A Financial **Sector Agenda** for Indonesia

**Indonesia paid a high price for its weak financial sector**

Indonesia’s financial sector crisis was one of the costliest in the world - more than 50 per cent of GDP was spent to bail out the banking sector following the turmoil of 1997/98, more than any other crisis country, except for Argentina almost two decades earlier (Figure 1). The failure of the financial sector caused growth to collapse, and the average income of Indonesians has yet to return to pre-crisis levels.

The banking sector is much stronger now

Indonesia’s banking sector is much healthier now than it was when the crisis hit. Following a painful restructuring, it now has fewer non-performing loans, higher capital-adequacy ratios, and higher profitability (Figure 2). IBRA, the bank restructuring agency, was closed in February 2003, and settlements with former bank owners are almost complete. The majority of banks that the Government took over during the crisis have either been closed, or sold back to the private sector. The Government has also started to sell minority stakes in state owned banks. Regulation and supervision of the sector has improved substantially. And the legal basis for the crucially
important financial sector safety net is being put in place, paving the way for an eventual phase-out of the blanket guarantee.

But much remains to be done

There is still a large unfinished agenda before the financial sector can move from being part of the problem to being part of the development solution.

- Bank lending has yet to recover, and needs to shift its focus from consumption to investment (Figure 3). Recapitalization bonds and central bank notes (SBIs) still dominate the bank’s balance sheets, and credit for productive investments continues to be scarce. Banks also lack the long-term resources to finance growth—nearly all bank deposits in Indonesia are three months or less in maturity.

- The governance of state banks remains weak. Recapitalization of state owned banks after the crisis cost Indonesia nearly a third of GDP; and the government continues to pay for weaknesses in these banks. Weak internal controls in state owned banks cost the government about US$300 million in 2003 alone.

- Non-bank financial institutions remain small, they make up less than 20 per cent of Indonesia’s financial system. These institutions - Pension funds, insurance, capital markets, mutual funds - are crucial for supplying long-term capital needed for development and growth, as well as for providing a stable source of financing for government deficits, and the refinancing of debt.

A three-pronged strategic approach for financial sector policy

It is time to focus on building a financial sector that can contribute to the long-term developmental needs of Indonesia. A sound well-regulated financial sector, consisting of strong banks, capital markets, non-bank financial institutions, and institutional investors such as pension funds, is key to unlocking the potential of Indonesia’s economy. Indonesia needs to adopt a three-pronged approach towards the financial sector going forward.

- First, further strengthen the financial sector to minimize the possibility of another crisis.
- Second, diversify the financial sector so that it becomes less vulnerable to shocks, and becomes a source of long-term domestic financial resources.
- Third, improve access of the poor to formal financial sector services so that the financial sector supports poverty reduction efforts.

Implementing these policies for a stronger and more diverse financial sector will send a clear signal to all participants in the Indonesian financial sector as well as the international community that the government is serious about addressing financial sector problems. These strategies will establish a stable and resilient financial system capable of driving the economy forward by mobilizing and allocating domestic resources for higher growth.

Strategic Focus I: Strengthen the financial sector

Action 1: Clarify The Role Of State Owned Banks

State banks make up 35 percent of Indonesia’s banking system and they continue to pose a risk to the banking system and the state budget. The recent scandals in some state banks have revealed systemic weaknesses in their internal controls.
Even more worrying was the fact that repeated warnings from the central bank about state banks' operations went unheeded. While state banks were originally set up to correct market failures and channel directed credits to select economic sectors, in this post-crisis era, there is little rationale for continued state ownership of commercial banks. Completing the privatization of these banks should be the ultimate goal. Of course this may be politically difficult, but the government could take steps towards this objective by making these banks attractive to private investors through improving internal controls and corporate governance. The government should also consider renewing and enforcing performance contracts and examining options to downsize the state banks. It should resist pressures from state owned banks to push for mergers in the wake of the new architecture policy statement from BI, as such mergers are contrary to both the government's and Bank Indonesia's goal of creating a competitive and strong banking sector. If Indonesia is to have an internationally competitive large bank, it is best left to the private sector to create one.

**Action 2: Establish A Sound Financial Sector Safety Net**

A sound financial sector safety net is critical for creating the incentives to protect depositors from bank failures, while avoiding the risks of future bailouts. Construction of the safety net, consisting of a lender of last resort, a deposit insurance agency, and an institutional mechanism to deal with distressed banks in future, is well under way: Amendments to the central bank law and a memorandum of understanding between Bank Indonesia and MOF have already created a lender of last resort. Passage of the law on deposit insurance has cleared the way for establishing a deposit insurance agency (LPS), a function currently administered by MOF. Now, the government needs to set up the LPS and adequately resource it. A formal coordinating mechanism should be established between BI, the MOF, and the LPS regarding the provision of support to and intervention in distressed banks. After the safety net is in place, implementation of a phased reduction in the current blanket deposit guarantee could reduce the government’s exposure to fiscal risks. Reducing the blanket guarantee will have to be done with great care to ensure that market confidence is not adversely affected at any step of the process.

**Action 3: Further Strengthen Banking Sector Regulation And Supervision**

Bank Indonesia’s regulation and supervision of the banking system has been aided by its new role as an independent authority that, by law, insulates it from political interference. However weaknesses remain and in practice BI is sometimes seen to have less authority over the state owned banks than private banks. To further strengthen the financial sector BI should be guaranteed the independence needed to supervise all participants in the banking sector equally. Implementation and enforcement of prudential regulations needs to be further improved. The absence of consolidated supervision of banks and their subsidiaries is a major weakness that needs to be remedied.

**Action 4: Provide An Enabling Environment For The Enhancement Of Skills And Infrastructure**

The crisis has brought about a fundamental change in banking in Indonesia. Credit assessment, risk management, and technology skills are now of critical importance, but in scarce supply. The Government and Bank Indonesia need to encourage the banking sector to invest in human resources and training. Regulations requiring minimum standards and certifications of key staff would also be useful. Better banking sector infrastructure - such as credit bureaus and stronger credit rating agencies - will help strengthen the financial sector overall.

**Action 5: Fully Implement Anti-Money Laundering (Aml) Reforms**

In June 2001, Indonesia was placed on the OECD's Financial Action Task Force (FATF) on Money Laundering list of Non-Cooperative Countries and Territories (NCCT). It has remained there ever since, despite the creation of PPATK and additional progress in AML. Getting Indonesia off the NCCT
list should be a priority for the Government. Being on the list increases the scrutiny of financial transactions with Indonesia and thereby increases the cost of doing business. It also exposes Indonesia to the possibility of counter-measures by the FATF and means that Indonesia continues to be seen as contributing to the vulnerability of the international financial system. The Government needs to fully implement the recommendations of the FATF, including demonstrating effective mutual legal assistance, implementing an AML compliance program that includes full on-site examinations, and successfully prosecuting money laundering cases to demonstrate the adequacy of the criminal offence.

**Strategic Focus II: Diversify the financial sector**

Non-bank financial institutions in Indonesia are small (Table 1). A more diversified financial sector would help reduce the vulnerability to future shocks, improve intermediation between savings and investments, and provide more long-term domestic resources for large investments in areas such as infrastructure. Pension funds, insurance companies, mutual funds, capital markets, and other institutional investors need to play a greater role in moving the economy forward.

<table>
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<tr>
<th>Table 1: Structure of the financial sector (December 2003, % of GDP)</th>
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<td><strong>Indonesia</strong></td>
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<td>Commercial banks assets</td>
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<td>Insurance firm assets</td>
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The Jakarta Stock Exchange is dominated by a handful of companies, leaving the market susceptible to manipulation. Ten of the 355 listed companies make up half of the market capitalization and nearly 60 percent of the trading volume. The government should see that the regulator (BAPEPAM) undertakes a program to improve disclosure requirements of the listed companies, and protect the rights of minority shareholders.

The government should facilitate the improvement of trading, payments and settlement systems infrastructure. This infrastructure faces substantial operational risks and any breakdown could damage the reputation of the market and therefore its long term development.

**Action 7: Develop The Government Bond Market**

Indonesian government bond markets are nascent, but face high demands. Government needs to raise large amounts of financing at reasonable costs; the central bank should over time be able to use this market for monetary policy purposes; and private sector issuers will use government bonds as a benchmark. The primary market has performed remarkably well, but the secondary market needs further development. The Government should encourage the development of the secondary market through, (i) developing a liquid benchmark government bonds issue that is available in large amounts, and (ii) promoting adoption of standardized repurchase agreements (repos) among market parties. A regulatory framework should be in place to expand the investor base for government bonds, including retail investors. Strengthening the debt management capacity in MOF will increase investor confidence in the market, which should pay off in terms of lower interest rates.

**Action 6: Revitalize Capital Markets**

Private sector led economic growth needs sound equity and corporate bond markets as a source of risk capital to encourage entrepreneurship and to finance the corporate sector as an alternative to bank finance. Sound capital markets also reduce the vulnerability of the economy to stresses in the banking sector. Currently the equity market is small by regional standards, with a total capitalization comparable to a single medium-sized American company, such as Ebay.
Action 8: Strengthen Institutional Investors

Insurance firms, pension funds and mutual funds are important institutional investors worldwide. In addition to providing risk management mechanisms for their investors and a safety net for the elderly and the vulnerable, they also mobilize long-term domestic resources that are critically needed in Indonesia.

The Indonesian insurance sector is small and concentrated. Its assets are 5 percent of GDP and 6 percent of total financial sector assets; three-quarters of these assets are concentrated in the ten largest companies. Numerous small insurers are undercapitalized and unlikely to withstand stiffer market competition in the future. The government has already introduced stricter capital requirements, but it is yet to act against firms that do not meet the requirements. Indeed, some firms have already been identified as insolvent, and they should be closed before further losses occur. At this stage, some of the costs of resolution may fall upon the state. To avoid this in the future, Government must further upgrade the regulatory and supervisory regimes as well as institutional capacity of the regulator.

The pensions sector is small, with only about 3 percent of the financial system’s assets. But the sector is set to expand: Indonesia’s relatively young population, a growing formal sector, and the mandatory nature of many retirement schemes, indicate that pension assets will grow significantly in the future. And the recently approved Social Security Bill proposes to expand coverage to those not yet covered.

There are also a number of problematic pension schemes. The civil servants and army pension plans (TASPEN and ASABRI) are poorly funded relative to their benefit promises, and require budgetary support. JAMSOSTEK, a mandatory defined contribution scheme for private sector employees and state owned enterprises, has been known to have made poor investment decisions, which undermine its capacity to provide reasonable returns to its contributors. All three state-run pension funds suffer from a lack of transparency and disclosure, weak management information systems and poor corporate governance. This is a significant risk to the budget - a poorly managed and designed pension system often results in a government bailout.

The first step in reforming pension schemes would be to appoint a task force to assess their governance and performance. The government should also review the Social Security Law recently passed by parliament. The public mandatory defined benefit schemes that this Bill proposes have a poor record around the world, and many countries are moving away from such schemes. Government and legislators should look again at the implications of this law on the budget, on pension security, and on capital market development. The Government should first assess the cost of the existing schemes and place the existing schemes on a sustainable footing through appropriate policy reforms. Following this, the implementation of a broader social security scheme that meets the Government’s social objectives in a sustainable manner should be considered.

The regulatory and supervisory regimes for capital markets, pensions, insurance, and other non-bank financial institutions should be strengthened on an ongoing basis, even as the Government sets up the integrated financial supervisory authority (OJK).

The mutual fund sector has grown from just Rupiah 8 trillion in early 2002 to Rupiah 73 trillion at the end of last year. But the fundamentals are weak. Many mutual funds do not follow international valuation norms and may be providing a false sense of security to their investors. A loss of investor confidence in this sector would damage the economy, for it would remove an alternate venue for private savings, as well as reduce the potential of a major long-term investor in government bonds and securitized instruments. Going
forward, BAPEPAM’s regulation and supervision of this industry needs to be tightened and brought into line with international practices.

**Strategic Focus III: Improve access of the poor to the financial sector**

Providing finance to the poor of Indonesia can help them work their way out of poverty. The government is clearly committed to this objective since it subsidizes many credit schemes for small business operators. But these schemes are not delivering. They suffer from bad program design, inadequate incentives, and a lack of support for the community-based organizations responsible for managing the funds. Although most schemes are designed to be self-sustaining with repayments funding new loans, in practice they are not, and the government has to continue to replenish their capital to keep them alive. Government-sponsored credit schemes compete with and sometimes undermine a diverse array of non-bank microfinance providers, all struggling to operate in a weak legal framework that works against their expansion, especially to rural areas outside Java and Bali.

**Action 9: Change The Focus Of Public Expenditures**

The focus should be on reducing direct capital transfers and interest rate subsidies and increasing the attention paid to building the capacity of microfinance providers. The Ministry of Finance should be assigned the mandate for evaluating the viability of line ministries’ capital transfer programs, with a view to substantially reducing them. It should also assess the effectiveness of the capacity building implemented as part of these programs. Under the leadership of MOF, a national strategy should be developed to provide support for sustainable microfinance services. This will require a greater reliance on partnerships with non-government providers of training and institutional support. Public support and funding to develop effective approaches to capacity building for microfinance providers should be increased.

**Action 10: Finish And Pass The Microfinance Law**

The government needs to finalize and submit to Parliament (DPR) a draft microfinance law. Links between the non-bank microfinance providers and the formal banking sector should be facilitated. Proper supervision of non-bank microfinance providers needs to be arranged. Existing experience with delegated supervision of these providers should be evaluated, so that focused testing and scaling-up can be pursued once a microfinance law is in place and an overall supervisory authority is established. The revised draft Cooperatives Law should be implemented to provide a better framework for microcredit; including a requirement for external audits and supervision for savings and loan cooperatives. Finally, accelerating land titling would facilitate it being used as a basis for collateral.

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1For more detail on this topic see the World Bank Policy Briefing on Finance for the Poor.