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The Authority of the Deposit Insurance Corporation as a Neo Lender of Last Resort: Prudential Principles and Risk Management from the Perspective of Monetary Constitutionalism

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Abstract

Law No. 4 of 2023 on the Development and Strengthening of the Financial Sector has given a new authority to the Deposit Insurance Corporation (LPS) to place funds in order to handle bank liquidation problems. This authority makes LPS like a neo Lender of Last Resort (LoLR) institution that the central bank generally plays. The placement of funds by LPS can pose a great risk considering that the bank that receives the placement of funds falls into the category of banks under the restructuring of the Financial Services Authority (OJK) and does not meet the requirements of receiving loans or short-term liquidity financing from Bank Indonesia (BI). The research shows that: first, the authority of LPS as a neo LoLR in the form of fund placement can still be debated because it creates a double LoLR that is not in accordance with the principle of division and separation of powers. However, in a historical perspective, the authority to place LPS funds has existed since the mass economic crisis conditions caused by COVID-2019 with the issuance of PP No. 33 of 2020. Second, BI's short-term liquidity loans or financing have more comprehensive requirements than the requirements for the placement of funds from LPS. These different requirements are very dangerous because they have the potential to ignore the character of predictability and knowledge in monetary constitutionalism. Even if the authority to place LPS funds exists, the implementation must apply the principles of prudence and risk management to anticipate potential unpredictable losses.

KEYWORDS *LPS, The Placement Of Funds, Neo-Lender Of Last Resort, Monetary Constitutionalism*

I. Introduction

Indonesia experienced a monetary crisis beginning in July 1997 that lasted nearly two years and subsequently escalated into a broader economic crisis.[1] The turmoil severely affected various sectors, particularly the financial system. The banking sector was hit hardest, leading to the closure

1 Lepi T. Tarmidi, "Krisis Moneter Indonesia: Sebab, Dampak, Peran IMF Dan Saran," *Bulletin of Monetary Economics and Banking* 1, no. 4 (1999): 1–25, https://doi.org/https://doi.org/10.21098/bemp.v1i4.183.

of 16 private national banks, primarily due to liquidity problems.[2] This financial crisis caused a sharp decline in public trust toward banks, the broader banking system, and other financial institutions such as insurance companies and pension funds.[3] Trust is a foundational principle in banking,[4] essential for ensuring that banks can perform their core function as financial intermediaries, mobilising and channelling public funds.

One of the state's responses to restore public confidence in the stability of the financial system, especially the banking industry, was to introduce a formal deposit insurance scheme.[5] Such a mechanism can directly enhance public trust in the banking system.[6] During the crisis, the Indonesian government issued Presidential Decree No. 26 of 1998 on Guarantees for the Payment Obligations of Commercial Banks and Presidential Decree No. 193 of 1998 concerning Guarantees for the Payment Obligations of Rural Banks, effectively guaranteeing all bank deposits.

However, this blanket guarantee policy carried significant risks, including potential moral hazard. Consequently, the responsibility for deposit insurance was shifted to a dedicated institution. This transition was formalised in the 1998 amendment to the Banking Law (Law No. 7 of 1992, as amended by Law No. 10 of 1998), particularly Article 37B, which mandated that all banks insure public deposits and led to the

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2 Mubyarto, "Mengatasi Krisis Moneter Melalui Penguatan Ekonomi Rakyat," *Jurnal Ekonomi Dan Bisnis Indonesia* 16, no. 2 (2001): 97–110.

3 Pauline W.J. van Esterik Plasmeijer and Fred van Raaij, "Banking System Trust, Bank Trust, and Bank Loyalty," *International Journal of Bank Marketing* 35, no. 1 (2017): 97–111, https://doi.org/https://doi.org/10.1108/IJBM-12-2015-0195.

4 Tri Budiyono, "Penjaminan Simpanan Dari Waktu Ke Waktu (Studi Penjaminan Simpanan Di Indonesia," *Refleksi Hukum* 3, no. 2 (2019): 129–144, https://doi.org/https://doi.org/10.24246/jrh.2019.v3.i2.p129-144.

5 Sebastian Schich, "Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects," *OECD Journal Financial Market Trends*, no. 2 (2009): 12–12, https://doi.org/https://doi.org/10.1787/fmt-v2008-art12-en.

6 Halim Alamsyah and Et.al, "Depositors' Trust: Some Empirical Evidence from Indonesia," *Research in International Business and Finance* 54 (2020): 1–18, https://doi.org/https://doi.org/10.1016/j.ribaf.2020.101251.

creation of the Indonesia Deposit Insurance Corporation (Lembaga Penjamin Simpanan or LPS).

The establishment of LPS was legally grounded in Law No. 24 of 2004 on Deposit Insurance Corporation (LPS Law), which took effect with the institution's formal operation in 2005. Under this law, LPS has two main functions: to ensure customer deposits and to contribute actively to maintaining the stability of the banking system. To fulfil the latter, LPS is tasked with formulating, determining, and implementing policies for the resolution of failing banks, including both non-systemic and systemic cases.

LPS's authority in resolving failing banks includes temporary equity participation and liquidation. This mandate was later expanded by Law No. 9/2016 on Prevention and Handling of Financial System Crisis (PPKSK Law), which introduced additional resolution tools such as Purchase and Assumption (P&A) and bridge banks. P&A allows for the transfer of assets and liabilities from a failed bank to an assuming bank,[7] while a bridge bank is a temporary institution established by LPS to take over part or all of a failed bank's assets and/or liabilities.[8]

In the context of financial crisis prevention and resolution under PPKSK Law, bank liquidity and solvency issues are handled separately. LPS becomes involved in solvency-related interventions once a bank is handed over by the Financial System Stability Committee (Komite Stabilitas Sistem Keuangan or KSSK). This is consistent with LPS Law, which authorises LPS to resolve failed banks upon referral from the Financial Services Authority (OJK) or KSSK.

Liquidity issues, on the other hand, fall under the authority of Bank Indonesia (BI), which provides short-term liquidity loans or financing. As

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7 Ahmad Aziz and Nur Fatwa, "Measurement of Islamic Bank Capital Capacity as an Assumption Bank in the Resolution Process of Purchasing and Assumption Methods," *Jurnal Middle East and Islamic Studies* 9, no. 2 (2022): 1–22, https://doi.org/https://doi.org/10.7454/meis.v9i2.153.

8 Zulfikar Hasan and Kamiluddin, "The Position of Bridge Banks as Instruments for Resolving Bank Failuresin Indonesia," *Journal of Central Banking Law and Institutions* 2, no. 2 (2023): 265–282, https://doi.org/https://doi.org/10.21098/jcli.v2i2.162.

stipulated in Act No. 23 of 1999 on Bank Indonesia (BI Law), the central bank serves as the Lender of Last Resort (LoLR).[9] Through its payment system infrastructure, BI can detect financial distress and intervene accordingly. This authority is codified in both Chapter III on Crisis Prevention and Chapter IV on Crisis Management of PPKSK Law.

The LoLR function draws on classical monetary theory. Henry Thornton first articulated the role of central banks as lenders of last resort during liquidity crises,[10] a view later refined by Walter Bagehot, who emphasised that central banks must provide liquidity to solvent but illiquid banks during financial turmoil because they are the ultimate source of money in the economy.[11]

The enactment of Law No. 4 of 2023 on the Development and Strengthening of the Financial Sector (P2SK Law) via omnibus law amended previous provisions on liquidity crisis management in PPKSK Law. Notably, it introduced a new provision allowing LPS to place funds in banks upon request from OJK. This provision also amended the powers of LPS as stipulated in LPS Law.

This new authority makes LPS a "risk minimiser" capable of early intervention before a crisis materialises, thus expanding its role beyond traditional resolution toward systemic risk prevention. LPS is no longer confined to minimising losses through bank resolution but can now act preemptively to protect the financial system's overall stability.

However, the fund placement authority also introduces significant risks. According to P2SK Law, banks eligible to receive LPS fund placements include those under recovery supervision and those ineligible for short-term liquidity support from BI. These banks are typically characterised by poor solvency, insufficient collateral, or inadequate

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9 Mustafa Aqib Bintoro, "Evolusi Kebijakan Bank Indonesia Dalam Penyelesaian Permasalahan Likuiditas Pada Bank Umum Syariah," *DHARMASISYA Jurnal Program Magister Hukum Fakultas Hukum Universitas Indonesia* 1, no. 4 (2021): 2004–2026.

10 Henry Thornton, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain* (London: J. Hatchard, 1802).

11 Walter Bagehot, *A Description of the Money Market* (London: Henry S. King and Co, 1873).

projected cash flow. The vague legal standards for asset eligibility as collateral, combined with the high-risk profile of the recipient banks, raise concerns about the prudence and effectiveness of this new LPS function.

In light of these concerns, this article examines LPS's authority to place funds, functionally positioning it as a "neo" Lender of Last Resort, a role traditionally held by central banks in other jurisdictions. It approaches this issue through the lens of monetary constitutionalism, a framework seldom used in Indonesian discourse where monetary and banking issues are generally analysed through economic or economic-legal approaches. Monetary constitutionalism introduces constitutional principles into monetary governance, emphasising prudence and risk management as fundamental legal obligations.

This article thus addresses two key research questions: First, how does the LPS's fund placement authority differ from BI's short-term liquidity loans? Second, how can prudential principles and risk management be applied in the exercise of this authority? By adopting a monetary constitutionalist perspective, the article aims to offer new insights into the normative and institutional dimensions of LPS's expanded role as a neo-lender of last resort.

This article employs a legal research methodology using a combination of statutory, conceptual, and historical approaches.[12] The statutory approach is used to examine relevant legislation concerning the LPS, OJK, BI, financial crisis prevention and resolution, and the development and strengthening of the financial sector. Primary legal sources include Law No. 23 of 1999 on Bank Indonesia, Law No. 24 of 2004 on the Deposit Insurance Corporation, Law No. 9 of 2016 on the Prevention and Handling of Financial System Crises, and Law No. 4 of 2023 on the Development and Strengthening of the Financial Sector.

The conceptual approach is used to explore the legal and theoretical constructs of the lender of last resort (LoLR), short-term liquidity loans,

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[12] Peter Mahmud Marzuki, *Penelitian Hukum* (Jakarta: Prenadamedia Group, 2016).

and fund placements as responses to banking distress, as well as the application of prudential and risk management principles, particularly from the perspective of monetary constitutionalism. The historical approach is employed to trace the evolution of LPS's fund placement authority—its origins, development, and contextual background.

This research also involves a literature review on the respective authorities of LPS, BI, and OJK, followed by a constructive-prescriptive legal analysis to assess and formulate appropriate legal recommendations concerning the implementation of LPS's fund placement authority.

II. What is Monetary Constitutionalism?

Before addressing the main research questions, it is necessary to first elaborate on the concept of *monetary constitutionalism*, particularly because this framework has yet to receive substantial scholarly attention in Indonesia. Terminologically, the concepts of *monetary constitutionalism* and *monetary constitution* are often used interchangeably to refer to a normative framework that governs the constitutional principles of monetary policy. The idea emerged as a response to *monetary anarchy*, a condition in which monetary governance operates without clear institutional limits, largely as a result of classical liberal economic thought that advocated minimal state intervention in societal affairs, including monetary matters.[13] This lack of state involvement contributed to a fragmented and unstable monetary ecosystem, resulting in repeated banking crises throughout the 19th century.

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[13] James M. Buchanan, "The Constitutionalization of Money," *Cato Journal, Cato Institute* 30, no. 2 (2010): 251–258.

In reaction, the doctrine of the welfare state emphasised the necessity of state intervention in monetary policy.[14] However, once the state assumed a greater role, monetary policy became susceptible to political interference. Given that the interests of the state are represented by political actors often driven by short-term incentives, such intervention led to financial instability and banking crises, as monetary decisions were shaped more by political expediency than by long-term economic goals. Stability is, however, a vital condition for monetary and economic governance.[15] This concern gave rise to new emphases on central bank independence, monetary globalisation, and financial market deregulation as the foundations of sound governance.

Monetary constitutionalism thus emerged to call for constraints, both institutional and normative, on the power and discretion of actors in monetary policy. While the domain is different, the logic of *monetary constitutionalism* parallels that of *political constitutionalism* in public law, which seeks to limit and structure political authority.

Alexander William Salter identifies three core arguments in favour of adopting a monetary constitution.[16] First is the issue of *time inconsistency*: without binding rules, discretionary monetary policy may produce suboptimal outcomes. Second, robust political economy suggests that policy must be designed with the recognition that decision-makers operate with limited information and often conflicting preferences. An institutional framework grounded in monetary constitutionalism can moderate self-serving behaviour and cognitive limitations by creating a stable, rule-based environment. Third, arbitrary interventions in monetary policy can threaten property rights and generate economic uncertainty. If monetary authorities act under government pressure, they may resort to

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[14] John Keynes, *The General Theory of Employment, Interest and Money* (New York: Prometheus Books, 1997).

[15] Friedrich Hayek, *Denationalisation of Money: An Analysis of the Theory and Practice of Concurrent Currencies* (Great Britain: The Institute of Economic Affairs, 1976).

[16] Alexander William Salter, "Is There a Self-Enforcing Monetary Constitution," *Constitutional Political Economy* 25, no. 3 (2014): 280–300.

inflationary finance for short-term gain, resulting in unjust redistribution and undermining the rule of law.

Several key features characterise *monetary constitutionalism*. The first is *predictability*, as articulated by James Buchanan in his essay "Predictability: The Criterion of Monetary Constitutions," published in *In Search of a Monetary Constitution*.[17] Buchanan argues that predictability, rather than the more abstract concept of stability, is the appropriate normative criterion for monetary governance. Predictability requires the formulation of accurate and objective monetary standards, which in turn fosters monetary and financial stability.

The second feature is *independence*, discussed by Milton Friedman in his contribution to the same volume, titled "Should There Be an Independent Monetary Authority?"[18] Friedman emphasises the importance of an autonomous central bank, insulated from political pressures and short-term electoral incentives, which he calls "political games." Political actors are bound by term limits and temporal considerations, which often result in policy decisions that sacrifice long-term stability for short-term advantage. In contrast, monetary governance demands a commitment to long-term stability.

Buchanan's predictability and Friedman's independence both advocate for an *evidence-based* and *professional judgment*-driven approach to monetary policy, in contrast to politically motivated decisions. This logic aligns with Salter's third argument: knowledge constraints. A well-designed monetary constitution must function effectively even in the absence of perfect knowledge among policymakers and market participants. In reality, actors operate under conditions of uncertainty and informational limitations. A system that relies on a small group of experts to micromanage the economy is inherently fragile. Thus, monetary

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17 James Buchanan, "Predictability: The Criterion of Monetary Constitutions," in *In Search of A Monetary Constitution*, ed. Leland B. Yeager (Cambridge: Harvard University Press, 1962).

18 Milton Friedman, "Should There Be an Independent Monetary Authority," in *In Search of A Monetary Constitution*, ed. Leland B. Yeager (Cambridge: Harvard University Press, 1962).

governance must be institutionalised in such a way that it ensures stability even when knowledge is imperfect and dispersed.

Additionally, consistent with classical constitutionalism's emphasis on the separation and limitation of powers, *monetary constitutionalism* demands clear institutional boundaries within the monetary domain. This includes a structured division of authority between different institutions—central banks, supervisory agencies, and deposit insurers—to avoid concentration of power, ensure non-overlapping mandates, and promote checks and balances.

From this conceptual foundation, four key characteristics of monetary constitutionalism can be identified: predictability, independence, knowledge, and separation of powers. These features are highly relevant to the central concern of this article, LPS's authority as a neo-lender of last resort, as they inform the design and limits of that authority, especially regarding prudential standards, risk management, and institutional accountability.

III. Historical Development of the Deposit Insurance Corporation's Fund Placement Authority

As previously discussed, the establishment of Indonesia's LPS was a policy response to restore public trust in the banking system following the severe loss of confidence during the 1997–1998 monetary crisis.[19] The institutionalisation of a formal deposit insurance scheme reassured the

[19] Muyanja Ssenyonga Jameaba, "Deposit Insurance and Financial Intermediation: The Case of Indonesia Deposit Insurance Corporation," *Cogent Economics & Finance* 6, no. 1 (2018): 1–32, https://doi.org/https://doi.org/10.1080/23322039.2018.1468231.

public that their savings in banks were protected, thereby stabilising expectations and behaviour.[20]

In fulfilling its mandate, deposit insurance institutions generally assume two core functions: acting as a *paybox* and as a *risk minimiser*.[21] Initially, under LPS Law, LPS was authorised to operate as a *paybox* and *loss minimiser*, but not as a full-fledged *risk minimiser*. The authority to act as a risk minimiser, particularly through the placement of funds in banks to address liquidity issues, was later introduced through P2SK Law.

The use of LPS funds to resolve banking problems can first be traced to Article 26 of the LPS Law, which authorises LPS to undertake various measures to rescue failing banks, including temporary capital injections. Additionally, PPKSK Law introduced the concept of "loan provision" by LPS. Under Article 41, LPS is empowered to implement a Bank Restructuring Program (Program Restrukturisasi Perbankan or PRP) during systemic financial crises that pose a threat to national economic stability. This includes the authority to extend loans to banks, although the statute provides little detail on the operational scope of this loan authority.

While temporary equity injections and loans are technically distinct from fund placement mechanisms, they share a common purpose: the use of LPS's financial resources to mitigate banking sector distress. The fund placement authority was more precisely codified in Government Regulation No. 33 of 2020 on the Implementation of LPS Authority in Handling Financial System Stability Issues (PP 33/2020), which was a derivative regulation of Law No. 2 of 2020 on the COVID-19 fiscal emergency. Article 11 of PP 33/2020 allows LPS to place funds in banks during the post-COVID economic recovery period. The operational

20 Thomas L. Hogan and William J. Luther, "The Explicit Costs of Government Deposit Insurance," *Cato Journal* 34, no. 1 (2014): 145–170.

21 David S. Hoelscher and Et.al, "The Design and Implementation of Deposit Insurance Systems," *Occasional Paper: International Monetary Fund*, 2006.

procedures were further elaborated in LPS Regulation No. 3 of 2020 (LPS Regulation 3/2020).

The primary objective of fund placement during the COVID-19 crisis was twofold: to enhance LPS's liquidity and to anticipate or resolve financial system stability issues that could lead to bank failure. Fund placement could take the form of increasing LPS's giro balances in designated banks or placing direct funds in banks in distress.

The implementation of direct fund placement involves a structured sequence of steps:

a. Eligibility requirements for the receiving bank;
b. Feasibility analysis;
c. Execution of a fund placement agreement;
d. Determination of placement amount and duration;
e. Interest rate determination;
f. Collateral requirements;
g. Selection of recipient banks;
h. Disbursement of funds;
i. Fund utilisation;
j. Repayment terms;
k. Early termination;
l. Oversight mechanisms;
m. Reporting obligations;
n. Collateral enforcement procedures;
o. Cost allocation;
p. Extension procedures; and
q. Other related provisions.

Fund placements were initiated upon request from banks, following due diligence by OJK (the Financial Services Authority), which assessed the bank's condition and recommended LPS intervention. This recommendation had to be preceded by a written notification from OJK, confirming that the controlling shareholder was unable to resolve the bank's liquidity problem. The request must be accompanied by: (i) the bank's estimated repayment capacity and asset collateral assessment; (ii) confirmation that liquidity issues were not caused by fraud; (iii) cash flow projections; (iv) updated financial and operational condition data; (v) a remedial action plan; (vi) the impact on the broader banking system; and (vii) a copy of OJK's written instruction to the shareholder to guarantee repayment to LPS.

Bank Indonesia also played a role by assessing the bank's payment system record and the state of the financial system, submitting its report to LPS within three working days of receiving OJK's notification. Based on OJK's recommendation and BI's assessment, LPS would then conduct its own feasibility analysis and decide whether to proceed with the fund placement. The decision was to be formally conveyed to both OJK and BI.

LPS's decision-making is based on multiple considerations: OJK's recommendation, BI's assessment, the bank's going concern status, collateral sufficiency, and compliance with LPS placement requirements. The decision is formalised in a fund placement agreement and secured by a collateral agreement. Should LPS decide not to proceed, OJK must handle the situation using its own powers. Notably, LPS retains the discretion to reject a placement request, even if the bank meets all technical requirements or if concerns arise over ownership composition or the quality of the offered collateral.

The total fund placement cap was set at a maximum of 30% of LPS's total assets (for all banks combined) and 2.5% per individual bank, based on LPS's financial position as of 31 December 2019. As of 2023, LPS's total assets exceeded IDR 213 trillion.[22] The fund placement term is limited to one month and renewable up to five times, with each extension requiring new assessments by OJK and BI.

[22] Lembaga Penjamin Simpanan, "Laporan Tahunan LPS Tahun 2023" (Jakarta, 2024).

A robust supervisory framework was put in place to ensure effective fund utilisation. Once LPS approved a placement, OJK and BI were required to intensify their oversight of the recipient bank. OJK reported on the bank's financial health, fund utilisation, and audit findings. LPS also had the authority to conduct its own audits, and the bank was legally obliged to provide all relevant data and documentation.

Although the fund placement framework has existed since the COVID-19 crisis and was subsequently reaffirmed in Law No. 4 of 2023, it has never been executed by LPS to date.[23] As such, the practical risks and legal complexities of implementation remain untested. A further complication is the expanded scope under the 2023 legislation: unlike the COVID-era emergency framework, the current law allows LPS to place funds not only during crises but also as a preventive measure before financial instability arises.

IV. The Authority of Bank Indonesia as Lender of Last Resort in Addressing Banking Liquidity Issues and the Role of LPS as a Neo Lender of Last Resort

Banks as financial intermediaries that collect and channel public funds must maintain adequate liquidity to fulfil their short-term obligations. Liquidity is critical to banking operations, serving as the lifeblood of the banking sector. A bank's liquidity is typically measured by the ratio of cash and other liquid assets to total assets or deposits.[24] A liquidity crisis occurs

[23] Lembaga Penjamin Simpanan, "Focus Group Discussion Lembaga Penjamin Simpanan" (2024).

[24] Allen N. Berger and Christa H.S. Bouwman, "Using Liquidity Creation to Measure Bank Liquidity," *New Perspectives*, 2016, 55–69.

when a bank is unable to produce sufficient cash to meet its short-term obligations.[25]

Such liquidity constraints not only affect a bank's operations but can also endanger the stability of the financial system, particularly if the affected institution is systemically important. To prevent such systemic threats, central banks are entrusted with the function of providing emergency liquidity, a role fulfilled in Indonesia by Bank Indonesia (BI). As the central bank, BI operates as part of the financial safety net in its capacity as the *Lender of Last Resort*, supplying liquidity during both normal and crisis conditions.

According to Thomas M. Humphrey, the LoLR function involves the central bank supplying emergency liquidity to solvent but illiquid banks to prevent financial panic from spreading.[26] The central bank steps in when no other actor is willing to provide liquidity,[27] thereby preventing systemic collapse and safeguarding trust in the financial system.[28]

The intellectual foundation of the LoLR function was laid by Henry Thornton, who emphasised the need for central banks to provide liquidity in times of financial distress.[29] A failure to intervene could exacerbate liquidity shortages, intensify crises, and trigger the collapse of the banking system. Walter Bagehot further refined this doctrine, arguing that central banks must lend freely during crises, but only to solvent institutions, against high-quality collateral, and at a penalty rate, to avoid moral hazard.[30]

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25 Eneng Trisnawati Dewi and Wimpi Srihandoko, "Pengaruh Risiko Kredit Dan Risiko Likuiditas Terhadap Profitabilitas Bank: Studi Kasus Pada Bank BUMN Periode 2008 - 2017," *Jurnal Ilmiah Manajemen Kesatuan* 6, no. 3 (2018): 131–138, https://doi.org/https://doi.org/10.37641/jimkes.v6i3.294.

26 Thomas M. Humphrey, "Lender of Last Resort: The Concept in History," *FRB Richmond Economic Review* 75, no. 2 (1989): 8–16.

27 Charles Goodhart, *The Evolution of Central Banks* (Cambridge: The MIT Press, 1988).

28 Ben S. Bernanke, "The Crisis and the Policy Response," Federal Reserve, 2009, https://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm .

29 Thornton, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*.

30 Bagehot, *A Description of the Money Market*.

In line with global central banking practices, BI's LoLR function includes regulating money supply, maintaining financial market stability, overseeing the financial system, and providing short-term funding to banks facing liquidity shortages.[31][32] This function is codified in BI Law, particularly Article 4(1) and Article 11. The latter authorises BI to extend credit or Sharia-based financing for up to 90 days to resolve temporary liquidity problems, subject to the provision of high-quality, easily liquidated collateral.

LPS Law, which amended BI Law, expanded this authority by introducing emergency financing facilities for banks facing systemic risks, the cost of which may be borne by the government. This marked a shift from ordinary short-term lending to systemic crisis intervention.

Subsequent legislative changes, such as Law No. 6 of 2009, further modified the regulatory framework, although primarily for procedural clarity. The enactment of PPKSK Law repealed earlier provisions on government-funded emergency lending and restructured BI's authority. P2SK Law introduced a new paradigm by linking liquidity management not only to monetary policy but also to broader macroeconomic objectives such as economic growth.

Article 10 of P2SK Law affirms BI's authority to manage liquidity as part of its monetary policy function, ensuring sufficient liquidity in money markets, foreign exchange markets, the banking sector, and the economy at large. Article 11 extends this function to include liquidity management in support of economic growth through secondary market operations, capital placements in financial institutions, reserve requirement policies, monetary policy instruments, and macroeconomic governance.

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[31] Peter S. Rose, *Commercial Bank: Management* (Boston: Mc Graw Hill, 2002).

[32] Zulfi Diane Zaini, "Functions of the Bank of Indonesia as Lender of Last Resort for Banks' Safety," *European Research Studies Journal* XXI, no. 3 (2018): 607–621, https://doi.org/https://doi.org/10.35808/ersj/1087.

In addition to these revisions, Article 20 of PPKSK Law authorises systemically important banks experiencing liquidity problems to request short-term liquidity loans (PLJP) from BI. BI and OJK jointly assess the bank's collateral sufficiency and repayment capacity. Acceptable collateral includes highly rated marketable securities and, where necessary, performing loan assets. OJK and BI are also mandated to supervise the use of these loans and ensure compliance with repayment plans.

P2SK Law further refined the conditions for accessing PLJP, requiring recipient banks to demonstrate solvency, provide adequate collateral, and submit credible cash flow projections. The law also stipulates that PLJP may be extended for a maximum of two consecutive 30-day periods.

In contrast, LPS's fund placement authority, initially exercised during the COVID-19 crisis—was designed as part of broader economic rescue measures under Law No. 2 of 2020 and later reaffirmed in P2SK Law. While BI's lending facilities target short-term liquidity issues, LPS's fund placement was first associated with solvency problems during the pandemic and only subsequently extended to include liquidity support in non-crisis periods.

Notably, the legal criteria for LPS fund placement are less stringent: recipient banks are only required to provide "acceptable" collateral without the comprehensive solvency, collateral, and cash flow requirements imposed by BI's PLJP framework. This discrepancy raises normative questions under the doctrine of *monetary constitutionalism*, particularly concerning the principles of functional separation and allocation of authority in monetary governance.

From a constitutional perspective, the dual provision of liquidity support, by BI through PLJP and by LPS through fund placement, creates overlapping mandates and a potential conflict in the institutional design of Indonesia's monetary system. Historically, LPS's authority to place funds was introduced as a crisis-era measure. Its continuation under P2SK Law warrants careful scrutiny.

Under *monetary constitutionalism*, duplicative authority between institutions undermines the principle of separation of powers and threatens the system's *predictability* and *epistemic integrity*. Granting LPS LoLR-like powers, especially with weaker prudential safeguards, risks eroding confidence in the coherence of financial regulation.

Internationally, such authority is not commonly granted to deposit insurers. For example, Spain's *Fondo de Garantía de Depósitos de Entidades de Crédito (FGD)* lacks fund placement authority.[33] Jan-Bong Choi, in his article *"Structuring a Deposit Insurance System from the Asian Perspective,"* emphasises the need to clearly distinguish the LoLR function from deposit insurance: the former maintains systemic liquidity and stability, while the latter protects individual depositors.[34]

Similarly, Douglas W. Diamond and Philip H. Dybvig have shown that LoLR, suspension of convertibility (SC), and deposit insurance serve distinct purposes in preventing bank runs, providing assurance either that deposits can be withdrawn or that they are protected in the event of bank failure.[35] The International Association of Deposit Insurers (IADI) echoes this distinction, defining the financial safety net as comprising prudential regulation, supervision, resolution, LoLR, and deposit insurance, without conflating the roles. Indeed, the IADI Core Principles do not include deposit insurers as LoLR actors.[36]

Accordingly, LPS's designation as a neo LoLR remains debatable due to institutional and normative incongruities. Nevertheless, this article

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[33] FGD Spanyol, "Interview with Fondo de Garantia Depositos de Entidades de Credito (FGD) Spanyol," (2024).

[34] Jang-Bong Choi, "Structuring a Deposit Insurance System from the Asian Perspective," 2000.

[35] Douglas W. Diamond and Philip H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy* 91, no. 3 (1983): 401–419.

[36] International Association of Deposit Insurers (IADI), "IADI Core Principles for Effective Deposit Insurance Systems," 2014.

does not make a conclusive claim that the fund placement authority is inherently inappropriate within Indonesia's monetary framework.

Rather, it adopts the position that, as long as the authority has become positive law under P2SK Law, it must be implemented. On this basis, the article proceeds to examine how prudential and risk management principles, central to both banking law and monetary constitutionalism, should guide the use of this authority by LPS.

V. The Application of Prudential Principles and Risk Management in LPS Fund Placement

As previously outlined, P2SK Law introduced major reforms to Indonesia's financial sector by strengthening institutional coordination and oversight mechanisms among the Ministry of Finance, OJK, Bank Indonesia (BI), and the Deposit Insurance Corporation (LPS). This regulatory overhaul enhanced the legal and institutional foundation for maintaining financial stability, while simultaneously empowering each authority, including LPS, with broader mandates.

As one of the key institutions tasked with safeguarding banking sector stability, LPS was granted additional powers under Law No. 4 of 2023. Among the expanded authorities are powers relating to deposit insurance and bank resolution, including the authority to place funds in distressed banks, now reclassified as banks in resolution.

legal basis for this authority is found in Article 6 of P2SK Law, which revises LPS Law. It provides that LPS, upon request by OJK, may place funds in banks undergoing rehabilitation (as defined by OJK) due to their failure to meet acceptable health, liquidity, or capital adequacy standards, with risk considerations taken into account. Fund placements must be initiated by the bank itself and preceded by a feasibility analysis conducted by OJK.

Additionally, the fund placement authority is reinforced in Chapter XXI of P2SK Law, which amends PPKSK Law by adding three new articles, Articles 20B, 20C, and 20D, devoted specifically to LPS's role in liquidity support. Article 20B allows LPS to place funds either directly or indirectly, the latter through a guarantee mechanism where a systemic bank places funds in another illiquid bank. Articles 20c and 20d govern the rights, obligations, and restrictions applicable to systemic banks receiving such placements.

A key concern arises under Article 20B(4), which states that systemic banks eligible for LPS fund placements are those that do not meet BI's criteria for short-term liquidity loans. This raises a serious question: if the underlying risk and function of both liquidity facilities are similar, why should the prudential thresholds differ so markedly?

BI requires that recipient banks be solvent, hold sufficient collateral, and present credible cash flow projections. In contrast, Article 20B(8) of P2SK Law merely stipulates that systemic banks or their controlling shareholders must provide "suitable" assets as collateral for repayment, an arguably vague and lower standard.

This discrepancy creates an asymmetry in institutional responsibility: LPS is now assigned a function historically reserved for BI but without the accompanying prudential safeguards. Such a shift diverges from foundational LoLR doctrine, which holds that liquidity support must be limited to solvent institutions with high-quality collateral, offered at penalty rates,[37] and subject to strict conditionality—to discourage moral hazard.[38]

Given that banks eligible for LPS placements are, by definition, in rehabilitation and have failed to qualify for BI liquidity assistance, the exercise of this authority carries significant inherent risk. Therefore, the application of prudential and risk management principles becomes

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[37] Bagehot, *A Description of the Money Market.*

[38] Humphrey, "Lender of Last Resort: The Concept in History."

essential. In the banking industry, such principles are typically applied through credit assessments—often guided by the *5C's* framework: Character, Capacity, Capital, Collateral, and Conditions of the Economy.[39]

Prudential assessment for LPS fund placements could thus incorporate:

1. **Character**- Does the bank exhibit integrity, regulatory compliance, and a reliable track record?
2. **Capacity**- Does the bank have the ability to repay the funds?
3. **Capital**- Is the bank's solvency level adequate?
4. **Collateral**- Are the offered assets of sufficient quality and value?
5. **Conditions**- Are the bank's business prospects viable and aligned with macroeconomic trends?

Under Law No. 4 of 2023, only collateral (via Article 20B(8)) is formally addressed. The other four prudential criteria, Character, Capacity, Capital, and Conditions, are not explicitly mandated, marking a regression from earlier frameworks.

This contrasts sharply with PP 33/2020, which was enacted during the COVID-19 crisis. That regulation explicitly authorised LPS to conduct comprehensive feasibility assessments prior to fund placement, thereby enabling the application of the full 5c analysis. In contrast, under P2SK Law, the authority to assess feasibility lies solely with OJK, not LPS.

Effective risk management is equally critical. Risk management involves identifying, analysing, and mitigating risks to enhance efficiency and minimise losses. In banking, risk management is used to address credit risk,[40] i.e., the risk that borrowers will default on their obligations.[41]

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39 Lastuti Abubakar and Tri Handayani, "Impelemntasi Prinsip Kehati-Hatian Melalui Kewajiban Penyusunan Dan Pelaksanaan Kebijakan Perkreditas Atau Pembiayaan Bank," *Rechtidee* 13, no. 1 (2018): 62–81, https://doi.org/https://doi.org/10.21107/ri.v13i1.4032.

40 Herman Darmawi, *Manajemen Risiko* (Jakarta: Bumi Aksara, 2006).

41 Matteo Accornero and Et.al, "Credit Risk In Banks' Exposures To Non-Financial Firms," *European Financial Management* 24, no. 5 (2018): 775–791, https://doi.org/https://doi.org/10.1111/eufm.12138.

LPS can adopt risk management protocols based on the COVID-era placement mechanism outlined in LPS Regulation No. 3 of 2020, which provided for 17 procedural stages: eligibility requirements, feasibility analysis, agreement execution, limit and tenor determination, interest rate setting, collateral evaluation, disbursement, utilisation monitoring, repayment terms, early termination, supervision, reporting, collateral execution, cost allocation, and extension or conclusion of the facility.

In addition, risk management can be organised into three stages:

1. **Risk Assessment**: Identifying causes and pathways of potential placement failure;
2. **Risk Treatment**: Selecting the most appropriate mitigation strategies;
3. **Monitoring and Review**: Evaluating ongoing effectiveness of risk controls and determining whether adjustments are necessary.

The application of prudential and risk management principles is essential not only to reduce exposure but also to ensure that LPS's operations do not introduce systemic vulnerabilities. These principles also align with the *Core Principles for Effective Deposit Insurance Systems* published by the International Association of Deposit Insurers (IADI), which emphasise good governance, accountability, and internal control.

Through consistent application of these principles, fund placements by LPS can be better aligned with their intended objectives and shield the institution from systemic repercussions in the event of default.

VII. Conclusion

The authority of LPS to place funds in banks as a crisis-response mechanism was first introduced during the COVID-19 pandemic. However, at that time, the placement function was primarily aimed at addressing bank solvency issues rather than liquidity shortages. The regulatory framework governing fund placement during the pandemic was notably comprehensive, covering both procedural stages and eligibility requirements. Although this authority has yet to be exercised in practice, a detailed and robust regulatory design remains essential to mitigate potential risks in future implementations.

Bank Indonesia's short-term liquidity loans or financing differ markedly from LPS's fund placement scheme. BI requires that banks meet three key conditions: solvency, adequate collateral, and sound cash flow projections, to qualify for liquidity assistance. In contrast, LPS's requirements are considerably less stringent: recipient banks are only required to provide "acceptable" assets as collateral. Moreover, BI's liquidity support is an inherent expression of its central banking function as LoLR, whereas LPS was not originally designed to engage in early intervention or to manage banking liquidity issues.

From a monetary constitutionalism perspective, LPS's fund placement authority, by positioning it as a Neo Lender of Last Resort, remains problematic and open to debate. This dual allocation of LoLR functions undermines the principles of institutional independence and the separation of powers. Furthermore, granting LPS LoLR-like powers contradicts classical LoLR doctrine, which holds that such authority should be exercised solely by the central bank.

If, however, LPS is to continue exercising this authority under the current legal framework, the principles of monetary constitutionalism particularly the values of *predictability* and *epistemic discipline* must be upheld. This necessitates adopting classical LoLR safeguards through the systematic implementation of prudential standards and risk management protocols. Given that recipient banks fall into the category of "rehabilitation" banks under enhanced supervisory status, and are deemed ineligible for BI liquidity assistance, LPS should rigorously apply the 5C credit assessment framework and adopt structured risk management processes, including risk identification, mitigation, monitoring, and review.

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