Governors
Volume: 05 | Number 01 | April 2026 |
E-ISSN: 2962-5505 | DOI: doi.org/10.47709/governors.v5i1.9284

The Role of the Indonesia Deposit Insurance Corporation (LPS) in Mitigating Systemic Risk

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ABSTRACT

The increasing number of Rural Bank (BPR) failures in Indonesia has raised concerns regarding depositor confidence and regional financial stability, highlighting the strategic role of the Indonesia Deposit Insurance Corporation (LPS) in mitigating systemic risk. This study aims to examine how LPS contributes to maintaining financial stability through the resolution of failed rural banks by analysing the cases of PT BPR Sembilan Mutiara and PT BPR Lubuk Raya Mandiri in West Sumatra. A qualitative case study based on documentary analysis was employed using official reports, regulatory documents, and other credible secondary sources related to bank resolution and deposit insurance. The findings indicate that the failures of both BPRs were primarily driven by weak corporate governance, inadequate capital management, declining liquidity, and ineffective risk management, while LPS effectively mitigated regional systemic risk through timely deposit reimbursement, coordinated bank resolution, and institutional collaboration with financial authorities. Beyond reimbursing insured deposits, LPS contributed to maintaining depositor confidence, supporting orderly bank resolution, and reducing the potential contagion effects arising from rural bank failures. The study concludes that strengthening corporate governance, early intervention mechanisms, institutional coordination, and public financial literacy is essential for enhancing the effectiveness of LPS and reinforcing the resilience of Indonesia's banking system.

Keywords: Bank Resolution, Deposit Insurance Corporation, Financial Stability, Rural Banks (BPR), Systemic Risk

INTRODUCTION

The banking system plays a fundamental role in supporting economic development by acting as a financial intermediary that channels funds from surplus units to deficit units, thereby facilitating investment, production, and consumption activities. A stable banking system is therefore essential for sustaining economic growth and maintaining public confidence in financial institutions (Niharotul Faizah et al., 2024; Basel Committee on Banking Supervision, 2024). However, the banking sector is inherently vulnerable to various financial shocks that may threaten institutional stability and disrupt the broader economy. When banking institutions experience severe financial distress, the resulting loss of public confidence can rapidly spread across the financial system, creating risks that extend beyond individual institutions. Such contagion effects have long been recognised as a defining characteristic of systemic risk within financial systems (Allen & Gale, 2000; Acharya et al., 2017).

Indonesia's experience during the 1997–1998 Asian Financial Crisis illustrates the importance of maintaining banking stability. The sharp depreciation of the Indonesian Rupiah and the collapse of numerous financial institutions significantly weakened public confidence in the banking sector (Rosalina, 2021). The crisis highlighted the emergence of systemic risk, which refers to the possibility that financial distress experienced by one financial institution may spread to other institutions because of their interconnectedness, thereby threatening the stability of the financial system as a whole (Allen & Gale, 2000; Acharya et al., 2017). These experiences demonstrated the necessity of establishing institutional mechanisms capable of preventing financial contagion while preserving depositor confidence during periods of banking instability.

As part of Indonesia's post-crisis financial sector reforms, the Indonesia Deposit Insurance Corporation (Lembaga Penjamin Simpanan/LPS) was established under Law No. 24 of 2004 (Ali

Asdon Tanjung et al., 2024). LPS serves two principal functions: guaranteeing customer deposits and resolving failed banks. Beyond protecting depositors, LPS constitutes an integral component of Indonesia's financial safety net by contributing to financial system stability, strengthening public confidence, and supporting orderly bank resolution. Consequently, the effectiveness of LPS extends beyond deposit reimbursement and encompasses broader responsibilities in mitigating systemic risk arising from banking failures.

The importance of these responsibilities has become increasingly evident through the recent failures of Rural Banks (*Bank Perkreditan Rakyat*—BPR) in West Sumatra. Throughout 2024, three BPRs in the province lost their operating licences following regulatory intervention. LPS subsequently reimbursed insured deposits amounting to IDR 10.4 billion, including IDR 3.42 billion for PT BPR Sembilan Mutiara, IDR 2.30 billion for PT BPR Lubuk Raya Mandiri, and IDR 4.69 billion for PT BPR Pakan Rabaa Solok Selatan (Antara News, 2024). Furthermore, as of 31 March 2025, LPS had processed deposit insurance claims for 22 BPR/BPRS institutions in West Sumatra under the CIU category, paying IDR 85.17 billion out of IDR 86.66 billion of eligible deposits after adjustments for coverage limits, loan offsets, and customer objections. These developments demonstrate the increasing significance of LPS in maintaining depositor confidence and supporting financial stability during episodes of bank failure.

Nevertheless, the recent failures of rural banks raise broader questions regarding the extent to which LPS contributes to mitigating systemic risk beyond its statutory responsibility of reimbursing insured deposits. While financial compensation represents an important mechanism for protecting depositors, preventing financial contagion also requires effective bank resolution, regulatory coordination, institutional governance, and timely public communication. Consequently, the failures of rural banks provide an important empirical context for examining whether LPS functions merely as a deposit insurer or as a strategic institution within Indonesia's financial safety net.

International studies have consistently recognised deposit insurance institutions as important mechanisms for maintaining financial stability, depositor confidence, and orderly bank resolution (Demirgüç-Kunt et al., 2015; IADI, 2024). However, studies conducted in Indonesia have primarily examined LPS from legal and institutional perspectives. Previous studies have examined the role of LPS from several perspectives. Pradana and Dewi (2019) emphasised the legal function of LPS in protecting depositors through deposit insurance schemes, while Niharotul Faizah et al. (2024) discussed the contribution of financial institutions to maintaining banking stability. Similarly, Ali Asdon Tanjung et al. (2024) highlighted the institutional role of LPS within Indonesia's financial regulatory framework following financial sector reforms. Although these studies provide valuable insights into the legal mandate and institutional responsibilities of LPS, they predominantly adopt normative or conceptual perspectives and place limited emphasis on how LPS performs its functions during actual cases of rural bank failure. Consequently, empirical evidence regarding the effectiveness of LPS in mitigating systemic risk through practical bank resolution remains relatively limited.

This limitation reveals both theoretical and empirical research gaps. Theoretically, existing studies have paid greater attention to the legal authority and regulatory framework of deposit insurance institutions than to their broader role in mitigating systemic risk through operational bank resolution. Empirically, previous research has focused predominantly on national financial stability, with relatively little attention devoted to regional cases involving failed rural banks. Considering the strategic contribution of BPRs to local economic development, understanding how LPS manages bank failures at the regional level is essential for strengthening financial resilience and maintaining public confidence.

Unlike previous studies, this research adopts a qualitative case study based on documentary analysis by examining the failures of PT BPR Sembilan Mutiara and PT BPR Lubuk Raya Mandiri in West Sumatra. Rather than focusing solely on legal provisions or institutional mandates, this study analyses official reports, regulatory documents, and institutional records to examine how LPS performs its functions in practice, identifies the factors contributing to bank failure, and evaluates its contribution to mitigating systemic risk and maintaining financial stability.

E-ISSN: 2962-5505 | DOI: doi.org/10.47709/governors.v5i1.9284

Based on these research gaps, this study aims to examine the role of the Indonesia Deposit Insurance Corporation (LPS) in mitigating systemic risk through the resolution of failed rural banks in West Sumatra. Specifically, the study analyses the institutional functions of LPS in maintaining financial stability, identifies the factors contributing to the failures of rural banks, evaluates the effectiveness of LPS in reducing systemic threats, and proposes policy recommendations for strengthening early intervention mechanisms and enhancing the resilience of Indonesia's banking system.

LITERATURE STUDY

Deposit Insurance Corporation (LPS)

The Deposit Insurance Corporation (LPS) is a legal entity established under Law No. 24 of 2004 concerning the Deposit Insurance Corporation. LPS was created to implement a deposit insurance program for bank customers with the objective of supporting a stable and sound banking system. A stable and sound banking system is essential for realizing a national economy that is strong, resilient, and sustainable (Mahesa Arya Pratama et al., 2024).

In carrying out its duties and responsibilities, LPS operates independently—free from government or political intervention—while maintaining transparency, openness to the public, and accountability to ensure reliability and trustworthiness. According to Article 4 of Law No. 24/2004, LPS has two main functions: *to insure customer deposits* and *to actively contribute to maintaining the stability of the banking system (as part of the broader financial system) within its authority*, including the resolution of failed banks (Niharotul Faizah et al., 2024).

The deposit insurance mechanism managed by LPS serves as one of the key instruments for maintaining stability and public confidence in the financial system. In the literature, the effectiveness of the LPS deposit insurance program is often assessed through several indicators, such as the level of protection provided, the adequacy of the insurance fund, and the institution’s capacity to resolve failed banks efficiently.

According to the International Association of Deposit Insurers (2024), effective deposit insurance systems contribute not only to depositor protection but also to financial stability by reducing the likelihood of bank runs and supporting orderly resolution processes. Similarly, Demirgüç-Kunt et al. (2015) argue that well-designed deposit insurance schemes enhance public confidence while minimizing systemic vulnerabilities during banking crises.

Systemic Risk

Systemic risk refers to financial instability that can spread like an epidemic, disrupting the functioning of the financial system and hindering economic growth. For instance, the failure of a single bank can trigger panic among customers of other banks, leading to massive withdrawals that may ultimately result in the collapse of the entire banking system.

The definition of systemic risk varies across the literature. De Bandt et al. (2010) describe it using an analogy from public health, comparing systemic risk to the spread of contagious diseases that can devastate a portion of the population. They argue that systemic risk is a unique phenomenon within the financial services industry, particularly in the banking sector. While other economic sectors may also experience systemic disturbances, the macroeconomic impact tends to be far greater when the source originates from the financial services industry (Permadi, 2019).

Allen and Gale (2000) explain that systemic risk arises because financial institutions are interconnected through payment systems, interbank markets, and depositor expectations, allowing financial distress in one institution to spread rapidly throughout the banking sector. Likewise, Acharya et al. (2017) emphasise that systemic risk should be understood as the potential impact of an institution's failure on the stability of the financial system as a whole rather than on the institution itself.

The failure of one bank can create a contagion effect on others due to the interconnectedness of financial institutions through interbank transactions, lending relationships, and public trust. This systemic risk poses a serious threat to overall economic stability, as illustrated by Indonesia’s banking crisis of 1997–1998.

The vulnerability of banks may arise from several factors, including balance sheet mismatches—where short-term liabilities (customer deposits) are not aligned with long-term assets (loans); non-performing loans and poor investment decisions—which can erode liquidity when borrowers or issuers default; and the loss of public confidence, which may trigger massive withdrawals and further intensify liquidity crises.

Bank Failure

Failures of financial institutions and associated risks in the banking sector represent serious threats that can undermine a country's economic stability. When a bank fails to meet its obligations, the impact is not limited to its customers and shareholders but can spread throughout the financial system through contagion effects—particularly if the bank plays a significant role in the market (Tobing et al., 2023).

This study discusses the underlying causes of bank failures, the mechanisms through which systemic risk propagates, and the contributions of institutions such as the Financial System Stability Committee (KSSK), the Deposit Insurance Corporation (LPS), and the Financial Services Authority (OJK) in anticipating and managing crisis situations. By understanding these dynamics, strategic measures can be formulated to strengthen the resilience of the banking sector and safeguard the national economy from potentially destructive impacts.

Banks play a vital role in a country's economy by serving as intermediaries between those who have excess funds and those in need of financing. However, banks can also experience failure if they do not adhere to prudent principles. A bank failure can have far-reaching consequences, eroding public confidence in the overall banking system and potentially triggering an economic crisis (Rafli et al., 2023).

Bank failure occurs when a financial institution is unable to meet its obligations to depositors, particularly during periods of massive withdrawals. Such situations may arise from internal factors—such as poor management practices, fraud, or misgovernance—as well as external factors including economic recessions or natural disasters.

Bank failure represents a serious risk that can emerge at any time when a bank is unable to fulfill its responsibilities, especially during large-scale withdrawals by customers. These events can lead to instability within the financial system, both in normal conditions and during periods of crisis. The management of banks that pose systemic risks falls under the responsibility of the Financial System Stability Committee (KSSK), while the Deposit Insurance Corporation (LPS) assumes a technical role in addressing liquidity and solvency issues faced by failed banks

BPR

The legal foundation for Rural Banks (BPR) in Indonesia is stipulated in Law No. 7 of 1992 on Banking, as amended by Law No. 10 of 1998. The law defines a BPR as a *"bank that conducts its business activities conventionally or based on sharia principles, and in its operations does not provide payment traffic services"* (Ramia Devi, 2018).

The legal forms of BPRs may take the shape of a Limited Liability Company (Perseroan Terbatas), a Regional Government-Owned Enterprise (Perusahaan Daerah), or a Cooperative (Koperasi). In terms of financing procedures, loans provided by BPRs can generally be classified into individual loans and institutional loans. Furthermore, from the perspective of purpose, these loans may be categorized as consumptive or productive financing.

The fund distribution activities of BPRs primarily consist of providing loans to Micro, Small, and Medium Enterprises (MSMEs) and to rural communities. The majority of loans granted to MSMEs by BPRs take the form of working capital loans (KMK), which can be further classified according to the borrower's business sector—namely, KMK for trade, KMK for industry, KMK for agriculture, and KMK for services. In addition to working capital loans, a smaller portion of BPR loans is provided as consumer credit to individual customers.

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METHOD

This study employed a qualitative approach using a case study design based on documentary analysis to examine the role of the Indonesia Deposit Insurance Corporation (LPS) in mitigating systemic risk following the failure of rural banks (BPR) in West Sumatra. A qualitative approach was considered appropriate because the study aimed to obtain an in-depth understanding of institutional responses, regulatory mechanisms, and the factors contributing to bank failures through the analysis of documentary evidence rather than numerical measurements. The study focused on two failed rural banks, namely PT BPR Sembilan Mutiara and PT BPR Lubuk Raya Mandiri, as representative cases of rural bank failures handled by LPS in West Sumatra.

The research relied exclusively on secondary data obtained from publicly available and official sources. These included reports published by the Indonesia Deposit Insurance Corporation (LPS), the Financial Services Authority (OJK), Bank Indonesia, relevant banking legislation, official government regulations, press releases, reputable online news reports, and previous academic publications related to deposit insurance, banking stability, and rural bank failures. Documentary evidence concerning the resolution processes of PT BPR Sembilan Mutiara and PT BPR Lubuk Raya Mandiri was selected because these cases provided comprehensive information regarding the causes of bank failure, the intervention of regulatory authorities, and the implementation of deposit insurance mechanisms.

Document selection followed purposive criteria to ensure the relevance and credibility of the collected information. Only documents that directly addressed the research objectives, originated from official institutions or reputable media sources, and contained verifiable information regarding the two failed rural banks were included in the analysis. Academic literature published in peer-reviewed journals was also reviewed to provide theoretical support and facilitate comparisons between the empirical findings and previous studies.

The collected documents were analysed using an inductive qualitative content analysis approach. The analysis began by systematically reviewing all documents to obtain a comprehensive understanding of the research context. Relevant information was subsequently extracted and organized into meaningful categories based on recurring issues identified across different sources. Similar categories were then synthesized into broader analytical themes concerning the causes of rural bank failures, the institutional role of LPS, and the contribution of deposit insurance mechanisms to mitigating systemic risk. Finally, these themes were interpreted by comparing the documentary evidence with relevant theories and previous empirical studies to develop comprehensive conclusions regarding the effectiveness of LPS in maintaining financial stability.

To enhance the credibility and trustworthiness of the findings, data triangulation was conducted by comparing information obtained from multiple documentary sources, including official reports issued by LPS and OJK, government regulations, academic publications, and reputable news reports. Cross-verification among these sources helped ensure the consistency and accuracy of the information presented. Furthermore, the interpretation of the findings was continuously guided by established literature on financial stability, deposit insurance, and systemic risk, thereby strengthening the dependability and confirmability of the research conclusions.

RESULTS AND DISCUSSION

Failure of PT BPR Sembilan Mutiara : Evidence of Governance Weakess and Institutional Resolution

PT BPR Sembilan Mutiara represents one of the rural bank failure cases that illustrates how weaknesses in financial management and corporate governance may ultimately lead to institutional insolvency. Documentary evidence obtained from official reports issued by the Financial Services Authority (OJK) and the Indonesia Deposit Insurance Corporation (LPS) indicates that the bank experienced persistent deterioration in its financial condition before its operating licence was revoked. The primary problems included inadequate capital adequacy, declining liquidity, and the inability of management to restore the bank's financial performance despite supervisory intervention.

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Official records show that OJK designated PT BPR Sembilan Mutiara as a bank under rehabilitation on 30 October 2023 after identifying significant weaknesses in its financial condition. During the rehabilitation period, the bank was provided with an opportunity to improve its capital structure, liquidity position, and operational performance. However, the corrective measures implemented by management failed to restore the institution's financial viability. Consequently, the bank's status was upgraded to a bank under resolution on 21 March 2024, followed by the revocation of its operating licence on 2 April 2024 after LPS determined that a rescue strategy was no longer economically feasible.

Following the licence revocation, LPS assumed responsibility for the resolution process by managing the bank's liquidation and reimbursing eligible depositors in accordance with the deposit insurance scheme. As reported by LPS, insured deposits amounting to IDR 3.42 billion were successfully reimbursed to 2,603 customers, representing approximately 98.47% of the total verified eligible deposits. This prompt reimbursement reduced financial uncertainty among depositors and ensured that customers retained access to their insured savings despite the bank's closure.

From an analytical perspective, this case demonstrates that the failure of PT BPR Sembilan Mutiara was not merely the consequence of declining financial indicators but also reflected broader weaknesses in governance and risk management. The inability to strengthen capital adequacy and maintain sufficient liquidity suggests deficiencies in strategic decision-making and prudential banking practices. These findings support previous studies arguing that ineffective governance, inadequate internal controls, and poor risk management constitute major determinants of rural bank failure (Rafli et al., 2023; Mahesa Arya Pratama et al., 2024). Rather than representing an isolated institutional problem, the deterioration of the bank illustrates how governance deficiencies may gradually undermine financial resilience until regulatory intervention becomes unavoidable.

The case also demonstrates the practical contribution of LPS within Indonesia's financial safety net. Documentary evidence indicates that the institution's role extended beyond reimbursing insured deposits by facilitating an orderly bank resolution process, coordinating with OJK during liquidation, and maintaining public confidence throughout the resolution period. These actions are consistent with the broader objective of deposit insurance systems, which is not only to compensate depositors but also to minimise contagion effects and preserve confidence in the banking system. Therefore, the experience of PT BPR Sembilan Mutiara provides empirical evidence that effective institutional coordination between OJK and LPS constitutes an essential mechanism for mitigating the broader financial consequences of rural bank failures.

Failure of PT BPR Lubuk Raya Mandiri : Institutional Intervention and Financial Stability

The failure of PT BPR Lubuk Raya Mandiri further illustrates the challenges faced by rural banks in maintaining financial sustainability under prudential banking standards. Documentary evidence from the Financial Services Authority (OJK) and the Indonesia Deposit Insurance Corporation (LPS) indicates that the bank experienced prolonged financial deterioration, particularly in terms of capital adequacy and overall financial soundness. These conditions ultimately prevented the institution from fulfilling regulatory requirements and maintaining normal banking operations.

According to official records, OJK classified PT BPR Lubuk Raya Mandiri as a bank under rehabilitation on 30 October 2023 after identifying that its Capital Adequacy Ratio (CAR) had fallen below the minimum regulatory threshold. During the rehabilitation period, the bank was granted an opportunity to improve its financial performance and liquidity position under supervisory oversight. Nevertheless, the corrective measures undertaken failed to restore financial viability, resulting in the bank being designated as a bank under resolution on 9 July 2024. Subsequently, OJK revoked its operating licence on 23 July 2024, officially terminating all banking activities.

Following the licence revocation, LPS initiated the bank resolution process by establishing a Liquidation Team responsible for administering the settlement of assets and liabilities. At the same time, LPS conducted verification and reconciliation of customer deposits to ensure that insured deposit claims were processed in accordance with prevailing regulations. These measures demonstrate that bank resolution extends beyond the closure of financial institutions and involves structured administrative, legal, and financial procedures aimed at protecting depositors while maintaining confidence in the banking system.

The documentary evidence suggests that the collapse of PT BPR Lubuk Raya Mandiri was primarily associated with persistent weaknesses in capital management and ineffective institutional governance. The bank's inability to recover despite regulatory supervision indicates that financial distress had reached a stage where internal corrective actions were insufficient to restore operational sustainability. This finding supports previous studies asserting that inadequate capitalization, weak governance structures, and ineffective risk management constitute the principal determinants of rural bank failure (Pradana & Dewi, 2019; Rafli et al., 2023). Therefore, bank failure should be understood as the cumulative outcome of prolonged managerial deficiencies rather than a sudden financial event.

Beyond resolving the failed bank, the actions undertaken by LPS demonstrate its broader contribution to preserving financial stability. By implementing an orderly liquidation process, verifying insured deposits, and coordinating closely with OJK throughout the resolution process, LPS helped minimise uncertainty among depositors and reduced the potential for financial contagion within the regional banking sector. These findings reinforce the argument that the effectiveness of deposit insurance institutions should not be assessed solely based on financial compensation but also on their capacity to ensure orderly resolution, preserve public confidence, and maintain the resilience of the financial system during episodes of institutional failure.

The Role of LPS in Maintaining National Financial Stability

The documentary evidence demonstrates that the Indonesia Deposit Insurance Corporation (LPS) performs a strategic role in maintaining financial stability that extends beyond its statutory responsibility of reimbursing insured deposits. Under Law No. 24 of 2004, LPS is mandated to guarantee customer deposits and resolve failed banks, both with and without systemic implications. This legal mandate positions LPS as an integral component of Indonesia's financial safety net, working alongside the Financial Services Authority (OJK), Bank Indonesia, and the Financial System Stability Committee (KSSK) to preserve the stability of the national banking system.

Documentary analysis indicates that the implementation of these responsibilities follows a structured resolution framework. When a bank experiences financial distress, OJK first conducts supervisory actions and determines whether the institution remains capable of recovery. If rehabilitation efforts prove unsuccessful, the case is transferred to LPS to determine the most appropriate resolution strategy based on the bank's systemic significance and financial condition. This institutional coordination enables bank failures to be managed systematically while minimising disruption to depositors and the broader financial system.

The cases of PT BPR Sembilan Mutiara and PT BPR Lubuk Raya Mandiri provide empirical evidence of how this institutional framework operates in practice. In both cases, LPS assumed responsibility after OJK revoked the banks' operating licences, subsequently administering liquidation procedures and reimbursing eligible insured deposits in accordance with prevailing regulations. These actions demonstrate that the effectiveness of LPS should not be measured solely by the financial value of deposit reimbursements but also by its ability to ensure an orderly resolution process that protects depositors while maintaining public confidence in the banking sector.

From a financial stability perspective, the prompt intervention undertaken by LPS plays an important role in mitigating the potential contagion effects associated with bank failures. The availability of deposit insurance reduces uncertainty among depositors and lowers the likelihood of panic withdrawals that could spread to other financial institutions. This mechanism is particularly important for rural banks because their operations rely heavily on community trust and local depositor confidence. Consequently, maintaining confidence through timely reimbursement and transparent resolution procedures contributes not only to depositor protection but also to the resilience of the regional banking system.

These findings are consistent with previous studies that recognise deposit insurance institutions as essential components of financial stability frameworks rather than merely compensation agencies (Pradana & Dewi, 2019; Niharotul Faizah et al., 2024). However, while earlier studies primarily discuss the legal authority and institutional responsibilities of LPS from a normative perspective, the present study provides empirical evidence demonstrating how those responsibilities are implemented during actual cases of rural bank failure. This finding therefore extends the existing literature by illustrating the practical contribution of LPS to mitigating financial instability through coordinated bank resolution and depositor protection.

Overall, the documentary evidence suggests that LPS contributes to financial stability through three complementary functions. First, it protects depositors by guaranteeing eligible deposits, thereby maintaining public confidence in the banking system. Second, it facilitates orderly bank resolution through liquidation and settlement mechanisms that minimise uncertainty following bank failures. Third, through close coordination with OJK and other financial authorities, LPS supports the prevention of wider financial contagion by ensuring that distressed banks are resolved in an organised and transparent manner. Collectively, these functions reinforce the institutional resilience of Indonesia's banking sector and strengthen the country's financial safety-net framework.

Factors Behind the Failures of BPR Sembilan Mutiara and BPR Lubuk Raya Mandiri

The documentary analysis indicates that the failures of PT BPR Sembilan Mutiara and PT BPR Lubuk Raya Mandiri were primarily associated with weaknesses in internal governance and deteriorating financial performance rather than external economic shocks alone. Official reports issued by OJK and LPS demonstrate that both banks experienced persistent problems in capital adequacy, liquidity management, and compliance with prudential banking regulations before their operating licences were revoked. These findings suggest that ineffective corporate governance constituted the principal factor undermining the financial sustainability of both institutions.

In addition to internal governance deficiencies, documentary evidence also points to several external challenges that aggravated the financial condition of both rural banks. Increasing competition from commercial banks and other financial institutions, limited product diversification, and relatively low levels of financial literacy among local communities reduced the competitiveness of the two BPRs. These external pressures weakened their capacity to expand lending activities, maintain profitability, and preserve depositor confidence, thereby accelerating financial deterioration.

The findings further indicate that the failures of the two BPRs should not be interpreted as isolated institutional events but rather as the outcome of interactions between internal managerial weaknesses and external environmental pressures. Weak governance reduced the banks' ability to respond effectively to increasingly competitive market conditions, while declining public confidence further constrained liquidity and operational performance. This interaction illustrates that financial vulnerability in rural banks is multidimensional, requiring improvements in governance quality, risk management, managerial competence, and regulatory compliance before financial conditions become irrecoverable.

Although the two failed BPRs were relatively small compared with commercial banks, documentary evidence suggests that their failures still carried the potential to generate regional financial instability by undermining depositor confidence in other rural banks. In this context, LPS played an important stabilising role through prompt reimbursement of insured deposits, close coordination with OJK during the resolution process, and public communication regarding deposit insurance protection. These measures helped minimise uncertainty, prevented panic withdrawals, and supported confidence in the regional banking system.

These findings are consistent with previous studies highlighting poor corporate governance and weak prudential management as the principal causes of bank failure (Pradana & Dewi, 2019; Rafli et al., 2023). However, unlike previous studies that mainly discuss bank failures from legal or regulatory perspectives, the present study demonstrates how governance deficiencies interact with regional market conditions and how LPS contributes to mitigating the resulting systemic risks through coordinated bank resolution and depositor protection. Consequently, this study extends the existing literature by providing empirical evidence from actual rural bank failures in West Sumatra and highlighting the strategic importance of LPS within Indonesia's financial safety-net framework.

The Contribution of LPS in Reducing Systemic Threats in the Banking Industry

The role of LPS in maintaining public confidence during periods of financial distress is crucial for preserving financial system stability. When a bank fails, LPS serves as a protector of depositor funds, providing assurance that their savings are guaranteed up to a certain limit. This assurance helps calm public anxiety and prevents panic withdrawals that could worsen the situation.

The documentary evidence indicates that the contribution of the Indonesia Deposit Insurance Corporation (LPS) extends beyond its statutory responsibility of reimbursing insured deposits following bank failures. The resolution processes of PT BPR Sembilan Mutiara and PT BPR Lubuk Raya Mandiri demonstrate that LPS plays a broader role in maintaining financial system stability by protecting depositor confidence, facilitating orderly bank resolution, and supporting institutional coordination among financial authorities. These functions position LPS as an essential component of Indonesia's financial safety-net framework rather than merely a deposit insurance agency.

Documentary analysis shows that the prompt reimbursement of insured deposits reduced uncertainty among customers following the closure of both rural banks. By ensuring that eligible depositors received compensation within the established regulatory framework, LPS helped maintain public confidence and minimised the possibility of panic withdrawals from other financial institutions. This finding suggests that deposit insurance contributes not only to protecting individual depositors but also to preserving the stability of the wider banking system by reducing the risk of financial contagion.

In addition to deposit reimbursement, the findings demonstrate that LPS contributed to financial stability through structured bank resolution mechanisms. Following the revocation of the banks' operating licences by OJK, LPS coordinated the liquidation process, verified eligible deposits, and administered the settlement of assets and liabilities in accordance with applicable regulations. This coordinated approach enabled the resolution process to proceed in an orderly manner while reducing uncertainty among customers and other stakeholders. Such institutional coordination illustrates that effective crisis management requires collaboration between supervisory and resolution authorities rather than relying on a single institution.

The documentary evidence further suggests that transparent public communication represents another important contribution of LPS in mitigating systemic threats. By disseminating information regarding deposit insurance coverage, claim procedures, and the progress of bank resolution, LPS helped reduce misinformation that could otherwise undermine public confidence in rural banking institutions. In regions where banking relationships are strongly community-based, transparent communication becomes particularly important because negative information may spread rapidly and trigger unnecessary panic among depositors.

These findings are consistent with previous studies that identify deposit insurance institutions as important mechanisms for maintaining financial stability and depositor confidence (Pradana & Dewi, 2019; Niharotul Faizah et al., 2024). However, while earlier studies mainly emphasised the legal mandate and institutional authority of LPS, the present study demonstrates how those responsibilities are implemented in practice during actual rural bank failures. Consequently, this study contributes empirical evidence that the effectiveness of LPS should be evaluated not only through the amount of deposits reimbursed but also through its capacity to facilitate orderly bank resolution, strengthen institutional coordination, preserve depositor confidence, and mitigate regional systemic risk.

Overall, the findings indicate that LPS contributes to reducing systemic threats through four complementary functions: protecting insured deposits, facilitating orderly bank resolution, strengthening coordination with financial authorities, and maintaining public confidence through transparent communication. Together, these functions reinforce the resilience of Indonesia's banking system and highlight the strategic importance of LPS in safeguarding financial stability, particularly within the rural banking sector.

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CONCLUSION

This study examined the role of the Indonesia Deposit Insurance Corporation (LPS) in mitigating systemic risk through the resolution of failed rural banks by analysing the cases of PT BPR Sembilan Mutiara and PT BPR Lubuk Raya Mandiri in West Sumatra using documentary analysis. The findings indicate that the failures of both rural banks were primarily driven by weak corporate governance, inadequate capital management, declining liquidity, and ineffective risk management. Rather than resulting from a single cause, these failures reflected the interaction between internal managerial weaknesses and external environmental pressures that gradually undermined the banks' financial resilience. The findings further demonstrate that LPS plays a strategic role not only in reimbursing insured deposits but also in maintaining depositor confidence, facilitating orderly bank resolution, coordinating with financial authorities, and reducing the potential contagion effects associated with rural bank failures. Collectively, these functions contribute to preserving regional and national financial stability.

This study contributes to the existing literature in several important ways. While previous studies have primarily examined LPS from legal, regulatory, and institutional perspectives, the present research provides empirical evidence demonstrating how deposit insurance mechanisms operate during actual cases of rural bank failure. By analysing the resolution of two failed rural banks in West Sumatra, this study extends existing knowledge by showing that the effectiveness of LPS should not be assessed solely in terms of deposit reimbursement, but also through its capacity to facilitate coordinated bank resolution, preserve depositor confidence, and mitigate systemic risk. These findings broaden the understanding of deposit insurance institutions as integral components of the financial safety-net framework in emerging economies.

From a practical perspective, the findings offer several implications for policymakers and financial regulators. Strengthening corporate governance and risk management within rural banks should become a priority to prevent financial deterioration before regulatory intervention becomes necessary. In addition, enhancing coordination among LPS, OJK, Bank Indonesia, and other relevant authorities is essential to improve early intervention mechanisms and ensure that bank resolution processes are implemented efficiently and transparently. Expanding public financial literacy regarding deposit insurance is equally important to strengthen depositor confidence, minimise unnecessary panic during periods of financial distress, and reinforce the resilience of the rural banking sector.

Despite these contributions, this study has several limitations. The analysis focused on two rural bank failure cases in West Sumatra and relied exclusively on documentary evidence obtained from official reports, regulations, academic publications, and reputable secondary sources. Consequently, the findings should be interpreted within the context of these specific cases and may not fully represent the conditions of all rural banks in Indonesia. Future research is encouraged to examine a larger number of bank resolution cases across different regions, compare rural and commercial bank failures, or adopt mixed-method approaches combining documentary analysis with interviews or quantitative financial analysis. Such studies would provide a more comprehensive understanding of the effectiveness of deposit insurance institutions in mitigating systemic risk and strengthening financial stability.

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