information provision on the impact of the programs, while output-oriented PB may induce distorted behavior from program managers and may not be meaningful information for the public. Shortcomings of outcome measures, however, exist: They are expensive to produce and require

expertise to interpret them to use in decision making process. Despite these shortcomings, outcome information is widely used in many OECD countries.

As a general framework for PB, outcome-oriented PB becomes a global standard for a performance monitoring purpose, while for specific areas, output-oriented PB are used to make more direct link between performance information and budget allocation. Particularly, for a formula-based performance funding, output information is usually incorporated into the formula. Preconditions for formula-based performance funding are very close ties between output and intended outcome, as well as proper mechanism to control the quality of output or homogeneity of output.

Another trend of PB among OECD countries is use of monitoring system rather than program evaluation. Performance monitoring system based on performance indicators are widely used to get timely and systematic performance information. In some countries, such as the United States and Korea, program review process based on a checklist is also adopted to get more comprehensive performance information on programs. Even though program evaluation can provide the most conclusive and in-depth information, it is too costly and its coverage is limited to a small set of programs given year. Therefore, for the purpose of decision making, program evaluation is often regarded as impractical.

In most OECD countries who adopt PB, a link between performance information and budget allocation is indirect. Given political nature of budget allocation process, it is natural that performance information is one of information used in budget allocation. Most countries stress that PB plays an important role in improving program performance.

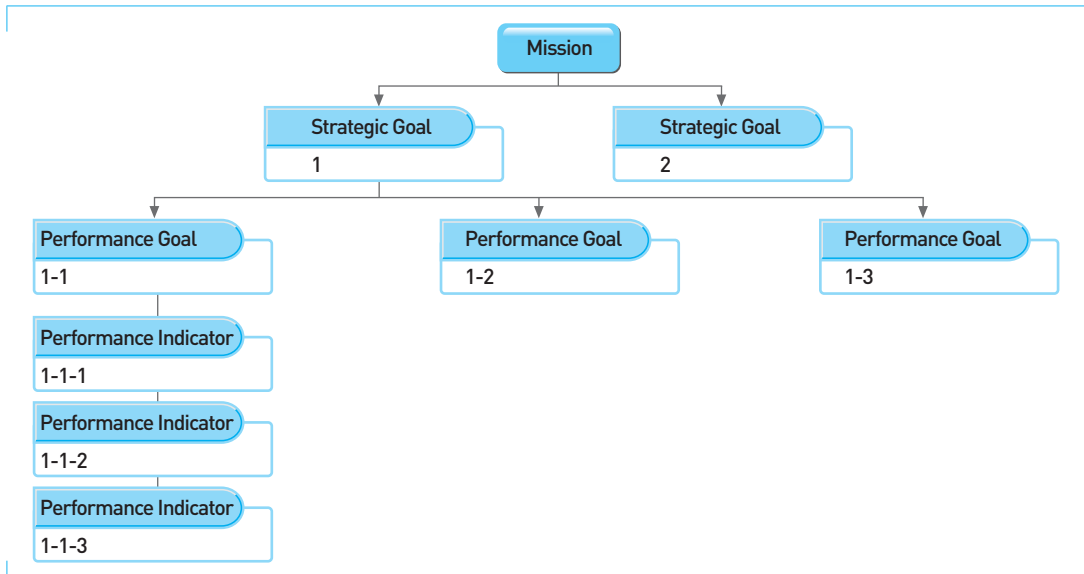
Elements of PB can be classified into two categories: production of relevant information and use of performance information. Relevant information for PB can be listed in the following: performance information, cost information, and program structure. Performance information measures performance of programs, which can be measured via indicators, program evaluation and review process. Cost information can be classified into three: total cost, unit cost and comparative cost. Issues involved in cost accounting are distribution of indirect costs and accrual accounting. Detailed discussion on the cost information merits another paper and will not be presented in this paper. Program structure is not essential elements of PB as long as relevant unit of performance evaluation can be identified, but it can help to develop systematic and comprehensive PB.

In addition to performance and cost information, and program structure, MTEF can be useful to maximize the benefits of PB by incorporating medium-term perspectives into PB. Other measures that enhance the managerial and financial flexibility, such as top-down budgeting, multiyear budgeting, and discretionary room for carry over can be complementary element with PB. However, these measures should be introduced after capacity of program managers are verified,.

Sequence of introducing PB can be suggested in the following. If program-based PB will be used, program structure needs to be developed first. Then performance information and cost accounting should be developed. IT system is useful to organize and utilize aforementioned information. Supporting element of PB, such as MTEF and financial and managerial flexibility can be added later to maximize the potential of PB.

Now let us briefly go over elements of performance monitoring, program review and program evaluation. Performance monitoring is based on performance indicators and works like traffic signal but does not provide much information on “why”.

Figure 5-13 | Structure of Performance Monitoring



Performance monitoring usually consists of three documents: strategic plan, annual performance plan and annual performance report. Strategic plan covers 3-5 year plan and should be updated at least every 3 years due to environment changes. Annual performance plan cover each program activity in the agency’s budget and describes performance targets of each program to achieve within a year. Annual performance report includes actual program performance results for the preceding 3 fiscal years.

Contents of strategic plan can be listed in the following:

- A comprehensive mission statement for major functions and operations of the agency
- General and outcome related goals
- A description of how the agency will achieve the goals and the operational process and resources required
- A description of how the goals relate to annual performance plan goals

- An identification of key factors external to the agency that could significantly affect the achievement of goals
- A description of program evaluations, with a schedule for future program evaluations

Contents of annual performance plan can be listed in the following:

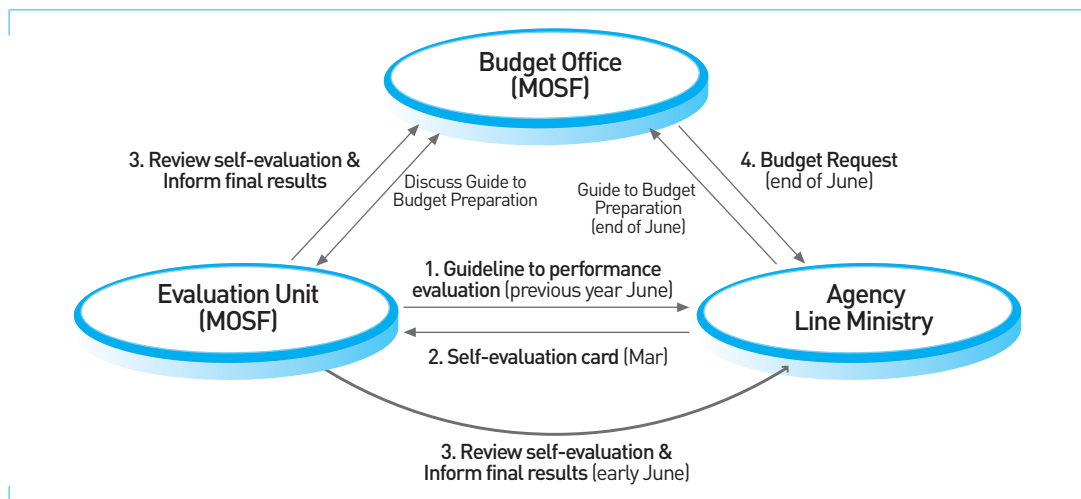
- Establish goals that define the level of performance to be achieved by a program activity
- Express goals in an objective, quantifiable, and measurable form
- Describe the operational processes and resources required to achieve goals
- Establish performance indicators to be used in measuring or assessing the relevant outputs, service levels, and outcomes of each program activity
- Provide a basis for comparing actual results with the established goals
- Describe the means to be used to verify and validate measured values

Contents of annual performance report can be listed in the following:

- Review how successfully performance goals were achieved
- Evaluate the performance for the current year relative to the performance goals achieved during the fiscal years covered by the reports
- Where goals are not met, explain and describe (a) why the goals were not met, (b) plans and schedules for achieving the goals, and (c) if the goals are impractical or infeasible, why that is the case and what action is recommended
- Include the summary findings of program evaluation completed during the fiscal year

Program review process is a way of systematically collecting performance information on the performance of program by using a checklist. Figure 5-14 shows how the program review process is implemented in Korea. The central budget authority develops a standardized checklist contains important criteria to evaluate the program’s performance. The check list can contain

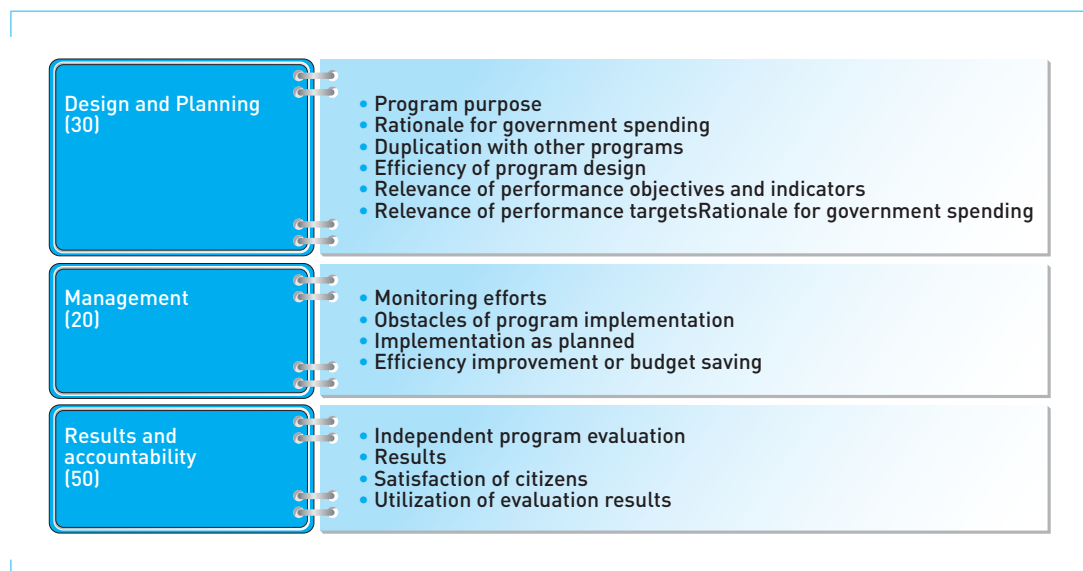
Figure 5-14 | Program Review Process in Korea



questions on design, performance management system, implementation and the actual performance of a particular program. Figure 5-15 summarizes the criteria used in program review process in Korea.

Each line ministry evaluates their programs based on the checklist and provides evidence. Usually a certain proportion of programs are reviewed each year. In Korea, 1/3 of programs are evaluated each year which provide more detailed and comprehensive information than performance indicators. If, however, line ministries do not have the capacity to evaluate their program, this poses a challenge to them.

Figure 5-15 | Criteria of Program Review in Korea



Program evaluation is based on the methodology of social sciences. Evaluation refers to the activity of systematically collecting, analyzing and reporting information that can be used to improve the operation of a program. The purpose of program evaluation is two folded: challenge the rationale of a program and improve program performance. Its strength lies in the rigor of methodology in identifying effects of a program excluding other confounding factors. However, it is costly and takes long time for a practical decision-making purpose.

Sound public finance management system needs to be in place since outcome-oriented PB is an advanced requirement.

- A realistic budget that is implemented with few significant deviations from plan
- Low level of corruption in public expenditure
- High transparency in public finance
- Reported expenditure corresponds to actual expenditure
- Reliable external and internal controls

- Spending units have reasonable certainty as to the funds that will be available
- A managerial culture that promotes compliance with formal rules

For emerging and developing countries, some strategic issues need to be considered to reflect their characteristics. Use of output-oriented performance information can be desirable for some countries or sectors. Output information is cheaper to obtain and readily acceptable to program managers. If connection between output and outcome is clear, output information can be useful. For developing countries where output goals are clear, output-oriented PB can be useful and practical as long as opportunistic behavior of program managers (due to incentives associated with output targets) can be controlled. For countries with little capacity, PB should be introduced in selective areas where its impact can be observed in short-term. For example, service delivery area can produce more immediate impact of PB than policy developing area.

3.2. Challenges of PB: Observation and Lessons from Korea

3.2.1. Description of Performance Management of budgetary Programs in Korea

The history of performance management of budgetary programs in Korea is described in the following:²⁷⁾ The first attempt to manage budgetary programs occurred during 1999-2002. In 1999, research on the existing various performance management systems around world was undertaken to find a viable way to introduce it. Based on the research, a pilot project was started on the selected divisions and branches of 16 ministries in 2000 and expanded to 22 ministries in 2002. Its design drew from the GPRA (Government Performance and Results Act) in the United States and it was named “Performance-based Budgeting.” Under this project, the spending ministries produced annual performance plans and reports. The response to the pilot project was lukewarm among the ministries and it ended with the incumbent administration.

In 2003, the “Performance Management System for Budgetary Programs (PMSBP)” was introduced in the 16 leading ministries. Implementation was not limited to selected divisions or branches within each ministry as previously, but applied to the entire ministry. It started with developing a mission statement, strategic goals, performance goals, and performance indicators in the annual performance plan. In 2003, performance information on 30% of budgetary programs was developed by the 16 leading ministries. In 2004, another 16 ministries developed performance information on 30% of their budgetary programs and the 16 leading ministries developed performance information on 100% of their budgetary programs. In 2005, 22 ministries produced an annual performance plan. In 2006, PMSBP changed its name to the “Performance Goal Management System for Budgetary Programs (PGMSBP)” and every ministry is required to submit annual performance plan to the MPB.

²⁷⁾ This section builds upon Kim and Park (2007).

The design of PMSBP also drew on the GPRA in the United States. What distinguished the GPRA from previous attempts in the US was the fact that it is initiated not by the Administration but by the Legislature. The GPRA was enacted in 1993 and implemented from 1997, and it requires each agency to submit its 5-year strategic plan, updated in every 3rd year, an annual performance plan and an annual performance report to the Office of Management and Budget (OMB) and the Congress.

Differences between PMSBP and GPRA include the following: (1) strategic planning was not introduced in PMSBP; (2) some programs were not included in PMSBP while GPRA covered every program including personnel management and operation programs; and (3) PMSBP developed performance information by employing a bottom-up approach, while the GPRA mandated a top-down approach.

These differences are a reflection of the Korean context. Programs mainly related to personnel management and routine operation were not included because there was another performance management system handled by the Office for Government Policy Coordination (OPC), and the Ministry of Planning and Budget (MPB) needed to avoid the perception of duplication. MPB took the easier approach by skipping strategic planning and by employing a bottom-up approach so that each line ministry would not have to consider reorganization of existing programs. Ministries/agencies developed performance goal and strategic goals from existing programs. As a result, one of the important components of performance management was lost. Subsequently, in 2006 the OPC introduced “Integrated Evaluation System of Government Affairs (IESGA)” to coordinate existing evaluation systems conducted by various ministries, such as, MPB, Ministry of Government Administration and Home Affairs, OPC, and Civil Service Commission, and strategic planning was introduced as a component of the requirements for this integrated system. Despite this genuine strategic planning has rarely been realized among line ministries.

In 2005, MPB introduced “Self-Assessment of Budgetary Programs” (SABP, sometimes called “Korean PART”) to enhance links between performance evaluation and budget allocation. Its design drew on the Program Assessment Rating Tools (PART) in the United States. While PMSBP relies on the small number of key performance measures for performance management, SABP collects more detailed information on budgetary programs. SABP examines planning, management and results of budgetary programs and sub-programs²⁸⁾ by a checklist designed by MPB. Line ministries/agencies assess their programs by answering the questions provided by the checklist. It is designed to assess all the budgetary programs over a 3 year period, covering about 30% of programs every year. More than 1,700 programs and sub-programs have been assessed between 2005 and 2007 and their results are reported in section 3.

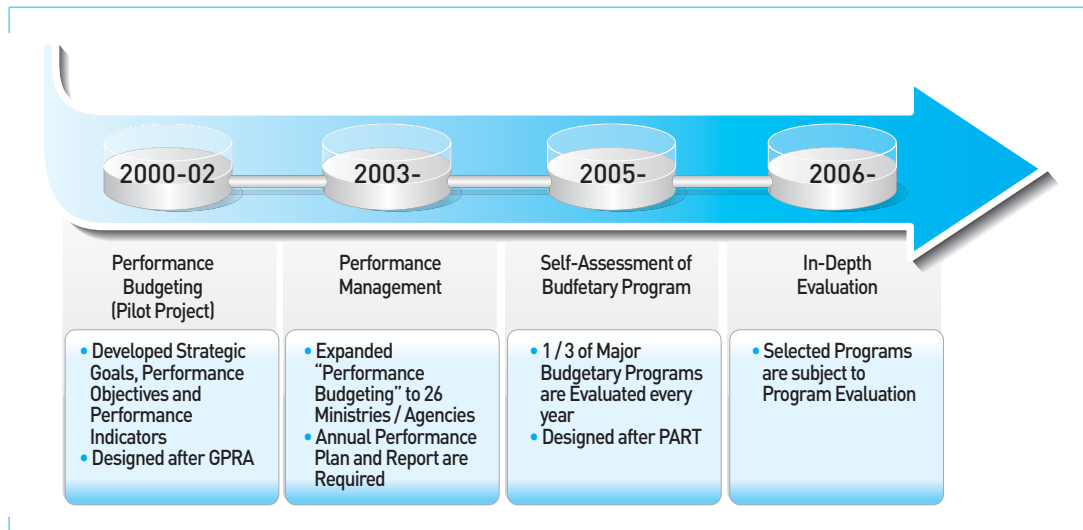
In the summer of 2005, MPB reorganized its departments and created a bureau of

28) The Korean government has 1,043 programs and 3,594 sub-programs in 2007.

performance management to give institutional backbone to the performance management system.

In addition to PMSBP and SABP, MPB introduced in-depth program evaluation in 2006. MPB selects programs to be evaluated based on the SABP results and inputs from experts, interest groups, and agencies. The aim is to provide more conclusive evidence for decision-making. While the experience of program evaluation is widely available in many OECD countries, Korea has little experience in the field. It remains to be seen how effectively program evaluation will be conducted.

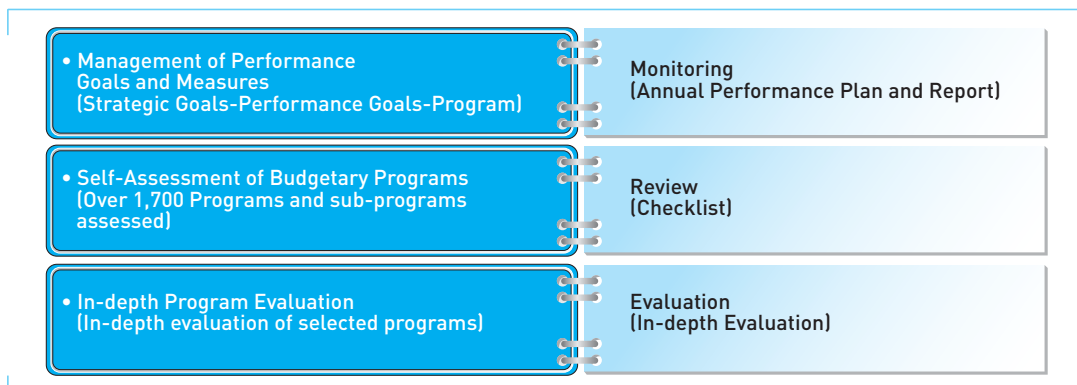
Figure 5-16 | History of Performance Budgeting in Korea



Following introduction of in-depth program evaluation in 2006, the Korean government is now equipped with a complete set of performance management system. Figure 5-17 shows the framework of performance management system for budgetary programs in Korea. PMSBP will play a role of monitoring by examining performance indicators at the level of programs and sub-programs, SABP will provide more detailed information on the performance of sub-programs by checklist, and in-depth program evaluation will offer more conclusive performance information on selected programs. The unit of analysis for in-depth program evaluation varies with evaluation issue of a specific program.

The National Finance Act, enacted in December 2006, stipulated the "Four Major Reforms in Public Finance", including the performance management system for budgetary programs. Inclusion of performance-oriented budgeting into the law is expected to give a stable environment for developing an effective performance management system, because it takes time to produce relevant performance information and to change spending ministry practices for managing budgetary programs.

Figure 5-17 | Framework of Performance Management of Budgetary Programs



3.2.2. Results of Performance-Oriented Budgeting during 2005-2008

As discussed in the previous section, even though the Korean government has three components of performance management system of budgetary programs and sub-programs, only SABP (a.k.a. KPART) has been actively implemented and has enough data to report its results. Thus, in this section, the results of the SABP will be mainly discussed. The statistical summary of results and their utilization in the budget process is discussed below.

3.2.2.1. Statistical Summary of SABP Results

The distribution of SABP sub-program ratings and scores (the total scores and those for the different sections that make up the SABP assessment) is presented in Table 5-1. A total score out of 100 is determined for each sub-program, from which an effectiveness rating (effective, moderately effective, adequate or ineffective) is derived. The distribution of the total scores across programs is illustrated in Figure 5-19. In 2005, the proportion of sub-programs rated as ineffective is 15.7% and a majority of the programs are rated as adequate. 5% of programs are assessed as effective.²⁹⁾ The distribution of sub-program ratings did not change much between 2005 and 2006, but it was greatly improved in 2007: the ratio of ineffective programs dropped to 5% and that of effective sub-programs doubled. The significant improvement in sub-program ratings in 2007 is attributable to the improvement of sub-program performance and agencies learning from a couple of years' experience with SABP.³⁰⁾ However, the ratio of ineffective programs dramatically increased to 27% in 2008. This is partly due to the evaluation unit within the central budget authority applied more stringent standard to the program review process.

29) Compared to the experience of the United States, it is very surprising, because 50% of programs there were given "result not demonstrated (RND)" rating at the first-year PART rating. If you listen to the inside story in Korea, however, a different picture emerges. According to the insiders, initially 70% of programs were judged as "result not demonstrated (RND)" due to lack of performance information. For some reason, MPB decided not to create RND rating and gave more generous assessment and came up with the ratings in <Table 3-1>.

30) This could be an effect of a change in the standard of assessment, though there is no convincing evidence of this.

The total score and effectiveness rating are determined for each sub-program on the basis of assessment across three sections, namely program planning, management, and results. The program management section is further divided into two sub-sections of program rationale and design, and performance plan. Among 15 common questions in the checklist, seven questions are about program planning, four questions are about program management, and the remaining four questions are about program results. The maximum scores for each section and part are shown in Table 5-1. These results are further illustrated in Figure 5-19 and Figure 5-22. The distribution of scores in the planning section is skewed towards the upper bound. Scores for rationale and design shows low variation among assessed programs and are high.³¹⁾ In contrast, scores for performance plan show significant variance among programs, which suggests that developing relevant performance plans is not easy. The distribution of the scores for management shows that many programs obtained perfect scores. The results section exhibits a skewed distribution of scores towards the lower bound.

Figure 5-18 | Program Review Results

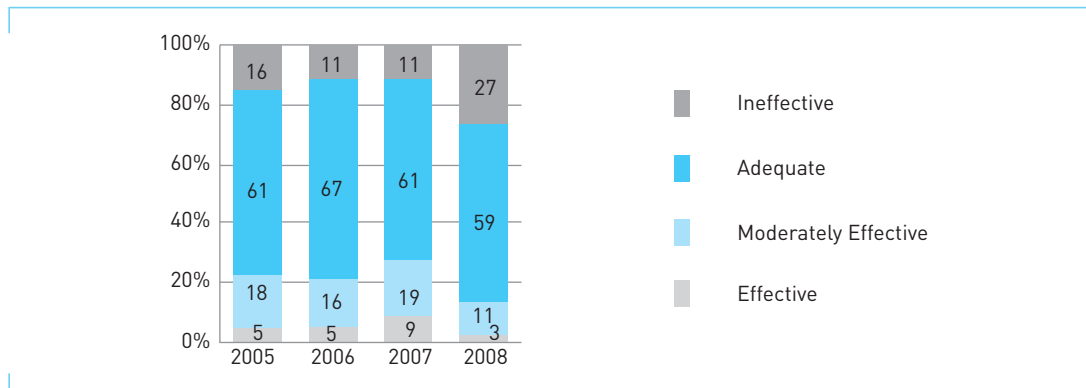
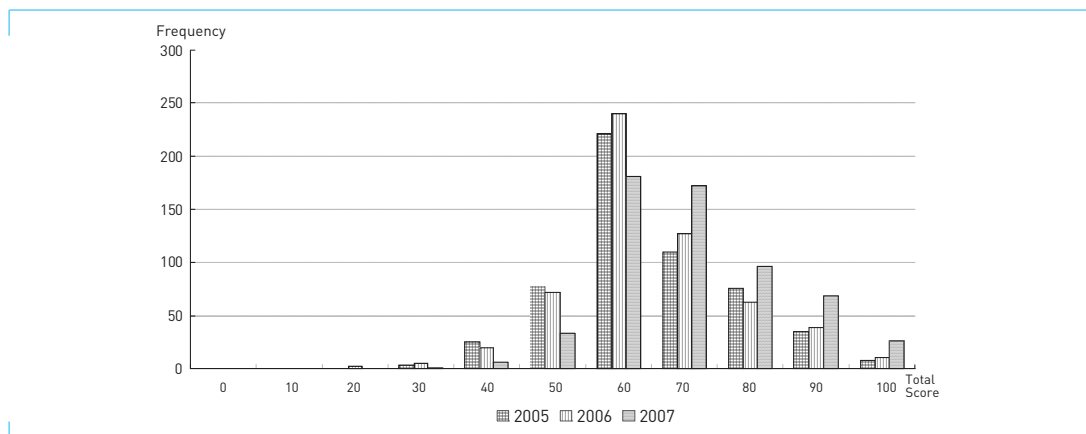


Figure 5-19 | Distribution of Total Score



31) It may be a reflection of the fact that SABP is an assessment within the Administration and, as a result, it is hard to question existing program rationale itself.

Figure 5-20 | Distribution of Scores in Planning Section

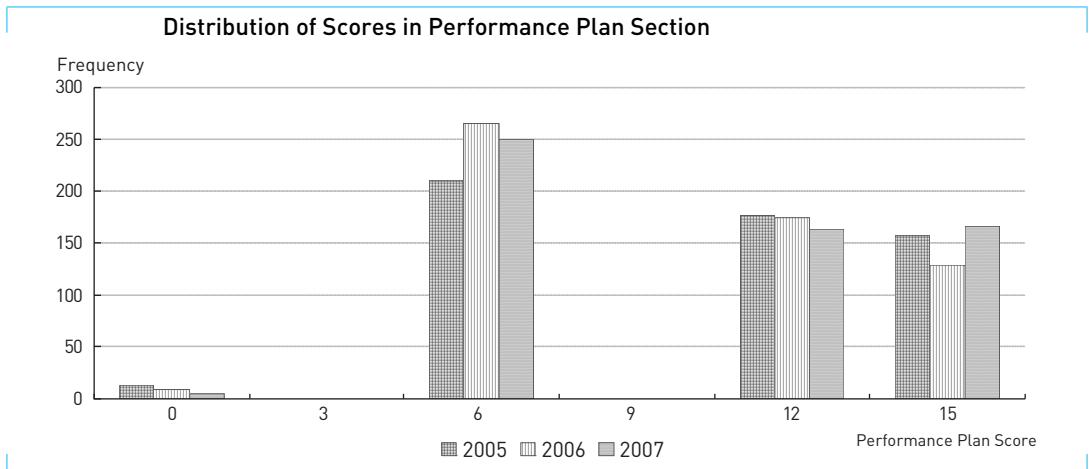
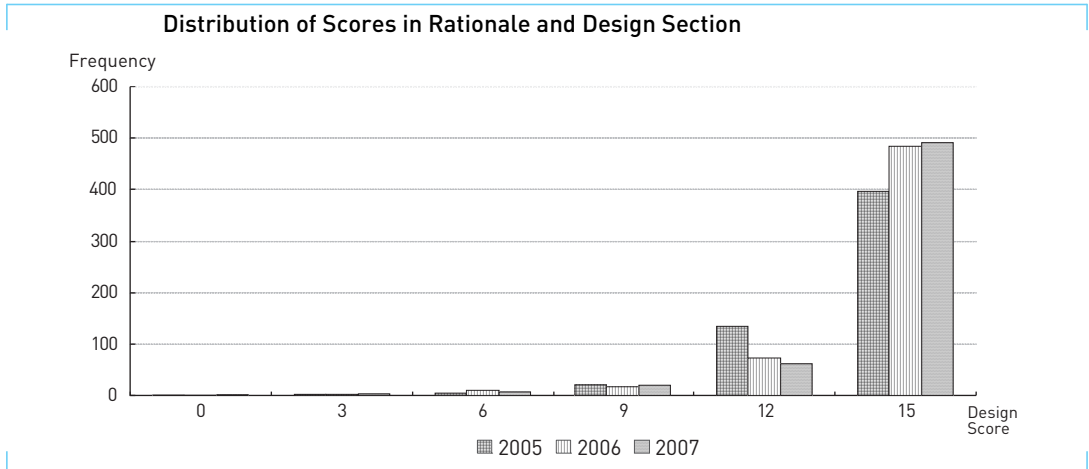


Figure 5-21 | Distribution of Scores in Management Section

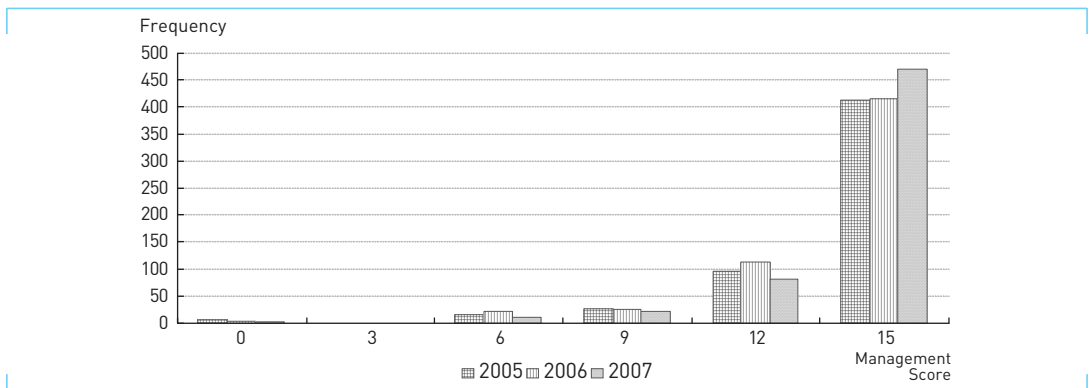


Figure 5-22 | Distribution of Scores in Results Section

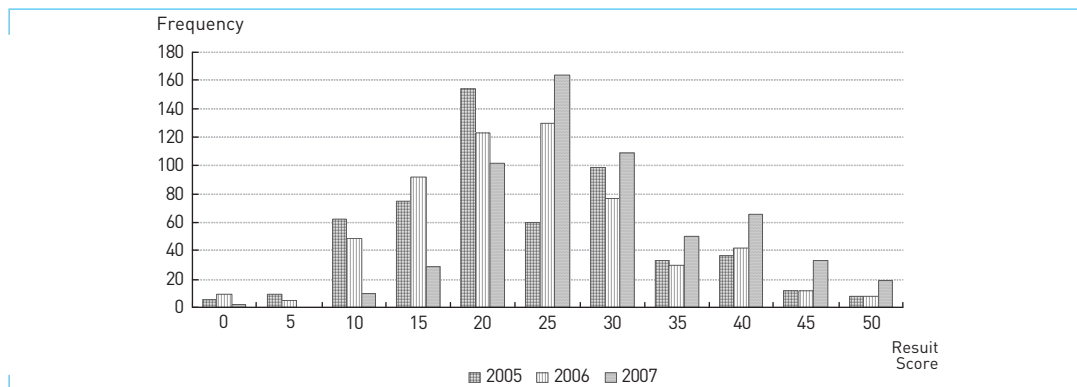


Table 5-1 | SABP Scores

Year	Total Score	Effectiveness Rating	# of Program (%)	Planning(30)			Management (20)	Results (50)
				Total (30)	Program Design (15)	Performance Plan (15)		
2005	Total		555	23.05	13.75	9.30	15.13	21.94
	>85	Effective	29(5%)	29.03	14.03	15.00	17.14	42.42
	70-84	Mod.Eff.	104		(19%)	26.37	13.87	12.50
	50-69	Adequate	337(61%)	22.50	13.94	8.56	15.30	19.74
	50>	Ineffective	85 (15%)	19.12	12.77	6.35	12.00	11.02
2006	Total		577	22.94	14.27	8.68	14.72	22.30
	>85	Effective	30(5%)	29.63	14.80	14.83	16.72	42.41
	70-84	Mod.Eff.	96(16%)	27.72	14.49	13.23	15.37	33.17
	50-69	Adequate	387(67%)	22.01	14.46	7.56	15.12	19.82
	50>	Ineffective	64(11%)	18.15	12.52	5.63	10.36	11.13
2007	Total		584	23.40	14.20	9.20	15.50	27.10
	>85	Effective	69(12%)	29.66	14.88	14.78	16.74	43.10
	70-84	Mod.Eff.	144(25%)	26.80	14.71	12.08	16.44	32.32
	50-69	Adequate	340(58%)	21.30	14.15	7.15	15.27	22.71
	50>	Ineffective	31(5%)	16.66	10.85	5.81	10.89	15.40

Note: Numbers in the parenthesis represent possible maximum scores.

The sub-section performance plan and results section exhibit relatively low mean scores compared to that of the program design and management section. The programs rated as ineffective received relatively low scores in the performance plan and results. Considering the fact that the scores in the results section are linked to that in the performance plan, the quality of the performance plan may be a critical factor in determining a program’s rating.

Table 5-2 reports detailed results on the crucial questions in determining program's rating. Two important questions on the performance plan are about whether a program has relevant performance indicators and reasonable performance targets. 39.8% of programs are assessed as having no relevant performance indicators in 2005, and it worsened in 2006 and 2007, where the ratios dropped to 47.5% and 43.9%, respectively. The ratio of those without relevant performance targets is higher, at 71.5% in 2005 and staying about the same level afterwards. It shows many programs do not have adequate performance information yet.

What, then, is the main reason for the improvement in program ratings in 2007? Since there is no noticeable change in the section of program design, performance plan and management, improvement in the result section is the main source of improvement. In Table 5-2 significant improvement comes from questions on meeting the performance targets (question 3-2), achieving citizens' satisfaction (question 3-3) and utilizing evaluation results in decision making process (question 3-4).

Table 5-2 | Results on Performance-related Questions

(Unit: %)

Year	# of Programs	Question	"Yes"	"No"	"Some-what"	"Very much"
2005	555	1-6 Performance Indicator	60.2	39.8	62.2	17.8
		1-7 Performance Target	28.3	71.7		
		3-1 Program Evaluation	62.7	37.3		
		3-2 Performance Results	9.5	10.5		
		3-3 Customers' Satisfaction	47.8	52.2		
		3-4 Feedback	57.5	42.5		
2006	577	1-6 Performance Indicator	52.5	47.5	72.3	10.7
		1-7 Performance Target	22.4	77.6		
		3-1 Program Evaluation	49.2	50.8		
		3-2 Performance Results	12.5	4.5		
		3-3 Customers' Satisfaction	57.5	42.5		
		3-4 Feedback	55.8	44.2		
2007	584	1-6 Performance Indicator	56.1	43.9	62.1	22.2
		1-7 Performance Target	28.7	71.3		
		3-1 Program Evaluation	47.6	52.4		
		3-2 Performance Results	14.4	1.4		
		3-3 Customers' Satisfaction	81.3	18.7		
		3-4 Feedback	79.7	20.3		

Source: MPB

3.2.2.2. Utilization of Performance Information in the Budget Process³²⁾

This section examines whether assessment results are utilized in the different stages of the budgetary process, which may be the ultimate purpose of the performance-based budgeting. Table 5-3-3 shows links between assessment results and budget allocations from 2005 to 2008. The first consideration is whether agencies utilized assessment results in their budget requests. In terms of absolute amount, programs and sub-programs rated as ineffective suffered a loss of 16 billion won in total, compared to 2005 budget. Since this big loss may be affected by huge losses in a few big programs, it would be better to examine average ratios of budget change to draw a more precise picture. For programs rated as ineffective, agencies requested for 2006, on average, 13% less than 2005 budget. It clearly shows that agencies consider assessment results in their budget requests. For the 2007 budget, agencies requested, on average, 47% less for ineffective programs compared to 2006 budget. However, in the 2008 budget request, ineffective programs received a cut of under 11% in budget requested, compared to the 2007 budget. This suggests that the extent to which assessment results affect agencies' budget requests has become smaller (as the number of ineffective programs has also shrunk).

The second consideration is whether MPB utilized performance information in their budget proposal. Table 5-3 shows clear links between SABP results and MPB's budget proposal. Programs rated as ineffective suffered a loss of 4.1 billion won in total and a 12% loss on average in 2006 budget. While ineffective programs lost 53% on average in the 2007 budget, they suffered a 21% budget cut in the 2008 budget.

In fact, MPB encouraged ministries/agencies to make use of assessment results in their budget requests and announced that a 10% budget cut will be imposed on the programs rated as ineffective. The analysis on the data strongly suggests that agencies and MPB made a clear link between evaluation results and budget allocation. While the extent to which assessment results are utilized becomes weak in 2008 budget formulation, they are still utilized by MPB.

The final consideration is whether the National Assembly utilized performance information. In contrast to the case of the United States, the Korean case shows that ineffective programs went through budget cuts in the Legislature in both 2006 and 2007 budget approvals. In sum, performance information is reflected in every stage of budget formulation between 2005 and 2007.³³⁾

³²⁾ The following results are based on the methodology employed in Park(2008).

³³⁾ Since budget allocation is affected not only by performance information but also by other factors, such as program type, ministries' characteristics, and demand for program, it is necessary to control these factors. Park(2008) found strong correlation between budget allocation and evaluation results after controlling other factors at every stage of budget process.

Table 5-3 | Links between SABP Results and Budget Allocation

Links between SABP Results and Budget Allocation ('05 KPART)

(Unit : 100,000 won)

	'05Budget (A)	'06			Budget Growth Ratio		
		Agency(B)	MPB(C)	Final(D)	(B-A)/A	(C-A)/A	(D-A)/A
Effective	15,600	24,948	18,955	22,489	0.60	0.22	0.44
Mod.Eff.	92,994	104,335	107,055	105,762	0.12	0.15	0.14
Adequate	208,066	204,473	195,625	201,214	-0.02	-0.06	-0.03
Ineffective	33,081	28,644	29,007	28,505	-0.13	-0.12	-0.14
Total	349,740	362,400	350,642	357,970			

Links between SABP Results and Budget Allocation ('06 KPART)

(Unit : 100,000 won)

	'06Budget (A)	'07			Budget Growth Ratio		
		Agency(B)	MPB(C)	Final(D)	(B-A)/A	(C-A)/A	(D-A)/A
Effective	8,891	9,467	9,337	8,872	0.06	0.05	0.00
Mod. Eff.	33,156	35,701	35,364	35,654	0.08	0.07	0.08
Adequate	297,180	296,769	290,481	289,969	0.00	-0.02	-0.02
Ineffective	11,431	6,039	5,400	5,380	-0.47	-0.53	-0.53
Total	350,658	347,975	340,582	339,875			

Links between SABP Results and Budget Allocation ('07 KPART)

(Unit : 100,000 won)

	'06Budget (A)	'08		Budget Growth Ratio	
		Agency(B)	MPB(C)	(B-A)/A	(C-A)/A
Effective	17,112	18,211	17,503	0.06	0.02
Mod. Eff.	266,051	295,121	291,319	0.11	0.09
Adequate	146,034	153,026	142,044	0.05	-0.03
Ineffective	3,870	3,457	3,066	-0.11	-0.21
Total	433,067	469,815	453,932		

Source: Park (2008)

3.2.2.3. Utilization of Performance Information in Line Ministries

So far evidence suggests that assessment results are utilized in the budget negotiation process and reflected in final budget allocation. This may be a stark contrast with other countries. In this part, it will be illustrated how performance information is utilized by line ministries and how line ministries are changing their management practices for service delivery. According to the survey conducted by the National Assembly Budget Office (NABO) in Korea, 70% of budgeting personnel in line ministries responded with neutral or positive answers to the question, "Are assessment results from SABP useful in the preparation of budget request?" Considering the tendency for critical evaluations, line ministries show quite a high satisfaction level with the process. Many budgeting personnel in line ministries indicated that the

availability of assessment results made their job easier, because performance information facilitates communication between them and program managers.

Not only do line ministries utilize results from SABP in their budget formulation, but they also change their program management to enhance the effectiveness of service delivery. An example from the Ministry of Public Health and Welfare is a case in point: Since 2000, the ministry has been running a program designed to provide assistance to unemployed low income families although less than 3 percent of recipients were found to have become 'economically independent'. Once such poor performance was highlighted, particularly after the introduction of performance-oriented budgeting, the ministry began to reform the program.

The program was managed in the following way: funds ranging between US \$120,000-\$190,000 were allocated to 242 regional centers. There was only one center in each locality and the amount of funds was decided by the number of dependent families. Thus there was no competition among the centers and flexibility was very limited.

Recently, the ministry decided to run a pilot program based on performance-based management. There will be separation between buyers and suppliers of the program: the service provider will be selected based on proposals submitted and eligibility will be extended to private firms as well as non-profit organizations. The contract is now performance-based. There will be fixed payment proportional to the number of families they serve. Then, two additional incentives will be provided: (1) if a recipient finds a job meeting a certain standard, a bonus will be given to the service provider; and (2) if a recipient moves off the government subsidy for low income families an additional bonus will be paid to the provider. To avoid the possibility of skimming the best clients, differentiated fixed payments will be allocated according to the characteristics of the family. This reform initiative aims to improve the effectiveness of service delivery. The pilot program was introduced in 2008 and will be evaluated in two years to see whether nationwide implementation is warranted.

Performance-oriented budgeting in Korea is still at the early stage, but it is gaining momentum and changing the way of program management in line ministries, as illustrated in this case.

3.2.2.4. Lessons

This paper explains the institutional background and current system of performance-oriented budgeting in Korea. This paper also tries to show whether performance information is utilized in the budget process and how it is utilized in line ministries. This paper concludes with lessons and suggestions for performance-oriented budgeting in Korea. At present, Korea is in the early stages of implementing performance-based budgeting; it is therefore too early to form a definite assessment.

However, overall, performance information appears to have had a positive impact on the budgeting process. Regarding the impact of performance information on ministry performance, there are cases, as illustrated above, in which ministries are changing their approach to managing programs to enhance service delivery performance.

Despite Korea's short experience in introducing performance budgeting, some general lessons can be drawn. The first is that reorganizing ministries/agencies and the budget structure needs to be undertaken before introducing the performance system. At present, in Korea, performance information is focused on individual program/projects, and cost information is not readily available because organizational units, programs, and the budget structure are not aligned with each other. As a result, it has been extremely difficult to develop meaningful outcome measures and efficiency/effectiveness measures.

Secondly, introducing performance-based budgeting as one component within a broader range of comprehensive reforms has helped to lower resistance and resolve institutional problems. However, at the same time, concerns have been raised that the concurrent implementation of multiple major reforms in itself imposes an inappropriately heavy burden on the government.

Korea's experience has also shown that in introducing the performance system, decision makers should be patient about reaping any benefits. Lack of patience may have forced the MPB to take excessive measures in order to show quick results—it was partly because of this kind of pressure that the MPB felt forced to quickly implement a 10% budget cut for ineffective programs. Interestingly, however, setting specific targets of budget reshuffling or budget cuts in terms of a certain proportion of total budget is adopted in other countries, too. For example, Canada recently aims to reshuffle 5% of each agency's budget after reviewing performance of spending programs. It appears that setting rules of budget reshuffling 3-5% of budget size is acceptable without causing significant side effects among some countries.

There is also a concern that decision makers may be more interested in introducing the performance system than in monitoring or improving it—if a country is accustomed to getting quick results from reforms, it may not be easy to develop and improve the system gradually over the longer term.

A further issue relates to the regular rotation of assignments that occurs in the Korean civil service, which may work against the capacity development of ministries/agencies. There needs to be proper understanding of the goals as well as the operational aspects of performance-based budgeting among the civil service, otherwise, wasteful and distorting behavior may proliferate.

With regard to the operational aspects, Korea's experience highlights that proper cost accounting and a solid program budget structure will greatly help to maximize the benefits of

the performance system. Recently, Korea is putting efforts in improving both issues. Accrual accounting is introduced in 2009 and financial statements will be available from 2010. Since, from the view point of performance budgeting, allocating indirect costs to each program is more useful than accrual accounting, the issue of developing full cost information is still unresolved.

Regarding improving program structure, new clause is added to the National Finance Law that states that program structure and performance goal structure in annual performance plan should be consistent and identifiable, in principle. This issue is raised because different organizational units are responsible in developing program structure and performance goal structure and there was lack of coordination between them. As a result, sometimes it is hard to match programs from given annual performance plan and report and it hinders decision makers from using performance information in budget formulation and deliberation process. It is important that performance information should be consistent to the program structure to facilitate use of performance information in budget process.

Broadly, Korea's experience confirms that a performance system evolves over time and raises different challenges at each stage. At the initial stage, merely developing relevant information presents the main challenge. As the performance system evolves, other changes become more important, namely behavioral change, such as how to get various actors to use performance information in the decision-making process, and how to monitor the performance of the performance system itself.

Looking forward, the major ongoing problem for Korea is the quality of performance information. More training and research are needed, along with a greater commitment to invest in collecting and organizing the information. Specifically, the analytical and administrative capacities of the central budget authority and ministries/agencies need to improve. This may require reinforcement of units specializing in analysis and assessment in both the MOSF and ministries/agencies.

3.3. Policy Recommendations for Indonesia

The core question of PB is what kind of link between performance information and budget allocation are observed and the following four types are observed among OECD countries: Type 1 is called as presentational PB in that there is no intention of using performance information for budget allocation. Performance information is just contained in budget documents. Not many countries are adopting this approach.

In type 2 PB, there is an indirect link between performance information and budget allocation. Performance information is important factor for budget allocation but no specific mechanism is established. It is most countries' official stance towards PB. However, there is not much evidence that performance information is really used for budget allocation.

In Type 3 PB, there are attempts to build closer link between performance information and budget allocation. Some countries set the specific target for budget reshuffling based on performance information. This is an attempt to move beyond the official “indirect link” between performance information and budget allocation. In Canada, non-performing 5% of departmental budget is target for budget reallocation and, in Korea, “ineffective programs’ are subject to at least 10% budget cut in principle.

In type 4 PB, direct/mechanical link between performance information and budget allocation is established. In this case, mechanical link between performance information and budget size is set by formula. The performance information is used for specific areas, such as public health, education and social welfare programs.

In theory, performance information should be used as one of important factors for budget allocation. In practice, however, Indonesia should consider setting specific targets for budget reshuffling, in order to secure fiscal space. It appears that setting target at about 3-5% of budget size does not cause serious unintended problems.

It is recommended to focus on selective areas/programs that are important and easily subject to performance budgeting at the initial stage of reforms. Since producing meaningful performance information for every program takes time, it can be a good strategy to start with selective areas/programs to demonstrate the impact of performance budgeting. It is recognized that developing performance information on service delivery areas is easier than that on policy formulation areas.

Indonesia should consider moving beyond performance indicators and targets, particularly if outcome indicators are used. Outcome indicators need interpretation to be used in decision-making purpose due to external factor affecting measured outcome. Therefore consider developing program review process to have more systematic performance information, unless communications between the central budget authority and line ministries are easily facilitated. Program structure combined with performance indicators can provide signals whether a particular policy area is going well, but it cannot provide enough information for decision making.

Indonesia should also consider using output indicators in some areas. If the link between output and outcome is very tight, output indicator can be a good proxy for outcome. If quality of services can be properly controlled, output-based budgeting can be useful. In some cases, aforementioned conditions can be met. For example, customs service can be managed by output-based budgeting. If quality control mechanism of inspection is properly developed, the number of inspections can be closely linked with budget size.

Capacity building for PB is very important in the following areas: the central budget

authority's evaluation capacity and line ministries' evaluation and data management capacity. If there are outside resources, such as research institute and universities, are available, cooperate with them.

Location of evaluation unit is important. For independence of evaluation, separated evaluation unit is desirable. However, if evaluation unit is separated from budget office, performance information is less likely to affect the budget allocation.

In Korea, evaluation unit is separated from budget office. As a result, even though there are efforts to convey performance information to budget office, the use of performance information in the budget formulation process is limited. The budget office does not pay attention to the details of evaluation results and its use of performance information is mostly limited to the 10% budget cut to 'ineffective programs'.

In the US, examiners, who are responsible for budget preparation for particular areas, are also responsible for program review process (PART). It means the budget office conducts program evaluation. So the producer and user of performance information are the same and there is no need to worry about communication between budget office and evaluation unit. The drawback of this approach is the possibility of overload to the budget office. One of the reasons why Korea established a separate unit is the resistance from budget office being afraid of heavy workload.

Next, develop proper incentive schemes for line ministries. Without proper incentives for program managers, the benefits of PB will be limited. Giving flexibility of management for good performance and giving sanctions for poor performance need to be considered.

The introduction of performance budgeting is often linked to broader efforts to improve expenditure control as well as public sector efficiency and performance. Thus, performance budgeting is generally combined with increased flexibility for managers in return for stronger accountability for the results, so as to enable them to decide how to best deliver public services. If not, there is a risk that managers will view performance budgeting as simply another layer of central controls and will resist it. Provisions for sanctions-including dismissal of staff-in the case of non-performance need to be in place. Robust system of accountability and control, including internal and external audit, are required before granting increased flexibility.

Lastly, leadership of top decision makers and engagement of politicians are the crucial factors for the success of PB. Otherwise, efforts of PB will not be materialized in real decision making process and PB will become just a shell.

The most difficult issue with implementing performance budgeting in OECD countries is to persuade politicians-ministers and members of the Parliament- to use it in decision-making.

They overwhelmingly continue to focus on inputs and ignore performance and results information.

4. Summary and Concluding Remarks

In many emerging and developing countries, reforms in the budget process are in full swing by benchmarking best practices in advanced countries. Korea also has gone through major budget process reforms during early and mid 2000s. They are called as 4 major fiscal reforms in Korea. That is, medium-term expenditure framework(MTEF), top-down budgeting, performance-oriented budgeting and digital accounting system. MTEF and performance-oriented budgeting is selected as topics of the 2009 Knowledge Sharing Project(KSP) with Indonesia. This paper attempts to present brief theoretical overview of both initiatives, raises some issues from Korean experiences and developed recommendation for Indonesia who is in the process of introducing both reforms. It is stressed that capacity of government and cultural and political environment of the particular country concerned should be considered, in designing and implementing the reforms. Based on the challenges that Korea had been facing in the process of reforms, practical recommendations that need to be considered for Indonesia are presented.

The purposes of MTEF are manifold: First, improve macro fiscal situation by introducing medium-term perspectives and fiscal discipline into budget process. Second, improve predictability of policy and funding to the program managers and the public by providing a picture of medium term plan. Third, improve the impact of government policy by linking policy priorities and performance to the budget allocation among sectors and programs.

To achieve these goals, some challenges need to be overcome. First, producing independent and objective macroeconomic projections and revenue estimates are crucial to give credibility of MTEF for decision makers, because the incumbent government tends to have too optimistic views on the economy. To make MTEF transparent, assumptions underlying medium-term macroeconomic forecasts should be made public. Second, costs and performance information of government policies should be credible and informative. Developing sound cost and performance information of existing policies and new policies creates a challenge of its own. It may take time to produce quality information, but it is a necessary procedure to realize full potential of MTEF. Third, the environments in which civil servants manage their policies need to be improved. Their line of responsibility should be clear and they need to have proper autonomy in managing their program. If their work environment is uncertain and they do not have proper incentives to manage their program effectively, performance of the government policies will not be improved even though MTEF.

Performance-oriented budgeting can be viewed as an infrastructure of MTEF, because it

provides performance and costs information of government policies and enhances links between budget allocation and performance of spending programs. For the successful implementation of performance-oriented budgeting, some challenges need to be overcome. First, infrastructure of performance-oriented budgeting needs to be developed, which takes time and requires patience. The infrastructure refers to performance and cost information of spending programs, and program structure. Second, communications between the Administration and the Parliament is very important, particularly when outcome-oriented performance budgeting is introduced. The Parliament wants to check the inputs and process of government programs, while outcome-oriented performance budgeting intends to give autonomy to program managers in the input and process management. Therefore, communication on the reform agenda with the Parliament is crucial for the successful implementation of budget process reforms.

It is easy to introduce the appearance of budget process reforms, while meaningful implementation of the reforms is hard to come by. With careful and persistent efforts of involved parties and leadership of high level decision-makers, MTEF and performance-oriented budgeting will make budget process more efficient and disciplined by providing longer term perspectives, meaningful performance and cost information into budget process.

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