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FINANCIAL DEVELOPMENT FOR STRONG
AND EQUITABLE GROWTH:

POLICY PAPER 3

ENHANCING FINANCIAL EFFICIENCY THROUGH BANKING CONSOLIDATION

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Financial Development for Strong and Equitable Growth:

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This policy paper is part of a series derived from the “**Financial Development for Strong and Equitable Growth**” white paper, launched in February 2024. By employing the IMF’s Financial Development Index framework, which encompasses depth, access, and efficiency dimensions, each paper offers a comprehensive analysis of critical financial development issues. These papers propose targeted strategies to enhance Indonesia’s financial landscape and foster sustainable economic growth.

The paper policy series consists of:

1. Financial Product Innovation to Enhance Financing Options
2. Increasing MSME Access to Credit through Collateral Assets and Credit System
- 3. Enhancing Financial Efficiency Through Banking Consolidation**
4. Navigating the Road to Improve Credit Sovereign Rating
5. Leveling Taxation Playing Field between Financial and Non-Financial Sectors
6. Managing Non-Performing Loan through Asset Management Companies
7. Expanding Financial Coverage through Non-Bank Financial Institutions
8. Leveraging the Potential of Green Financing

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Executive Summary

Bank consolidation refers to the process of merging smaller, less efficient financial institutions into larger entities to achieve economies of scale, enhance operational efficiency, and improve financial resilience. It is a crucial strategy to enhance efficiency and competitiveness by strengthening the banking sector and ensuring it can withstand economic shocks and compete in a rapidly evolving financial landscape. Despite its importance, Indonesia's banking sector has struggled to fully embrace consolidation due to various structural and regulatory challenges. The government has taken measures to implement consolidation but still faces barriers including regulatory fragmentation, lack of leadership or designated authority to drive consolidation efforts, resistance from stakeholders due to conflicting interests, operational challenges in merging entities, and inadequate support for smaller banks to navigate the complexities of the process.

These challenges are compounded by broader issues within Indonesia's banking sector such as elevated interest rates, rapid technological advancements, intensified competition, insufficient capital, and the burden of non-performing loans. These issues are crucial to tackle because the sector plays a pivotal role in the country's economy. This sector's performance and stability are closely tied to the country's overall economic health and development trajectory. Ultimately, regulatory disharmony is urgently needed for necessary reform to enhance efficiency and competitiveness in banking sector.

All of these problems stem from the absence of specific authority to spearhead bank consolidation efforts. This lack of leadership hampers the coordination and implementation of the reform in the banking sector. Currently, neither the Financial Services Authority (OJK) nor Bank Indonesia has a clear mandate to drive this critical process. Additionally, no institution is mandated with related Key Performance Indicators (KPIs). While the Ministry of Finance houses the Centre for Financial Policy, it has yet to establish a specialized unit focused on bank consolidation. This creates a gap leaving a void in strategic oversight. As a result, consolidation efforts have been largely overlooked in recent policy frameworks and initiatives.

Other significant challenges are Indonesia's fragmented banking regulations, limited focus on consolidation in policies like the Indonesian Banking Architecture (API) and the 2020-2025 Indonesia Banking Development Roadmap, and the lack of a centralized strategy for conventional banks. High capital requirements pressure smaller banks into mergers without sufficient planning, while shareholder disputes, culture clashes, and compliance burdens further hinder progress. Recent regulations such as Financial Services Authority Regulation (POJK) Number 12/POJK.03/2020 and POJK Number 17 of 2023 aim to strengthen governance but add complexity, highlighting the need for a streamlined framework that balances innovation, financial stability, and efficiency.

Promoting effective banking consolidation requires strategic measures. Establishing a specialized advisory body under the Ministry of Finance or integrating this function with OJK or KSSK could provide essential technical and financial guidance for mergers. Financial incentives, such as tax breaks and streamlined procedures, along with a simplified regulatory framework, would further encourage consolidation. Proactive regulatory approaches can ease the process. Addressing shareholder disputes through mediation, offering financial support, and ensuring clarity in post-merger integration are also critical. These actions are vital for fostering a competitive, efficient, and resilient banking sector to support Indonesia's financial development.

1. Background and Problems Identification

Bank consolidation refers to merging two or more banks into a single entity through mergers or acquisitions.¹ This process is essential for building resilient financial institutions capable of withstanding economic turbulence, competing in an increasingly technology-driven landscape, and adapting to disruptions like digitalization. Global trends and developments highlight the need for stronger, more efficient financial systems. Consolidation aims to create stable institutions with robust capital, enhanced governance, and improved operational capabilities. It also enables cost reduction, market expansion, and better financial risk management, contributing to the stability and competitiveness of the banking sector.

Bank consolidation in Indonesia is essential for improving sector efficiency and stability. As shown in Figure 1, Indonesia's Net Interest Margins (NIM) is the highest among ASEAN-5 nations. While wide NIMs may seem profitable, they create a significant gap between deposit and lending rates, undermining banks' role as effective financial intermediaries and weakening their competitiveness. High NIMs are partly driven by elevated credit rates in Indonesia, which remain above 8%, compared to lower rates in countries like China. This is influenced by higher inflation in Indonesia, forcing banks to set higher nominal interest rates. Consolidation, driven by deregulation, helps improve efficiency by enabling well-managed banks to grow while inefficient ones exit, optimizing resource allocation, reducing costs, and enhancing profitability.

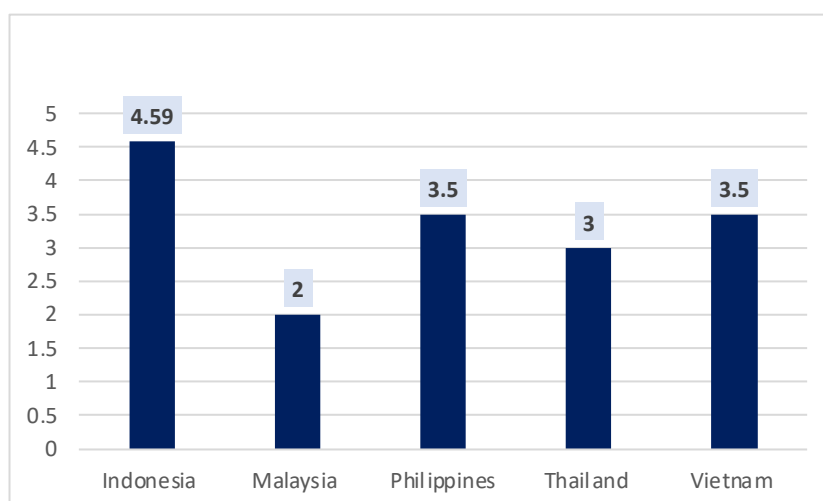


Figure 1. Indonesian Banks' Net Interest Margin Compared to other ASEAN 5 (% , March 2023)²

Despite clear benefits of banking consolidation, it still faces challenges such as bank's lack of interest, the absence of authority, insufficient regulatory framework, shareholder dispute, different culture, and insufficient capacities. There are also potential risks coming from post-merger consolidation such as unfair competition and financial and operational risks.

The issues hindering bank consolidation mirror the broader challenge of financial sector development in Indonesia. The financial system continues to lag behind regional peers, as evidenced by its stagnant score of 0.36 on the Financial Development Index from 2015 to 2021 (Figure 2). This score places it below other ASEAN countries, including Singapore, Malaysia, Thailand, the Philippines, and Vietnam. The index, which evaluates the depth, access, and efficiency of financial institutions and markets, underscores the urgency for comprehensive reforms to address systemic barriers and foster meaningful growth in Indonesia's financial sector.³

¹ Berger, A. N., Demsetz, R. S., & Strahan, P. E., 1999

² The Global Economy (BCA Banking Outlook), 2023

³ IMF Financial Development Framework, 2021

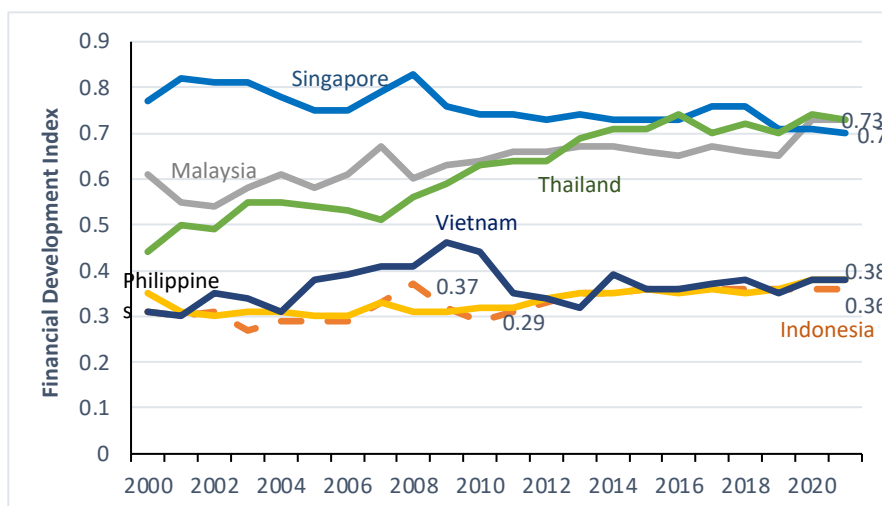


Figure 2. Comparison of the Indonesian Financial Development Index with other ASEAN Countries⁴

Indonesia’s financial sector struggles with inefficiency, shallow depth, and limited access, all of which hinder financial development. A key indicator of this inefficiency is the excessive number of commercial banks, standing at 106, significantly higher than in peer countries (Table 1). This oversupply of banks weakens the competitiveness of Indonesia’s banking sector and increases its vulnerability. These challenges underscore the urgent need for consolidation to strengthen the sector and enhance its resilience.

Table 1. Total Number of Banks and Bank Concentration in ASEAN, 2024⁵

ASEAN Countries	Total Number of Banks	Bank Concentration
Indonesia	106	43.3%
Singapore	132	80.81%
Malaysia	54	52.99%
Thailand	30	44.82%
Philippines	45	52.25%
Vietnam	49	37.85%

These inefficiencies reduce the sector’s competitiveness, particularly as the market is dominated by a few large banks. Sixteen banks in Bank Classification Based on Core Capital (KBMI) 3 and KBMI 4 controlling 74% of total banking assets.⁶ Accelerated consolidation is necessary to address these structural challenges, create a more competitive banking landscape, and improve financial stability in a high-interest rate environment.

Regulators have implemented measures that could drive bank consolidation, recognizing its potential benefits for the efficiency and stability of the financial sector. The most significant driver of consolidation is the Minimum Core Capital Requirement, while advancements in digital technology have also pushed banks toward consolidation. However, these drivers must be balanced with the challenges and risks associated with consolidation, which could outweigh the benefits.

4 IMF, 2021

5 Statista & Tradingeconomics, 2024

6 Mulyaningsih, T., Daly, A., & Miranti, R., 2015

1.1 Drivers for Banking Consolidation and Associated Risks Pre-Merger

1.1.1 High Minimum Core Capital Requirements

Otoritas Jasa Keuangan (OJK) has progressively raised capital requirements for banks to strengthen the financial sector. Beginning with a minimum core capital of 100 billion Rupiah in 2013, the requirement was later increased to 1 trillion Rupiah for commercial banks and 3 trillion Rupiah for systemically important banks. In 2020, POJK No. 12/POJK.03/2020⁷ further stipulated that banks with core capital below Rp1 trillion by the end of 2021 must either merge or downgrade to rural bank (BPR) status. Additionally, OJK Regulation No. 12/POJK.03/2021 established a minimum core capital requirement of Rp10 trillion for new banks.

These regulations present significant challenges for smaller banks struggling to meet these elevated thresholds albeit intended to improve the sector's stability and competitiveness through consolidation.⁸ Many of these institutions are pressured into rushed mergers or forced to exit the market, severely limiting their ability to engage in strategic planning. Others may opt to downgrade to rural bank status, reducing the pool of viable candidates for meaningful consolidation and leaving the sector fragmented with undercapitalized institutions. This undermines the regulatory intent of creating a more stable, consolidated banking industry and threatens long-term sectoral growth.⁹

The ineffectiveness of this regulation is evident in the significant number of small-capital banks continue to operate. As shown in Figure 3, 62% of commercial banks in Indonesia have capital of less than 1 trillion Rupiah, accounting for more than half of the country's banks. The persistence of these small banks contributes to inefficiencies within the financial sector.

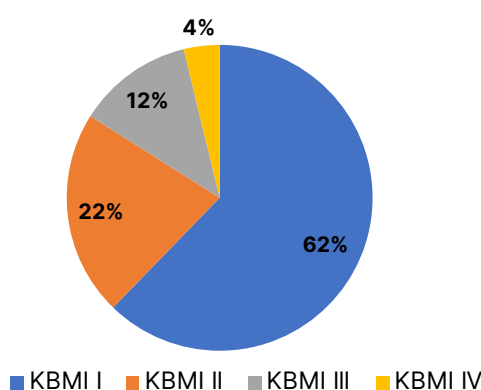


Figure 3. Percentage of Number of Banks Based on The Core Capital Requirement (as of April 2024)¹⁰

Note: KBMI refers to Core Capital Requirement categories. KBMI I includes banks with core capital of up to IDR6 trillion; KBMI II includes banks with core capital between IDR6 trillion and IDR14 trillion; KBMI III comprises banks with core capital between IDR14 trillion and IDR70 trillion; KBMI IV represents banks with core capital above IDR70 trillion.

⁷ OJK, 2020

⁸ Dwiyantri & Wondabio (2023); Hartadinata & Fariyah, 2023

⁹ Hadi, 2024

¹⁰ Indonesian Banking Statistics, 2024

1.1.2 The Rapid Acceleration of Digital Transformation

The rapid acceleration of digital transformation has been another driver for banking consolidation in Indonesia. According to McKinsey Indonesia (2020), activities such as grocery delivery, online learning, and telemedicine saw a 40-50% increase during the COVID-19 pandemic.¹¹ This shift has created considerable opportunities for banks, with Indonesia's potential income from digital financial services projected to grow at a CAGR of 34%. However, these opportunities also bring challenges, particularly for smaller banks that lack the resources to compete with larger, more digitally advanced institutions.

One of the primary challenges for smaller banks is technological readiness. Implementing advanced technologies like Artificial Intelligence (AI), big data, and cloud computing requires significant investment, which many smaller banks struggle to afford. As a result, these banks risk falling behind, especially as fintech companies continue to innovate and offer customer-centric financial solutions.

However, the challenge also drive banks to consider consolidation. The gap in digital capabilities limits the banks' competitiveness and ability to meet market demands. As a result, the pressure to stay relevant and efficient push these smaller banks to consolidate with larger, more digitally advanced institutions. By merging, they can enhance their technological capabilities, improve service offerings, and strengthen their position in an increasingly competitive financial landscape.

1.2 Challenges Hindering Banking Consolidation

1.2.1 Lack of Interest in Consolidation

Many banks have been hesitated to consolidate due to a lack of interest, driven by a complex mix of factors. Smaller banks, especially those with strong local ties or operating in niche markets, often fear losing their identity and autonomy through consolidation. Cultural factors also play a role, with long-standing family-owned banks resisting change due to emotional attachments or concerns about losing control.

Despite efforts to provide various incentives, many banks still find them unappealing. Bank Indonesia Regulation (PBI) Number 8/17/PBI/2006 offered measures such as easier permits for becoming a foreign exchange bank, temporary relaxation of Rupiah Minimum Statutory Reserve (GWM), extended periods for resolving excesses in the Maximum Limit of Credit Provision (BMPK), and reimbursement of due diligence costs. However, these incentives have not effectively encouraged small banks to merge with or be acquired by larger ones, as the complex, time-consuming, and costly consolidation process often outweighs the perceived benefits. Consequently, many smaller banks remain reluctant to pursue consolidation.

1.2.2 The Absence of Authority in Bank Consolidation

A fundamental impediment to increase efficiency in the banking sector lies in the absence of a dedicated leadership role for bank consolidation. Neither OJK nor Bank Indonesia has a primary mandate for driving this critical process. OJK focuses on prudential regulation, while Bank Indonesia oversees monetary policy, leaving a strategic gap in oversight and leadership for bank consolidation. Although the Ministry of Finance houses the Center for Financial Policy, it lacks a dedicated unit specifically tasked with managing and advancing consolidation efforts.

11 McKinsey Indonesia, 2020

The P2SK Law outlines the Financial Stability Committee's (*Komite Stabilitas Sistem Keuangan* or KSSK) tasks to ensure a stable financial system. These responsibilities include overseeing and monitoring the financial system for potential risks, intervening to address systemic financial crises, and handling systemic bank problems both in stable periods and during crises. However, the function does not cover a task for promoting bank consolidation during periods of financial stability.

1.2.3 The Insufficiency in the Bank Consolidation's Regulatory Framework

The regulatory framework governing bank consolidation in Indonesia is overly restrictive, hindering the consolidation process. Compliance is time-consuming and resource-intensive, discouraging many banks, particularly smaller ones, from pursuing mergers and acquisitions.¹² The banking sector has suffered from regulatory disharmony, and the government acknowledges the need for comprehensive reform, as evidenced by the P2SK Law, aimed at improving the banking sector, enhancing financial inclusion, and fostering regulatory cooperation.¹³

Key regulatory drivers of complexity is PBI No. 9/12/PBI/2007. It sets capital requirements, compliance with accounting standards, and strict administrative procedures that are burdensome for small banks. Additionally, POJK No. 21/POJK.03/2014, which enforces stricter capital requirements for Sharia banks, adds further strain. Small Sharia banks, often with limited capital and a narrow pool of potential consolidation partners as well as specific and distinct financial products and practices, face increased operational complexities due to these regulations, making consolidation even more challenging.

1.2.4 Disagreements among Controlling Shareholders

Controlling shareholders often create challenges for banking consolidation by disagreeing on key issues such as strategic goals, asset valuation, and profit-sharing. These disagreements can slow down or disrupt efforts to make banks more efficient and competitive. In some cases, political differences between regional leaders and bank managers make the process even more difficult, with debates over how consolidation should be handled and who should lead it causing further delays.

For Regional Development Banks (BPDs), regional leaders often oppose consolidation to retain control, arguing it is necessary to protect local economic interests and meet regional needs. However, this opposition is often linked to political networks that rely on BPDs to fund local projects or reward allies. Consolidation threatens these arrangements, leading some leaders to prioritize their political influence over the banks' long-term financial stability.

1.2.5 Differences in Corporate Cultures

Cultural differences often create major challenges during banking consolidation, affecting customer service, internal policies, and management styles. When merged banks have contrasting work cultures, such as strict hierarchies versus more flexible structures, employees can struggle to adapt. This misalignment can lower productivity and service quality, particularly in Indonesia's banking sector, where such differences frequently complicate domestic mergers and disrupt operations, making it harder to achieve the expected benefits.

A clear example is the government-mandated merger of four state-owned banks, including: Bank Mandiri, Bank Rakyat Indonesia, Bank Negara Indonesia, and Bank Tabungan Negara. Despite financial motivations, the merger faced significant difficulties in integrating systems, aligning work cultures, and managing the workforce. This demonstrates that successful consolidation requires more than just combining financial assets. It depends on effectively unifying different corporate cultures. Without

¹² "Bank kecil terhimpit regulasi permodalan," *Kontan*, accessed November 15, 2024, <https://keuangan.kontan.co.id/news/bank-kecil-terhimpit-regulasi-permodalan> & "Disparitas Bank Kecil dan Bank Besar Bikin Biaya Regulasi Makin Tinggi," *Bisnis.com*, August 26, 2020, accessed November 15, 2024, <https://finansial.bisnis.com/read/20200826/90/1283274/disparitas-bank-kecil-dan-bank-besar-bikin-biaya-regulasi-makin-tinggi>.

¹³ Presiden RI, 2023; Bank Indonesia, 2023; OJK, 2023

proper programs to address these cultural differences, the benefits of consolidation, like improved efficiency and stronger performance, may not be fully realized.¹⁴

1.2.6 Insufficient Capacity for Consolidation Management

Consolidation process requires adequate capacity and talents since it encompasses planning, asset evaluation, system integration, and corporate culture alignment. However, small banks generally lack the necessary expertise and human resources to manage it. This situation is worsened by limited technical support and guidance from financial regulators, who often impose complex regulations, leaving smaller banks to navigate these difficulties on their own.

The lack of expertise has left small banks increasingly wary of the risks associated with pursuing mergers. They are particularly concerned about navigating regulatory hurdles and managing operational challenges, fearing that a poorly executed merger could jeopardize their financial stability and long-term performance. These apprehensions have ultimately discouraged many small banks from exploring consolidation opportunities.

1.3 Potential Post-Merger Risks from Banking Consolidation Implementation

1.3.1 Unfair Competition, Monopolistic Practices and Systemic Risk

Bank consolidation also raises concerns about market concentration and unfair competition particularly post-merger or acquisition. As smaller banks merge into larger entities, market power becomes concentrated among a few dominant players, reducing competition and potentially restricting consumer choice and innovation. The dominance of Category 4 banks (KBMI 4), which control 46% of the sector's core capital and 51% of total assets highlights these concerns.¹⁵ Smaller banks in KBMI 1 and KBMI 2 face significant barriers to growth, struggling to compete with larger institutions' scale and resources. This lack of competition risks creating a less dynamic banking sector, which could negatively impact the broader economy.

The Indonesian government has sought to address these risks through regulatory frameworks like Law 5/1999, which prohibits anti-competitive practices such as oligopoly, price fixing, and abuse of dominant market positions. However, applying general competition laws to the banking sector is complex, as consolidation efforts must also maintain financial stability. Striking a balance requires a nuanced regulatory approach that promotes efficiency while preventing excessive concentration. Without further refinement of these regulations, the benefits of consolidation could be overshadowed by reduced competition and heightened systemic risks.

Concentration of assets and liabilities within a small group of large banks also increases systemic risk, as financial distress in one institution could destabilize the entire sector. Additionally, ownership concentration within certain banks can lead to governance challenges,¹⁶ undermining the interests of minority shareholders and eroding trust in the financial system.

14 Abdullah & Santoso, 2001

15 OJK, Indonesian Banking Statistics, June 2023

16 C. T. Shehzad et al., 2010

2. Literature Review

This chapter addresses the challenges outlined earlier by presenting a review of relevant literature. Through an examination of existing studies and theoretical perspectives on bank consolidation, it provides insights into the implications and effectiveness of such efforts.

2.1 Definition and the Importance of Banking Consolidation

Bank consolidation refers to merging two or more banks into a single entity through mergers or acquisitions. Consolidation is imperative for fostering robust financial institutions that can withstand economic turbulence, compete effectively in a rapidly evolving technological landscape, and mitigate the disruptive impact of fintech entrants. The study by Jayaratne and Strahan (1996) demonstrates how deregulation can promote efficiency and competition within the banking sector. It suggests that when driven by deregulation and healthy competition, bank consolidation strengthens financial intermediation, supports economic growth, and enhances financial access. By removing geographic branching restrictions, deregulation allowed well-managed banks to expand while less efficient ones were forced to merge or exit, leading to improved profitability, loan quality, and overall sector efficiency. This process, essential for developing economies, underpins the transformation of banking systems, enhancing accessibility and economic support.¹⁷

Consolidating smaller, inefficient banks into larger entities can help address inefficiencies driven by high Net Interest Margins (NIMs), which result from low deposit rates and high loan rates. These high NIMs create significant barriers to growth. By merging smaller banks into larger institutions, consolidation can streamline operations, reduce inefficiencies, and narrow NIMs, enabling banks to better balance deposit and lending rates. A study by Petria et al. (2015) found a positive correlation between competition and profitability, highlighting the benefits of consolidation in creating a more competitive and efficient banking environment.¹⁸ Therefore, consolidation not only reduces NIMs but also enhances overall efficiency and performance within the banking sector.

Consolidation also addresses the growing need for banks to increase their capital base. Adequate capital is vital for absorbing losses, managing Non-Performing Loans (NPLs), and ensuring overall stability. By merging, banks can pool resources, augment their capital, and strengthen their financial foundations. This enhanced resilience is crucial in the face of economic shocks, asset quality concerns, and regulatory challenges. Additionally, consolidation provides an opportunity for banks to diversify their portfolios, mitigate risks from global geopolitical uncertainties, and improve their ability to absorb external shocks. Consequently, consolidation emerges as a critical strategy for strengthening the banking sector, ensuring its stability, and fostering sustainable economic growth.

Consolidation streamlines operations by eliminating redundant functions, resulting in cost savings in administration, IT, and branch networks as shown in Table 2. It allows banks to benefit from economies of scale, lowering average costs by spreading fixed costs over a larger asset base. In a more competitive environment, consolidated banks are incentivized to improve efficiency and financial health, optimizing resources, and adapting to changing economic and regulatory conditions.^{19 20}

17 Jayaratne, J., & Strahan, P. E., 1998

18 Petria, N., et al., 2015

19 Group of Ten, 2001; Yildirim & Philippatos, 2007; Reda, 2013; Shin & Kim, 2013

20 Mulyaningsih, et al., 2016

Table 2. Forms of Streamlining Operations in the Context of Banking Consolidation²¹

Branch Network Optimization	Technology Integration	Centralization of Back-Office Functions	Workforce Rationalization
<ul style="list-style-type: none"> • Consolidating overlapping branches in the same geographical areas. • Closing underperforming branches. • Repurposing branches for specialized services. 	<ul style="list-style-type: none"> • Merging IT systems and platforms. • Implementing unified core banking systems. • Adopting cloud-based solutions for improved scalability. 	<ul style="list-style-type: none"> • Consolidating administrative tasks (e.g., account processing, loan servicing). • Creating shared service centers for functions like HR, finance, and compliance. • Standardizing processes across the merged entity. 	<ul style="list-style-type: none"> • Eliminating redundant positions. • Retraining and redeploying staff to areas of need. • Implementing performance-based retention strategies.
Product Simplification	Risk Management Consolidation	Procurement and Vendor Management	Customer Service Integration
<ul style="list-style-type: none"> • Streamlining product offerings to reduce complexity. • Discontinuing overlapping or underperforming products. • Focusing on high-margin, customer-centric products. 	<ul style="list-style-type: none"> • Implementing unified risk assessment methodologies. • Centralizing risk monitoring and reporting systems. • Enhancing data analytics for better risk prediction. 	<ul style="list-style-type: none"> • Consolidating supplier relationships. • Negotiating better terms with vendors due to increased scale. • Standardizing procurement processes across the organization. 	<ul style="list-style-type: none"> • Implementing unified customer relationship management (CRM) systems. • Centralizing call centres and customer support functions. • Developing omnichannel customer service capabilities.

Mergers also offer strategic synergies that can strengthen banks' market positions. Mergers allow banks with similar expansion and product diversification strategies to enter new markets more effectively, enhancing growth opportunities. Furthermore, merging banks are better positioned to manage regulatory changes and evolving economic environments by sharing best practices for compliance and risk management. Larger, consolidated banks are also better equipped to access capital markets, as they often have stronger credit ratings and lower funding costs, which can be used to fund new technology or expand business operations.

21 Ayadi, R., Ferri, G., & Pesic, V., 2018

Box 1: Merger of Commercial Banks

A study investigates the effectiveness of economic policy reforms in the Indonesian banking industry, specifically focusing on the impact of mergers on commercial banks' performance from 1997 to 2006.²² This period encompasses significant events such as financial deregulation, the Asian economic crisis, and extensive bank restructuring programs. Despite overall technical efficiency and productivity improvements post-merger, as illustrated in Table 3, not all banks uniformly benefited.

Table 3. Banks Productivity Performance Before and After Merger²³

Banks	Before Merger			After Merger		
	EFFCH	TECHCH	TFPCH	EFFCH	TECHCH	TFPCH
Bank Danamon Indonesia	0.844	0.735	0.620	1.000	1.165	1.165
Bank Mandiri	0.944	0.537	0.507	1.000	1.090	1.090
Bank Permata	0.990	0.880	0.871	1.000	1.152	1.152

Note: EFFCH is the product of technical efficiency change; TECHCH is the technological change; TFPCH is the total factor productivity change (this TFP indices index is claimed to be superior in identifying the net gain in efficiency after adjustment for inputs by the firm)

As depicted in Table 4 below, it shows a comparative financial performance analysis of Bank Permata, Bank Mandiri, and Bank Danamon, pre- and post-merger, which was conducted employing one-way ANOVA and the Tukey Kramer Procedure at the 5% significance level. The Return on Equity (ROE) showed positive changes, with Bank Permata improving from -69.80 to 11.00, Bank Danamon improving from -96.54 to -33.80, and Bank Mandiri improving from -18.14 to 3.96. These improvements suggest higher profitability relative to equity, though none of the banks met the minimum ROE requirement of 12.25%. LDR stands for Loan-to-Deposit Ratio. Some banks, like Bank Permata, improved their ROA but failed to meet the central bank's minimum requirements. While Return on Equity (ROE) improved for all banks, they still needed to reach the minimum requirement of **12.25%**.

Table 4. Banks' Financial Performances Before and After the Merger

Indicators	Bank Danamon		Bank Mandiri		Bank Permata	
	Before	After	Before	After	Before	After
ROA	-49.38	-0.28	-130.55	-2.07	-5.03	0.56
ROE	-69.80	11.00	-96.54	-33.8	-113.12	2.17
NIM	-18.14	3.96	-17.39	2.86	0.09	4.99
CAR	-151.64	34.53	-39.35	25.76	1.65	11.38
NPL	33.83	9.53	13.26	9.11	15.75	7.52
LDR	135.33	46.98	85.69	39.21	42.25	60.12

Note: The **Return on Assets (ROA)** measures a bank's profitability relative to its total assets, indicating how efficiently it utilizes its resources to generate profit. **Return on Equity (ROE)** reflects the bank's ability to generate profit from shareholders' investments. **Net Interest Margin (NIM)** gauges the difference between interest income from assets and interest expenses, showcasing how well a bank manages its investments versus its costs. The **Capital Adequacy Ratio (CAR)** assesses a bank's capital strength against risk-weighted credit exposures, highlighting its resilience to financial losses. **Non-Performing Loan Ratio (NPL)** shows the percentage of loans in default, revealing the health of the bank's loan portfolio, while the **Loan to Deposit Ratio (LDR)** measures liquidity, indicating how much of a bank's deposits are loaned out, reflecting its ability to meet unforeseen financial demands.

22 Viverita, 2008

23 Ibid

Furthermore, the efficiency gains from mergers were not fully passed on to the public, as merged banks tended to invest in risk-free central bank notes rather than extending more loans. This trend indicates that the anticipated benefits of mergers in terms of enhanced lending and financial inclusion were not fully realized. These findings suggest that while mergers can improve specific financial metrics and efficiency, they also bring challenges to meeting regulatory standards and achieving broader economic benefits.

2.2 Global Trends in Banking Consolidation

In recent years, there has been a notable trend of banking consolidation on a global scale. Changes in regulations have made it easier for banks to merge, leading to a decrease in the total number of banks. This reduction has an impact on the increased concentration, as measured by the share of total deposits held by the largest banks and by Herfindahl-Hirschman (HH) indices.²⁴

The consolidation trend in the global banking industry is primarily driven by the imperative to enhance systemic stability and resilience. By consolidating financial institutions, the sector seeks to strengthen its resilience against economic downturns and emerging threats from technological advancements and intensified competition. Nevertheless, the motivations and mechanisms for consolidation vary across different economic contexts. In developed countries, consolidation effectively reduces excess capacity through market forces, while in emerging markets, it is often driven by significant government intervention in response to financial crises. This divergence reflects the banking systems' differing maturity levels and regulatory environments.

The contrast between developed and emerging markets extends beyond the immediate drivers of consolidation. In mature markets, the consolidation process is primarily shaped by broader economic trends and technological progress. Globalization, advancements in information technology, and deregulation drive the consolidation of mature market banking systems. Although these factors also influence emerging markets, they are counteracted by issues such as lack of information and transparency, differences in regulatory frameworks, ownership structures, and cultural factors.

Critical aspects of the consolidation process in emerging markets include government-led restructuring and the entry of foreign banks. Most consolidations have historically resulted from government-led efforts to restructure inefficient banking systems, particularly in Latin America²⁵, or interventions following banking crises, such as in South Korea and Southeast Asia. However, with increased competition due to deregulation, privatization, and the entry of foreign banks, consolidation is becoming more market driven. Mature financial markets like Singapore and Hong Kong are also pursuing consolidation to enhance competitiveness on a regional or global scale.

Studies conducted after the 2008 financial crisis, have examined the efficiency gains and shareholder outcomes of bank mergers, especially in the United States and Europe. The literature highlights diverse impacts on efficiency, shareholder gains, and market competition across regions and periods²⁶. The 2007–2009 financial crises in the United States and Europe further accentuated the banking consolidation trend, highlighting its global significance. The U.S. banking sector has consolidated significantly over the past century, with the number of banks decreasing from over 30,000 in 1921 to just over 4,000 by 2022, largely due to regulatory changes favouring deregulation²⁷. Acts like the Depository Institutions Deregulation and Monetary Control Act of 1980 and the repeal of the Glass-Steagall Act in 1999 facilitated this trend by reducing restrictions on financial institutions and allowing commercial and investment banks to merge. As a result, bank mergers have increased since the 1980s,

24 Berger, A. N., et al., 1999

25 Olivero, et al., 2011

26 Demirguc-Kunt, et al., 2004; Bikker & Spierdijk, 2008; DeYoung, et al., 2009; Claessens, 2009

27 Kowalik, et al., 2015

with community banks being particularly affected. This decline in bank numbers is due to several factors, including bank failures during financial crises, consolidation driven by the relaxation of state branching and national interstate banking restrictions, and voluntary mergers between independent banks.

Since the end of the 2007-09 recession, voluntary mergers have been the primary driver of this decline. The initial impact of the Riegle-Neal Act²⁸ on consolidation and profitability in the U.S. banking industry extends previous research to examine whether the immediate effects of the Act have continued or moderated over time²⁹. Depicted in Figure 4, the data indicates that the number of banking institutions has decreased, although the decrease rate has slowed since the Riegle-Neal Act became fully effective. Profitability trends show that ROA has increased, while ROE has slightly decreased.³⁰ The percentage of unprofitable U.S. banks has recently declined, in contrast to the increase immediately following the Act's implementation. Additionally, the rate of institutions experiencing earnings growth has decreased, but this decline is significantly smaller than in the earlier period.

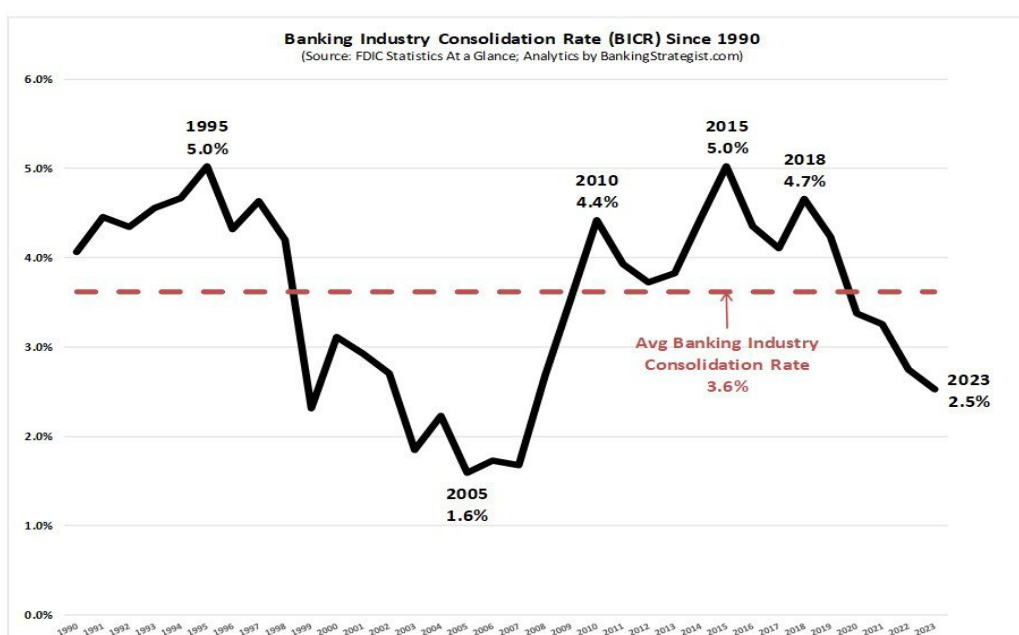


Figure 4. The US's Banking Industry Consolidation Rate Since 1990³¹

During the financial crisis, bank mergers decreased market-adjusted systemic risk, particularly when smaller banks acquired larger targets. Banks that merged during the crisis exhibited lower return volatility and fewer nonperforming loans than banks that did not merge. This indicates that strategic consolidations during periods of financial instability can improve the stability and performance of the banks involved. In both emerging and developed economies, the five-firm concentration ratio for countries such as Brazil, Chile, Mexico, Hong Kong, Indonesia, and Korea have witnessed substantial rises in this ratio over time³².

Bank consolidation in Hong Kong and Singapore presents a nuanced policy challenge, such as fostering the development of major domestic institutions aligned with the local economy while ensuring they can compete regionally and internationally. This issue is less about local banks' viability and more about ownership structure within the domestic banking industry.

28 Federal Reserve History, n.d, <https://www.federalreservehistory.org/essays/riegle-neal-act-of-1994>

29 Heiney, 2010

30 Chronopoulos et al., 2011

31 BankingStrategist.com, 2023

32 Claessens et al., 2000

Legal and judicial factors play a critical role in determining the outcomes of consolidation efforts. In some instances, governments have encountered significant legal challenges, such as forced mergers in the Czech Republic or blocked mergers in South Africa. Conversely, countries like Malaysia does not experience legal obstacles but could tackle bank resistance through other channels. Market-driven bank consolidation is relatively new and primarily observed in Central Europe.³³

2.3 Bank Consolidation Approach in Various Countries

Bank consolidation has been a critical strategy for enhancing the stability and efficiency of banking systems worldwide, especially in emerging market economies (EMEs). The process of consolidation, however, is not uniform across different countries and regions. It is shaped by various factors including the specific economic conditions, regulatory environment, and the overall financial sector development of each country. Table 5 summarises the diverse approaches to bank consolidation in various countries, highlighting the method used and their implications on the banking sector’s stability and efficiency.³⁴

Table 5. Summary of Bank Consolidation Approaches in Various Countries

Consolidation Approach Type	Country/ Region	Details
Government-Led Consolidation	Malaysia	Driven by the need to stabilize the banking sector post-1997 Asian Financial Crisis and prepare for increased competition. Strategies included capital controls, asset management companies, capital injection, and corporate debt restructuring. In response to the challenges faced by the banking sector, the government established ‘Dana Modal’ (dedicated fund) to facilitate bank recapitalization and consolidation. While initial voluntary merger efforts proved unsuccessful, the central bank subsequently mandated a consolidation process, designating ten anchor banks to lead the initiative. These anchor banks were supported through tax concessions and deposit guarantees. The consolidation aimed to reduce 54 banking groups to a few large entities.
	South Korea	The government primarily drove bank mergers to address unsound banks in South Korea. These mergers involved significant public funding and capital support to facilitate the takeover of assets and liabilities from closed banks. The government also established financial holding companies to induce healthier banks to merge, offering buyouts of non-performing loans and increased market share as incentives. Despite these efforts, strong labor unions posed challenges in realizing efficiency gains from these mergers.
	Indonesia	The Indonesian government merged four state banks into Bank Mandiri, creating an institution that controls about a quarter of total commercial bank deposits. Eight private banks were also merged into a new institution, Danamon, under the Indonesian Bank Restructuring Agency (IBRA) oversight. This consolidation led to significant staff layoffs and branch closures, raising questions about the fundamental purpose of mergers if they result in such high retrenchment costs.

33 Sato, et al., 2001

34 Hawkins & Mihaljek, 2001; Olivero, et al., 2011; Shin & Kim, 2013; Fernandez-Bollo, et al., 2021; ECB Banking Supervision, 2021

Mixed Approaches	Thailand	Response to 1997 financial crisis included enhanced data collection, legal reforms, risk management practices, and significant mergers allowed greater foreign participation in the banking sector. Thailand's government has been less involved in direct mergers, supporting only one merger but generally favouring private initiatives. This approach contrasts with the more hands-on policies observed in Malaysia and South Korea.
	Phillippines	Phillippines adopted a range of incentives to encourage bank mergers, including better access to rediscount facilities and temporary relief from certain prudential requirements. This approach reflects a more supportive stance towards private merger initiatives compared to other countries where government intervention was more direct.
Market-Driven Consolidation	Mexico	Following the 1995 banking crisis, Mexico's consolidation efforts focused on recapitalizing private domestic banks through government schemes that bought non-performing loans. This process was complemented by easing regulations on foreign bank entry, which encouraged foreign participation and enhanced efficiency. To further support consolidation, the Mexican government introduced tax relief measures, such as reduced withholding tax rates on interest payments for non-residents and tax credits for withholding agents, lowering the financial burden on entities raising funds. Additional incentives, including reduced capital gains taxes and exemptions for specific securities transactions, aimed to attract investors and promote mergers within the financial sector. However, as consolidation progressed, concerns arose about potential over-concentration if too few banks dominated the market, necessitating a balance between consolidation and competition.
	Venezuela	Similar to Mexico, Venezuela's efforts in consolidation is driven by new legislation and banking crisis, aimed at strengthening capital base and improving technological capacity. More consolidation needed to reduce the number of banks.
	Central Europe	In countries like the Czech Republic, Hungary, and Poland, market-driven consolidation has only recently begun. Initially, liberal licensing promoted competition and financial market development. However, following numerous bankruptcies of private banks, a wave of market-driven consolidations started. Authorities often promote mergers to strengthen domestic banks or restructure ailing banks before privatization. Mergers between parent banks in EU countries have also influenced consolidation in Central Europe.
	European Countries	Many countries encourage market-driven consolidation to address inefficiencies and enhance competitiveness. By merging or acquiring smaller banks, larger institutions aim to streamline operations, reduce duplicate costs, and achieve economies of scale. This strategy is seen as a way to improve cost efficiency, rationalize branch networks, and leverage shared resources.
	United States	The Covid-19 pandemic accelerated branch closures, doubling the closure rate and leading to a significant reduction in the number of small banks. The Great Consolidation resulted in a few large megabanks dominating the market, with small community banks disappearing. Between 2017 and 2021, nearly 9% of all branches closed, with low to moderate-income and minority neighborhoods being disproportionately affected.
	Macedonia	Driven by the need to enhance competition, Macedonia, through bank consolidations, improve services, and increase profitability and efficiency. Confronted by structural overhauls and potential reputational hazards.

2.3.1 The Bank Consolidation in Malaysia

The Malaysian banking consolidation between 1999 and 2002 was driven by the need to stabilise the banking sector in the aftermath of the 1997 Asian Financial Crisis and the anticipation of increased competition following liberalisation and international agreements.³⁵ The consolidation program in Malaysia aimed to reduce the number of domestic banking institutions to create a core group of strong and well-capitalized banks, ultimately leading to a more effective and competitive banking system.

At the end of 1996, Malaysia had 37 locally incorporated banks, including 23 domestic and 12 foreign-owned banks. At the end of 2002, through a consolidation program, the number of domestic banking institutions was significantly reduced to 10 banking groups comprising 10 commercial banks, 10 finance companies, and 9 merchant banks. This led to the formation of ten anchor banks designed to be the core group of strong and well-capitalized institutions.

The Malaysian government responded to the financial crisis by implementing a comprehensive strategy of bank consolidation aimed at stabilizing the sector and preparing for increased competition under WTO accords. Key measures included implementing capital controls to stabilize the currency and curb capital flight, establishing asset management companies like Dana Harta to handle non-performing loans, and creating institutions such as Dana Modal to infuse capital and recapitalize banks. Furthermore, the Corporate Debt Restructuring Committee (CDRC) was set up to expedite corporate debt restructuring. These strategic actions collectively ensured the stability and resilience of Malaysia's banking sector, facilitating a swift recovery and enhancing its competitiveness.

Malaysia's consolidation strategy involved merging numerous banks into smaller, stronger institutions. By merging multiple smaller banks, the consolidation program reduced domestic banking institutions to ten anchor banks by the end of 2002, resulting in stronger capital bases and improved operational efficiencies. A study highlights the use of Data Envelopment Analysis (DEA) to show that while initial efficiency gains from Malaysia's bank consolidation strategy were modest, but the long-term benefits included reduced duplication of resources and greater economies of scale.³⁶ However, some anchor banks initially showed reduced efficiency post-consolidation, suggesting a need for more time to fully realise the benefits of consolidation. The consolidation process was subject to criticism due to allegations of political influence in the selection of anchor banks.

Notably, Bank Bumiputra was chosen as an anchor bank despite its weak management and historical failures, raising questions about the motivations behind its selection. Such politically motivated selections led to the integration of banks with starkly different cultures and management practices, which posed significant challenges. For instance, the merger between Bank Bumiputra, a government-owned and less profit-driven entity, and Commerce Asset, a well-managed and profit-oriented private bank, was particularly problematic. The dominance of Bank Bumiputra's inefficient practices over the more efficient operations of Commerce Asset created integration difficulties, thereby delaying the restructuring process.

Furthermore, the task of rationalizing and aligning different information and risk management systems across the merged entities added to the complexity. This was compounded by the need to harmonize internal control procedures, which required substantial effort and time. The politically influenced mergers often resulted in a mismatch of capabilities and operational styles, leading to inefficiencies that needed to be addressed over an extended period.

³⁵ Lim, et al., 2004
³⁶ Ibid

In response to these complications, the Malaysian government later showed flexibility by allowing banks to select their partners, an amendment aimed at mitigating the negative impact of the initial political decisions. However, this flexibility came after the initial delays and complications had already set in, illustrating how political considerations initially hampered the restructuring efforts.

2.3.2 The Bank Consolidation in Thailand

The process of bank consolidation in Thailand has involved a period of rapid liberalization, crisis, and comprehensive reform aimed at creating a more resilient and modern financial system.³⁷ In the early 1990s, Thailand began financial liberalisation, integrating its markets with the global economy. The establishment of the Bangkok International Banking Facilities (BIBFs) in 1993 facilitated international banking activities and attracted substantial capital inflows. However, this swift liberalisation lacked the necessary regulatory frameworks and management mechanisms. The initial excitement concealed underlying vulnerabilities, leading to lenient credit policies and misuse of funds in the corporate sector.

The situation deteriorated in July 1997 when Thailand experienced its most severe economic and financial crisis. Structural weaknesses, such as inadequate information systems, outdated legal frameworks, and poor risk management practices, exacerbated the crisis. The rigid exchange rate system and high-interest rate policies further aggravated the situation, revealing the financial system's unpreparedness to handle such shocks.

In response to the crisis, Thailand implemented decisive measures to address these weaknesses and prevent future crises. The country enhanced its data collection and reporting standards, including introducing the Credit Bureau Act to improve the monitoring of foreign liabilities and credit risks. Legal frameworks were overhauled, with foreclosure and bankruptcy laws amendments to expedite the resolution of bad debts. Transitioning to a managed float exchange rate system gave the Bank of Thailand greater flexibility to respond to economic fluctuations.

Risk management became central to the financial sector reforms. Banks were encouraged to adopt better risk assessment practices, focusing on cash flow analysis, project feasibility, and collateral. The Bank of Thailand promoted these practices through symposiums and enhanced regulatory guidelines. Supervisory mechanisms were strengthened, emphasising a risk-based approach prioritising transparency and accountability.

Several Thai banks were nationalized during the crisis to prevent a financial system collapse. The government's strategy involved privatizing these banks through competitive bidding processes to ensure transparency and fair competition. The Financial Institution Development Fund (FIDF) provided comprehensive deposit guarantees and loss-sharing agreements to facilitate the sale and restructuring of these banks. Significant mergers were undertaken to reduce the number of smaller financial institutions and create more robust banking entities.

The crisis paved the way for greater foreign participation in Thailand's banking sector. Regulations were relaxed to allow foreign investors to hold majority shares in local banks, leading to a significant presence of foreign-owned institutions. These banks brought international expertise and diversified financial services, particularly in the retail sector, traditionally dominated by domestic banks. The entry of foreign banks enhanced competition and introduced advanced banking practices, further strengthening the sector.

Thailand's process of bank consolidation showcases its resilience and adaptability. Through regulatory reforms, improved risk management, and strategic mergers, Thailand has developed a

37 Watanagase, 2001

more robust and stable banking system. The financial crisis catalysed change, driving the country to implement measures to ensure economic stability in the future.

As Thailand continues to navigate the complexities of the global financial landscape, the lessons learned from past experiences remain invaluable. The nation's steadfast commitment to ongoing reform and modernization equips the banking sector to navigate future challenges effectively, thereby fostering a climate of economic stability and prosperity.

2.3.3 The Bank Consolidation in the Philippines

The regulatory approach to bank consolidation in the Philippines, spearheaded by the *Bangko Sentral ng Pilipinas (BSP)*, combines government initiatives with market-driven strategies. The BSP's proactive role in facilitating and regulating this approach has been instrumental in shaping the banking sector's landscape, providing a clear direction for the industry.³⁸

The BSP has proactively issued regulations and circulars to consolidate and clarify the rules and obligations related to bank mergers and consolidations. This proactive approach, demonstrated by significant developments like the circular issued in April 2000, fosters healthy competition, enhances financial services, reduces costs, and promotes stability and efficiency in the banking sector.³⁹ The precise regulatory framework these regulations provide reassures the industry of a stable environment.

To encourage bank consolidation, the BSP has introduced several incentive programs. Notable among these are the Strengthening Program for Rural Banks (SPRB) and the Consolidation Program for Rural Banks (CPRB). These programs provide financial assistance, advisory services, and other support to facilitate mergers and acquisitions. The SPRB and CPRB aim to enhance rural banks' financial soundness and competitiveness, ensuring their ability to serve rural areas effectively and withstand economic challenges.⁴⁰

The BSP provides various incentives for merging banks to make the consolidation process more appealing and manageable for banks. These incentives include improved access to rediscount facilities and temporary relief from certain prudential requirements, which is intended to encourage banks to pursue mergers and acquisitions.⁴¹

Legislative support has also been a critical component of the government-led initiatives. The passage of the General Banking Act of 2000 (Republic Act No. 8791) replaced the 52-year-old General Banking Act and further liberalised the entry of foreign banks.⁴² This legislation expanded the provisions of previous regulations, allowing foreign banks to own existing local banks, subject to certain limitations fully. This move has encouraged consolidation through foreign investments, adding a new dimension to the banking sector's competitiveness.

The BSP has implemented prudential regulations to strengthen banks' financial stability. These measures include increasing minimum capital requirements, introducing risk-based capital adequacy ratios (following Basel I and Basel II standards), and enforcing stricter criteria for granting new bank licenses and establishing new branches. These regulations ensure that banks are financially sound and capable of managing risks effectively.

38 Sato, et al., 2001

39 Manlagñit, 2011

40 Kashiwabara, 2017

41 Sato, et al., 2001

42 Manlagñit, 2011

Market-driven strategies have also significantly influenced bank consolidation in the Philippines.

Liberalising the banking sector, including the entry of foreign banks, has created a more competitive environment. The increased presence of foreign banks has pushed local banks to merge or consolidate to maintain their competitiveness. This competitive pressure has been a significant driver of consolidation as banks seek to achieve economies of scale and improve their market positions.

The response to financial crises, such as the East Asian financial crisis, has also influenced the consolidation landscape.

In the aftermath of such crises, the BSP implemented measures to rehabilitate or prevent the closure of ailing banks. By offering incentives for mergers and acquisitions, the BSP aimed to strengthen the banking sector's resilience to economic shocks. These incentives included financial assistance and regulatory support to facilitate the consolidation process.

Market dynamics have naturally led to market selection, where more efficient banks survive and consolidate with or acquire less efficient ones.

This market-driven consolidation has resulted in a more robust and efficient banking sector. Higher bank asset concentration has been negatively related to profitability and overhead costs, suggesting that consolidation has led to the survival of more efficient banks with lower fees.

2.3.4 The Bank Consolidation in the European Countries

Merger and acquisition (M&A) activity in the European banking sector has been slow since the end of the global financial crisis.⁴³

In Europe, bank consolidation took place in two stages: The first stage involved mergers and acquisitions within individual countries in the late 1990s and early 2000s. This was followed by a slowdown during the economic downturn, reaching a low point in 2003. As the European economy grew and integration progressed prior to the global financial crisis, there was an increase in cross-border transactions, reaching a peak in 2007. Since the crisis, the value of bank mergers has remained low due to factors such as low bank valuations, weak profitability, and increasing regulatory constraints.

Low valuations during this period discouraged banks from bidding on potential acquisition targets due to high consolidation costs and the need to raise costly capital.

However, low valuations also present opportunities for healthy acquirers to purchase targets at significant discounts, potentially absorbing consolidation costs and reinforcing capitalisation. Motivations for bank consolidation vary, with cost synergies being a common rationale for domestic mergers, while cross-border transactions often seek new business opportunities. However, misaligned incentives linked to management remuneration growth drive some acquisitions, which can be problematic from a prudential perspective due to inadequate due diligence or risk management.

Consolidation should help banks address long-term challenges by leveraging economies of scale and enabling diversification.

Mergers can enable investment in digital technologies and the transition to a low-carbon economy, which is unattainable for smaller banks but achievable for merged entities. However, the track record of bank mergers could be better. Studies from the 1990s and early 2000s show moderately positive effects on bank profitability, while more recent assessments suggest mixed or neutral outcomes.⁴⁴ Some M&A transactions have led to financial distress due to insufficient due diligence and risky funding strategies, as seen in the collapse of the Royal Bank of Scotland (RBS) following its acquisition of ABN AMRO.⁴⁵

43 Figueiras, et al., 2021

44 Altunbas & Marqués-Ibáñez, 2004

45 Fassin & Gosselin, 2011

Consolidation can carry benefits and risks to financial stability and market structure. Successful transactions that improve individual firms' resilience and business models can enhance economic stability, turning merged entities into shock absorbers during crises. Absorbing weaker targets removes the lowest players from the market, reinforcing the banking system's soundness and resilience. Cross-border consolidation can enhance private risk-sharing, smoothing domestic economic shocks. Despite risks to competition, further consolidation optimizes the euro area banking market structure without compromising customer interests. Larger banks might gain market power, but empirical evidence suggests consolidation has not harmed customers, as reduced marginal costs rather than higher mark-ups have driven market power increases.

Nonetheless, consolidation may amplify systemic risks by creating more significant, more systemically essential banks perceived as "too big to fail," potentially leading to implicit subsidies and increased contagion risk. Excessive size may also result in diseconomies of scale, making significant financial conglomerates challenging to manage. Global and European regulators have adopted reforms to contain systemic risks posed by large and complex banks and ensure their orderly resolution if they fail. Preliminary findings suggest these reforms have made banks more resilient and resolvable, although their effectiveness remains to be tested in practice.⁴⁶

Effective integration strategies are key to successful consolidation. These strategies include aligning infrastructure, streamlining operations, and ensuring adequate capitalization to manage risks and meet regulatory demands. **Equally critical is the integration of risk management and internal control frameworks to mitigate execution risk, a common pitfall in large-scale mergers. Governance structures must oversee the integration process with clarity and precision, and the management body must actively monitor and guide the consolidation effort. Specific supervisory functions should ensure strong oversight, with leadership roles filled by members possessing adequate expertise. For instance, given the operational importance of IT integration, a clear governance plan must be established, with management body members closely overseeing IT-related processes to ensure seamless integration and operational stability.**

While banks devise these consolidation strategies, regulatory authorities play a crucial role in overseeing and assessing these mergers to ensure they contribute to a stable and efficient banking sector. In the European context, the European Central Bank (ECB)'s role in assessing mergers involves evaluating the consolidation strategy's credibility and ensuring compliance with prudential standards. This evaluation is multifaceted, considering various aspects of the proposed merger. For instance, Pillar 2 requirements, which are part of the Basel framework for banking supervision, are based on weighted averages of pre-merger levels, with adjustments made for significant developments. This approach allows the ECB to ensure that the merged entity maintains adequate capital levels to support its operations and risk profile.

However, the ECB's considerations extend beyond just the financial health of the merging entities. Market competition and financial stability concerns are carefully balanced, with authorities addressing resolvability and systemic risks. This holistic approach aims to maintain a competitive banking landscape while safeguarding the overall stability of the financial system. It is a delicate balancing act that requires careful analysis and foresight.⁴⁷

46 Fernandez-Bollo, et al, 2021

47 Ibid

2.4 Historical Review of Bank Consolidation in Indonesia

The Indonesian banking sector has undergone significant transformations over the past few decades, outlined in Figure 5. These changes have been driven by regulatory reforms, market dynamics, and efforts to enhance the stability and efficiency of the financial system. Below is an overview of the consolidation process in the Indonesian banking sector, highlighting key phases and developments from the pre-1997 period to recent times.

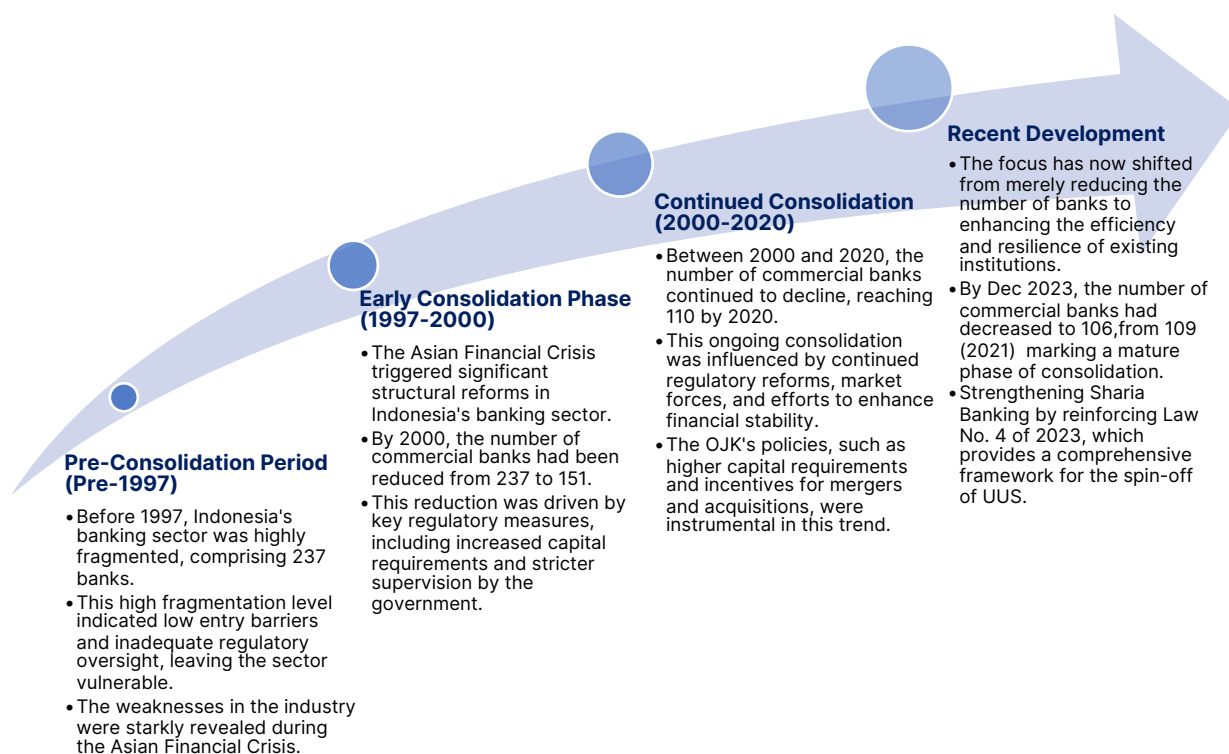
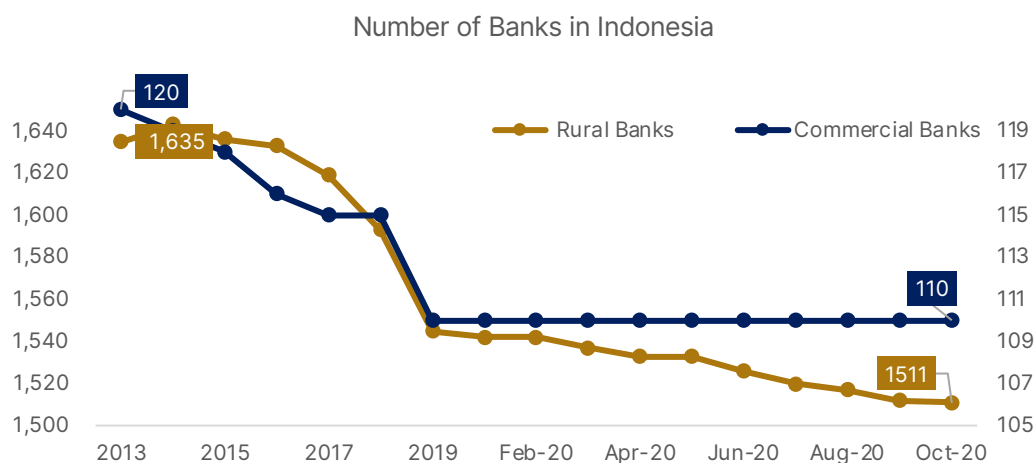


Figure 5. Overview of Indonesia's Banking Consolidation Trends⁴⁸

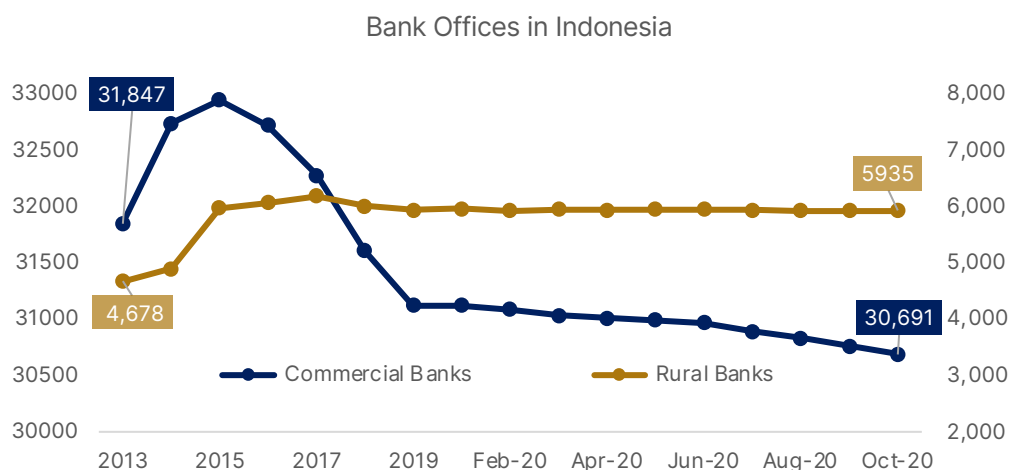
Since 1997, government has taken some regulatory measures such as increased capital requirements and stricter supervision. Post-COVID-19, these efforts have positioned the sector to better withstand economic shocks and support long-term stability and growth. OJK's framework has facilitated mergers, enabling smaller, less stable entities to integrate with larger, stronger institutions.

This trend, illustrated in Figure 6, highlights OJK's focus on optimizing the banking sector by improving resilience and competitiveness through consolidation and digitalization. A key emphasis has been placed on smaller commercial banks (BUKU 1 and BUKU 2) to address declining performance and build a robust infrastructure. Rural banks declined from approximately 1,635 in 2013 to 1,511 by October 2020, while commercial banks decreased from 120 to 110 in the same period, as shown in Figure 6 (1). Furthermore, Figure 6 (2) shows a reduction in commercial bank branches from 31,847 in 2013 to 30,691 in 2020, reflecting cost-saving measures and operational streamlining driven by mergers.

48 Mulyaningsih et al., 2011



(1)



(2)

Figure 6. (1) Number of Bank in Indonesia, (2) Bank Offices in Indonesia

2.4.1 Pre-Consolidation Period (Pre – 1997)

Indonesia's banking sector, consisting of 237 banks, was highly fragmented before 1997. This fragmentation indicated low entry barriers and inadequate regulatory oversight, leaving the industry vulnerable to risks. Recognizing these vulnerabilities, the government introduced policy reforms aimed at modernizing the banking industry.

The **June 1, 1983, policy package (PAKJUN)** marked an initial step in liberalizing the banking sector. This was followed by the **October 27, 1988, policy package (PAKTO)**, which significantly eased licensing requirements for establishing new banks and opening branch offices. Under PAKTO, investors could start new banks with as little as IDR 10 billion. This liberalization led to a sharp increase in the number of banks, intensifying competition in the sector.

However, the rise in the number of banks also had unintended consequences. Many private banks were owned by large business conglomerates that mobilized public funds through their banks to support their business interests. This practice often diverted funds from the broader economy and increased the risk of violations of BMPK (Legal Lending Limits), weakening the banking infrastructure.

These weaknesses became apparent during the **Asian Financial Crisis of 1997-1998**, which starkly exposed the fragility of Indonesia's banking system. The crisis led to a severe loss of confidence in the rupiah and the national banking system, further exacerbated by the closure of 16 banks in **November 1997**. Public trust plummeted, leading to widespread financial instability.

In response to the crisis, the Indonesian government, with assistance from the International Monetary Fund (IMF), implemented stabilization and reform programs to restore public confidence and strengthen the financial system. A critical step was the enactment of **Law No. 23 of 1999 concerning Bank Indonesia**, which emphasized the central bank's role in achieving and maintaining the stability of the rupiah as a prerequisite for sustainable economic growth.

To further enhance the resilience and competitiveness of the banking sector, Bank Indonesia introduced the **Indonesian Banking Architecture (API)**, a comprehensive framework for the sector's development over the subsequent five to ten years. Supported by strengthened bank capitalization structures, the API aimed to create a stable banking environment that could function effectively as an intermediary and compete with foreign banks in the international market.

2.4.2 Early Consolidation Phase (1997 – 2000)

The Asian Financial Crisis led to significant changes in Indonesia's banking sector. In response, the Indonesian government undertook major efforts to stabilize the sector, including consolidating several banks. One significant action was the creation of Bank Mandiri in 1999, formed through the merger of four state banks: Bank Bumi Daya, Bank Dagang Negara, Bank Exim, and Bapindo. This merger formed one of Indonesia's largest banks, controlling about a quarter of total commercial bank deposits. Additionally, in 2000, eight private banks, which had been taken over by the Indonesian Bank Restructuring Agency (IBRA), were combined to establish Bank Danamon.

The mergers resulted in high retrenchment costs, with an expected 90% staff layoff and 80% branch closures. This sparked debates about the purpose of such mergers, some policymakers questioning their value if they led to the near extinction of banks. In contrast, others argued that the primary concern should be the safety of bank deposits rather than job cuts. A significant reduction in the number of commercial banks in Indonesia, from 237 in 1997 to 151 by 2000, resulted from the Asian Financial Crisis and government efforts to stabilize the financial sector. These interventions included closing insolvent banks, establishing restructuring agencies, increased capital requirements, and stricter regulatory supervision. The goal was to create a more resilient, efficient, and competitive banking sector supporting sustainable economic growth.

2.4.3 Continued Consolidation (2000 – 2020)

From 2000 to 2020, the number of commercial banks consistently declined, reaching 110 by 2020. Despite the reduction, Indonesia still had a significantly higher number of banks compared to peer countries such as Malaysia (26 banks), Thailand (30 banks), and India (34 banks).⁴⁹ This ongoing consolidation was influenced by continued regulatory reforms, market forces, and efforts to enhance financial stability. OJK has encouraged consolidation through mergers and acquisitions by issuing the Single Presence Policy and Minimum Capital Requirement regulation. OJK enforced higher capital

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Data from each countries' central bank authorities, 2020; Yusgiantoro, Wirdiyanti, & Harjanti, 2020

requirements and provided incentives for mergers and acquisitions, encouraging smaller and weaker banks to merge with larger, more stable institutions. These policies aimed to create fewer but stronger banks capable of effectively managing market challenges.

A significant issue in the Indonesian banking sector is the dominance of mid to small-scale banks, which account for 75 out of 110 banks, or 68% of the total. In contrast, only 7 large banks make up just 6% of the total number of banks. The market is heavily concentrated, with the four largest banks controlling 50% of the market share, leaving the remaining 106 banks to compete for the rest. This imbalance in market power between large and small banks could negatively impact the competitiveness of the banking industry.

These regulations have prompted a series of mergers and acquisitions within the Indonesian banking sector. Since the majority of banks in Indonesia are mid- to small-sized institutions, optimizing market share distribution and enhancing banking capacity through mergers and acquisitions could bolster competitiveness, stability, and overall performance in the long term.

Recent Developments (2021 - Onwards)

The enactment of the P2SK Law marked a significant milestone in Indonesia's financial consolidation strategy, encompassing commercial, Sharia, and Regional Development Banks (BPDs). The law encourages financial institutions within conglomerates to integrate under a financial holding company (PIKK). It also provides a framework for voluntary restructuring aimed at strengthening the resilience and competitiveness of the banking sector.

In line with the P2SK framework, the Financial Services Authority (OJK) has targeted creating Sharia banks with assets exceeding IDR 100 trillion by 2027. This initiative aligns with OJK's broader goals of strengthening the Islamic finance sector. Sharia bank consolidation is a cornerstone of the strategy to enhance the Islamic finance sector. The merger of Sharia Business Units (UUS) into Sharia Commercial Banks (BUS), supported by OJK Regulation No. 12 of 2023, aims to establish larger and more competitive institutions.



Box 2: Post-Merger Challenges: Case of Bank Syariah Indonesia (BSI)

A notable consolidation in 2021 saw the merger of Bank BRI Syariah, Bank Syariah Mandiri, and Bank BNI Syariah into Bank Syariah Indonesia. It enables Sharia banks to leverage economies of scale, expand market access, and comply with regulatory standards for stability and growth. While the merger led to several improvements, including enhanced financial and stock performance, it also introduced new challenges that needed to be addressed.

Following the merger, the stock prices of Bank Mandiri, BNI, and BRI remained largely unaffected, despite the significant positive impact on BRIS, rebranded as BSI. The market responded favourably to BSI's financial and operational synergies, as seen in improved Price-to-Earnings Ratio (PER) and Price-to-Book Value (PBV) indicators. However, this enthusiasm did not translate to the parent banks, indicating that investors recognized BSI's performance improvements without broader financial market effects for its parent companies.

Separation of Operations

The merger had little direct impact on the broader operations of Bank Mandiri, BNI, and BRI. Investors may have perceived that the merger's benefits were largely confined to BSI and not sufficiently transformative to influence the financial performance of the parent companies as a whole.

1) Minor Contribution to Total Assets

For each parent company, the assets and profitability of the Islamic banking subsidiaries (BSM, BNIS, BRIS) were relatively small compared to their overall operations. For example, Bank Rakyat Indonesia (BRI) holds a large portfolio of conventional banking services, and BRIS accounted for only a small fraction of its total assets before the merger. As a result, any positive impact on BRIS post-merger was unlikely to significantly boost BRI's overall stock performance.

Another factor contributing to the limited impact on parent companies' stock prices relates to governance and control dynamics. Post-merger, Bank Mandiri became the dominant shareholder of BSI, holding a 51.20% stake, while BNI and BRI held 26% and 18%, respectively (Figure 7). This shift in control dynamics might have contributed to investor uncertainty regarding the influence of Bank BNI and BRI over the new entity, further limiting positive reactions to their stock.

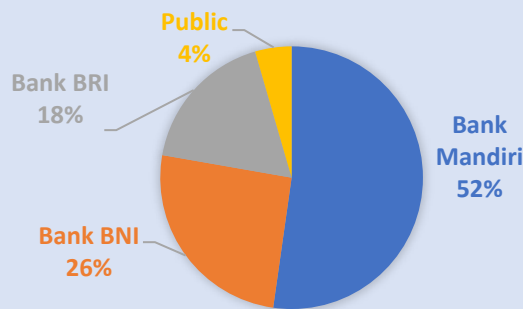


Figure 7. Share Ownership of Bank Syariah Indonesia (BSI)⁵⁰

Investors may have been cautious about the merger's long-term implications, particularly since Bank Mandiri's increased influence over BSI's management suggested that Bank Mandiri's strategic priorities would dominate. As a result, the stock performance of BNI and BRI may not have benefited as much because these banks had less control over BSI's future trajectory.

OJK has also encouraged mergers to create larger, more robust BPDs capable of better supporting regional economic development. This is to address challenges faced by BPDs in terms of limited capitalization and inefficiency. Consolidated BPDs are expected to enhance their credit services, risk management, and capacity to invest in digital banking infrastructure. These improvements are crucial for supporting SMEs and local infrastructure projects while meeting the demands of an increasingly digital economy.

50 Setiawan, H., 2023

Commercial bank consolidation has also progressed significantly, with the number of commercial banks declining to 106 as of December 2023. The focus has shifted from reducing the quantity of banks to enhancing their efficiency and resilience. OJK Regulation No. 12/POJK.03/2020 has been instrumental in this process, requiring banks to raise their minimum core capital to IDR 3 trillion by 2022. This regulation also provides flexibility for controlling shareholders to consolidate through mergers, acquisitions, and other methods, strengthening the banking sector's structural foundation.

The P2SK Law continues to shape Indonesia's financial landscape by supporting digital and bullion banking. It further introduces other innovative mechanisms for banking consolidation such as including foreign exchange and fund transfers for BPR. By enhancing financial inclusion, promoting operational efficiency, and addressing sectoral gaps, these developments signify Indonesia's commitment to fostering a robust, modernized, and globally competitive banking industry.

2.5 Bank Consolidation Scheme

POJK No. 12/2020 introduced five bank consolidation schemes to strengthen Indonesia's banking structure. This consolidation aims to create more efficient, stronger, and competitive banking at the national and regional levels, particularly for smaller banks with core capital less than IDR 3 trillion.

These schemes include mergers, consolidations, or integrations (P/P/I), takeovers followed by consolidation or merger, and the formation of KUB either through existing ownership or through the spin-off of UUS. Another scheme allows for the formation of KUB after a takeover. These methods enable smaller banks to pool resources, reduce operational inefficiencies, and increase competitiveness. This regulation gives rise to two primary consolidation schemes. The first scheme involves the merging or integrating existing banks. This applies to banks under the control of either a single controller or multiple controllers. Banks are encouraged to combine resources and capabilities in this scheme to improve operational efficiency and competitiveness.

The second focuses on a takeover followed by a merger, consolidation or integration of banks. This scheme applies to parties who already control one or more banks or plan to become bank controllers by taking over multiple banks. After the takeover, the next step is to merge, consolidate or integrate these banks. The aim is to create a bigger and more competitive bank capable of operating efficiently on a larger scale.

The regulation allows for the formation of KUB. A KUB can be formed under three conditions: first, when a controller, such as a bank, owns one or more other banks; second, when the controller is a non-bank financial institution, non-financial institution, or individual, including those domiciled abroad, who controls two or more banks; and third, when a KUB is created through the separation (spin-off) of a UUS from a conventional bank or as a result of a takeover. These KUBs allow for the integrated management of multiple banks under a single structure, optimizing operational synergies and improving efficiency.

Furthermore, the regulation also emphasizes that the KUB structure is designed to improve the management of segregated business units, particularly within the Sharia banking sector. Forming a KUB enables focused oversight and enhances the performance of Sharia business units. The formation of KUB due to takeovers applies to banks that have already been acquired by a controlling entity. In such cases, KUBs help integrate the acquired banks, ensuring better management and operational alignment. With these various consolidation schemes, Indonesia's banking structure is envisaged to become more solid and able to compete globally. POJK No. 12/2020 provides a clear framework for consolidating banking industry players, with various options that suit each bank's conditions and needs.

As of July 2022, 37 banks, comprising 24 commercial and 13 regional development banks, were consolidating to meet the required IDR 3 trillion minimum capital. This regulatory push is part of a broader effort to ensure a more robust and competitive banking system. Alongside consolidation, OJK supports restructuring loans impacted by the COVID-19 pandemic, notably decreasing from IDR 830 trillion in 2020 to IDR 560 trillion by mid-2022. Specific sectors, such as hospitality and real estate, continue to see high levels of restructuring.

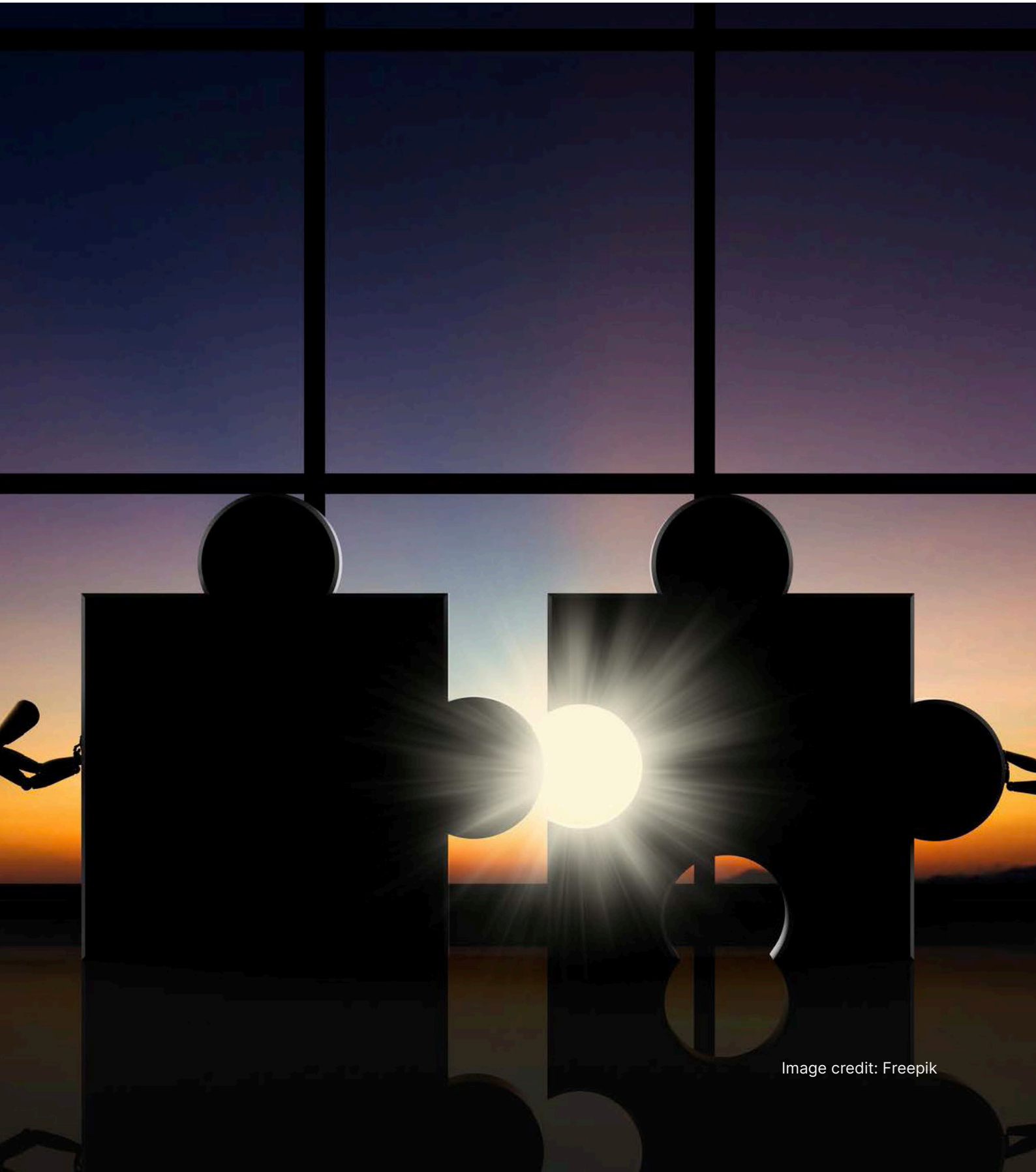


Image credit: Freepik

3. Findings and Discussions

Banking consolidation in Indonesia is a complex process driven by regulatory requirements, technological advancements, and the need for greater financial stability. It is imperative to examine banking consolidation's importance, exploring the underlying drivers, associated risks, and challenges that arise before and after mergers. Through detailed analysis of regulatory gaps, shareholder disagreements, cultural differences, and capacity-building post-merger, strategies will be developed to navigate these complexities and foster a more robust banking system.

3.1 The Imperative of Banking Consolidation in Indonesia

According to Daruri (2024) Indonesia should ideally reduce the number of banks to 25 to improve efficiency and competitiveness. This ideal reflects a broader trend of bank consolidation, where mergers help streamline operations, reduce redundancies, and improve overall performance. The consolidation process, however, should prioritize the compatibility of merging banks' behavioural traits, such as credit policies, risk management, and service innovation, which can ensure smoother adaptation and create effective synergies post-merger. Integrating back-office operations can reduce costs, improve operational margins, and allow banks to channel resources into technology investments or other growth areas. By consolidating branches, banks can capitalize on economies of scale and focus more on delivering quality services for customers.

Consolidation benefits go beyond large banks. It also allows small banks, including regional ones, to unify their resources, facilitating investments in digital infrastructure and services. By pooling financial and technological capabilities, banks can innovate and expand their product offerings, enhance operational efficiency and customer satisfaction, and improve their agility in responding to market changes. This inclusivity ensures that banks of all sizes are better equipped to adapt to a rapidly evolving financial ecosystem.

Bank consolidation in Indonesia is crucial to tackle the inefficiencies in the banking sector reflected in high Net Interest Margin (NIM). Indonesia's banks have the highest Net Interest Margin (NIM) among the ASEAN-5 countries. NIM represents the gap between a bank's interest earnings and costs relative to its assets. While wide NIMs may appear profitable, they undermine the banks' role as effective financial intermediaries by creating a significant gap between deposit and lending rates. Eventually, high NIMs could make banks perceived less attractive further weaken its competitiveness.

A high Net Interest Margin (NIM) can result from elevated credit rates, as seen in Indonesia, where credit rates remain above 8%, compared to just around 3% in China. This disparity is partly driven by higher inflation in Indonesia (2.13% as of July 2024) compared to China's 0.5%, which forces banks to set higher nominal interest rates to maintain favorable real interest rates. By fostering competition through deregulation, consolidation enables well-managed banks to grow while inefficient ones exit, optimizing resource allocation, reducing costs, and ultimately enhancing profitability.

Consolidation is also crucial to addressing the issue of Non-Performing Loans (NPLs). As of June 2024, the NPL ratio for commercial banks in Indonesia stands at 2.26%, which is relatively low, falling below the 5% threshold, but still higher than some other countries, such as China, where the NPL ratio ranges from 1-2%, as shown in Figure 8. While Vietnam's NPL ratio used to be lower than Indonesia's, it saw a significant increase in both corporate and consumer NPLs during the challenging economic conditions of 2022-2023, which greatly affected personal and household incomes. In contrast, Malaysia's NPL ratios remained stable over the past decade, fluctuating between 1.46% and

1.84%. Thereby, consolidation could improve NPLs by creating larger and more financially stable banks that are better equipped to manage and absorb these risks. Ultimately, it will help to improve overall asset quality and lending practices.

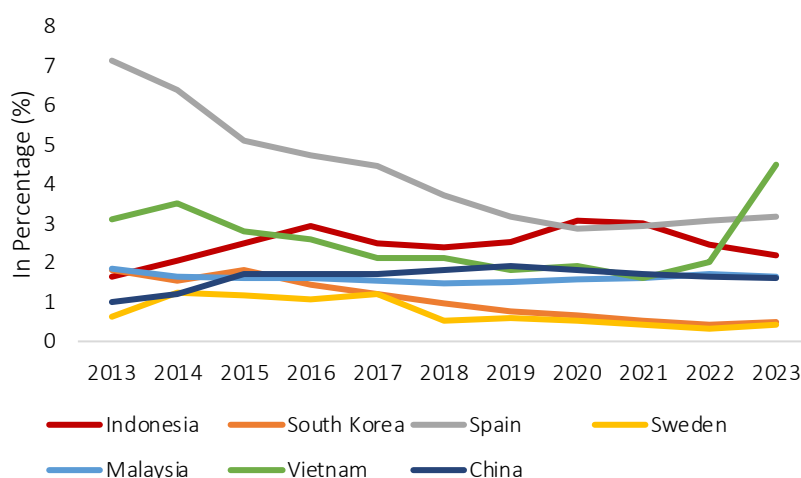


Figure 8. NPL Ratio Comparison in Selected Country

3.2 Drivers: Leveraging Opportunities and Addressing Pre-Merger Risks

3.2.1 High Minimum Core Capital Requirements

Indonesia's financial sector has witnessed transformative regulatory changes aimed at bolstering the stability, competitiveness, and global presence of its banking industry. However, for over a decade, the minimum core capital requirement of IDR 100 billion remained unchanged, despite the sector's evolving scale and complexity.

OJK introduced a phased increase in minimum core capital requirements in 2020 considering the need to enhance financial resilience. As stipulated in POJK 12/POJK.03/2020, banks are mandated to hold at least IDR 2 trillion by the end of 2021 and IDR 3 trillion by the end of 2022. This measure aligns with international standards, such as Basel III, which emphasize strengthening capital adequacy to improve banks' ability and absorb financial shocks. By raising capital thresholds, OJK aims to promote a more resilient banking system and indirectly encourage consolidation among smaller banks, fostering greater stability in Indonesia's financial sector.

To ensure a seamless transition, OJK has implemented structured compliance deadlines and reporting requirements. Banks were required to submit comprehensive action plans in stages, beginning in 2020, detailing strategies for achieving incremental capital targets. These plans were incorporated into their annual business plans to ensure systematic execution. For regional government-owned banks, a more flexible deadline of December 31, 2024, acknowledges their specific challenges. Foreign bank branches, however, face stricter requirements, including raising their Capital Equivalency Maintained Assets (CEMA) to IDR 3 trillion by the end of 2022. This phased approach reduces disruptions and provides clear guidance for banks to align with regulatory expectations. It also reflects a thoughtful balance between modernization and the challenges of implementation.

Complementary to these measures, OJK transitioned from the BUKU framework to the KBMI classification system as outlined in POJK No. 21/POJK.03/2021 as depicted in Figure 9. This categorization aligns banking activities with their core capital, promoting sound management and ensuring operational stability. The KBMI system comprises four categories: KBMI 1 for banks with the smallest core capital and limited operations, KBMI 2 for those with moderate capital and broader activities, KBMI 3 for substantial capital with foreign exchange capabilities, and KBMI 4 for the largest banks offering extensive domestic and international services. Unlike the previous BUKU system, the KBMI thresholds are designed to reflect banks' financial capacity without mandating a universal increase in minimum core capital beyond the IDR 3 trillion requirement. Notably, while POJK No. 21/POJK.03/2021 introduced the KBMI classification system with higher core capital thresholds for categorization, the minimum capital requirement remains capped at IDR 3 trillion.

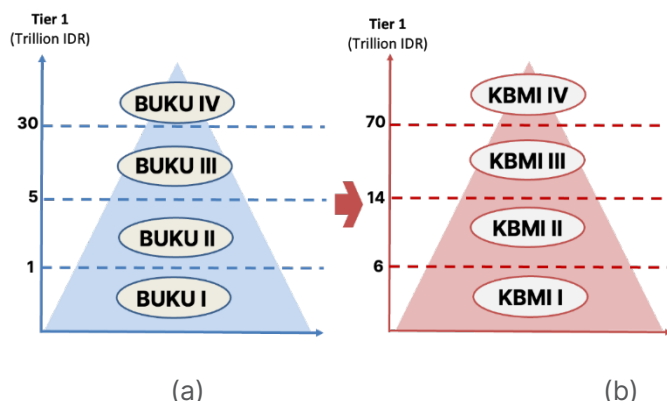


Figure 9. Indonesian Bank Classification Switch from BUKU to KBMI

The majority of banks in Indonesia are categorized as KBMI 1, with data from February 2024 indicating that 49 banks fall within this group, operating in the asset range of IDR 10 to 50 trillion (Figure 10). These smaller institutions often face financial constraints that challenge their ability to achieve regulatory compliance, underscoring the need for consolidation within this segment. In contrast, banks in KBMI 2, KBMI 3, and KBMI 4 typically exceed core capital requirements, reflecting stronger financial resilience and greater capacity for sustainable growth. This disparity underscores the importance of regulatory efforts to enhance financial stability and mitigate systemic risks, particularly for smaller, less capitalized banks.

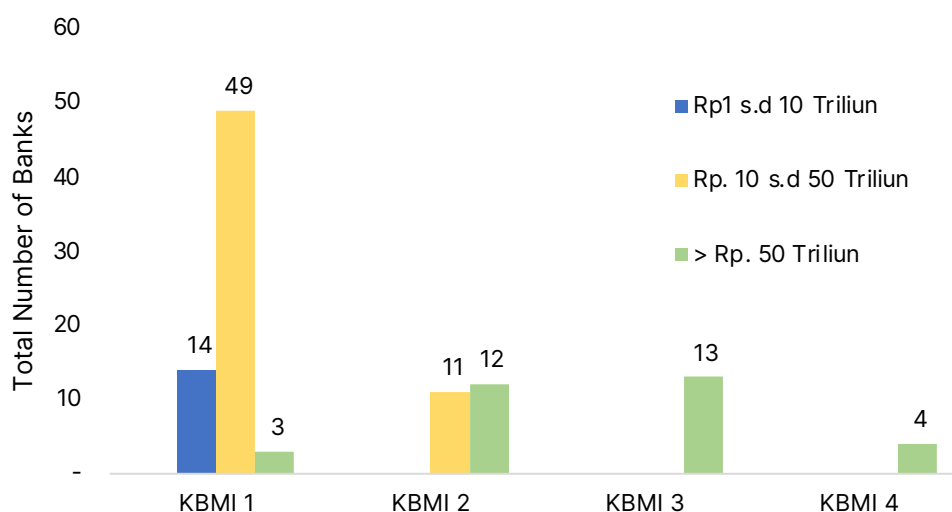


Figure 10. Total of Commercial Banks Based on Total Asset (KBMI) Data as of February 2024⁵¹

51 Data as of February 2024 at OJK, 2024

The findings underscore the challenges posed by the high minimum core capital requirements, which, while intended to fortify the sector, have inadvertently created barriers to entry and hindered consolidation efforts for smaller banks. These institutions often struggle to independently meet the capital thresholds, leading to delays or inefficiencies in the consolidation process. Addressing this issue requires innovative strategies that not only facilitate compliance but also provide targeted support to ensure smaller banks can contribute to a stable and competitive banking ecosystem. Benchmarking successful cases from countries like Malaysia, Indonesia can explore the creation of government-led entities to inject capital, recapitalize banks, and accelerate consolidation while preserving financial stability.

3.2.2 The Rapid Acceleration of Digital Transformation

A prime example of leveraging consolidation to drive digital transformation is the merger of PT Bank Central Asia Tbk (BCA) and PT Bank Royal Indonesia. The resulting digital bank demonstrated significant benefits. First, it generates financial gains. Increased revenue streams and reduced operational costs realized through streamlined processes and fewer physical branches. Second, it enhances market position. BCA could capture a larger share of the digital banking market and attracted tech-savvy, younger customers, boosting its brand and competitiveness. Additionally it could improve customer experience since it enable seamless 24/7 banking access, technology upgrades, and more efficient operations. Finally, it also enhanced regulatory compliance and risk management. The merger allows the bank to adhere to banking regulations and ensured secure transactions, addressing integration challenges effectively. This success illustrates how consolidation, coupled with digital transformation, can strengthen market leadership and operational efficiency, aligning with global banking trends.

The consolidation trend is not limited to larger banks. Rural banks (BPRs) are also feeling its effects, with branch networks showing slight declines since 2017. This reflects a shift toward digital banking, where fewer physical branches are needed to serve customers effectively. Smaller institutions must embrace similar strategies to remain relevant in the evolving banking landscape.

As mandated by POJK No.25/POJK.03/2021, regional development banks must consolidate to support digital transformation, ensuring their competitiveness and regulatory compliance. This regulation emphasizes the need for innovation, expanded digital services, and resource optimization, enabling banks to invest in advanced technologies that enhance service quality and operational stability in an increasingly digital landscape.

This regulation also governs the principled and efficient operation of rural banks (BPRs) and Sharia BPRs, fostering innovation and collaboration with commercial banks. It introduces two models of BPR products. The first is basic products encompassing traditional banking services such as fund collection, distribution, and placement. The second one is advanced products such as technology-based services, including digital banking and partnerships with other financial institutions. These measures align with broader efforts to modernize Indonesia's banking system and enable financial institutions to meet rising customer demands for seamless, 24/7 banking access. POJK No.25/POJK.03/2021 builds on previous directives such as POJK No.75/POJK.03/2016, which established standards for IT infrastructure, governance roles, human resources, and IT security. Together, these regulations aim to ensure that banks adopt robust digital infrastructure while maintaining strong governance and compliance.

While those regulations focus on traditional banking operations, there is a growing need to incentivize digital modernization. Several measures are proposed to encourage digital transformation. Provisions include grants and tax relief, reduce regulatory fees, and partnership support. These supports are likely to drive investments in digital platforms, cybersecurity, and fintech partnerships. They can also enable banks to adopt technology-based solutions and encourage collaborations between smaller banks and

larger commercial banks for shared digital infrastructure.

By incorporating such incentives, regulations can align consolidation efforts with the technological advancements shaping global banking, ensuring that all financial institutions, large and small, are equipped to navigate the digital era successfully.

3.3. Challenges: Overcoming Barriers to Banking Consolidation

3.3.1 Incentives to Address the Lack of Interest in Consolidation

The Indonesian banking industry must strengthen its resilience and competitiveness to address dynamic regional and global economic developments, which necessitates a robust banking structure. Achieving this requires a regulatory framework that incentivizes consolidation while addressing the challenges and complexities associated with the process. Over time, Indonesia has introduced several policies to encourage banking consolidation, such as the incentives outlined in PBI No. 8/16/PBI/2006, PBI No. 9/12/PBI/2007, and PBI No. 14/24/PBI/2012 (Table 6). These regulations provided various incentives, including licensing ease, temporary governance leniencies, and financial relief for mergers, to facilitate smoother transitions and attract banks to consolidate.



Image credit: Freepik

Table 6. Summary of Bank Indonesia Regulation (PBI) Related to Banking Consolidation Incentives⁵²

Regulation	Description	Details
PBI No. 8/16/PBI/2006	Incentives for Banking Consolidation	<p>Purpose Strengthening the banking system by encouraging the consolidation. Strengthening GCG and also bank capital in the banking sector. Enhancing the stability and efficiency of the banking sector to support financial system stability. Augmenting bank capital and operational capacity to foster resilience against competitive pressures and evolving regulatory frameworks, such as Basel II.</p> <p>Incentives Provided Ease of licensing. Temporary reduction of requirements (reduction of the mandatory GWM by 1% for one year). Extended time for resolving issues. Branch opening simplification. Cost reimbursement.</p> <p>Implementation and Monitoring Banks planning to merge or consolidate must submit a proposal for the utilization of incentives, signed by the directors of all participating banks, to Bank Indonesia at least six months before the merger or consolidation. The proposal should be included in the bank's business plan.</p> <p>Sanctions Controlling shareholders, commissioners, and directors of eligible banks exhibiting reluctance to participate in merger or consolidation initiatives are subject to administrative sanctions, including written warnings and potential fitness and propriety assessments.</p> <p>Effective Date and Further Provisions Effective upon issuance on October 5, 2006.</p>

⁵² Bank Indonesia, 2006; Bank Indonesia, 2007

PBI No. 9/12/PBI/2007	Amendments to PBI No. 8/17/PBI/2006 concerning Incentives for Banking Consolidation	<p>Purpose</p> <p>Accelerating the consolidation of the banking sector by providing additional incentives for banks to merge or consolidate.</p> <p>Enhancing the provisions and effectiveness of the incentives initially provided in PBI No. 8/17/PBI/2006.</p>
		<p>Amendments to Incentives</p> <p>Ease of licensing.</p> <p>Temporary reduction requirements.</p> <p>Extended time for resolving issues.</p> <p>Branch opening simplification.</p> <p>Cost reimbursement.</p> <p>GCG Leniency.</p>
		<p>Conditions for Incentives</p> <p>Foreign exchange bank licensing.</p> <p>Reporting and monitoring.</p>
		<p>Implementation and Transitional Provisions</p> <p>Banks planning to merge or consolidate must submit a proposal for the utilization of incentives, signed by the CEOs of all participating banks, to Bank Indonesia before the merger or consolidation.</p> <p>Banks that have already submitted plans for utilizing incentives before the effective date of this regulation can submit additional plans under the new provisions.</p>
		<p>Sanctions</p> <p>Banks that fail to meet the requirements for the incentives within the stipulated timeframe lose the incentives and must comply with existing PBIs for non-foreign exchange banks to become foreign exchange banks.</p>

PBI No. 14/24/PBI/2012	Sole Proprietorship in Indonesian Banking	<p>Purpose Enhancing the resilience and competitiveness of the banking sector to anticipate regional and global economic dynamics. It seeks to achieve a strong and healthy banking structure by restructuring the policy on single ownership in Indonesian banking.</p> <p>Key Provisions Introduced the single ownership rule. Allowed exemptions for different business principles and joint venture banks. Provided compliance methods (merger, holding company, holding function). Offered incentives for mergers/ consolidations. Defined requirements for holding companies and functions. Mandated strategic direction and consolidated reporting. Outlined regulation and supervision by Bank Indonesia Imposed restrictions and mandatory divestment for non-compliance. Included sanctions and repealed previous related regulations.</p>
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Earlier regulations primarily focused on specific incentives like forex status or temporary relief from Good Corporate Governance (GCG) requirements. While these measures helped streamline transitions and addressed immediate challenges, they were narrow in scope, benefiting primarily banks with international or foreign exchange operations. Broader challenges, such as digital transformation, long-term governance restructuring, and post-merger integration complexities, were not comprehensively addressed.

The 2012 regulation (PBI No. 14/24/PBI/2012) marked a pivotal shift by introducing single ownership policies and streamlining regulatory processes for consolidation (Figure 11). It repealed previous provisions that constrained consolidation efforts and provided more flexibility for banks to pursue mergers. This included reducing administrative burdens and extending timeframes for compliance with governance standards, allowing banks to focus on operational integration. However, even with these refinements, structural issues remain, particularly for smaller or domestically focused banks that lack the financial capacity to leverage existing incentives.

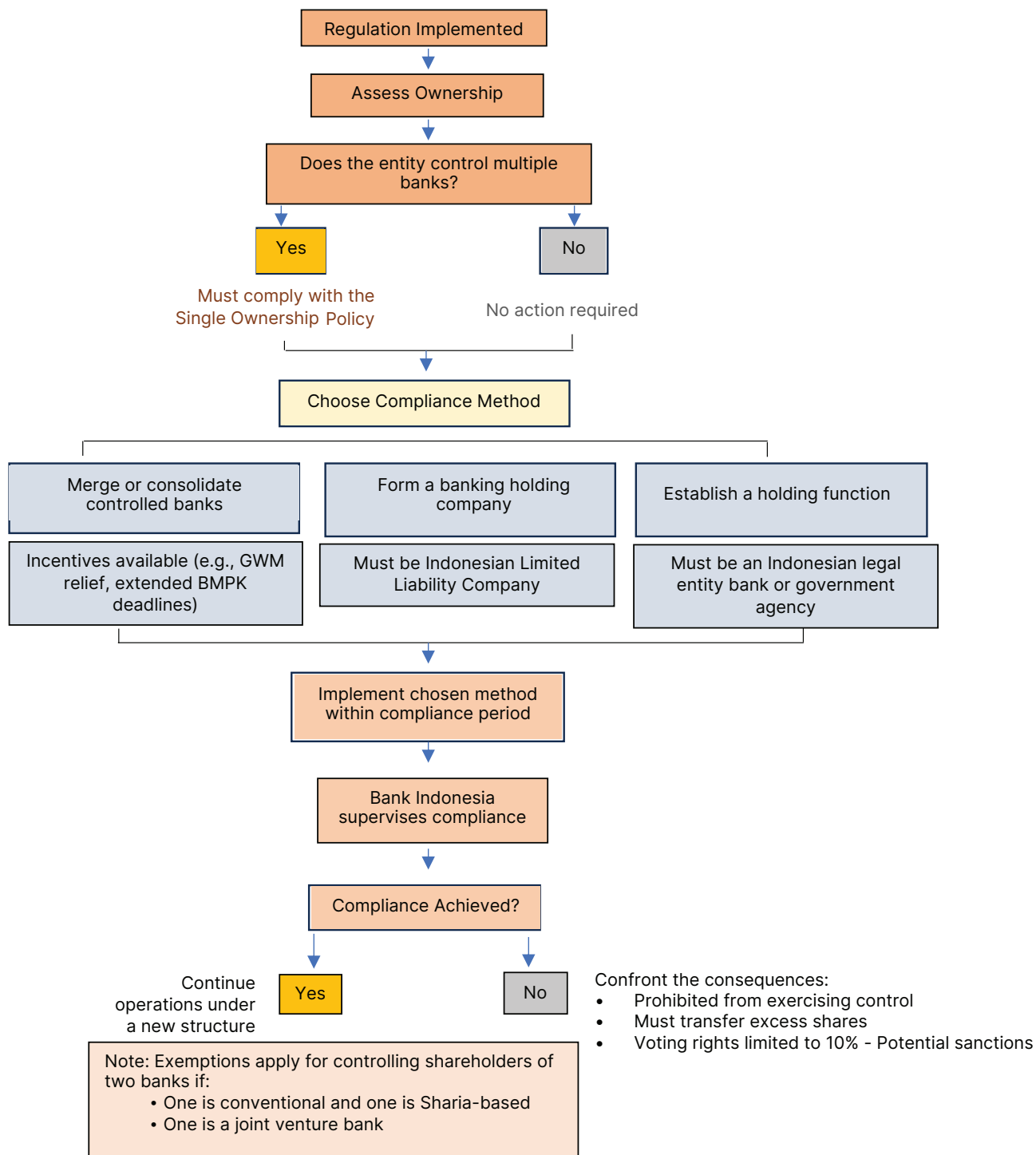


Figure 11. Key Steps and Options Outlined in PBI No. 14/24/PBI/2012

To encourage wider participation in consolidation, authorities should expand the range of incentives beyond forex status. Offering capital adequacy relief, tax reductions, or lower regulatory compliance costs could make consolidation more appealing to smaller and mid-sized banks. Additionally, extending the compliance timeline for GCG requirements to 12 or 18 months would provide banks with greater flexibility during the transition, especially for complex mergers requiring significant operational integration.

Financial relief measures should also be expanded. One of the examples is the Ministry of Finance Regulation No. 43/PMK.03/2008, which allowed asset transfers at book value. Incorporating broader tax incentives, including corporate tax reductions and exemptions from transaction fees, would also alleviate the financial burden of consolidation, particularly for smaller banks.

Finally, introducing incentives aligned with sustainability and green finance could modernize consolidation efforts while addressing global priorities. For instance, tax relief for investments in green projects or reduced regulatory fees for banks adopting sustainable policies post-merger could attract more participants. Additionally, authorities should streamline approval processes for voluntary mergers and provide post-consolidation support. For instance by providing technical assistance and regulatory guidance. These steps would help banks to modernize operations, meet customer expectations, and enhance competitiveness.

By broadening incentives and addressing structural challenges, Indonesia can create a more attractive and supportive regulatory environment for banking consolidation. This will ensure the industry is well-positioned in navigating future economic and structural changes.

3.3.2 Filling the Absence of Authority in Bank Consolidation

A significant barrier to effective banking consolidation in Indonesia is the absence of a dedicated leadership entity. Neither the Financial Services Authority (OJK) nor Bank Indonesia (BI) has a clear mandate to drive consolidation. OJK focuses on prudential regulation, while BI's primary role is monetary policy, leaving a strategic gap in oversight and leadership. Although the Ministry of Finance (MoF) houses the Center for Financial Policy, it lacks a specialized unit dedicated to advancing bank consolidation efforts.

This fragmented approach is evident in various frameworks, such as the Indonesian Banking Architecture (API), the establishment of OJK, and the Indonesia Banking Development Roadmap 2020–2025. These initiatives treat consolidation as a secondary priority, lacking clear targets or actionable steps. For example, while the roadmap encourages the formation of *Kelompok Usaha Bersama* (KUB), it does not strongly emphasize consolidation. Similarly, the recently enacted P2SK Law focuses on Sharia but fails to provide a comprehensive strategy for conventional banking consolidation.

A practical solution to address this gap is by consolidating authority under a single dedicated entity or integrating the consolidation mandate into an existing structure, such as the Financial System Stability Committee (KSSK). The KSSK, established under the P2SK Law, is responsible for maintaining financial system stability, overseeing potential risks, and addressing systemic financial crises. However, its mandate is primarily reactive, focusing on crisis management rather than proactive consolidation during periods of financial stability.

One potential approach is for the President to mandate the Ministry of Finance to establish a specialized Project Management Office (PMO) dedicated to overseeing bank consolidation initiatives. This PMO could work closely with Bank Indonesia, OJK, and the Indonesia Deposit Insurance Corporation (LPS) to ensure a coordinated and strategic method. By fostering collaboration among key stakeholders, this structure could streamline decision-making, provide clear accountability, and prioritize consolidation as a critical component of financial system reform.

A dedicated leadership framework is essential for addressing the structural challenges of banking consolidation. Whether through the KSSK or a newly established PMO, the integration of clear responsibilities and targeted mandates would significantly enhance Indonesia's ability to achieve a robust and efficient banking system. The proposed organizational structure is depicted in Figure 12.

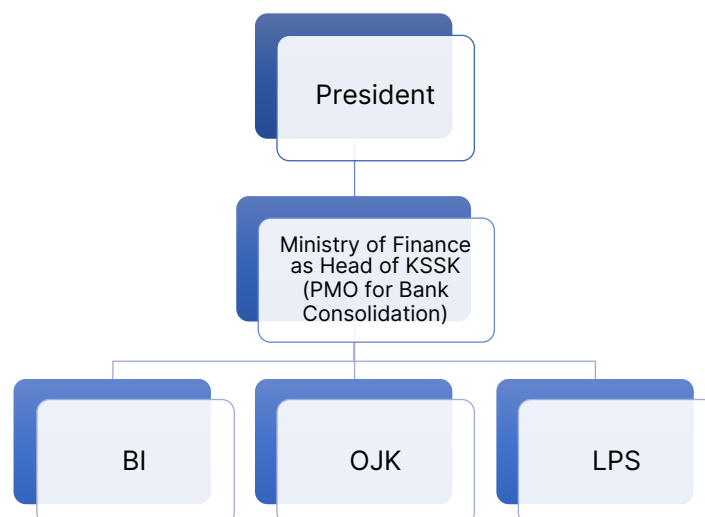


Figure 12. Proposal of PMO for Effective Bank Consolidation Management

3.3.3 Overcoming Insufficiencies in the Bank Consolidation Regulatory Framework

The Indonesian regulatory framework for banking consolidation is characterized by fragmentation and overlapping mandates, which hinder the effectiveness of consolidation initiatives. Various regulatory bodies, including the Financial Services Authority (OJK), Bank Indonesia, and the Ministry of Finance, oversee different aspects of the banking sector without a unified approach to consolidation. This fragmentation is evident in frameworks such as the Indonesia Banking Development Roadmap 2020–2025 and the Indonesian Banking Architecture (API), which treat consolidation as a secondary priority and lack actionable, integrated strategies for achieving consolidation goals.

The government has made notable progress in streamlining and harmonizing framework for banking consolidation, particularly with the enactment of Law No. 4/2023 (P2SK). This law represents a significant step toward creating regulatory coherence, addressing various aspects of the financial sector, and enhancing coordination among regulatory bodies to promote financial stability. However, despite these advancements, challenges remain, particularly regarding the operational and administrative complexities of the consolidation process for conventional banks.

P2SK introduces measures to facilitate Sharia banking consolidation, such as requiring Sharia Business Units (UUS) to spin off into independent Sharia Commercial Banks (BUS). Nevertheless, the scope is limited. The law does not provide comprehensive guidance or incentives for conventional banking mergers and acquisitions. Additionally, certain procedural requirements, such as those related to asset transfers, licensing, and compliance reporting, remain complex and time-consuming. This discourages banks from pursuing consolidation due to the significant costs and delays involved.

To build on the progress initiated by P2SK, Bank Indonesia and OJK must simplify and consolidate existing regulatory requirements to reduce the administrative burden on banks. This includes revising outdated policies, harmonizing overlapping mandates across regulatory bodies, and ensuring clarity in the roles of key stakeholders. A more straightforward and coherent regulatory framework would enable banks to navigate the consolidation process more effectively, reducing time, costs, and complexities. Aligning these efforts with broader national and regional financial integration objectives would further promote a cohesive environment for banking consolidation.

Additionally, establishing a dedicated consultative body within OJK to provide technical assistance and guidance would help banks navigate the regulatory landscape more efficiently. Such a body could

support banks in understanding and complying with revised regulations. Thereby, it can foster greater confidence among institutions that considering consolidation and encourage proactive engagement with regulatory authorities.

Indonesia can create a more supportive and efficient framework for banking consolidation by addressing these remaining challenges. Consequently, it can complement the advancements made through the P2SK Law. These efforts will facilitate a smoother process, foster institutional growth and resilience, and position the banking sector for long-term competitiveness.

3.3.4 Managing Disagreements Among Controlling Shareholders

The Single Presence Policy (SPP) has historically been a cornerstone of Indonesia's banking regulatory framework, limiting controlling shareholders (PSPs) to significant ownership in only one bank. Initially designed to prevent conflicts of interest, reduce systemic risk, and promote financial stability, the SPP aimed to ensure that no single shareholder could exert undue influence over multiple financial institutions. However, as the banking landscape has evolved, this rigid approach has become less effective in addressing the current challenges of consolidation, particularly when banks face financial difficulties.

Regulations such as POJK No. 12/POJK.03/2020 and PBI No. 14/24/PBI/2012 have introduced alternative frameworks to adapt to these changing dynamics. POJK No. 12/POJK.03/2020 offers greater flexibility, allowing PSPs to manage multiple banks through the formation of a *Kelompok Usaha Bersama* (KUB), provided they meet stringent capital and liquidity requirements. This approach enables PSPs to maintain strategic oversight and operational efficiency without mandatory mergers, fostering financial stability across all banks in the KUB. In contrast, PBI No. 14/24/PBI/2012 enforces a stricter single ownership policy, requiring PSPs to either merge their banks or establish a KUB within a defined timeframe to streamline ownership structures and reduce systemic risks.

Despite these advancements, challenges remain in addressing disputes among controlling shareholders during the consolidation process. POJK No. 18/2020, which governs the handling of bank problems, provides guidelines for restructuring financially troubled banks through mergers, consolidations, and acquisitions but lacks specific provisions for resolving shareholder conflicts. This omission creates potential obstacles to smooth consolidation, as unresolved disputes can lead to delays, inefficiencies, and instability within the banking sector.

OJK should address this gap by revising POJK No. 18/2020 to include clear guidelines and procedures for conflict resolution, ensuring transparency and fairness in mediation and arbitration processes. Requiring banks to disclose significant shareholder conflicts in their annual reports and report them to OJK would further enhance accountability and governance. An independent mediation and arbitration body could also play a crucial role in fostering timely and equitable resolutions, minimizing disruptions during the consolidation process.

Indonesia can strengthen its governance framework for handling shareholder disputes by learning from successful consolidation strategy. One of the best practices is shown by the European model that provide clear decision-making and competent management. Eventually, measures such as robust oversight mechanisms, enhanced transparency, and adherence to capital adequacy and liquidity standards would resolve conflicts more effectively and bolster the resilience and stability of consolidated banks.

3.3.5 Tackling Differences in Corporate Cultures

Cultural differences between merging banks often pose significant challenges during consolidation, as they can create friction in leadership styles, decision-making processes, communication norms, and operational practices. These misalignments, if not addressed, can lead to employee disengagement, higher turnover rates, diminished customer satisfaction, and inefficiencies that undermine the merger's success. Corporate culture is deeply ingrained and influences how employees interact, solve problems, and execute tasks. Without a deliberate focus on cultural integration, mergers may fail to achieve their intended synergies, even when financial and operational goals are met.

To address these challenges, merging banks must conduct thorough cultural assessments before consolidation. These assessments should evaluate key areas such as organizational values, leadership styles, risk appetites, and customer service approaches to identify areas of alignment and potential conflicts. Involving employees at all levels through surveys, interviews, and focus groups can provide valuable insights into cultural dynamics and help pinpoint integration priorities.

Additionally, the cultural integration program should also be conducted. Metrics such as employee engagement scores and customer satisfaction indices can offer quantitative benchmarks for measuring cultural alignment. Banks should develop tailored programs that include workshops, team-building activities, and change management initiatives to foster collaboration and unity.

A notable example is from Malaysia's merger of Bank Bumiputra and Commerce Asset Holding Bhd. The stark cultural and operational differences between these two entities led to integration difficulties, as inefficient practices from Bank Bumiputra overshadowed the more effective operations of Commerce Asset. This mismatch delayed restructuring and underscored the importance of aligning corporate cultures during the consolidation process. Additional challenges arose from harmonizing information systems, internal controls, and risk management practices across merged entities, requiring substantial time and resources.

The Malaysian government's flexibility in later allowed banks to choose their merger partners based on the cultural compatibility. This highlights the importance of addressing cultural alignment early in the consolidation process. This adjustment mitigated some of the earlier inefficiencies but only after significant delays and challenges had occurred. Ultimately, cultural integration is not a secondary concern but a critical factor in the success of banking consolidation.

Against this background, OJK should facilitate a cultural assessment program that provides guidance and tools for banks to evaluate cultural compatibility. This program should emphasize knowledge-building rather than penalization, empowering banks to proactively identify and address cultural gaps. It would promote capacity-building efforts, equipping banks with the skills and frameworks needed for effective cultural integration.

3.3.6 Resolving Insufficient Capacity for Post-Merger Management

Another critical challenge is the insufficient capacity to manage the complexities of post-merger integration. Successful consolidations require expertise across multiple domains, including leadership, risk management, IT integration, compliance, and human resources. However, many banks, especially smaller institutions, lack the necessary skills and experience to navigate the complexities of mergers and acquisitions effectively. Key areas such as aligning operational systems, managing change, and maintaining customer satisfaction during the transition often suffer due to gaps in capacity. This insufficiency can lead to delays, operational inefficiencies, and difficulties in achieving the intended synergies of the merger.

To address these challenges, OJK and financial institutions should prioritize capacity building through targeted training programs and skill development initiatives. These programs should provide clear guidance and support to bank executives, middle management, and specialized teams such as M&A specialists, compliance officers, IT experts, and risk management professionals. Incorporating bank consolidation-related skills into professional certifications, such as the Bank Financial Management Certification, would ensure a structured approach to enhancing expertise across the industry.

3.4 Risks: Mitigating the Possibility of Market Concentration and Unhealthy Competition Post-Merger

Indonesia’s banking consolidation, driven by mergers and acquisitions, mirrors global trends where consolidation reshapes financial systems while increasing market concentration. In Indonesia, the largest banks (KBMI 4) dominate the sector, holding 46% of core capital, 51% of total assets, 52% of total credit, and 53% of third-party funds (Figure 13). This significant market share reflects their commanding position but raises concerns about reduced competition and systemic risks. Smaller banks (KBMI 1 and KBMI 2) struggle to compete due to high operational costs and limited market access, creating a disparity in financial resource distribution.

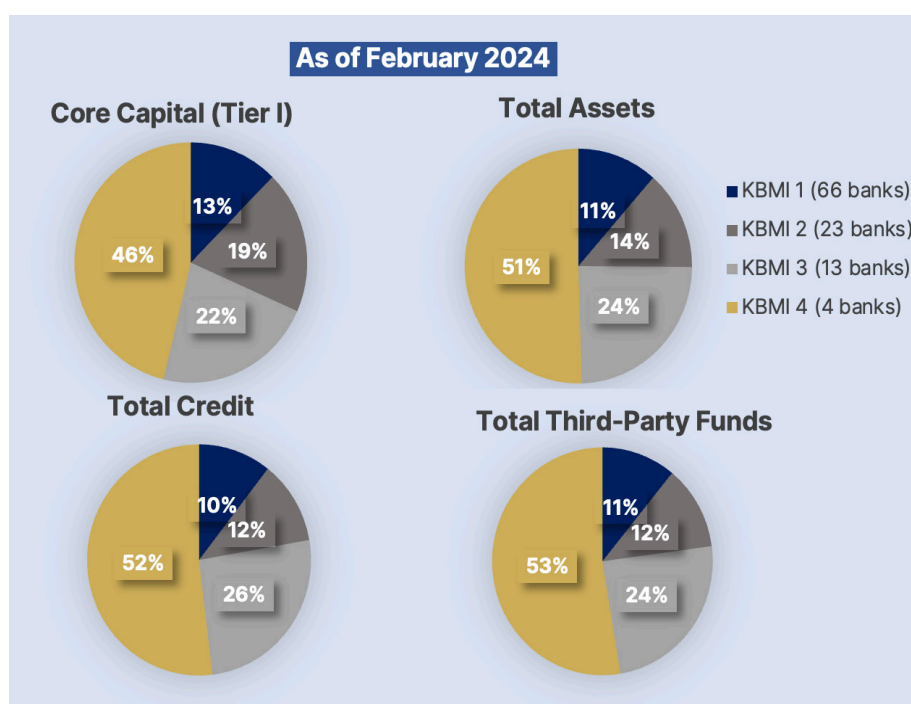


Figure 13. Indonesia’s Recent Bank Performance⁵³

Benchmarking from Latin America, Europe, and Malaysia underscores the challenges of consolidation. In Latin America, between 1996 and 2006, the five largest banks in countries like Brazil, Chile, and Mexico gained a substantial share of total assets, enhancing stability but also leading to high concentration levels.⁵⁴ In Europe, post-2008 financial crisis consolidation improved efficiency but reduced competition, with larger banks exerting significant market power and raising concerns about monopolistic behaviour. Malaysia’s consolidation in the late 1990s reduced the number of domestic institutions to ten anchor banks, strengthening capital bases but increasing market concentration, as shown by rising Herfindahl-Hirschman Indices (HHI). These examples demonstrate that while consolidation can enhance stability and efficiency, it also risks fostering monopolistic tendencies and reducing competition without proper regulatory oversight.

53 OJK, 2024

54 Olivero, et al., 2011

In Indonesia, these dynamics are evident in high net interest margins and Lerner Index levels, signalling limited competition. Large banks' dominance allows them to influence market conditions, restrict credit access for underserved segments, and engage in riskier practices, leveraging their "too big to fail" status. Lessons from past crises, such as the 1997 Asian Financial Crisis, highlight the dangers of moral hazard when dominant institutions take excessive risks, expecting government bailouts. Such behaviours destabilize the financial system and amplify systemic risks, underscoring the need to address market power imbalances.

Current regulatory measures, including minimum capitalization requirements and the single presence policy, aim to balance stability and competitiveness. However, these efforts must be strengthened to prevent excessive market concentration and promote a level playing field. Encouraging competition among smaller banks, alongside enhanced regulatory oversight of dominant institutions, is critical to maintaining a healthy and resilient banking ecosystem.

Indonesia must strengthen its regulatory framework by enhancing anti-monopoly enforcement to mitigate market concentration risks and promote fair competition. The Ministry of Law, in collaboration with OJK and KPPU, should update Law No. 5 of 1999 to support this effort, including increased monitoring, regular audits, and stricter penalties for anti-competitive practices such as fines and business restrictions. Establishing clear anti-competitive conduct guidelines and revising legal frameworks will further foster a balanced financial system. These measures will ensure that banking consolidation enhances stability and efficiency without compromising competition, paving the way for sustainable growth in Indonesia's financial ecosystem.



4. Conclusion and Recommendations

Bank consolidation is essential for strengthening financial institutions in Indonesia, making them better equipped to compete in a rapidly evolving financial landscape driven by technological advancements and intensifying competition. Global trends and studies show that consolidation can enhance stability, improve service quality, and increase efficiency. However, the process involves significant challenges such as high interest rates, cybersecurity threats, capital requirements, non-performing loans, weak regulatory compliance, and integration issues. Other countries' experiences demonstrate that while consolidation can drive stability and performance improvements, it must be carefully managed to avoid monopolistic practices and ensure fair competition.

Indonesia's regulations have played a significant role in addressing the challenges of bank consolidation, leading to a more stable and resilient banking sector. Recognizing the significance of bank consolidation, the government has taken steps to encourage it by implementing the POJK No. 12/POJK.03/2020 which mandates banks to increase their minimum core capital to IDR 3 trillion by the end of 2022 as measures to support it. Although these regulations have effectively reduced the number of banks and enhanced sector stability, further issues and support for smaller banks are still needed to improve the consolidation process. One key issue is that the regulation's higher capital requirements, encourage smaller banks to merge or consolidate to meet these standards, reducing fragmentation. However, this approach risks making the policy counterproductive, as smaller banks may become less attractive to investors and struggle with limited resources for their operations. This dynamic can inadvertently hinder consolidation efforts rather than foster them, further complicating the process for smaller institutions.

It is also important to consider that many banks have unique characteristics and cater to specialized market segments. Some banks have developed expertise in serving specific communities or niche industries, providing services that larger institutions may not effectively deliver. Therefore, regulators should ensure that consolidation efforts do not undermine the diversity of the banking sector or limit the availability of niche financial services. Careful consideration should be given to preserving the unique roles of these banks, so that consolidation strategies enhance overall sector resilience without sacrificing the specialized services that meet the needs of diverse customer segments.

To address the challenges identified in the discussion, several recommended strategies can be implemented. The recommended solutions for addressing challenges in bank consolidation can be categorized into financial and non-financial strategies. Financial strategies focus on alleviating monetary barriers and incentivizing mergers, such as through expanded tax relief, simplified tax procedures, capital injections for small banks, and the establishment of dedicated funding mechanisms to strengthen financial capacity. Meanwhile, non-financial strategies target operational, cultural, and governance challenges, including simplifying regulations, resolving shareholder disputes, fostering cultural integration, enhancing expertise through training and certifications, and promoting digital competitiveness with streamlined processes and robust cybersecurity measures.

4.1 Injecting Capital and Recapitalizing Small Banks to Provide Capital Support in the Consolidation Process

- **The Government should increase capital injections into small banks to minimize financial pressure during consolidating.** Small banks often face challenges in meeting regulatory capital requirements and handling the costs associated with mergers or acquisitions.
- **The Government should encourage the creation of mechanisms that facilitate capital increases for banks** such as the establishment of Dana Modal Malaysia. Thus fund would provide the financial resources needed to strengthen the capital base of small banks, ensuring they can meet regulatory

requirements and participate effectively in the consolidation process without compromising their financial stability.

4.2 Enhancing Bank Digital Competitiveness

- **Otoritas Jasa Keuangan (OJK)** should streamline the **approval process for mergers and acquisitions (M&As)**, with a specific focus on **facilitating digital transformation**. This means fast-tracking approvals for banks looking to consolidate as a strategy for pooling resources to invest in essential digital infrastructure. Smaller banks often lack the financial capacity to make significant technological investments on their own. By consolidating, they can achieve the scale necessary to adopt advanced digital technologies, such as **cloud computing, artificial intelligence (AI)**, and **cybersecurity systems**, ensuring that they remain competitive in the rapidly evolving banking sector.
- **Bank Indonesia (BI)** should play a crucial role by providing **technical assistance** and establishing **clear standards for digital integration post-consolidation**. The merging of banks often comes with the challenge of integrating different technologies, legacy systems, and customer service platforms. BI should ensure that banks have the guidance and support needed for a **smooth technological transition** after a merger, allowing them to quickly adopt **unified digital banking services**.
- **OJK** and **Badan Siber dan Sandi Negara (BSSN)** must prioritize the **implementation of robust cybersecurity measures** in consolidated banks. The process of merging different institutions increases the potential for cybersecurity vulnerabilities, as the integration of systems often exposes banks to higher risks of cyberattacks. Therefore, regulators should mandate regular **cybersecurity audits** and ensure that banks are adhering to **strong cybersecurity protocols** throughout and after the consolidation process.

4.3 Enhancing Financial Drivers to Encourage Bank Consolidation

- **The Ministry of Finance with Bank Indonesia** should expand the provision of financial incentives under **MoF regulation No 43/PMK.03/2008** by offering significant tax relief, including corporate tax reductions, exemptions from transaction fees, and accelerated depreciation for merged assets—to minimize financial pressure on merging entities and make consolidation more financially viable, particularly for smaller banks.
- **A comprehensive overhaul of tax incentive regulations is essential to stimulate consolidation**, including implementing tax policies tailored to encourages mergers and acquisitions in the banking sector.
- **The Ministry of Finance should simplify tax procedures for consolidating banks** to not complicate the consolidation process.

4.4 Establishing a Specialized Advisory Body dedicated to Manage Bank Consolidation

- **OJK should introduce new regulations to establish a specialized task force** within the organization, tasked with offering technical support and strategic guidance to banks undergoing consolidation.
- **The Government should revise the P2SK Law to establish a dedicated new body with clear KPIs** to oversee and manage bank consolidation effort.

4.5 Streamlining Regulations and Enhancing Institutional Governance for Bank Consolidation

- **The government should simplify and consolidate existing regulatory requirements** to reduce the administrative burden on banks, which impedes the consolidation process. Administrative burdens, such as asset transfers, are naturally time-consuming and discourage many banks from pursuing

mergers and acquisitions.

- **OJK should establish a dedicated consultative committee** to provide technical assistance and guidance to banks considering consolidation.

4.6 Accelerating the Fair Handling of Shareholder Disputes

- **The Ministry of Law with OJK should develop clear guidelines and procedures for conflict resolution**, ensuring transparency and fairness in the mediation and arbitration processes.
- **The Financial Services Institutions should encourage transparency in proactively handling conflicts between shareholders** by requiring banks to disclose significant conflicts between controlling shareholders in their annual reports and to OJK.

4.7 Fostering Bank's Cultural Integration Program

- **OJK should implement comprehensive cultural assessments programs as a guide for banks to carry out their own cultural assessment evaluations prior to bank mergers.** The program released by OJK should only facilitate and offer guidance to banks to promote knowledge and skillsets which focus on key areas such as leadership styles, decision-making processes, communication norms, risk appetites, and customer service approaches. These assessments should utilize a combination of surveys, interviews, and focus groups with employees at all levels to identify potential cultural conflicts and synergies. Specific metrics like employee engagement scores, turnover rates, and customer satisfaction indices should be analyzed to gauge cultural health. The program should also guide banks to evaluate their values, mission statements, and organizational structures to pinpoint areas of alignment and divergence. However, the program shall not penalize banks for not executing the assessment to the highest standards, rather, it motivates and guides banks to gain capacity building.
- **Based on these findings, OJK, in collaboration with the merging banks, should develop tailored cultural integration programs.** These programs should include targeted workshops addressing identified cultural gaps, cross-functional team-building activities to foster collaboration, and change management initiatives that clearly communicate the new, unified organizational culture. The integration plan should also establish concrete milestones and KPIs to track cultural integration progress throughout the merger process, ensuring a smoother transition and minimizing cultural clashes that could impede the merger's success.

4.8 Increasing the Expertise and Skills Needed to Handle Bank Consolidation

- **OJK, together with financial institutions, should encourage increased expertise and capabilities in the bank consolidation process** through programs that offer direction for all relevant levels of banking personnel. This initiative should assist target bank executives, middle management, specialized teams (including M&A specialists and due diligence teams), legal and compliance officers, HR professionals, IT experts, risk management professionals, financial analysts, and customer-facing staff.
- **OJK and Financial Institutions should establish capacity building and training programs as guidance.** Also, a newly added skill set related to Bank Consolidation can be added and included in individual Certifications in Bank Financial Management for professional certifications. Skillsets which focuses on key areas such as leadership styles, decision-making processes, communication norms, risk appetites, and customer service approaches for bank consolidation can be included in as part of the overall comprehensive training for banking certification programs. In the long term this would better ensure that banks are better prepared to manage mergers and acquisitions effectively.

4.9 Preventing Monopolistic Practices and Encouraging Transparent Markets

- **OJK and KPPU should strengthen their enforcement of existing antitrust laws** by increasing their supervisory capabilities.
- **The Government should involve regular audits and inspections of banks** to ensure compliance with business competition laws.
- **The Ministry of Law should implement stricter penalties for banks** found guilty of monopolistic practices, including stiff fines and potential restrictions on business activities.



No	Problem	Solution	Existing Regulations	Recommended Change in Regulation	Policy Adjustment Timeline
2	Inadequate incentives for bank consolidation in Indonesia hinder significant mergers and acquisitions.	Enhance financial incentives: Provide significant tax breaks and simplified tax procedures for banks undergoing consolidation. Introduce measures similar to those in Mexico, where tax policies are adjusted to minimize financial strain on merging entities, thereby encouraging more banks to consolidate.	POJK No. 12/POJK.03/2020 sets the framework for bank consolidation but does not sufficiently address tax incentives PBI No. 9/12/PBI/2007 provides some incentives, but they are not sufficient to significantly encourage consolidation.	OJK should update POJK 12/2022 to specifically provide sufficient tax incentives for Consolidated Banks. Bank Indonesia in collaboration with the Ministry of Finance should update PBI 9/2007 to provide significant tax breaks and simplified tax procedures for banks undergoing consolidation.	Mid-term Mid-term
3	The absence of a specialized entity offering expert guidance to banks on merger and acquisition strategies.	Establish a specialized advisory body under the Ministry of Finance or integrate it within existing institutions like OJK or KSSK who will provide tailored technical, legal, and financial assistance to banks	Currently, there are no regulations or special advisory bodies dedicated to providing technical assistance to banks wishing to consolidate banks. The absence reflects the institutional failure to adapt to the evolving needs of the banking sector, particularly in facilitating strategic consolidations. This regulatory gap contributes to institutional inefficiencies and broader sectoral challenges.	OJK should introduce new regulations to establish a specialized task force within the organization, tasked with offering technical support and strategic guidance to banks undergoing consolidation The P2SK Law should be revised to establish a dedicated new body with clear KPIs to oversee and manage bank consolidation effort.	Short-term Mid-to-long-term

No	Problem	Solution	Existing Regulations	Recommended Change in Regulation	Policy Adjustment Timeline
4	Stringent regulatory framework for the banking sector makes compliance challenging for banks.	Streamline regulations to reduce complexity and make compliance more manageable for banks. Consolidate existing regulations into a more coherent framework, similar to the proactive regulatory approaches seen in the Philippines, making it easier for banks to navigate and comply with the rules.	PBI No. 9/12/PBI/2007 adds complexity to bank consolidation, in addition to POJK No. 21/POJK.03/2014 concerning Minimum Capital Requirements for Sharia Banks, adds layer of regulation for banks that operate based on the sharia principles.	Bank Indonesia with OJK should simplify and consolidate existing regulatory requirements to reduce the administrative burden on banks. By creating a more straightforward and coherent regulatory framework, OJK and Bank Indonesia can make it easier for banks to navigate the consolidation process.	Short-term
5	Disagreements among controlling shareholders can impede consolidation processes.	Establish an independent mediation and arbitration body to handle shareholder disputes quickly and fairly in line with an experienced European consolidation strategy that highlights the importance of clear decision-making capacity and a competent management team to ensure successful integration.	POJK 18 / 2020 regarding Written Orders for Handling Bank Problems provides guidelines for restructuring banks experiencing financial difficulties, including through mergers, consolidations, and acquisitions. However, it does not specifically address conflict resolution among controlling shareholders.	OJK should update POJK 18/2020 to develop clear guidelines and procedures for conflict resolution, ensuring transparency and fairness in the mediation and arbitration processes OJK should establish new regulations that require Banks to disclose any significant conflicts among controlling shareholders in their annual report and to OJK.	Short-term Short-term

No	Problem	Solution	Existing Regulations	Recommended Change in Regulation	Policy Adjustment Timeline
6	Differences in corporate cultures can impede successful bank consolidation	Encourage the implementation of cultural integration programs, as exemplified by Malaysia's large banks such as Bank Bumiputra, is crucial for overcoming challenges associated with mergers and acquisitions.	POJK 55 / POJK.03 / 2016, POJK Regulation No. 18/POJK.03/2016, and POJK 12 / 2021 indirectly address cultural integration through governance and risk management practices. However, there are no specific measures for pre-merger cultural assessment to identify potential conflicts and create strategies to resolve them and there is a lack of comprehensive cultural integration programs.	OJK should update POJK 55/2016, POJK 18/2016, and POJK 12/2021 to provide specific cultural guidelines before mergers to identify potential conflicts and create strategies to address them OJK should provide comprehensive guidelines for developing cultural integration programs that encompass workshops, team-building activities, and change management initiatives	Mid-term Mid-term
7	Shortage of capacities hampers banks' ability to efficiently navigate and implement consolidation processes, resulting in operational inefficiencies and potential delays.	Encourage specific regulations governing the expertise and skills required to handle consolidation and change management processes would be beneficial.	POJK No. 24/2022 emphasizes the importance of enhancing the skills and expertise of bank staff. However, it does not explicitly mention training specifically for merger and acquisition strategies, integration processes, and change management. Although the regulation broadly covers the development of human resources, it does not specifically address training programs for handling consolidation processes, including mergers and acquisitions, integration processes, and change management. The focus is more on general banking competencies, risk management, and leadership skills.	OJK should update POJK 24/2022 to establish capacity-building and training programs, create dedicated integration teams, leverage external expertise, and implement knowledge-sharing platforms, OJK can ensure that banks are better equipped to manage mergers and acquisitions effectively, including skill to manage post-merger and acquisition management skill.	Mid-term

No	Problem	Solution	Existing Regulations	Recommended Change in Regulation	Policy Adjustment Timeline
8	Unfair business competition, including monopolistic practices and anti-competitive behaviour, can hinder the fair and efficient functioning of the banking sector.	Strengthen anti-monopoly regulations, promoting market transparency, encourage competitive practices, implement anti-competitive conduct guidelines, and revise the legal framework are essential steps	<p>Law No. 5 of 1999 on the Prohibition of Monopolistic Practices and Unfair Business Competition aims to prevent monopolistic practices and promote fair competition in all sectors, including banking. However, enforcement of these regulations is not sufficiently robust.</p>	<p>The Ministry of Law collaborating with OJK and KPPU should update Law No.5 of 1999 to strengthen the enforcement of existing anti-monopoly laws by increasing the monitoring capabilities of OJK and KPPU. This can involve regular audits and inspections of banks to ensure compliance with competition laws.</p> <p>The Ministry should update Law No.5 of 1999 to introduce stricter penalties for banks found guilty of engaging in monopolistic practices, including hefty fines and potential restrictions on business activities.</p>	Mid-term

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Appendix 1 - Table 8. Summary of the OJK Regulations on the Indonesian Banking Sector

OJK Regulation	Topic	Objective	Key Provisions	Previous Regulation
POJK 11 / 2016	Minimum Capital Requirements for Commercial Banks	Create a robust and competitive banking system capable of absorbing risks from financial crises and excessive credit growth	Enhancing the quality and quantity of bank capital according to international standards, adjusting requirements for capital components and instruments, and forming additional capital buffers above the minimum requirements based on the bank's risk profile to ensure financial stability during economic disruptions.	<ul style="list-style-type: none"> Revoking: PBI No. 15/12/2013 on Minimum Capital Requirements for Commercial Banks Revoking: Bank Indonesia Circular Letter Number 9/31/DPNP on Framework for Utilizing Internal Models in Computing Minimum Capital Requirements for Market Risk Exposed Commercial Banks
POJK 34 / 2016	Amendments to POJK Number 11/POJK.03/2016 concerning Minimum Capital Requirements for Commercial Banks	Enhance the quality and quantity of bank capital to better absorb potential losses, aligning with international standards such as Basel III	Emphasizing the need for banks to maintain a certain level of capital adequacy to absorb potential losses. This includes the establishment of buffers such as the Capital Conservation Buffer, Countercyclical Buffer, and Capital Surcharge for Systemically Significant Banks.	<ul style="list-style-type: none"> POJK No. 11/POJK.03/2016 on Minimum Capital Requirements for Commercial Banks

OJK Regulation	Topic	Objective	Key Provisions	Previous Regulation
POJK 18/2020	Written Orders for Handling Bank Problem	Ensure that banks experiencing financial difficulties or whose controlling shareholders are unable to strengthen the bank can be restructured through mergers, consolidations, acquisitions, integrations, and/or conversions. This is intended to preserve the overall stability and soundness of the national banking sector.	Guidelines for banks to carry out or agree to mergers, consolidations, acquisitions, integrations, and/or conversions to address financial issues and uphold stability in the banking sector. The regulation necessitates that participating banks create action plans, provides for specific regulatory exemptions, and mandates compliance to ensure organized restructuring.	N.A.
POJK 12/2021	Commercial Banks	Enhance the competitiveness, adaptability, and contribution of Indonesian banks to the national economy by providing a comprehensive regulatory framework for the development and operation of both conventional and digital banking models, ensuring higher economic scales, efficiency, and regulatory compliance.	Detailed regulations for the establishment, operation, and governance of commercial banks in Indonesia, covering aspects such as capital requirements, corporate plans, digital banking, ownership, management, office networks, licensing, reporting, and ensuring compliance with both conventional and sharia principles.	<ul style="list-style-type: none"> • Revoking: POJK No. 17/POJK.03/2018 concerning Amendments to POJK No. 6/POJK.03/2016 on Business Activities and Office Networks based on Bank Core Capital • Revoking: PBI No 13/27/PBI/2011 on Amendments to PBI No.11/1/PBI/2009 on Commercial Banks

OJK Regulation	Topic	Objective	Key Provisions	Previous Regulation
POJK 27/2022	Minimum Capital Requirements	Ensure that there is sufficient capital to strengthen the resilience and stability of the Indonesian banking system.	Establish various capital buffers based on their classification, requires all banks to maintain a Countercyclical Buffer, imposes a Capital Surcharge for Systemic Banks, enforces administrative sanctions for non-compliance with capital requirements, excludes direct reference to the Single Presence Policy, and necessitates comprehensive Capital Adequacy Ratio reporting, including credit, operational, and market risks.	<ul style="list-style-type: none"> POJK No. 11/POJK.03/2016 on Minimum Capital Requirements for Commercial Banks



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