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# A Comparative Study: The Banking Reforms in Indonesia, Thailand, the US, and the UK, and How it Affected the Banking Performance and the Economic Growth

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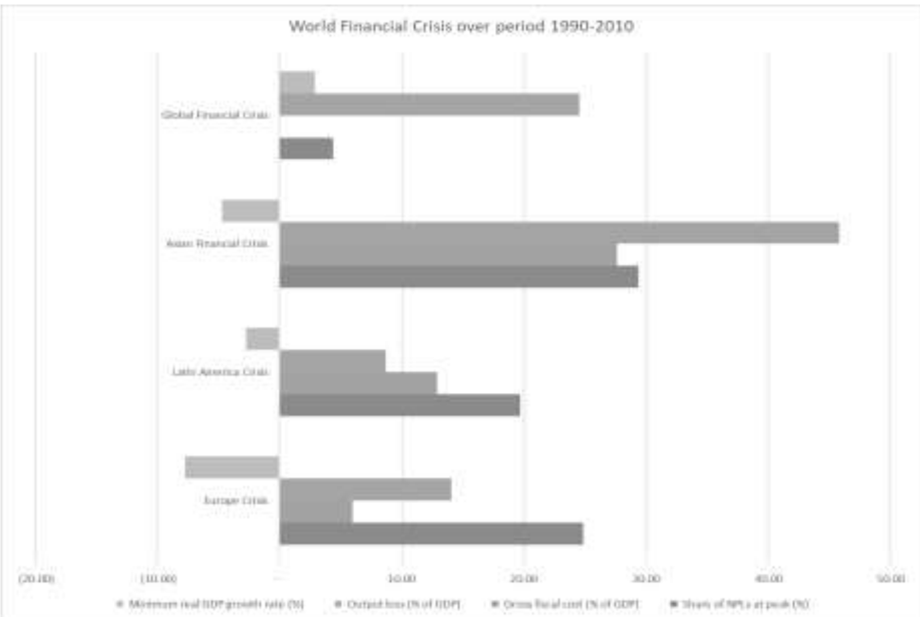
**Abstract**

*The banking crisis occurred as a result of the massive financial deregulation that lead thebanks to expand their businesses on the large-scale and tends to increase the risk their portfolio,such as in the Asian and the US crisis. The aftermath of the crisis became the challenge for the government and regulators, as it required a tremendous amount of liquidity injection either fromthe international lender of last resort such as the IMF, or from the government (by using taxpayers money), undeniably it remains painful for the economic recovery. The banking reformsaim to strengthen the banks and the financial industry. There are numerous reforms agenda in every crisis, however this study focus on several issues that most often arises in every crisis. Themost common issues are; (1) the presence of deposit insurance institution protecting thedepositor's money to reducing public panics, and bank runs, (2) ensuring sufficient capital as a buffer to the crisis and liquidity management by adopting the Basel requirements. By comparingthe banking reforms in the US, the UK, Indonesia, and Thailand, this study aims to give insight which reforms were the most effective to address the crisis and had an impact to the bank's performance, particularly in the profitability and also the economic performance, by measuring loan to GDP ratio. The result of this research are the banking reforms to some extent, have had a positive impact on the banking profitability in emerging countries. However, in the developed countries, the financial crisis and the banking reforms were not necessarily affected the recoveryof the industry. Meanwhile, the banking reforms that focus on strengthening the regulation couldslow down the economic growth as the banks become more prudent in giving the new loan. However, lowering the net interest margin could boost the lending growth. In the end, the policies recommendation are implementing the risk-based premium scheme on deposit insurance institution, and the implementation of counter-cyclical capital variation on the capitalrequirement.*

Keyword: the regulators, banking reforms, banking performance, profitability, economic performance.

## 1. INTRODUCTION

The financial crisis is an interesting topic to discuss either in the academic or the practitioner's context as it could not only affect the financial market, such as banking sector, the stock market, and government debt (Tressel, Demirguc-Kunt and Peria, 2015). However, it also obstructs the economic sectors in general including investment, unemployment, poverty, real incomes, social tensions, and political stability (Riley, 2017). The questions that commonly arise are; what is the source of the financial crisis, how are the government policies responses the crisis, and what is next after the crisis. These become subject to debate, as there are several factors to answer those matters. During the last two decades, there are many financial crises that happened in Latin America, Asia, the US, and Europe countries (Caproasia Institute, 2016). The complete list can be seen in Appendix 1. However, there are two financial crises that occurred which had a massive impact on the financial system regionally and globally the Asian financial crisis (“AFC”) in 1997 and the Global financial crisis (“GFC”) in 2008-2009. In figure 1, it can be seen that the AFC and GFC massively affected the output loss and the fiscal cost relative to the Latin America crisis and Europe crisis period 1990-1996. Furthermore, figure 2 compares the regional GDP annual loss with the global GDP, although the AFC slashed the GDP more than GFC, it was not affected to the global GDP, or in other words, it did not have a massive impact to the global economy. However, in contrast, the GFC knocked the world GDP even though the GDP annual loss was not as significant as




AFC.

**Figure 1:** The Comparison between financial crisis over period 1990-2010. Source: (Smith, 2012).

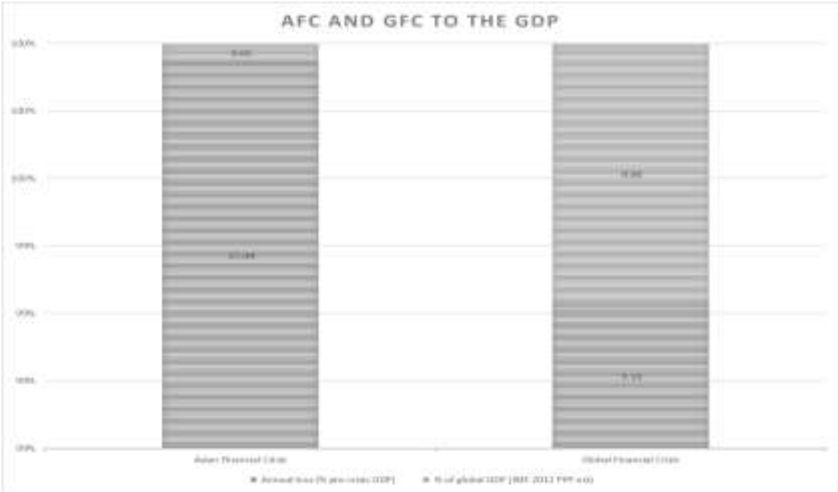



**Figure 2:** The AFC and GFC effect to the GDP. Source: (Laeven et al., 2012).

Starting with the AFC in 1997 centred in Thailand and spread to the most of Southeast Asia countries and South Korea. The AFC caused the failure of Thailand's pegging exchange rate regime (Dickinson and Mullineux, 2001) that affected the devaluation of currency and the massive decline of the stock index mainly in Indonesia, Malaysia, Philippines, and South Korea. Additionally, Radelet and Sachs (2000) believed that the core of the AFC was the massive foreign capital inflow, followed by the expansion of international lending. However, the sudden reversal of the capital inflow affected the fragile ASEAN countries' macroeconomics caused the financial crisis. However, Krugman (1998) argued that the primary cause of the AFC was the asset price bubble that burst in the stock market and land price that herald the currency crisis as a result from speculative behaviour and excessive risk-taking from the bankers. Also, the currency crisis is believed to be the indicator, rather than a source of the crisis. Indeed, the crisis was the effect from when Thailand's government announced that the baht allowed to floating on June 1997 (Chowdhry and Goyal, 2000). One year after, the contagion had broadened to another emerging country and global capital market (Wong, 2000). The responses from governments in each nation varied, while Malaysia preferred to tackle the recovery on its own; Indonesia, Thailand, and South Korea demanded the IMF rescue package. Thus, it also affected the regulatory reforms of each country.

Second, a decade after the AFC, with almost similar sequences, the GFC shocked the US economy in 2008. The asset bubble on housing was one primary caused by the crisis since the banks gave easy money to the subprime lenders for a mortgage as the consequences of financial liberalisation (Buckley, 2011). The innovation in the financial market also aggravated the crisis that initiated by shifting the lending models from original-to-hold to original-todistribute allowed banks to sell their mortgage and other loans to another bank or the other financial institution. The investment banking or other financial institutions create innovative products by securitisation that consists of several types of loans, either a prime loan or subprime loan, in one bundle. The products such as collateralised debt obligation ("CDO") or mortgage-backed security ("MBO") has become an attractive investment for the speculators before the crisis. Further, the credit default swap ("CDS") also held the key role caused the crisis as a derivative product. The moral hazard and agency problem play a vital role in the CDS market by increased asymmetric information and led to adverse selection for the investors (Mishkin, 2010). Hence, the unethical behaviour for the bankers to secured higher bonuses became an additional factor for the crisis. When the government increased the Fed interest rate, the subprime mortgage responded negatively, and as a result, many lenders failed to pay their instalment, and the burst occurred. The securitisation and CDS created high interconnection between financial institutions, not only in the U.S., but also the UK and EU financial institutions. As a result, the contagion effect of the U.S. crisis immediately spread globally since the U.S. is the centre of the financial market. The market crash caused the banks, and other financial institutions to collapse, and the economic downturn becomes the consequences of the GFC. The bailout from the U.S. government was common at that time as a way to rescue the economy, while the regulators with the government simultaneously formulated the reforms for the better financial market.

Generally speaking, both crises almost had a similar factor, mainly on moral hazard, excessive risky lending, and financial deregulation. So, what makes them different? Beside asymmetric information, and moral hazard issues, combined with the financial liberalisation among those crises, the issues on AFC was on the currency, fiscal imbalance, and country budget deficit. The table below summarises the central issue of both crises. Therefore, the study will focus on the following fundamental questions:

a. What factors determine the banking reforms in the AFC and the GFC?
b. What is the impact of the reforms on the performance of the banking industry?
c. How does the banking industry contribute to the economic growth post-crisis?

## 1.1. Literature Review

Table 1 below summarises the fundamental idea of reforms from the experts from various perspectives either from the AFC or GFC views. As we can see, from both crises, there was similarity that most of the expert argued as a vital aspect to tackle the crises; (1) the importance of the capital adequacy and liquidity coverage, and (2) the role of deposit insurance institution, which becomes the focus in this research. The reason is that those issues are most often appearing in the most financial crisis. Even though there is many other factors comprised the reforms such as incentives issue, accounting method, TBTF and the macroeconomic policies including exchange rate policy, fiscal policy, and structural reforms on the central bank's function. Further, in the next subsection below, the explanation about deposit insurance, and capital and liquidity requirement as the similar issues either in the AFC or GFC reforms provided and synchronised with the theories.

**Table 2.**
**Key Ideas Comparison about Bank Reforms**

| Expert / Key Issue | Scott Jr, Jens Jr and Al (1992) | Goldstein (1998) | Berg (1999) Kim and Haque | Goodhart (2008) | Kapoor (2010) | Claessens and Kodres (2014) | Hancock and Dewatripont (2017) |
|---|---|---|---|---|---|---|---|
| ***Deposit insurance requrement*** | v | v | v | v | v | | |
| ***Close insolvent banks*** | | v | v | | | | |
| ***Address TBTF issue*** | v | | | | v | v | |
| New banking business | v | | | | | | |
| Bank insolvency regime | | v | | v | | | |
| ***Capital Requirement*** | | v | v | v | v | v | v |
| Improving supervisory structure | | v | | | v | | |
| Incentives issue | | | | | v | v | |
| ***Liquidity coverage*** | | v | v | v | v | v | v |
| Securitisation | | | | v | | v | |
| Reform on accounting methods | | | | | | v | |
| OTC derivatives | | | | v | | v | |

Source: Author

The interconnection between the banking reforms, bank performance,and economic performance becomes essential to analyse as the sequence post-financial crisis. In this paper, the comparison between the selected countries would be elaboratedon further in the discussion section, and below is the theoretical framework of this paper

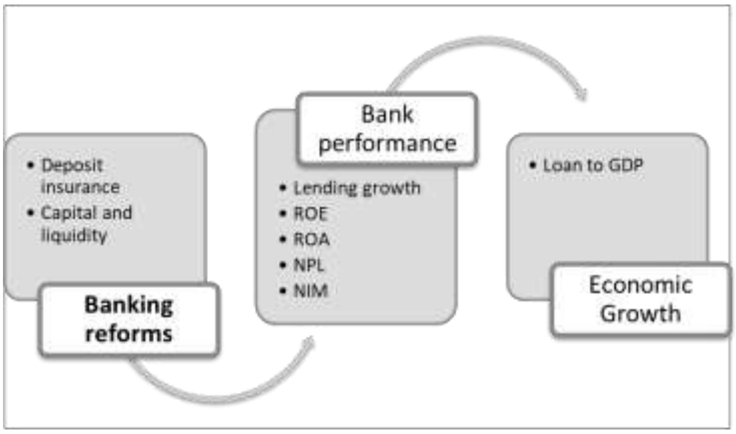



**Figure 3:** The theory framework.
Source: Author

## 2. METHOD

This research employs the qualitative methods by emphasising inductive approaches. While the data for analysis utilised secondary data sources from an academictextbook, journal, working paper, and an article related to the topic such as the type of banking reforms in each country, how the banking performance post-crisis, and how the banks contribute to the economic growth. Furthermore, to support the discussion and to find the conclusion, the exploratory research conducts and also compare in each country.

## 3. RESULTS AND DISCUSSION

The banking reform in Indonesia, Thailand, the US, and the UK run on the different directives, but fundamentally have a similar objective, which is to enhance the banking industry stability by established the prudential supervisory and sound banking regulation. The political environment has a substantial factor in determining the direction of the reform, for instance, in Indonesia; the political issue aggravated the recovery from the crisis and took more than three years to fully recovered. The assistance from the international institution, such as the IMF, is not only limited for liquidity injection, but also they drive the reform with the aggressive and immediate reform agenda that may not fit with the country's characteristic. Generally speaking, the presence of the international body, such as the IMF and World Bank, for the developing countries is such a guardian angel that expected to give hope. Nevertheless, many countries had a more prolonged recovery as the policy brings by that institutions miscarried. On the other hand, if the financial crisis occurred in developed countries, it seems they could handle it by themselves and might only be to some extent. However, the critics came when the bailout employed the taxpayer's money especially if the trigger was the speculative and greedy behaviour of the bankers. Despite the criticism by using the taxpayer's money, the recovery without assistance from the other external institution seems to be more productive to assign the reform agenda as no intervention may have another interest in those reform agenda.

Both the AFC and GFC initiated from the financial liberalisation without any sufficient supervision and regulation, one of the consequences was the speculative behaviour cultivate from the lax of regulation. The corporate governance from the individual banks or institutions must be questioned, as the excessive risk-taking aiming at the higher incentives quite popular on that crisis. Furthermore, on the institutional reforms, in Indonesia for instance, the central bank finally received the maximum authority as banking supervision including the power to handle the banking licence and imposition of administrative sanction, which previously handled by the Minister of Finance. The IMF recommended establishing the Financial Service Authority (Otorita Jasa Keuangan, OJK) with the aim of supervising and regulating several sectors: banks, security market, insurance firms, and pension funds. Previously, the central bank only regulated and supervised the banks, and the other financial institution was under the surveillance of the Minister of Finance. Nonetheless, the establishment of the OJK rescheduled until 2010. A decade after, the UK reformed their central bank function, which prior to the GFC, the banking supervision and regulation supervised by the FSA. However, as the FSA failed to create the financial soundness, the task returned to the Bank of England, and FSA transformed become FPC. The FSA transformed into FPC and segregated into two different institutions, where one of them focuses more on the particular issue including the consumer protection and financial market. It will be interesting to observe whether the OJK in Indonesia will give more resilient supervisory of the financial sector including the banking sector or it will follow the UK way.

Indonesia and Thailand also experienced the absence of deposit insurance institution prior the AFC, compared to the US that had the first deposit insurance institution in the world and the UK established a deposit insurance institution in 1982. Historically, most of the deposit insurance institutions formed post-crisis, and it became the reaction of the government to establish the soundness in the financial industry. The question arises why there is a bank runs in the countries with deposit insurance institution. As described in the literature review, the presence of deposit insurance is not necessarily guaranteed bank runs. However, it could reduce the panics in the market when the crisis began, the public panic could then deteriorate the banking and financial industry and cause it to spread rapidly. Nevertheless, the deposit insurance institution also had limited resources to avoid bank failure notably when the large depositors and other counterparties unable to evaluate the solvency of individual banks or the country experienced the vast magnitude of the crisis (Feyen and Vittas, 2009). In such circumstances, the blanket guarantee as an a to shield the interbank deposits and debt may become essential, and it worked effectively in Finland, Japan, Sweden, Indonesia, and Korea, while they were in the crisis.

According to the data from the FSB (2012), shown in figure 6 below, Indonesia and the US achieved the higher level of coverage (on an absolute level) compared to other the FSB's members. However, for Indonesia, they still need to increase their deposit coverage level, as their GDP per capita was more significant compared to the deposit coverage level. It means if there is future crisis occurs in Indonesia, it will potentially generate a substantial problem related to the guarantee the depositor's money, unless the crisis is relatively insignificant.

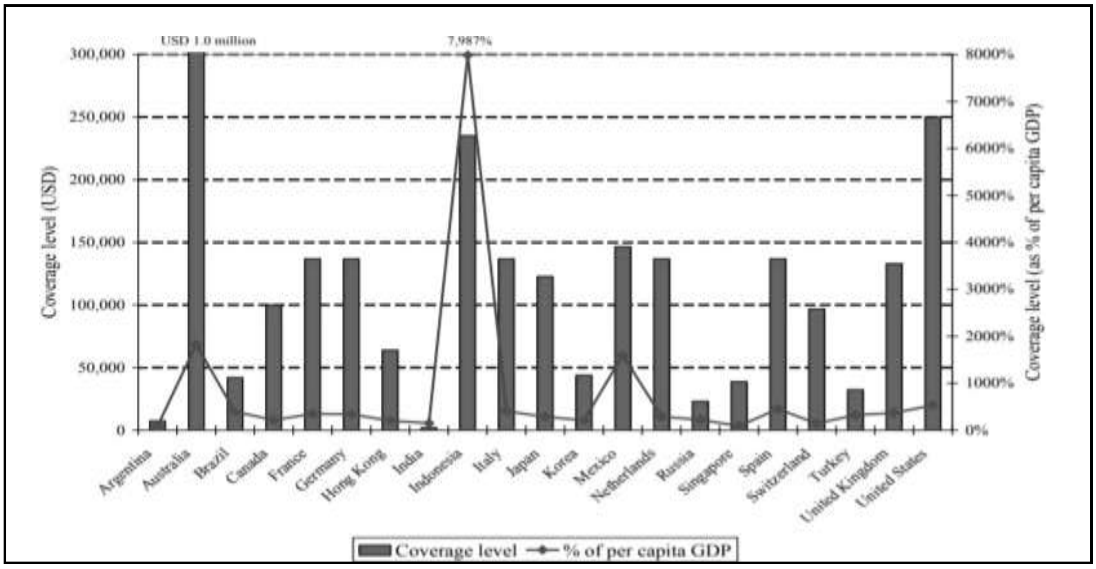



**Figure 4:** Cross-Country Comparison of Coverage Levels at end-2010 (absolute level and % of per capita GDP).
Source: FSB (2012).

In the capital requirement area, the Basel Committee on Banking Supervision ("BCBS"), as an international body, has been arranged the capital requirement for international standard since 1988 on the Basel I, which required the banks hold minimum capital as 8% until the last Basel III to responded the GFC. However, either in the AFC or GFC, the financial liberalisation pushed the bank to lower their capital requirement and to expand their business (Cook, 2008; Rosengren, 2013). For instance in Indonesia, the country is supposed to comply with the Basel I accord to hold a minimum 8% of capital. However, when the government enacted the Banking Act number 7 1992 as deregulation for the banking industry, most of the new banks were allowed to hold the capital adequacy at only 2-3%.

Clearly, it was harm for the financial industry as the banks had fewer buffers when they encountered the shock. In this case, Indonesia tried to increase the banks' profitability by lowered the capital ratio for the short-run effects, but it was such a risky decision and had enormous consequences. The regulators should measure their optimal capital ratio before they allow banks to hold a lower capital ratio.

Based on the data from the World Bank, prior to the crisis, the countries such as the US, UK, and Thailand already maintained the capital adequacy ratio about 12%, which was more than the Basel standard. Indeed, the larger the capital does not mean it could avoid the risk, but at least it could minimise the risk of bank failure. Indonesia experienced shut down of 16 banks and recapitalised 54 other banks as the consequences of the lower capital implementation, while another country not experienced as worse as Indonesia. That proved that the capital requirement is essential to reduce the impact of the bankruptcy. Post-crisis, most of the banks owned higher capital up to threefold from the Basel standard, even though each country has a different standard for the capital requirement. In the end, to prevent the bankruptcy, banks should not only rely on the higher capital adequacy, but also required to provide liquidity and also a resolution plan. The lesson related to the capital is the higher capital is must not necessarily reduce the profitability, but vice versa. It could increase the profitability in the long run, as the higher the buffer that banks owned, the lower the risk of bankruptcy, and would build the trust for the investors.

## 4. CONCLUSION AND IMPLICATIONS

The financial crisis mostly triggered by the massive financial deregulation or liberalisation such occurred on the AFC and the GFC. The banking reform could work differently based on how the crisis comes and occurs. The treatment on the AFC may have differed on the GFC. The AFC reform focused on established prudential framework, which adopted the international standard including capital and liquidity requirement. Also formed the deposit insurance institution, strengthen the function of central banks, reduced the number of banking and other financial institution. On the other hand, the GFC reform emphasised how to break-up the big banks to reduce systemic risk, creating new regulation for investment banking, increase the capital surcharge for SIFIs, and set- up a resolution plan. The banking reform also has a strong connection and cannot be separated from the political issues that somehow could deteriorate the reform itself. Thepresence of international bodies, such as the BCBS and the FSB, was expected to strengthen the banking industry from the global perspective, while the local supervision could work together either in domestic or regional level to establish prudential banking.

Indeed the banking reform aimed to improve the bank performance in the future,for example, increasing the profitability including NIM, reducing NPL, and stimulating loan growth. This argument may verified in the case of post-AFC, but on the post-GFC, it showed slightly different, the country such as the UK experienced negative lending growth from period 2008-2017. The difference in banking characteristics between developing countries that rely on the commercial banking loan and the developed countries that have many options such as bonds, stocks, and another source of funding may lead to the slower lending growth. Additionally, the public remains traumatic from the GFC crisis, and the rise of FinTech and another sources of funding encourage public to leave the conventional banking services. It may be a challenge for the regulators and the bankers to bring back the public confidence and trust in the banking system. Shiftingto the economic performance, the banking reform is not necessarily giving a positive contribution to the economic growth, mainly on loan to GDP ratio. As the prudential level increased would affect slower loan growth. However, if the central banks and the government established the lower NIM policy, potentially it could trigger the loan growth.Further, to some extent, the government is required to achieve the equilibrium on the lending scale; the decision on the contraction and expansion should be arranged sensibly. The moral hazard issue should be thrown away when the regulators set up the prudent expansion level.

The policy recommendation is that it is suggested that the deposit insurance scheme implements the risk-based premium, rather than the flat rate for the sake of fairness. Further, the implementation of counter-cyclical capital variation needs to be assessed because it may encourage banks to achieve their optimal profitability depends on the economic cycle, encourage the banking stability and smoothing credit cycles for the economic growth. The jurisdictions must have separate extra strict prudential supervision body for banks, insurance and investment banks, and the government body for consumer protection and promote competition to reduce speculative behaviour and moral hazard. Besides that, the internal policy in the banking and other financial institutions must be strengthened from the good corporate governance, assertive internal control, and better incentive schemes.

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