Budi Mulya: Managing risk in the new landscape

Keynote speech by Mr Budi Mulya, Deputy Governor of Bank Indonesia, at the Banker Association for Risk Management (BARa) seminar on "Managing Risks in an Uncertain World", Jakarta, 26 October 2009.

* * *

Chairman, Board members and members of the Indonesian Bankers Association and Banker Association and Risk Management, Distinguished Speakers, Ladies and Gentlemen,

It is such a great honore to be here today, especially to join in a dialog amongst experts and practitioners, on risk management. The risk management topic, has become an important subject to be seriously addressed, considering on what we have observed during the most recent global financial crisis.

The impact of the crisis that emerged back in September 2008, has spread deeply and widely through, both financial market and real economic, in particular passing through international trade channel. Since then, we all have witnessed that over the past year, there has been dramatic change, in many aspects of the economy and financial market globally. The magnitude impact of the crisis into individual country differs, depending on how, and to what extent the economy of individual country, and its financial institutions is linked into the global market. Yet, there is no single country immune from the recent turbulence. This is mostly because at the first stage the financial turmoil which started in the US financial market has triggered panic amongst financial market players, in face with high uncertainty, and this behavior was spreading almost instantly worldwide.

To that respect I would like to emphasize, that such market behavior has much to do with risk management, more specifically in the weakness, of its implementation in the real world. Thus, the recent crisis shows somewhat in contrast of the fact that during the last decade risk management has become one important topic in discussion. As a management tool, the practice of risk management so far, has failed to change human being behavior that tends to be easily trapped in complacency. That is, a tendency of not assessing risk properly in good time, partly covered by expected high return, but then reacting so extremely in reverse when thing goes in the opposite direction.

However, as we observed from the ongoing public debate with regard to the cause of the recent turmoil, the similar phenomenon can be found within the authority's or regulator's perspective. In particular, on how they perceived risk in setting policy and in regulating financial industry. More specifically on the assumption that market discipline will always work properly.

One highlight that we can derive from what has been happening so far, is that the financial industry must always be closely linked with the real sector activities, the fundamental economic.

The Indonesian economy and financial industry during turmoil

As in some emerging economies, Indonesia essentially has quite a strong fundamental, and much better compare to what was during 1997/98 Asian crisis. However, as I previously mentioned the crises that caused global economic growth slump and the international trade volume squeeze, as well as a high degree of uncertainty that surrounded the international financial market has also weakened the domestic economic activities. Yet, the economy is still able to expand. The Indonesia's economy grew at 6.1% in 2008. The Indonesian economic growth reached the bottom in quarter II 2009 at 4%, a 0.4% drop from previous quarter of 4.4%. We expect that the Indonesian economy will grow at 4.0 to 4.5% in 2009, higher than previously estimated. The domestic economic growth is mainly supported by domestic demand which contribute more than 60% of GDP and natural resources export. In 2010, we expect the economy will grow at 5% to 5.5%. Along with declining domestic economic activities in 2009, inflation rate has also descended. As of September 2009, the year to date inflation rate is 2.28%. Inflation is expected back to its normal pattern in 2010 at 5 +/-1 % as economic activities start accelerating.

In addition, the domestic banking industry is also in relatively sound condition and well capitalized. The average capital adequacy ratio (CAR) is around 17% and the gross non-performing loan (NPL) ratio is below 5%.

Those facts show that the Indonesian economy is relatively sheltered from the biggest turbulence since the world's war II. However, foreign investors tend to undermine those facts, and perceived risks exaggeratedly on the Indonesian economic fundamental. Despite that, it was true that the crisis caused panic and lost of confidence, in particular post Lehman Brothers collapsed on 15 September 2008, which led to the phenomenon of holding cash alike and safe haven assets, it has put significant pressure on Indonesian economy and increasing volatility in the domestic financial market. Risk perception on the Indonesian financial market has been so high as shown in the hike of CDS spread, that reach a peak of around 1000 bps in October 2008, the highest spread amongst countries within the region. Further, the exodus from emerging market financial assets, led the government bond (SUN) price index (IDMA index) to fall to its lowest level ever at 67.11 in October 2008, which mean that across the board yield of SUN, has hike to above 15%. The IDR exchange rate again US Dollar, has also weakened dramatically from around 9.200 levels, to reach its peak at 12.000 levels in November 2008.

However, the above symptoms of increasing counterparty and credit risk also could be observed in domestic market. The inter-bank money market indicators also revealed similar shape, to those found in global market during the crisis. The spread of JIBOR 1 month over BI Rate for instance, has widened significantly to around 250 bps, despite that the interest rate was in a declining trend, while in normal condition it is always below 50 bps. Further, there was also a tendency that banks prefer to hold their reserve, in shorter maturity of Bank Indonesia's OMO instruments (FASBI and short-term deposit collection, the so-called FTK). These, along with nervous as observed in the banking industry with regard to its funding source, public or third parties deposit that led to unhealthy competition amongst banks, has showed that, there was some potential liquidity risk in the domestic banking sector.

To cope with the above mention situation, the Government and Bank Indonesia took some necessary measures to safeguard the domestic economy. Government has provided fiscal stimulus to secure the real sector activities, as well as to prevent the deterioration purchasing power of the poor. Meanwhile, the monetary policy stimulus, took form in accommodative stance, as inflation has fallen, by reducing BI Rate 300 bps since November 2008, from 9.5% to 6.5%. In addition, from the operational level, Bank Indonesia has also undertaken some measures aimed at addressing market liquidity concern, by providing and ensuring the supply of liquidity in cash money market, both in US Dollar and in Rupiah.

In US Dollar market, Bank Indonesia reduced the required reserve ratio, from 3% to 1%, lengthening the maturity of swap operation, and ensuring the US Dollar liquidity need for domestic corporations via banks, by providing window for rediscounting export underlying instrument. Meanwhile, in the rupiah money market, Bank Indonesia took similar measure, such as providing window for "repo" transaction, using underlying assets of government bonds, and certificate of Bank Indonesia ("SBI"), for various maturity, recently up to 3 months, through an auction mechanism. The auction mechanism is also aimed at averting, the negative "stigma" from banks' perspective in dealing with the central bank to obtain temporary liquidity in fair market price.

All those measures, which in essence is similar to those taken by major authorities globally, even though differ in scale and instrument variety, has so far help the Indonesian economy and financial sector, in passing by the most challenging episode during the crisis. Along with improvement in global economy and financial market, those indicators have move back to their more normal level. The spread of JIBOR 1 month over BI Rate, for instance, has decline significantly at around 15 bps. Yield of SUN has declined to 10%-11% for the 10 years SUN and longer maturity. The CDS spread has also dropped to below crisis level of below 200 bps, close to the pre crisis level. Meanwhile, the IDR exchange rate has also recovered and hover around 9,400 recently, despite still at higher volatility compare to the pre crisis period.

However, the policy transmission into the real sector has been slowing down as uncertainties remain. The banks' lending, needed to support the economic growth, is still quite slow. The year to date banks' lending growth up to September 2009 is still below 5%. In addition, the lending rate also does not decline as expected. Despite that, this is sensible, in face with the declining economic slowdown and uncertainty, but is also closely linked with the way banking implement risk management. For some extent, this reflects, that they tend to avoid risk rather than, properly identifying and manage risk accordingly.

We also observe that the way financial investors globally, do not show any change in their behavior, as mainly reflected in the high volatility of stock market. They tend to over react on every single news and data announcement, which indicates their eagerness, to try to recover their lost during the crisis, and nervousness of potential lost. This behavior, is potentially threatening the sustaining economic recovery.

The risks and challenge ahead

There are now more signs of global economic recovery and improvement in the prospect of financial market. However it is still too early to conclude, that the recovery path will be smooth and sustainable, since as I previously mention, the lag of policy transmission tend to lengthen and uncertainty remains. In addition, issues concerning the implication of extraordinary measures, that has been taken by major authorities, such as the widening of fiscal deficit in major countries, and the “exit policy” of quantitative easing taken to fight deflationary pressure in those countries has started to emerge. To cope with this issue, authorities have intensified their policy communication, to convince that all needed measures and tools have been prepared. Yet, it seems that all of those are not convincing enough, as at this stage, the political involvement in every country tends to increase.

With the above background, we have to keep optimistic, but still have to be cautious. From the risk management perspective, the challenge in the period ahead, is in identifying the potential risk appropriately, which is the key in risk management. The recent turbulence has changed the global economy and financial market landscape. Consequently the standard indicators, both in financial market and real economic, might have also changed, and we cannot rely on their empirical behavior. In face with this situation, we all have to widen the indicators to be considered, including qualitative indicators.

The recent development has also lead the authority, to adjust and shift their paradigm and approach in setting the macroeconomic policy, and supervising as well as regulating financial sector. In addition, authorities globally have been challenged, with a more serious dilemma. On one side, their need to maintain sustainable economic recovery process, which means need to be expansionary or accommodative. While on the other side, they need to maintain financial system stability, mainly by strengthening regulation and supervision and improve the balance sheet structure of financial industry, banking in particular, and its risk management as well as to avoid the potential inflation in the medium to long term horizon. Striking the optimal balance between these two situations will be challenging and dynamic.

The situation we have in Indonesia is considerably better than those faced by developed countries, but we have to always be aware, that we are in an integrated world, and that there is structural changes. Hence, more prone to external shock. In this regard, Bank Indonesia always commit, in achieving a balance between financial stability and monetary stability, in order to maintain low and stable inflation needed to safeguard a healthier and sustainable economic growth.

The situation I just described, should always be taken into account in conducting business in a more challenging period ahead, more specifically in the risk management practice. For banking industries, considering their important role in the economy, and the severe impact in the society when they fail, I hope there will be more professional, and more proper implementation of risk management, and in particular a more efficient asset and liabilities management.

From today's seminar, I hope we will have a better insight in risk management area and a fruitful discussion to enhance our understanding and more importantly to increase confidence in implementing it.

Thank you.