



Legal policy in credit distribution to increase public trust in banking and minimize non-performing loans in Indonesia

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Abstract

Banks, as financial intermediaries, have the main function of collecting funds from the public in the form of deposits and channeling them back in the form of credit. However, credit distribution activities always come with risks, especially the risk of Non-Performing Loans (NPL). High levels of NPL can reduce public trust in the banking sector and may even trigger a wider financial crisis. The paper focused on how do regulation increase public trust and minimize the NPL using qualitative literature review. The study suggested the government needs to step in through regulations to ensure that banks apply the prudential principle in their credit distribution process and the banks need to implement proper examination before lending the credit.

Keywords: Legal policy, credit, banking, non-performing loans

Introduction

The healthier the bank, the greater its contribution to the economic growth. Banks, as financial institutions, play an important role in collecting funds from depositors and redistributing them as credit. Credit distribution is a key activity for banks, society, and overall economic growth. Therefore, banks are essential to the economy (Bossone, 2011). Supported by Shajahan, K.M (1998) ^[1] who argued priority sector lending was used as an important policy tool to make credit more balanced across sectors and to make sure people in weaker groups within those sectors could also get access to loans.

For banks, lending is a core business because they earn profits from the interest margin, whether for productive, consumptive, or investment purposes. On the other hand, the public, especially business actors, relies on bank credit to support their business activities. This relationship between banks and society helps drive financial sector growth and supports the national economy. However, credit distribution also carries inherent risks, particularly the risk of default, which can lead to Non-Performing Loans (NPL). NPL occurs when debtors fail to fulfill their repayment obligations to creditors, in this case, banks. A high level of NPL not only affects the financial health of individual banks but can also disrupt the stability of the financial system as a whole. In addition, compliance and lending effectiveness influenced by host of factors (Kumar *et al*, 2016) ^[6]. Developing countries finance vulnerable sectors such as agricultural and small businesses.

As argued by Khairi *et. Al* (2021) that lending is the main activity in retail banking, and bad loans (NPLs) have become a big concern in recent years. Their study found several factors that affect NPLs, as well as factors that are affected by NPLs. However, there is no factor related to policies. Therefore, this paper will include several policies that enforced bank to implement prudential principle.

Sharma (2001) ^[12] argued that the weakness of state financial system, especially in banks, is one of the main factors from Indonesia's economic vulnerability which could lead to economic crisis. To prevent the negative

impact of high NPL at a macro level, the government has established regulations on credit distribution. One of them is Article 8 paragraph (1) of the Banking Law (Law No. 10 of 1998), which states:

"In providing credit, banks must have confidence based on a thorough analysis of the debtor's good faith, ability, and capacity to repay the debt."

Therefore, even though credit is the main source of income for banks, they must apply the prudential principle when granting loans. This is important not only to protect banks from potential losses but also to ensure that borrowers receive loans that match their financial capacity, which in the end helps build public trust.

Problem Statement

Based on the explanation above, the main issues in this study are:

1. How do regulations build public trust in banks in the credit distribution process?
2. How do these regulations help minimize non-performing loans?

Discussion

1. Legal Policy in the Banking Context

According to Mahfud MD (2009) ^[7], legal policy can be understood as the basic direction that determines the form, content, and implementation of laws established by the state.

In this context, legal policy has three main functions:

First, it serves as the official direction of the state in deciding which laws should be applied to achieve national goals as stated in the Preamble of the 1945 Constitution. Second, legal policy reflects the political, economic, social, and cultural conditions behind the formation of laws. Third, it becomes the foundation for implementing and enforcing laws in practice, including evaluating how effective those laws are in society.

This means legal policy is not just about producing regulations, but also about shaping society and driving structural changes (Nasir, 2025) ^[8].

In the banking sector, legal policy is reflected in:

- Maintaining financial system stability
- Controlling credit risk
- Protecting national economic interests

In other words, banking regulations are not only technical rules, but also part of a broader strategy to manage economic risks, build trust in the financial system, and reduce the possibility of bad loans.

1. Credit in Banking

According to Article 1 paragraph (11) of Law No. 10 of 1998:

“Credit is the provision of money or claims based on an agreement between a bank and another party, which requires repayment with interest.”

From this definition, there are three key elements in credit distribution:

a. Agreement

There must be an agreement between the debtor (customer) and the creditor (bank). This includes loan amount, tenor, interest rate, penalties, due dates, and other terms agreed by both parties.

b. Repayment Obligation

The debtor is responsible for repaying the loan along with interest within the agreed timeframe.

c. Risk

Banks must carefully assess potential borrowers, including their financial condition, business performance, and character, to avoid future NPL. Guy (2015) stated non-performing loans (NPLs) are commonly used to measure the quality of a bank’s assets, and they are often linked to bank failures and financial crises, both in developed and developing countries. This is where the prudential principle becomes crucial. Cucinelli (2015) ^[3] claimed that the credit risk has an impact on bank lending behavior since the research showed that banks reduce their lending activity while facing an increase of credit risk.

Furthermore, Indonesia’s government also enforce bank to assess the debtor’s ability through Article 8 paragraph (1) of the Banking Law (Law No. 10 of 1998) that states:

“Banks must have confidence in the debtor’s ability to repay their debt.”

Other than the Banking Law No. 10 of 1998, the policy is supported by Bank Indonesia Regulation Number 8/13/PBI/2006 Concerning The Legal Lending Limit for Commercial Bank, especially Article 2 (1) that stated:

“Banks are required to apply prudential principles and risk management in the extension of Provision of Funds, especially Provision of Funds to Related Parties, large exposures, and/or Provision of Funds to other Parties with interest on the Bank.”

Those regulation aims to protect banks in the lending process. Based on the findings by Vasiliki et. al (2014) ^[14], there is a strong correlation between NPL and bank specific. Thus, the implementation of the prudential principle is strongly important.

Prudential Principle Implementation often translated to:

1. 5C Analysis (Character, Capacity, Collateral, Capital, Condition):

Banks are required to assess the debtor’s personality, financial capacity, collateral, available capital, and overall business conditions. Research by Stania & Heliani (2026)

^[13] showed that applying the 5C principle works as a good first filter to assess a customer’s integrity, ability to repay, and available collateral, so the risk of default can be reduced. Overall, using these five principles together is important to keep a company’s credit portfolio healthy, protect its assets from major losses, and support more accurate and responsible credit decisions. In addition, Saputra et. al (2020) ^[10] found that bad character, capacity, dan conditions resulted to bad loans.

2. Credit Scoring

Banks use credit scoring to evaluate the debtor’s ability to repay. One commonly used tool is iDeb (Debtor Information System) issued by the Financial Services Authority (OJK), which provides the debtor’s credit history across financial institutions.

3. Risk Management

Banks must implement comprehensive risk management, including:

- Risk identification
- Risk measurement
- Risk control
- Risk monitoring

This process should be carried out continuously. In addition, banks must also develop internal systems to minimize fraud risks, including those potentially committed by employees during the credit process.

With proper implementation of these principles, banks can reduce the risk of NPL and maintain financial stability, which ultimately helps increase public trust in the banking system. However, the Author argued that there is no standardized process regulate by the government in national level to assess the potential debtor.

Conclusion

Banks need to be more transparent and careful in managing their assets. Because of pressure from regulators and other institutions, banks are now expected to assess their loan portfolios more accurately, which has led to the need for higher reserves, especially during times of low interest rates and low profits.

Regulations on credit distribution are designed to help banks avoid financial crises and maintain the stability of the financial system. From a legal policy perspective, credit regulation in Indonesia focuses on strengthening the prudential principle to increase trust in the banking sector and minimize bad loans.

However, in practice, its effectiveness still depends heavily on implementation at the operational level. Challenges such as target pressure, information asymmetry, and weak credit analysis are still common. To fill in the gap, the government needs to step in and create a checklist for banks before they can lend the loan to avoid increase bad debts that can trigger a financial crisis if it is not maintained within a safe range.

Recommendations

To improve public trust and minimize NPL, the following steps can be considered:

- Strengthening the implementation of the prudential principle
- Improving data-based credit analysis
- Enhancing regulatory supervision
- Developing early warning systems for NPL

In the end, risk management in credit distribution is a concrete form of the prudential principle required by regulations. It means that banks should not only assess borrowers at the beginning, but also continuously manage risks to maintain stability and reduce bad debts. On the other hand, the government should also present to regulate the standard of loan assessment and perform its function to monitor the growth of non-performing loan regularly.

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