2nd INTERNATIONAL CONFERENCE ON MANAGEMENT
(2nd ICM 2012) PROCEEDING
11th - 12th JUNE 2012. HOLIDAY VILLA BEACH RESORT & SPA, LANGKAWI KEDAH, MALAYSIA
ISBN: 978-967-5705-07-6. WEBSITE: www.internationalconference.com.my

INFORMATION CONTENT ANALYSIS ON NEW REGULATION OF COMMERCIAL BANKS' HEALTH: A STUDY ON INDONESIAN CASE

Ika Permatasari
Universitas Negeri Surabaya, Indonesia
ikarifin@yahoo.com

Dian Anita Nuswantara
Universitas Negeri Surabaya, Indonesia
dianuswantoro@yahoo.com

ABSTRACT

Bank Indonesia (central bank in Indonesia) has never stopped to monitor the bank performance in Indonesia. This is because of the condition of banks can be an indicator in assessing the economic conditions in a country. Bank Indonesia issued Regulation No. 13/1/PBI/2011 about the Assessment for Commercial Banks' Health (risk profile, good corporate governance, earnings, and capital—RGEC) which replaces the previous Regulation No. 6/10/PBI/2004 about the Assessment for Commercial Banks' Health (CAMELS—capital adequacy, asset quality, management quality, earnings, liquidity, and sensitivity to market risk). This research aims to test whether the new regulation has incremental information value over the older one. To answer this question, we have to know the reasons of government replace the older regulation. This is a preliminary study on the assessment of bank performance in Indonesia. From the study conducted, we found that Bank Indonesia changed the regulation because of business complexity and risk profile, the application of consolidated supervision, as well as changes in bank condition assessment approach adopted internationally that affect the assessment approach of the bank. Substantively, there are some changes in valuation factors, but the principles and process of calculating the level of bank's health of new regulation are not much different from the older one. Thus, some of the indicators in the previous CAMELS is rearranged and put a new factor in RGEC, namely risk factors.

Keywords: *bank performance, CAMELS, risk profile, good corporate governance, earnings, capital*

---

1. INTRODUCTION

Indonesia Central Bank (Bank Indonesia) has issued a new regulation Number 13/1/PBI/2011 on January 5, 2011 about Bank's health measurement which considers the risk and performance of the Bank. This regulation will be effective since of January 1, 2012. Previously, the soundness of bank assessment was

ISBN: 978-967-5705-07-6. WEBSITE: www.internationalconference.com.my

under regulation Number 6/10/PBI/2004 about the Rating System for Commercial Banks. This regulation has been used for almost seven years.

The previous regulation is using CAMELS to measure banks' health. All components of CAMELS 2004 more directed to the company's performance measures internally, from Capital Adequacy, Asset Quality, Management Quality, Earnings Power, Liquidity, and Sensitivity to Market Risk. This scoring system is referred to CAMELS Rating System. This approach is not quite different with the older one, CAMEL, except it include Sensitivity to Market Risk ratio.

This research aims to test whether the new regulation, Regulation Number 13/1/PBI/2011, has incremental information value over the older one, Regulation Number 6/10/PBI/2004. To answer this question, we have to know the reasons of government replace the older regulation.

2. LITERATURE REVIEW

Research on Banking Performance Measurement

Bank performance is generally assessed based on financial ratios. Research on the assessment of bank performance is done by Fethi and Pasiouras (2009). They use operational research (OR) and artificial intelligence (AI) techniques that result in a shift towards the use of superior engineering. Nowadays, Data Envelopmental Analysis (DEA) is a technique of OR/AI widely used in assessing the performance of banks as well as to estimate various measures of efficiency and productivity growth in the bank.

Ploegmakers et.al. (2000) try to investigate the possibility of Risk-Adjusted Performance Measurement (RAPM) implementation based on the value-at-risk (VAR) to allocate the bank's capital. This concept is often applied to measure and monitor the risks of particular investment strategies as well as a natural defensive nature. The authors proposed the concept that risk management and performance measurement can allow banks to use risk management infrastructure offensively. The results showed that the system is able to increase transparency, improve the efficiency of capital allocation, and overall bank performance.

In Indonesia, the soundness of bank is a result of a qualitative assessment of various aspects affecting the condition or performance of a bank or an assessment of quantitative and qualitative assessment of the factors such as capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (CAMELS). Quantitative assessment is an assessment of the position, development, and projected financial ratios of banks. While the qualitative assessment is an assessment of the factors that support the quantitative assessment, risk management, and bank compliance. This measurement has been implemented since 1991 under Decree of Directors of Bank Indonesia No. 30/11/KEP/DIR along with Circular Letter No. 30/2/UPPB dated 30 April 1997 and has been revised in 2004 under Bank Indonesia Regulation Number: 6/10/PBI/2004 about Regular Banks Health Assessment System.

ISBN: 978-967-5705-07-6. WEBSITE: www.internationalconference.com.my

Bank Indonesia Regulation Number: 6/10/PBI/2004 about Regular Banks Health Assessment System

Under this regulation, the soundness of the bank include an assessment of capital factor (capital), asset quality (asset quality), management (management), profitability (earnings), liquidity (liquidity), and sensitivity to market risk (sensitivity to market risk). An assessment of the capital factor includes assessment of: (1) adequacy, composition, and projected (future trends) capital and the ability of the bank capital to cover troubled assets and (2) the ability of banks to meet the need for additional capital from earnings, banks' capital plan to support business growth, access to sources of capital, financial performance and shareholders to increase bank capital.

Assessment of asset quality includes assessment of: (1) asset quality, concentration of credit risk exposure, the development of earning assets, and adequacy of the allowance for earning assets and (2) the adequacy of policies and procedures, review of systems (review) internally, the system documentation, handling and performance earning assets. An assessment of the management factors include an assessment of: (1) the quality of public management and risk management practices and (2) compliance with the provisions of the applicable bank and commitment to Bank Indonesia or other parties.

An assessment of the earnings factor includes assessment of: (1) the achievement of return on assets (ROA), return on equity (ROE), net interest margin (NIM), and the level of bank efficiency and (2) the development of operating profit, revenue diversification, implementation of the principle accounting in the recognition of revenues and expenses, and operating profit prospects. An assessment of the liquidity factors include an assessment of: (1) the ratio of assets/liabilities of liquidity, the potential maturity mismatch, loan to deposit ratio (LDR) condition, cash flow projections, and the concentration of funding, and (2) the adequacy of policy and liquidity management (assets and liabilities management/ALMA), access to sources of funding, and funding stability. Assessment of sensitivity to market risk factors include an assessment of: (1) the ability of the bank capital to cover potential losses as a result of fluctuations (adverse movement) interest rates and exchange rates, and (2) the adequacy of risk management market.

Procedures for measurement using the CAMELS in general are as follows: First, calculate the value of the indicator or assessment component for each factor according to the formula specified in the following Letter of Bank Indonesia (see the details at www.bi.go.id). Second, based on the value of that component, such as CAR, look at the assessment matrix composites for capital factor that has been provided by the Bank Indonesia. Of the matrix we will find out the value of its rank if known to the CAR. For example, banks with CAR = 8% will get the "Composite 3".

Third, calculate the composite value for all components of the starting factor "C" to "S". For example, the factor "C" consists of eight indicators/assessment component. So we have to assess the eight indicators on the factor "C" is in the same manner as described in step 1 and 2 above. Fourth, set the value of the composite factor based on the ranking value for each indicator constituent parameters. So we will set a composite value for each factor, the "C", "A", "M", "E", "L" and "S". This is where the need to "expert judgment", particularly when assessing the value of the indicator variable factors.

Finally, after knowing the value of the composite for all six factors (CAMELS), the final step is to determine the final composite value of the bank. For example, if a bank obtain a composite value for the factor "C", composite 2 to "A", composite 2 for "M", composite 3 for "E", a composite one for "L", and

ISBN: 978-967-5705-07-6. WEBSITE: www.internationalconference.com.my

Composites 3 for the "S" , then how the final composite value of the bank? Once again, there is no mathematical formula that connects the composite value of each factor in the final composite value of the bank.

Bank Indonesia Regulation Number: 13/1/PBI/2011 about Regular Banks Health Assessment System

Regulation Number: 13/1/PBI/2011 requiring re-grouping and weighting of evaluation factors or dimensions eventhough its relative coverage has not changed much. The new PBI characterize assessment factors to be only four factors: (1) the risk profile, (2) Good Corporate Governance, (3) Earnings, and (4) Capital. So this new regulation can be simply abbreviated to RGEC.

Compare to the older BI regulation, there is a relatively new element, that banks are required to assess the soundness of individual banks using a risk approach (risk-based bank rating). Assessment of the risk factor profile is an assessment of the risks inherent and quality of risk management in banking operations carried out on eight risks are credit risk, market risk, liquidity risk, operational risk, legal risk, strategic risk, compliance risk, and reputation risk.

Other elements of the GEC (Good Corporate Governance, Earnings, and Capital) basically have much in common with the older regulations. Assessment of the GCG factor is the rating of the bank's management for the implementation of the principles of good corporate governance. Assessment of earnings factor includes an assessment of earnings performance, sources of earnings, and bank earnings sustainability. Assessment of the capital factors includes assessment of capital adequacy and capital management.

3. DISCUSSION

To compare the regulation, first we have to see both regulation sides. Below are the summary of Banks' Health Assessment System under Regulation Number: 13/1/PBI/2011 compare to Regulation Number: 6/10/PBI/2004:

Tabel 1
Comparison of New and Old Regulations

Components	Regulation Number: 13/1/PBI/2011	Regulation Number: 6/10/PBI/2004
Risk Profile	Risk profile which must be assessed consists of Credit Risk, Market Risk, Operational Risk, Liquidity Risk, Legal Risk, Strategic Risk, Compliance Risk, and Reputation Risk	Asset Quality of CAMELS' assessments have similarities in assessment of Credit Risk on risk profile of RGEC
	Liquidity parameters do not calculate the ratio of LDR (Loan to Deposit Ratio) The other parameters are the same of both regulations	Liquidity parameters calculate the ratio of LDR (Loan to Deposits Ratio)

ISBN: 978-967-5705-07-6. WEBSITE: www.internationalconference.com.my

	The existence of strategy and business policy parameters on each bank's market risk profile	Market risk focus on implementation of market risk management system
	If bank ranking on an indicator of Risk Profile worse, the bank would not be predicted bankruptcy as long as bank's risk management parameters are very well, so that it can prevent or minimize the occurrence of bankruptcy	If bank ranking on an indicator of Asset Quality, Liquidity, and Sensitivity to Market Risk is bad, then it can be predicted that the bank is going to bankrupt
Good Corporate Governance (GCG)	Implementation of GCG are the same as CAMELS Implementation of risk management system contained in the risk profile Bank compliance indicators contained in Compliance Risk factors in the risk profile	Indicators of GCG practices (board structure and composition, handling of conflict of interest, the board independency, ability to limit or prevent the decline in quality of GCG, transparency of customer information and education, the effectiveness of performance of committee function) Application of risk management systems Bank compliance (maximum credit limit, net open position, principles of Know Your Customer, compliance to commitments and other provisions)
Earnings	Performance of profit components (operating income, operating expenses, non-operating income, non-operating expenses, net income) compared with budget projections	Not available
Capital	- CAR calculation using BASEL II - Risk-weighted assets are using credit risk, market risk, and operational risk	- CAR calcuation using BASEL I - Risk-weighted assets are using credit risk and market risk only

The main reason behind the regulation change are the existence of an amendment to complexity of the business and risk profile, the application of consolidated supervision, as well as changes in bank condition assessment approach adopted internationally which affect the assessment approach of the bank. For the assessment factors, previous regulation classified in the six-factors called CAMELS. There seems no significant changes, there are only classification rating categories that showing a focus on certain factors. The new regulation characterize assessment factors to be only four factors: (1) risk profile, (2) Good Corporate Governance, (3) Earnings, and (4) Capital. Where risk profile includes 8 types of risks, which are: (a) credit risk, (b) market risk, (c) liquidity risk, (d) operational risk, (e) risk of law, (f) strategic risk, (g) compliance risk, and (h) reputation risk. It looks like some of the indicators in the previous CAMELS, do remodeling and risk profile factors included in the new regulation. The factor of

ISBN: 978-967-5705-07-6. WEBSITE: www.internationalconference.com.my

"A" or Asset Quality, "L" or Liquidity, and "S" or Sensitivity to Market Risk in the previous assessment (CAMELS) fused to the factor "R" on a new assessment (RGEC).

The earnings factor "E" and capital "C" are still present on the new system. As if there is a new factor, that is Good Corporate Governance "G", which replaces the management factor "M" on the previous assessment. However, if observed, adherence to good corporate governance has been entered on the application of management factor "M" on the CAMELS assessment that is included in the general management components. Good corporate governance factor in the new assessment system would be enriched by the Bank Indonesia with some models, principles, or practices of the latest changes or developments in accordance with the conditions and current situation.

In the Capital factors, calculation of risk-weighted assets (RWA) on CAMELS including of market risk and credit risk only, whereas RWA on RGEC accounts three risks, namely market risk, credit risk, and operational risk. The reason to include operational risk is to take into account the risk of direct or indirect losses caused by a factor of weakness or failure of internal processes, human resources, systems, and external events. While the credit risk calculations are more complicated. There are risks which include losses due to the debtor/counterparty who fails to fulfill its obligations.

4. CONCLUSION

The assessment system of bank soundness between CAMELS and RGEC does not vary much. Some parts still look the same as the scoring system was used Capital and Earnings. The scoring system was changed to Good Corporate Governance. For the components of Asset Quality, Liquidity, and Sensitivity to Market Risk finally put together in a Risk Profile.

The old system (CAMELS) replaced with new models (RGEC) that require commercial banks to conduct self-assessment of bank soundness by using the approach of risk (risk-based bank ratings—RBBR) both individual and consolidated basis. The new regulation just re-grouping and weighting factors or dimensions of assessment, which in terms of relative coverage has not changed much. Assessment mechanism also remain self-assessment by each bank that conducted every semester, but the central bank will conduct a validation or confirmation step to the assessment made by the bank. In addition, the scale or the predicate is the same as the previous assessment, namely "Rank 1" to "Rank 5" where the rank order of the smaller factor reflecting the bank's conditions better.

Future research is recommended to continue this preliminary study. First, it needs to consider whether self-assessment report of the banks' soundness which first published in July 2012 (according to new rule) give value added to the public. It can be tested on the information content of bank soundness report on public perception. Second, future studies need to compare between assessments based RGEC and assessment based on best practices of banks in the world, so it can produce the best indicator that can be used to assess the health of banks and can be used as recommendations for policy makers.

ISBN: 978-967-5705-07-6. WEBSITE: www.internationalconference.com.my

REFERENCES

Bank Indonesia Regulation Number: 6/10/PBI/2004 about The Assessment of Commercial Bank's Health

Bank Indonesia Regulation Number: 13/1/PBI/2011 about The Assessment of Commercial Bank's Health

Berger, Allen N. and Sally M. Davies (1994). The Information Content of Bank Examinations. Working Paper 94-24.

Payamta (2009). Kandungan Informasi Laporan Keuangan Interim Perbankan: Model Prediksi Kesehatan Bank dari Perspektif Pemakai Laporan Keuangan. Thesis. Universitas Diponegoro.

Fethi, Meryem Duygun and Fotios Pasiouras (2009). Assessing Bank Performance with Operational Research and Artificial Intelligence Techniques: A Survey. University of Bath, School of Management, Working Paper Series, 2009.02.

Ploegmakers, Hein, Mark Schweitzer, and Alireza Tourani Rad (2000). Risk-Adjusted Performance Measurement and Capital Allocation for Trading Desks Within Banks, Managerial Finance, Vol. 26 Iss: 3, pp. 39-50.