

# **UNLOCKING INDONESIA'S DOMESTIC FINANCIAL RESOURCES: THE ROLE OF NON-BANK FINANCIAL INSTITUTIONS**

December 2006

Poverty Reduction and Economic Management  
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## FOREWORD

Non-bank financial institutions (NBFIs) - such as insurance firms, pension funds, mutual funds, leasing and venture capital companies, and capital markets (including equity and bond markets) - have a key role to play in Indonesia's future development. Well functioning NBFIs - alongside a sound banking system - can help achieve the Indonesian government's objectives of increasing access to financial services, reducing the cost of financial services, and improving the stability of the financial system. A strong well diversified financial sector provides a solid foundation to support economic growth. That growth is good for poverty reduction has by now been well established with evidence from across the world.

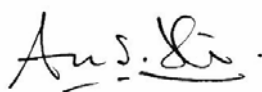
Nearly a decade after the onset of the economic crisis, Indonesia's financial sector continues to be dominated by commercial banks. NBFIs in Indonesia are much smaller than those in several other large developing countries and in many countries of the East Asia region. In line with the economy-wide shift towards longer term development agendas and emerging development priorities, strengthening NBFIs is now an urgent policy imperative. Indonesia needs the long-term domestic resources that can be mobilized by NBFIs; these can be used to finance productive investments - including, among others, infrastructure. This provides a window of opportunity for much needed reforms.

The Government clearly recognizes the importance of a strong financial sector - as articulated in the financial sector policy package in June 2006 and its ongoing implementation. While this is an excellent start, more challenges lie ahead on the path to comprehensive reform and strengthening of NBFIs. While each sub-sector has its own specific issues, there are also some common problems across sub-sectors.

This report "Unlocking Indonesia's Domestic Financial Resources - The Role of Non Bank Financial Institutions" - is intended to assist policy makers in developing a strategic vision for the future development of NBFIs. The main findings of this report have been widely disseminated through four workshops held during 2005 and 2006. We hope that the report will serve as a basis for informed discussion about the role of NBFIs, their ability to meet Indonesia's objectives, and policy actions necessary to stimulate their sound development.

The World Bank considers it a privilege to work with the Government in this critical area of financial sector reform and we stand ready to further support the Government in its future efforts.

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## REPORT TEAM AND ACKNOWLEDGEMENTS

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## ABBREVIATIONS

Abbreviation	Indonesian	English
AAJI	Asosiasi Asuransi Jiwa Indonesia	Association of Indonesian Life Insurance Companies
APPI	Asosiasi Perusahaan Pembiayaan Indonesia	Indonesian Financial Services Association
ASABRI	PT Asuransi Sosial Angkatan Bersenjata Republik Indonesia	The Indonesian Armed Forces Social Insurance
ASEAN		The Association of Southeast Asian Nations
BAPEPAM & LK	Badan Pengawas Pasar Modal Lembaga Keuangan	Capital Market and Non Bank Financial Institution Supervisory Agency
BCBS		The Basel Committee on Banking Supervision
BEJ	Bursa Efek Jakarta	Jakarta Stock Exchange
BES	Bursa Efek Surabaya	Surabaya Stock Exchange
BI	Bank Indonesia	Bank Indonesia
BI-RTGS		Bank Indonesia's real-time gross payments system
BI-SSSS		Bank Indonesia's scrip-less securities settlement system
BKPM	Badan Koordinasi Penanaman Modal	The Investment Coordinating Board
BPUJ	PT Bahana Pembinaan Usaha Indonesia	
CARAMEL		Capital Assets Risk analysis Asset-liability matching Management Earnings Liquidity
DAI	Dewan Asuransi Indonesia	Indonesian Insurance Council
DPLK	Dana Pensiun Lembaga Keuangan	Financial institution-based pension funds
DVP		Delivery-versus-payment
EET		Exempt exempt taxable
ETF		Exchange traded funds
EU		European Union
FASBI	Fasilitas Bank Indonesia	Bank Indonesia rupiah deposit facility
FITS		Fixed income trading system
GAAP		generally accepted accounting principles
GDP		Gross Domestic Product
HHI		Herfindahl index
HIMDASUN	Perhimpunan Pedagang Surat Utang Negara	Inter-Dealer Market Association
IAI	Ikatan Akuntan Indonesia	the Indonesian Accountant Association
IAIS		International Association of Insurance Supervisors
IAS		International Accounting Standards
IBNR		Incurred But Not Reported
IDM		Inter-Dealer Market
IFRS		International financial reporting standards
IFSL		International Financial Services, London
IGSTS		Indonesian Government Securities Trading System
IMF		International Monetary Fund
IOSCO		The International Organization of Securities Commissions
IPO		Initial public offering
ISO		International Standards Organization
JAMSOSTEK	PT Jaminan Sosial Tenaga Kerja	Employees Social Security
JATS		Jakarta Automated Trading System
JHT	Jaminan Hari Tua	Old Age Benefit Scheme
KIK	Kontrak Investasi Kolektif	Collective Investment Trust
KMK	Keputusan Menteri Keuangan	Ministry of finance decree
KPEI	Kliring Penjaminan Efek Indonesia	Clearing and Settlement Corporation
KSEI	Kustodian Sentral Efek Indonesia	Central Securities Depository
LPS	Lembaga Penjamin Simpanan	Indonesian Deposit Insurance Corporation
MAPPI	Masyarakat Profesi Penilai Indonesia	organization of professional appraisers in Indonesia
MoF		Ministry of Finance
MOFiDS		Ministry of Finance Dealing System
NASD		National Association of Securities Dealers
NAV		Net asset value
NBFI		Non-bank financial institutions
NYSE		New York Stock Exchange
OECD		Organization for Economic Co-operation and Development
OJK	Otoritas Jasa Keuangan	An integrated supervisory authority for the financial

OTC-FIS		sector
PAI	Persatuan Aktuaris Indonesia	Over-the-counter, fixed-income service
Perseroan Terbatas		Indonesian Actuary Association Limited Liability Company
PP	Peraturan Pemerintah	Government regulation
PSAK	Pernyataan Standar Akuntansi Keuangan	Indonesian financial accounting standards
RBC		Risk Based Capital
REIT		Real estate investment trust
Repo		standard repurchase agreements
SBI	Sertifikat Bank Indonesia	Central Bank Notes
SJSN	Sistem Jaminan Sosial Nasional	National Social Security System
SME		Small to Medium Enterprises
SRO		Self Regulatory Organization
TASPEN	PT Dana Tabungan dan Asuransi Pegawai Negeri.	Annuity pensions and endowment insurance benefits scheme for government civil servants.
THT	Tunjangan Hari Tua	Old Age Lump Sum Benefit
WMI	Wakil Manajer Investasi	Investment manager license

### Currency Equivalents

Currency Unit: Indonesian Rupiah (Rp.)

Year	End of Year	Average
1999	7,085	7,855
2000	9,595	8,422
2001	10,400	10,261
2002	8,940	9,311
2003	8,465	8,577
2004	9,290	8,939
2005	9,830	9,705

Fiscal Year of Indonesia

January 1 – December 31



## EXECUTIVE SUMMARY

### Unlocking Indonesia's Domestic Financial Resources The Role Of Non-Bank Financial Institutions

A well diversified financial sector – with sound banks as well as non-bank financial institutions (NBFIs)<sup>1</sup>, – is key to supporting the Indonesian Government's articulated development objectives of increased economic growth, greater job creation, and a better standard of living for Indonesians. Banks and NBFIs are both key elements of a healthy and stable financial system that complement each other and offer synergies.

However, at present, Indonesia's financial services industry continues to be dominated by banks – with nearly 80% of financial system assets (in 2005) in banks. The rest of the financial sector – including insurance, pensions, mutual funds, leasing, factoring, and venture capital companies – is still small, with less than 15 per cent of GDP in assets combined. Banks were at the heart of Indonesia's economic crisis in 1997/98 – with more than 50% of (2000) GDP spent to recapitalize them. Given the scale of the banking crisis, policy attention has – until recently – been focused on strengthening the banking system and its regulation and supervision. In line with the economy-wide shift towards a long term development agenda, as articulated in the various policy packages released in 2006, strengthening NBFIs is now an urgent policy imperative.

A well-developed NBFIs system can play a major role in achieving Indonesia's development goals and can enhance the stability of the country's financial system. NBFIs have the potential to unlock long-term domestic resources for investment in sectors critical to growth, such as infrastructure, and increase access to low-cost financial services.

The primary objective of this report is to assist policy makers in developing a strategic vision for the future development of NBFIs in Indonesia. It is hoped that the report will serve to create a basis for informed discussion about the role of the NBFIs sector, its ability to meet Indonesia's objectives, and policy actions necessary to stimulate its sound development. This report has two key outcomes in mind: development of a diversified financial sector and improved mobilization as well as allocation of long-term domestic resources for development.

The report is organized as follows. Chapter 1, **Overview**, provides a synopsis of the report and highlights key recommendations. It begins by addressing cross-cutting issues that are common problems across many sub-sectors and then focuses on each sub-sector that the report covers. While detailed discussions and recommendations are presented in subsequent chapters, this chapter highlights a short prioritized list of policy actions that the study recommends as needing immediate policy focus. Regulation and supervision of NBFIs is still weak and needs to be strengthened; lack of adequate capacity and gaps in the regulations that have the potential to lead to regulatory arbitrage need to be addressed. With the decision to establish an integrated financial supervisory authority (OJK; Otoritas Jasa Keuangan) must come as a commitment to undertake a wider scope of regulatory reforms and to develop greater enforcement capacity. An important step that the report recommends is to immediately consider making Bapepam & LK (Badan Pengawas Pasar Modal Lembaga Keuangan, Capital Market and Non Bank Financial Institution Supervisory Agency) more independent. Enforcement is poor across a large spectrum of financial sector activities. Staff needs to be better trained to address compliance problems, and the enforcement

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<sup>1</sup> In this report, NBFIs includes capital (equity and bond) markets, insurance firms, pension funds, mutual funds, leasing, factoring, and venture capital companies

of regulations needs to be coordinated across the different regulators; a problem the proposed integrated authority is intended to address.

Effective competition in several NBFIs segments in Indonesia is hampered by the existence of uneven playing fields. In some cases such as insurance, several large players are known to have solvency problems, which have yet to be addressed, and these adversely impact the rest of the industry; regulations that create an uneven playing field between incumbents and new entrants inhibit new entry. In pension funds, the role of the public sector is large and could potentially grow further as the social security law is implemented. Such imbalances need to be urgently addressed. Tax distortions impede the development of virtually all of the industries studied. A priority in this area is to take a comprehensive look at tax regulations and assess remedies. A deregulated and competitive environment creates new demands for financial expertise and skills. Such expertise is sorely lacking in Indonesia, and regulations are needed to facilitate the growth of the financial services professions. This can be done by establishing and promoting minimum uniform standards of education and qualifications. In addition, consideration should be given to opening the professions to foreign competition. Finally, Indonesia needs better-educated investors and there is a need to focus on investor education. The potential economic benefits of financial literacy are widespread: better-informed consumers and investors would improve market efficiency and help to keep unscrupulous operators at bay. To this end, the authorities are encouraged to develop a financial literacy program, in collaboration with the private sector.

Chapter 2 deals with the **Equity market**. Indonesia's equity market has risen steadily since 2002, and Jakarta Composite Index was among the top performers in the region in 2004 and 2005. As of December 2005, total market capitalization was Rp 801 trillion (30% of GDP). About 336 companies are listed on the exchange. The market is largely an institutional market with few individual investors having accounts. Well-functioning equity markets encourage entrepreneurship by providing a source of risk capital to complement bank financing. The Indonesian stock market is small, highly concentrated, and relatively illiquid. It is not a major source of risk capital, with limited new equity being raised since the crisis. It is yet to be a widely used store of value for assets – with fewer than 100,000 retail accounts in a country of 220 million people. The market is not yet a sound means to price risk adequately – given its concentration (10 of 336 listed firms account for half of market capitalization and trading volume) and limited liquidity (free float of the top 20 companies by market capitalization is less than 40 per cent). Moreover, transparency, information disclosure, and corporate governance are still weak, and that the securities regulator faces significant shortcomings in its ability to oversee the markets, supervise market participants, and enforce issuer compliance. Decisive policies are needed, both by the government and by market participants, such as the stock exchange, to enable the market to reach its full potential. In essence, there is a need to improve corporate governance, improve and strengthen the role of Bapepam & LK in supervision, improve market infrastructure, and improve corporate financial health.

Chapter 3 focuses on **Bond markets**, which can supply long-term financing for the government, infrastructure projects, and corporations. Indonesia has achieved significant progress in building the core government bond market, but has not developed the corporate bond market. At end-2005, tradable government bonds outstanding amounted to Rp 389 trillion (14 per cent of GDP). Corporate bonds outstanding amounted to only Rp 63 trillion, representing 2 per cent of GDP. Banks are the largest investors in government bonds – holding 71 per cent of all government bonds, including recap bonds. Insurance and pension funds hold about 14 per cent of government bonds. The key priorities in this area are to improve the coordination between Bank Indonesia and the Ministry of Finance, further enhance the certainty of periodic government issuance, improve the market infrastructure for government bonds, clarify the regulatory requirements for credit-rating agencies, and improve the collection of secondary-market pricing information.

Chapter 4 addresses **Mutual funds**. Until early 2005, the Indonesian mutual fund industry grew rapidly – growing from assets under management (AUM) of Rp. 8 trillion in 2001 to nearly Rp. 104 trillion in December 2004. The industry’s growth was driven by the shift of individuals out of rupiah time-deposit accounts in commercial banks and into mutual funds that invested mainly in rupiah-denominated government securities, principally recapitalization bonds. However, massive redemptions rocked the industry subsequently, and assets under management fell to Rp 29.4 trillion (US\$3 billion, 1.1 percent of GDP) by December 2005. The main causes for the debacle were a sudden rise in interest rates that caused the value of “fixed income” mutual funds – which were the vast majority of funds – to fall, leading investors into a panic. Despite its recent decline, the mutual fund industry should remain an important building block in Indonesia’s financial sector, helping individuals and institutions to manage risk and savings. Mutual funds have the potential to be a significant investor in government and corporate bonds. Yet Indonesia’s mutual fund industry is small compared with regional and global markets, and the capacity is weak. The structure is skewed toward fixed-income funds, and the range of products is limited. Despite extensive rules, disclosure and investor protection are inadequate, the concept of net asset value is not used, and sales procedures are poor. The priority for the sector is to bring regulation and supervision of the industry in line with international practices by restructuring the industry, strengthening enforcement and market discipline, and addressing the challenges of net asset valuation.

**Pension funds** are the subject of Chapter 5. Indonesia’s pension sector is small controlling in total less than 4.7 percent of GDP in assets, compared with Thailand (8.4 percent), Malaysia (57 percent), and Australia (75 percent). While there is great potential to mobilize domestic resources, especially if the industry would undertake reforms and the government would promote pension funds, decisive measures are needed. The two defined-benefit plans for civil servants (Taspen; PT Dana Tabungan dan Asuransi Pegawai Negeri) and the armed forces (Asabri; PT Asuransi Sosial Angkatan Bersenjata Republik Indonesia, The Indonesian Armed Forces Social Insurance) are poorly funded and invested inappropriately with large holdings of short-term bank deposits. Together with Jamsostek (the defined contribution plan for formal sector workers), they suffer from lack of transparency and disclosure, weak management information systems, high expense ratios, and poor internal governance. Indonesia’s private pension funds are growing rapidly, and some positive steps have been taken to improve the industry, including a shift to risk-based supervision and the decision to create OJK, an integrated supervisory authority for the financial sector. The priorities for the sector are to formulate a coherent strategic master plan for providing retirement income in a fiscally sustainable way; undertake an actuarial audit and reform of Taspen and implement reforms before addressing funding issues; encourage outsourcing of Jamsostek’s activities to improve efficiency, and improve the asset allocation of private pension funds.

Chapter 6 focuses on **the Life Insurance industry** (the non-life insurance sector is not dealt with in detail in this report, largely due the fact that the life insurance industry is a potential source of long-term resources – which is one of the focus areas of this report). The Indonesian insurance industry is small – with total assets of Rp. 75 trillion (US\$ 7.7 billion) – 2.8 percent of GDP. Insurance penetration in Indonesia—premiums as a percent of GDP—is low, with premiums equal to 1.4 percent of GDP (life, 0.8 percent; non-life 0.6 percent). Insurance density – premium per capita – is US\$ 14.5 per capita (life - US\$ 6.4 per capita, and non-life, US\$ 8.1 per capita). The industry is highly fragmented – with a large number of relatively small players in both life and non-life insurance sectors. There are large insurance companies in the industry that are widely considered to be insolvent and posing a potential systemic risk. While life insurance is traditionally an industry that produces long-term savings, in Indonesia this potential is not yet being fulfilled. Poor sales practices, and inappropriate products result in a high lapse rate i.e. many policies are not renewed. Many small insurers are undercapitalized and unlikely to withstand stiffer market competition in the future. The top priority for policy makers and regulators are to rationalize the

industry including addressing the resolution of weak and bankrupt firms. The other priority in this area is to modernize and upgrade the institutional capacity of the regulator and improve enforcement. This includes developing a flexible approach to supervision that emphasizes risk management, consumer protection, and market discipline, developing a harmonized approach to risk-based capital management, and reviewing the approach to reinsurance. A sustained education campaign using a public-private partnership approach to promote the industry would help the development of the industry. The establishment of joint government-industry high-level committee to develop future action plans for the industry is also an important step.

Chapter 7 deals with **Leasing and consumer finance** while Chapter 8 deals with **the Venture capital industry**. Leasing and factoring services provide financing for small and medium enterprises, while venture capital fosters innovation and entrepreneurship. Further development of these industries would broaden competition for financial services, introduce businesses and financiers to innovations such as cash-flow-based credit analysis, and provide small and medium enterprises with access to risk capital. The sector is small, but growing strongly in Indonesia, driven largely by consumer finance. To encourage further growth, the priorities are to put in place a reasonable but light level of regulation and supervision, allow depreciation of leased assets, widen the financing base, develop credit information systems, support corporate restructuring through private equity funds, separate the operation and management of venture capital funds, and develop legal trust vehicles.

# CHAPTER 1

## OVERVIEW

Indonesia has turned the corner from crisis management and is moving towards sustained growth and poverty reduction. Policy makers are focusing on longer-term development issues on a variety of fronts. This is evident by the actions of and policy pronouncements by the current Government since taking office in late 2004. That a strong financial sector is critical to support growth – and that growth is good for poverty reduction – has by now been well established with evidence from across the world. In Indonesia as well, a well diversified financial sector – with sound banks as well as NBFIs is key to support the Government’s articulated development objectives.

Until recently, strengthening and supervising banks has been at the centre of Indonesian financial sector policy focus due to the scale of the economic crisis in the late nineties. In one of the costliest banking crises in the world, more than 50% of (2000) GDP was spent to recapitalize the banks and put them on a sound footing. It must be mentioned that several issues remain in the banking sector, in particular concerning the role and continuing problems of state owned banks as well as sound implementation of a financial sector safety net. However, these issues are dealt with in greater detail in other reports, and are outside the scope of this particular report.

A well-developed NBFi system has the potential to fulfill these long-term developmental objectives by bringing further stability to the financial system, reducing the cost of financial services as whole and unlocking domestic resources for developmental purposes. A strong NBFi sector will allow the Government to place bonds in the domestic market, provide Rupiah financing for infrastructure purposes, provide financing for SMEs (and thereby create jobs) and enhance the financial security of Indonesians by allowing access to different kinds of risk-management products. The private sector in Indonesia needs to have access to different types of capital—risk capital from capital markets, short-term financing from banks, as well as longer-term financing through capital markets and institutional investors. Leasing and factoring services could help provide term funding for the private sector, especially small and medium enterprises, which are often constrained by collateral. As decentralization becomes firmly rooted, sub-national governments are looking to capital markets for resources for development. In particular, municipal bond markets and investors are needed. The Government is considering a national

contributory social security system, and these resources will require avenues for investment. Given all these likely demands, a sound NBFIs sector could contribute in a big way to Indonesia's development.

Macroeconomic stability and a sound framework for macro policy are required for the sustained development of the financial sector. Maintaining this stability has been a challenge in post-crisis Indonesia in part due to underdeveloped financial markets, but macroeconomic foundations are now improving rapidly as interest rates and inflation move toward regional averages and the exchange rate stabilizes. These developments will naturally extend savings and investment horizons and risk tolerance but the likelihood of internal and external shocks remains high and both savers and investors need the ability to diversify to match currency and maturity profiles. This makes it an opportune moment to solidify a strengthening macroeconomic picture with a diversified and efficient financial sector – including further developing NBFIs. Improved financial markets in turn create the potential for higher sustained growth, raise domestic financing – including for investment in infrastructure, while making the economy more robust in the face of inevitable shocks.

The primary objective of the report is to assist policy makers in developing a strategic vision for the future development of NBFIs in Indonesia. It is hoped that the report will stimulate an informed discussion on required policy initiatives to meet these goals.

This chapter provides the overview of the report and specific recommendations in each sub-sector that the report covers – equity markets, bond markets, mutual funds, pension funds, insurance, leasing, and venture capital. While detailed discussions and recommendations are presented in subsequent chapters, the sections in this chapter highlight a short prioritized list of policy actions that the study recommends as needing immediate policy focus. This chapter then highlights several cross-cutting issues that affect the development of the NBFIs sector as a whole and recommends concrete actions in these areas. In subsequent chapters, each sub-sector is examined in-depth, a fuller context for the recommendations in the overview provided, and a wider set of policy recommendations made for future development. For ease of policy focus, each subsequent chapter ends with a matrix of actions – prioritized as in the short term (less than one year) and medium term (1-3 years) that the Government should be focusing on.

There are clearly limitations to a wide-ranging study such as this. First, at the request of the Government this study focuses on market/sector development issues. (In-depth work on regulatory structure issues – especially that of the establishment of OJK is being supported by the Asian Development Bank and AusAID). Clearly, a report on market development has to necessarily touch on regulatory issues and constraints – and make recommendations for reform, which this study does. But it does not go into depth on issues related to the OJK. Second, there was also a decision made early in the preparation process that the study will focus on key recommendations across a wide set of sub-sectors. As a result, therefore, the report identifies areas where further work is needed – especially on issues related to implementation. This study lays out a strategy and a vision for the NBFIs sector – and highlights key policy decisions that have to be made in the process. In several cases, arriving at a detailed road-map of implementation issues will need further work.

This report uses comparisons of Indonesia with other relevant economies where appropriate and helpful. For a more exhaustive comparison of Indonesia's financial sector with those of other regional economies readers are referred to the recent World Bank publication – "East Asian Finance; The Road to Robust Markets" (2006).

## THE IMPORTANCE OF NBFIs & CAPITAL MARKETS<sup>2</sup>

Deep and broad financial markets facilitate savings mobilization, by offering both individual and institutional savers and investors additional instruments and channels for placement of their funds at more attractive returns than are available on bank deposits. At the same time, deep and broad financial markets enhance access to finance for more firms and individuals, with competition also making such access more affordable. Developed financial markets also have the capacity to reduce volatility, distortions, and risk by operating in an environment that is transparent, competitive, and characterized by the presence of a diverse array of products and services, including derivative instruments that allow for effective risk management. Therefore, reforms in a country's financial architecture often lay the groundwork for improved economic performance. In almost all advanced economies, financial systems deliver a broad range of financial services and sophisticated products, and the efficiency of such well-developed systems has contributed to macroeconomic stability and sustained economic growth and prosperity.

Increased availability of funding and more efficient allocation of capital for productive private sector investment is beneficial economy-wide, with particular benefits for small and medium sized enterprises (SMEs) that are often constrained in their financing options prior to effective banking reforms and non-bank financial sector development. According to recent analyses, growth in private credit volumes and equity market capitalization as a percent of GDP have consistently been correlated with growth in per capita income. Thus, effective functioning of a full service financial system is essential for economic development and prosperity.<sup>3</sup>

Banks and non-bank financial intermediation are both key elements of sound and stable financial systems. Both sectors need to be developed as they offer important synergies. While banks dominate financial systems in many countries, businesses, households and the public sector all rely on the availability of a wide range of financial products to meet their financial needs. Such products and services are provided not only by banks, but also by insurance, leasing, factoring and venture capital companies, as well as mutual funds, pension funds and investment trusts. The ratio of equity market capitalization to banking system assets is high in most economically advanced countries, and there is a general tendency for the market capitalization-to-bank deposit ratio to increase with the level of economic development.

By providing additional and alternative financial services, NBFIs improve general system-wide access to finance. They also help to facilitate longer-term investments and financing, which is often a challenge in the early stages of bank-oriented financial sector development. The growth of contractual/collective savings institutions such as insurance companies, pension funds, and mutual funds widens the range of products available for people and companies with resources to invest. These institutions also provide competition for bank deposits, thereby mobilizing long-term funds necessary for the development of equity and corporate debt markets, municipal bond markets, infrastructure finance, mortgage bond markets, leasing, factoring and venture capital. Collective savings institutions also allow for better risk management, while helping to reduce the potential for systemic risk through the aggregation of resources, allocation of risk to those more willing to bear it, and application of portfolio management techniques that spread risk across diversified parts of the financial system.

Thus, countries have a lot to gain from deep and broad financial markets and a mature financial services industry. This development paradigm is increasingly recognized around the world,

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<sup>2</sup> This section draws on Bakker and Gross (2004).

<sup>3</sup> The relationship between finance and economic growth has been explored in detail by, among others, the World Bank (2001)

especially in the aftermath of repeated emerging market crises in countries with bank-dominated financial systems.

### NBFIs in the Indonesian Context

Many of the above arguments are valid in Indonesia's case as well. Indonesia's financial sector is currently dominated by commercial banks (Table 1.1). The current situation and the above discussion on the role of NBFIs points to the need to further develop capital markets, pension funds, mutual funds, insurance companies, leasing companies, and venture capital funds in Indonesia, as these institutions are better geared toward bearing several types of risk. Indonesia needs strong NBFIs for at least three reasons: (i) they can play a critical in mobilizing and allocating domestic resources for financing development – an urgent priority (ii) they can reduce the vulnerability of the financial sector to future shocks and (iii) they can help meet other articulated Government objectives. In order to motivate the focus on NBFIs, this section provides a brief overview of the overall financial sector in Indonesia.

A regional comparison reinforces the previous observations about the financial sector in Indonesia (See Table 1.2). Compared to the region, the Indonesian financial sector is relatively underdeveloped, highly bank-dominated. NBFIs are relatively smaller in Indonesia as well.

**Table 1.1: Structure of the Financial Sector (Rp trillion)**

Type of institution and year	Assets (Rp trillion)	Percent of assets	Percent of GDP
Banks (2005)	1,470.0	79.7	53.9
Non-bank financial institutions	374.5	20.3	13.7
Finance companies (2005)	67.7	3.7	2.5
Insurance companies (2005)	75.1	4.1	2.8
Pension funds (2004)	107.1	5.8	4.7
Securities firms (2004)	10.1	0.5	0.4
Pawnshops (pegadaian) (2005)	4.8	0.3	0.2
Rural institutions (2004)	14.7	0.8	0.6
Mutual funds (2005)	29.4	1.6	1.1
Venture capital companies (2005)	2.7	0.1	0.1
Outstanding corporate bonds (2005)	62.8	3.4	2.3
Total	1,844.5	100.0	67.6
Equity market capitalization (2004)	680	N/A	30.1
Equity market capitalization (2005)	801	N/A	29.4

Source: Bapepam & LK, Bank Indonesia

Note: Numbers include some double counting because pension funds, insurance companies, and mutual funds invest in banks. Percent of GDP of each sector is calculated using the GDP of the year corresponding to year of the data. Total as a percent of GDP uses 2005 GDP figure.

**Table 1.2: Regional Comparison of Financial Sectors (US\$ billion)**

Sector	Indonesia		Malaysia		Thailand		Singapore	
	Assets	% of GDP	Assets	% of GDP	Assets	% of GDP	Assets	% of GDP
Banks	151.5	53.9	166	159.8	172	114.9	213	233.4
Insurance companies	7.7	2.8	20	19.5	5	3.4	46	49.8
Pension funds	12.0	4.3	58	56.4	7	4.8	60	65.7
Mutual funds	3.0	1.1	21	20.1	18	12.2	18	20.0
Outstanding corporate bonds	6.5	2.3	40	*38.0	19	*12.3	30	*32.4
Others	10.5	3.7	n.a	0.0	n.a	0.0	n.a	0.0
Total	191.2	68.0	305	293.3	221	147.4	367	403.3
Equity market cap	82.5	29.3	168	162.2	119	79.4	148	162.3
GDP	281.3	100.0	104	100.0	150	100.0	91	100.0

Source: Respective central banks, public information, World Bank

Note: Indonesian data as of 2005, the rest as of 2003.

\*:2004 data.

## Brief Summary of the Banking Sector

Banking is the largest segment of the financial system, controlling nearly 80 percent of financial assets. Following the crisis, Indonesia's banking sector was restructured. It is much healthier now, with fewer nonperforming loans, higher capital-adequacy ratios, and higher profitability. Most of the (previously private) banks taken over by the government during the crisis have either been either closed or sold back to the private sector. The government has also begun to sell minority stakes in state-owned banks. Regulation and supervision of the sector has been strengthened substantially, and the blanket guarantee on bank deposits in existence since the crisis is being gradually phased out as a deposit insurance scheme is being put in place. Despite these improvements however, a significant agenda of further reforms remains in the banking sector – with state owned banks being at the core of the agenda. Recent figures indicate that the two largest state banks – accounting for about 30 per cent of assets of the banking system, account for 2/3rds of the system's NPLs. Improving governance at these institutions remains a challenge.

Despite its size and recent improvements, the Indonesian banking sector is not a source of long-term capital. Similar to the banks of many countries in the region, Indonesian banks obtain most of their funding from short-term deposits, and more than 90 percent of bank deposits are less than one month in maturity. Prudent asset-liability management calls for banks to offer short-term, floating-rate loans, and this is what happens in the market. This liability structure therefore severely limits banks from being able to finance long-term assets. In addition, recapitalization bonds still feature prominently in bank balance sheets (17 percent of assets), and bank credit for investments is scarce. Since 2000, credit has grown 18 percent a year, with consumption lending growing 22 percent and investment lending growing 13 percent. The relatively slower growth of investment lending is the result of a poor investment climate, a dearth of attractive investment opportunities, and economic growth driven largely by consumption. In addition, although in the aggregate SME lending is growing rapidly (from a small base), the vast majority of SMEs in Indonesia continue to face constraints in access to credit. Bank lending is heavily collateral based – and with weak land titling and collateral documentation, especially for land, many SMEs find the banking sector hard to access.

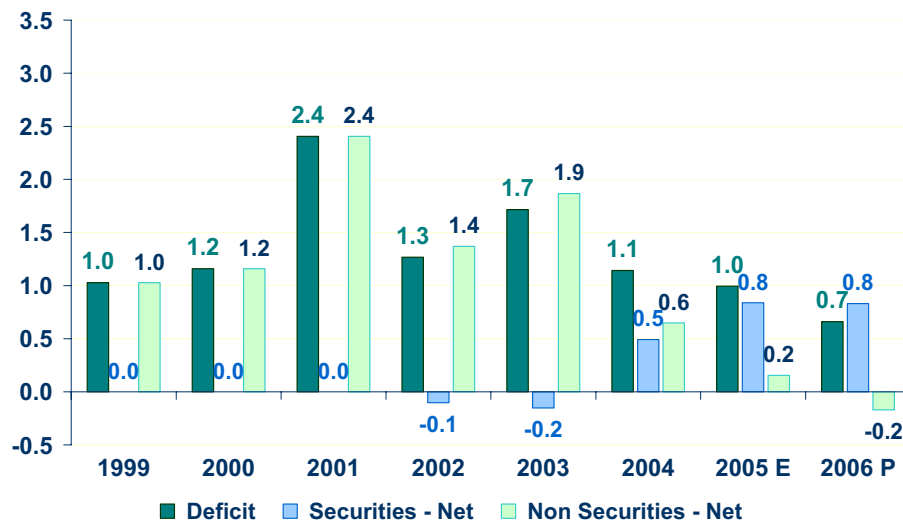
## MOBILIZING LONG-TERM DOMESTIC RESOURCES

Indonesia has a large and growing need for long-term domestic resources. The government has established a substantial borrowing program since 1999, borrowing about 1 percent of GDP annually (see figure 1.1). In its debt management strategy, the government has articulated its desire to (i) increase the share of domestic debt vis-à-vis foreign borrowings and (ii) lengthen the maturity of domestic debt as much as possible. In addition, Indonesia's infrastructure development program has large financing needs. The Bank estimates (Figure 1.2) that Indonesia needs to increase its spending on infrastructure by about 2 percent of GDP – US\$ 5 billion per year – in order to reach the governments 6 percent per year medium term economic growth target.

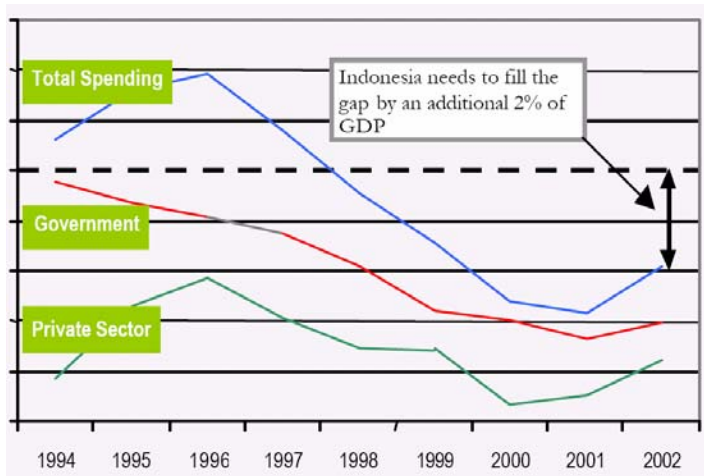
Much of this is expected to be financed from private sources. Clearly, local and international capital markets will have to provide much of this financing. Meeting these objectives will demand better functioning capital markets and NBFIs. At present, however, Indonesian institutional investors are relatively small and not yet a source of long-term capital. Indonesia's pension funds (with assets of about US\$12.5 billion, 4.7 percent of GDP) and insurance companies (with assets about US\$7.7 billion, 2.8 percent of GDP) offer a pool of assets that have not yet been tapped for long-term investments. Currently pension funds and insurance firms invest a significant portion of their resources in short-term bank deposits, in essence transforming scarce long-term resources

into short-term assets. Corporate bond financing (including infrastructure financing) is small and a sound policy environment for securitization still needs to be put in place.

**Figure 1.1: Government's Borrowing Program as a Percent of GDP, 1999–2006**



**Figure 1.2: Indonesia's Infrastructure Finance Needs**



Source: Indonesia Averting an Infrastructure Crisis, World Bank, 2004

## REDUCING THE VULNERABILITY OF THE FINANCIAL SECTOR

The necessity for Indonesia to have a diversified financial sector - with well-developed NBFIs and capital markets - was brought home strongly during the 1997/8 crisis. In a famous speech in 1999<sup>4</sup>, former Federal Reserve Chairman Alan Greenspan pointed out: "One wonder(s) how severe East Asia's problems would have been during the past eighteen months had those economies not

<sup>4</sup> Remarks by Chairman Alan Greenspan before the World Bank Group and the International Monetary Fund, Program of Seminars, Washington, D.C., September 27, 1999.

relied so heavily on banks as their means of financial intermediation. Had a functioning capital market existed, the outcome might well have been far more benign. Before the crisis broke, there was little reason to question the three decades of phenomenally solid East Asian economic growth, largely financed through the banking system, so long as the rapidly expanding economies and bank credit kept the ratio of nonperforming loans to total bank assets low. The failure to have backup forms of intermediation was of little consequence. The lack of a spare tire is of no concern if you do not get a flat. East Asia had no spare tires.”

Indonesia still has no “spare tires”. It urgently needs to develop these if it is to reduce the vulnerability of its still bank-dominated financial system to future shocks, which will almost inevitably occur. It needs NBFIs and capital markets that can pick up the slack and act as shock absorbers – strong institutional investors such as pension funds and insurance firms; well developed capital markets – both equity and fixed income; and well-functioning other NBFIs such as leasing and venture capital firms that can support a variety of industries.

## MEETING OTHER GOVERNMENT OBJECTIVES

The Government’s financial sector reform agenda is motivated by three broad considerations – improving access to financial services, reducing the cost of financial services, and improving the stability of the financial system. The case for NBFIs in meeting some of these objectives has been made above. In addition, NBFIs improve the intermediation between savings and investments by providing healthy competition to banks – and thereby can contribute to reducing the cost of finance. Mutual funds and pensions and insurance firms enable a wider set of investors – including individual investors to participate through intermediaries and invest in instruments such as government and corporate bonds. Leasing firms provide an efficient means of broadening the access to financial services for a wider set of individuals and enterprises – especially SMEs. NBFIs broadly provide a set of products that can be used by the society to manage individual and corporate risks better. Given that Indonesia has placed many of these objectives high on its own developmental agenda, focusing on the development of NBFIs can be a strategy that is line with Government priorities.

## CROSS-SECTORAL ISSUES AND RECOMMENDATIONS

While NBFIs comprise a wide range of institutions – as highlighted in the discussion above – there are several common cross-cutting issues that several types of institution face. This section focuses on such issues and summarizes the findings for the NBFIs sector in the areas of regulation, enforcement, creation of OJK, competition, taxes, skills, and investor education (see Annex 1 at the end of the chapter for a matrix summarizing the findings).

### Regulation

Weak regulation and supervision, as well as lack of adequate capacity of the agencies responsible for regulation and supervision of NBFIs is one of the primary reasons why the restructuring of the financial sector has been costly and the broad-based development of NBFIs in Indonesia has been slow. A recurring finding of this report is the lack of effective follow-up on legislation with clear and consistent elucidating regulations. As one example, the social security law (Law no. 40 of 2004) lacks details on benefits, contributions, and other major issues that affect the design of these schemes. All relevant laws need to be complemented by regulations elucidating them. In practice, there are considerable delays in promulgating timely regulations.

A second recurring deficiency consists of gaps in the regulatory landscape. For example, Jamsostek is a state-owned enterprise and thus has the Ministry of Finance as the de jure shareholder and the Ministry of State Owned Enterprises as the de facto shareholder with delegated responsibility for exercising rights of ownership. Jamsostek is subject neither to the Insurance Law for its insurance programs nor to the Pension Law for its old-age benefits program. It is subject to ad hoc government regulations under the general supervision and oversight of the Department of Manpower and Transmigration.

Similarly, although Taspen provides old-age benefits to civil servants, its pension program was specifically exempted from the Pension Law. It does not need to comply with obligations imposed on other pension programs, such as the use of a custodian, the segregation of assets, and the appointment of an administrator distinct from the sponsor—that is, the government itself—or with any particular funding and solvency requirements.

A third example of the present ambiguity regards the prudential framework for employer pension funds and financial institution pension funds. The framework is a series of decrees dealing with key issues such as funding and solvency requirements, investment regulations, tax treatment, and qualifications of fund administrators. However, it is silent regarding governance structure. Therefore, some sponsors copy the familiar structure of a board of commissioners and a board of directors for the pension fund, both with members appointed by the sponsor. Whether such a structure is legally necessary is unclear, and it leads to diffusion of accountability and responsibility, and higher operating costs.

## **Enforcement**

A recurring finding of this study is the poor level of enforcement across the entire spectrum of NBF activities. In virtually every industry studied in this report—mutual funds, pensions, insurance, and leasing—there are enforcement problems. To cite a few examples: in the pension industry, noncompliance with the law mandating private contributions to Jamsostek is pervasive because enforcement is lax. Similarly, the securities enforcement capacity is increasingly tested in dealing with the complex regulatory issues confronting participants in the capital markets. However, Bapepam & LK is faced with a shortage of experienced staff to conduct complex investigations. The recent difficulty in implementing the mark-to-market regulation regarding net asset values of mutual funds is a case in point. A third example is the government's timid response to insolvent insurance firms. There are several large insurance companies that are in substantial need of capital and Bapepam & LK has been reluctant to assess and publicize the true financial state of these companies. Bapepam & LK has withdrawn the licenses of some insolvent firms, but this action was substantially delayed and even after withdrawal, such firms have not been closed. Market sources indicate that some of these firms may be continuing to write new policies to the detriment of ignorant consumers. Consumer protection – which is paramount to maintaining market confidence – is thereby adversely affected and so is the future development of the industry. As financial markets grow, regulators will be asked with increasing frequency to ensure compliance with financial market laws and regulations. Often, the problem is inadequate resources - there are too few trained staff to address compliance problems. Governance issues and coordination across different regulators are also important constraints. The inability to preserve the integrity of financial markets by enforcing the regulations has potentially severe developmental consequences.

## Competitive landscape

Competition within and across segments of NBFIs is inhibited by the existence of an uneven playing field for different industry participants and the dominant role of the public sector in some segments.

The insurance and pensions sectors provide illustrations of these issues. In insurance, the playing field has long been uneven due to differential capital requirements for new entrants and for existing participants – the latter having been grandfathered under old (and much lower) capital requirements. This effectively provides significant protection to the incumbents and makes it expensive for new private participants – domestic or foreign – to consider entry. This has led to difficulties in encouraging consolidation across a fragmented industry with many small, and some unviable, participants. The insurance industry also presents an example where a few dominant players widely considered to have solvency problems, continue to function without these problems being addressed – due to implicit or explicit support of the state. In several other countries, the insurance industry offers a one-stop package of services to private pension funds comprising the creation, registration, implementation, and administration of benefits and management of assets. In Indonesia, insurance companies, with the benefit of actuaries, and claims-processing expertise, have the competence to offer such services but are not permitted to do so. As a final example, the state plays a dominant role in the pension industry – and this role is potentially set to increase depending on the implementation of the social security law. This is clearly against international trends where the role of the state in pensions and social security provision is changing from one of provider to regulator.

All these are examples of situations that need policy focus so that the competitive landscape of the NBFIs sector can be changed and private participation encouraged. It is desirable to consider measures to increase competition. Many segments of NBFIs need to be fundamentally restructured so that more vibrant, competitive, and substantial players emerge. This can be done through addressing regulations that currently cater to vested interests and incumbents, reducing the role of the public sector and increasing the role of the private sector in NBFIs.

## Risks in the Indonesian financial sector

Due to the historic domination of the Indonesian financial system by banks, as well as the experience during the East Asian crisis, financial sector risks have been considered to be largely in the banking system. This report finds that there are also emerging areas of risks in the NBFIs that would need to be carefully watched and managed. One important area of risk build-up is the liabilities of the pension system. The implicit pension debt of the civil service pension system – the present value of the future stream of pension benefits already promised—is about 11 percent of GDP by some estimates (although an independent verification of this estimate needs to be undertaken). As the economy grows, and civil service wages rise, these obligations will grow as well unless the system is reformed and rationalized. There are other pension and social security programs from which liabilities arise, but about which little is currently known – for example, the armed forces pension fund and liabilities due to the implementation of the social security law. The insurance sector is another potential source of risk. Several large insurance firms are widely considered to have solvency issues, although the extent of these solvency issues has not been made public. Although the impact of these companies on the overall financial sector is likely to be limited (given the relatively small share of insurance assets in the economy), they pose a systemic risk to the insurance sector and require special handling. This report recommends that a prompt and detailed analysis of the options for resolving these companies be undertaken on an urgent basis, so as to form the basis for a discussion of resolution options. An early resolution would

facilitate the government's desire to mobilize greater resources from the sector by creating an environment for growth. Equally, the universal experience suggests that the earlier a resolution is undertaken, the lower the cost of resolution is likely to be.

There are also risks due to concentration of ownership. The Indonesian capital markets, both the equities and the bond markets are still relatively young, small, illiquid and ownership is not well diversified. For example, over twelve percent of government bond are owned by foreign investors. While this introduces potential risks should these investors liquidate their funds quickly, there is no quick fix to this problem. The long-term solution is to develop the local institutional and retail investors and diversify and develop the capital markets. Also as in many other developing countries, the Indonesian financial landscape is dominated by a few large players (see Table 1.3).

**Table 1.3: Top 10 Market Share of Indonesian Financial Sectors**

Sector	Top 10 Market Share %
Banking	63
Life Insurance	61
General Insurance	60
Pension	55
Multifinance	48
Securities	40

Source: Bank Indonesia, Infobank, Company Publication

While at present financial conglomerates in Indonesia are still in an early stage, they are by no means insignificant. The most typical form of conglomerates is banks investing in non-bank financial institutions (Table 1.4). It is not easy to assess the level of financial conglomeration in the system due to dearth of publicly available data and absence of benchmarks. Bank Indonesia requires all commercial banks to provide their ultimate beneficiary owners. However, this is not yet a practice in the NBFi sector. Such a practice would increase transparency of ownership links and make it easier to assess the risks.

Commercial banks in Indonesia have been permitted to play active roles in the pension and insurance sectors. In 2003, the largest financial institution pension fund was owned by Bank Negara Indonesia. Also, the employer pension funds of Bank BRI and Mandiri are in the top ten private pension funds in Indonesia. By year-end 2003, an estimated 10 banks, at least, were delivering bancassurance, with a potential market of around Rp 14 trillion, and at least 15 banks were offering mutual funds, investing mostly in government bonds. Banks have a large share of the mutual fund business. Up to June 2003, banking institutions sold around 85 percent (or roughly Rp 58 trillion) of the mutual funds (Siregar and James 2004, pp. 21–22). The situation can lead to potential conflicts of interest. For instance, because banks both extend loans to corporations and advise on investments of their mutual funds, they may seek to reduce their own lending risk by getting the funds they sell to invest in the firms to which they lend money.

These and other sources of risk need to be carefully monitored and addressed on an ongoing basis.

**Table 1.4: Financial Conglomerates in the Indonesian Financial Sector, 2005**

Banks	Insurance	Pension Funds	Multifinance	Securities	Comment	Group Assets (Rp trillion)
Mandiri		Mandiri Pension Funds		Mandiri Securities		247.2
BCA	Indolife Pensiortama (Life), Central Asia Raya (Life), Central Asia (General)				Same owner	153.4
BNI		BNI Pension Funds		BNI Securities	Bank BNI has ownership at BNI Pension Funds and BNI Securities	150.1
BRI		BRI Pension Funds			BRI has ownership at BRI Pension Funds	117.6
Danamon				Adira Dinamika Multifinance	Danamon has ownership at Adira Dinamika Multifinance	66.5
Niaga				GK Goh Indonesia	Niaga and GK Goh has same owner i.e. Commerce Asset Holding Berhard	39.3
Panin	Panin Insurance (General) Panin Life				Bank Panin is owned by Panin Life. Panin Life is owned by Panin Insurance	39.6
Permata	Astra Buana	Astra Pension Funds	Astra Sedaya Finance, Federal International Finance		Has same owner i.e. PT Astra International	45.0
	Tugu Pratama Indonesia	Pertamina Pension Funds			Has same owner i.e. Pertamina	5.1

Source: Bank Indonesia, Infobank, Company Publication, staff estimate

## Taxes

In virtually all of the industries studied in this report, tax distortions impede the development of the industry. It is important that a comprehensive look at tax regulations – and fiscal implications – be undertaken to enable the development of the sector. A concerted effort is needed to review the extent of tax distortions and ensure a level playing field. The entire gamut of tax issues is listed in Annex 1. It is important to note trade-offs are involved in changing the current tax-regime to one that can support Indonesia's development objectives and one that is more in line with international best practice. Rationalizing the tax regime may involve some short-term reduction in revenues. However, given that the entire NBFIs sector is small at present, the current revenue, and hence any potential short-term losses, are likely to be small. However, an improved tax regime could help support the growth of both the NBFIs industry as well as the real sector, which would then be a source of additional tax revenues. More detailed assessment of these issues is necessary.

The most obvious "quick fix" is the leasing industry. In most other countries where the leasing industry has developed, leasing is tax-neutral. For lessees, lease payments are treated as expenses, which can be set off against revenue when calculating taxable profit, while lessors benefit from deducting the depreciation on capital assets. In Indonesia, depreciation of leased assets is not allowed at present, for either the lessor or the lessee. The tax distortion raises the costs of capital, hinders the formation of capital, and retards the growth of client companies and the leasing sector. This tends to adversely affect SMEs most critically.

Following are several other illustrative tax distortions. In the pension industry, annuities are not attractive because single premiums paid out of a private pension fund to purchase a life annuity at retirement are taxable, ending the tax shelter. The treatment contradicts practices prevailing in many other parts of the world, which is exempt-exempt-taxable (EET). In the insurance industry, non-life companies are penalized more than life companies by the non-deductibility of incurred but not reported (IBNR) reserves, which are 40 percent of non-life liabilities. Finally, the fiscal treatment of insurance and pensions offers no great incentives; on the contrary, mutual funds offer much better tax advantages, being practically exempt from taxes, which partially explain the slow growth of both insurance and pension assets.

### **Access to finance**

There is a need to evaluate and analyze the access that households have to different types of financial instruments and markets. To this end, it would be useful to conduct household surveys of demand for and access to financial services. At present most of the information is generated from the supply side, with little systematic knowledge about what households look for and what constraints they face in accessing financial services. A substantial amount of survey work has been undertaken to assess enterprise-level access to finance. The results of these surveys and their policy implications need to be made more widely available.

The findings of this report indicate that there is need for further analysis of each NBFIs segment and its client base and undertake efforts to expand the client base both in terms of numbers and also by types of investors and by investors of different purchasing power. For instance, the mutual fund sector catered to over 250,000 unit holders as of December 2005, with three quarters being individuals. The first observation is that this is a small number given Indonesia's large population. Next, the average unit holding of each investor was around Rp 300 million (around US\$30,000), compared to GDP per capita of approximately US\$1,300 indicates that the investors in mutual funds are high net worth individuals. It is important to analyze the breakdown of clients further across different sub-sectors and try to promote broader access across the economic spectrum.

### **Improving education**

Equally, there is a need to develop a base of active investors who invest in securities, pension funds, insurance companies, and collective-investment schemes. The development of institutional and retail investors hinges on educating investors in cities, towns, and rural areas about the benefits and risks of investing in securities, collective-investment vehicles, pensions, and insurance. Stock exchanges and securities regulators should fulfill a developmental role that complements their role in regulation and enforcement by raising the awareness of potential issuers of the role of the securities market in the economy and the viable alternative it can provide for funding business operations and expansion.

Financial literacy is a global challenge. Throughout the world, retirement benefits are shifting away from "defined-benefit" programs, in which pensions depend on earnings and years of service, to "defined-contribution" programs in which citizens are being asked to assume a larger role in providing for their own retirement. While this creates and encourages individual choice and responsibility, it puts added responsibilities on the public. Therefore, the changes raise important questions: How informed are people to take on these new responsibilities? How informed are they about basic financial concepts? The answer seems to be not very much. One survey in Australia found that 37 percent of the people who owned investments did not know that the investments could fluctuate in value. In USA, 31 percent did not know that the finance charge on a credit card

statement is what they pay to use credit.<sup>5</sup> Well-aimed information can make a difference, though. In Sweden, which started a new pension system in 1999, a mixture of financial education and a media campaign prompted more people to choose their mix of investment funds for themselves. Indonesia needs better educated investors to form the foundation on which sound financial markets are built. The potential economic benefits of financial literacy in Indonesia are widespread. More informed consumers—not just investors—would improve the efficiency of markets and help to keep unscrupulous operators at bay. The authorities are therefore encouraged to develop a financial literacy program in collaboration with the industry.

### **The Integrated Financial Regulatory and Supervisory Authority - Otoritas Jasa Keuangan (OJK)**

The report addresses several of the issues discussed above in individual sector-specific chapters. Therefore, only key issues have been highlighted in this chapter. On the issue of the OJK, however, this section contains the entire discussion – as the report does not revert to it in later sections.

Global experience on the issue of an integrated financial regulator is mixed. There are arguments both in favor of such an arrangement as well as in favor of a model where there are different, but strong, regulatory authorities. In Indonesia, this debate is now moot, as a decision on establishing a new integrated regulatory agency - the OJK - to regulate and supervise banks, insurance companies, pension funds, capital markets, venture capital, and leasing has already been made. The Bank Indonesia Law no. 23/1999 has been amended in 2003 with the objective of transferring the supervisory role of the banking sector from Bank Indonesia to OJK by the end of 2010. In 2005, a presidential decree merging Bapepam and DGFI – has also been passed. Therefore, there are now two financial sector regulators in Indonesia – BI and Bapepam & LK.

Given that a decision to establish the OJK has been made, the critical question now is one of effective implementation. This report recommends that for NBFIs, instead of waiting till 2010 for the establishment of the OJK, the current Bapepam-LK should be made independent immediately – and its capacity strengthened. Part of the process of making it independent from the Ministry of Finance is to give it the authority to raise its resources through levies on market participants. Budgetary independence should go hand-in-hand with greater operational independence. The case for an integrated regulatory agency in Indonesia, as in other countries, was based on the increasing presence of financial conglomerates. The case for immediately upgrading and strengthening Bapepam & LK can be made on the numerous gaps in the current regulatory and enforcement process – as identified throughout this report. An independent and strong Bapepam & LK would be more in line with BI – the banking regulator – and together they could more effectively form the basis for the new OJK. A stronger Bapepam & LK is also needed to develop a coherent policy and regulatory approach conducive to the development of NBFIs.

The current draft OJK law is broadly sound. It provides OJK with consistent powers across all prudentially regulated sectors, encompassing licensing, standard making, information gathering, inspection, direction, investigation, statutory management, and transfer of business. In particular, it provides OJK with extensive powers with respect to conglomerates. The consistency and coherence of these powers is in line with international practice.

There are significant risks as well as challenges involved in the process of establishment of such an agency, and these need to be kept in mind. First, the risk of political interference is very real in Indonesia, especially with an agency as powerful as OJK is intended to be. A further risk is that the financial sector expertise so necessary to designing and implementing a sophisticated, unified

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<sup>5</sup> “Financial Literacy: Caveat Investor,” *Economist*, January 12, 2006.

strategy will be lacking - and this will make it difficult to develop coherent policies and regulations. Therefore, regardless of the ultimate location of the agency, three conditions must be met: independence, adequate resources, and qualified staff. It should be kept in mind that simply changing the structure of the supervisory system will not correct the present problems with prudential and market conduct standards, surveillance, and enforcement. A single supervisory agency does not constitute a "quick fix" tool for addressing weak supervision of financial intermediaries.

The lessons of experience from other countries—Australia, Korea, the United Kingdom, and others—has shown that making the decision to move to an integrated agency is the easiest part of the process. Implementation is the most demanding. It is fraught with problems regarding merging different regulatory cultures, assembling qualified expertise, and ensuring that the process is completed without neglecting the ongoing oversight of the financial industry.

The expectations for OJK are very high. The deadline for this mammoth task is 2010. The establishment of a single supervisory agency needs considerable advance planning to ensure creation of a viable agency. Indonesia is moving to an integrated model of supervision with a significant advantage: ample time for preparation as well as the lessons of experience from other countries that have adopted a model of integrated supervision. Provided that sufficient effort is dedicated to planning during the transition period, OJK will be able to take over the responsibilities of the present regulators and supervisors and to minimize disruption to the industry when it commences operations. It is essential that the planning process start now to ensure that OJK is capable of exerting its responsibility at the time of transfer of authority.

The tasks before the new agency are great. The plan to adopt a unified supervisory agency must come with a commitment to proceed with a much wider scope of regulatory reforms and to develop enforcement capacity in the country. It will have to harmonize industry-based regulations to prevent regulatory arbitrage, consider the regulation of financial conglomerates and holding companies, devise strong standards of accountability and performance, design an organizational structure, and build a relationship with Bank Indonesia and the Ministry of Finance. In addition, the agency will have to consider the work being conducted in the international regulatory community to formulate international standards and update national prudential requirements in line with evolving international standards. International agencies working in these areas include industry-based organizations such as the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), and the International Organization of Securities Commissions (IOSCO). Finally, OJK will have to demonstrate high standards of accountability, probity, and performance in its conduct. Indonesia has decided to establish a coordinating group, including representatives from Bank Indonesia, Bapepam & LK, with responsibility for starting the planning process. This is a step in the right direction, as the time for planning is passing quickly.

The expected creation of OJK should not be an excuse for delaying reforms that could be implemented sooner. There is a need to accelerate the shift to an independent NBF1 regulator today. The merger of Bapepam & LK offers an opportunity to create a strong and independent NBF1 regulator. The Ministry of Finance could advance the process without waiting for the establishment of the OJK in 2010. It could unilaterally transform the merged Bapepam & LK into an independent regulator that looks after the capital markets and all NBF1s and protects investors and consumers.

## **Skills**

A deregulated and competitive environment creates new demands for financial expertise. Countries that liberalize and develop the financial system require a well-developed set of skills for

measuring and assessing risk. Insurance and pension schemes require actuarial expertise, while collective-investment instruments require a high level of professional expertise such as investment managers and analysts.

Despite the difficulty in measuring the differential in skills across countries and adjusting for productivity, there is evidence on the small role of financial sector services in many emerging-market countries. Employment in finance, insurance, real estate, and business services as a percentage of total employment is lower in countries such as Brazil (2.76 percent), Indonesia (0.75 percent), the Philippines (2.46 percent) and Poland (2.62 percent) than in the United States (11.28 percent). The following discussion of select professions indicates the challenges across the entire spectrum of financial professions.

**Actuaries.** There were 324 members of the Indonesian Actuarial Association (Persatuan Aktuaris Indonesia, PAI) in 2006 – with 134 fellow actuaries (recognized by the international actuarial association) and 190 associate actuaries. Actuaries are essential to the smooth working of the insurance and retirement benefits sectors. They make it possible to assess and address risks. Nevertheless, actuaries are scarce in Indonesia. The quantitative data in Table 1.6 document the wide disparity in the availability of actuarial skills in Indonesia relative to other countries in the sample. While Singapore and Hong Kong (China) have 43 and 45 actuaries per million population, Indonesia has roughly 0.6 excluding associate actuaries. It is desirable for the Indonesian Actuarial Association, with government guidance, to take a more active role in developing the actuarial profession, including permitting foreign participation in the industry. Among its immediate challenges are to develop and implement rules for the accreditation of individual members and to recommend educational guidelines and a syllabus for an internationally recognized actuarial qualification.

**Appraisers.** There were 1,800 members of the Indonesian Society of Appraisers as of December 2005.<sup>6</sup> Appraisers reduce the risk involved in property transactions by assigning credible values to property based on standard methods: all participants recognize the methodology, and the valuation is consistent. For example, if a viable, securitized mortgage market is to develop, appraisers are needed to value property. A brief look at the quantitative data in Table 1.6 indicates wide differences in the availability of appraisal services in select markets. The density ranges from 907 appraisers per million population in the New Zealand to nine appraisers per million population in Indonesia. Further, the limitations are not only quantitative: the standards of certification are lacking. The information from Indonesia suggests that there is probably no consistent treatment of the appraisal and valuation profession with respect to training and regulation.

**Accountants.** Indonesia has 43,500 registered accountants, but only 4,500 are members of Ikatan Akuntan Indonesia (IAI), the Indonesian Accountant Association, which has 6,000 members. The Ministry of Finance is responsible for the registration of accountants.

**Insolvency experts.** INSOL International, the international federation for insolvency professionals, has only 28 members in Indonesia.<sup>7</sup> An inadequate number of professionals hampers the corporate restructuring process in Indonesia.

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<sup>6</sup> Masyarakat Profesi Penilai Indonesia/MAPPI [www.mappi.or.id](http://www.mappi.or.id). MAPPI was established in 1981 and is the recognized organization of professional appraisers in Indonesia. The members of MAPPI work in appraisal firms, banks, and financial institutions, the Directorate of Land and Building Tax, insurance companies, auction houses, and property businesses.

<sup>7</sup> INSOL International is a worldwide federation of national associations of accountants and lawyers who specialize in turnaround and insolvency. There are currently 35 member associations worldwide with more than 7,700 professionals participating as members of INSOL International. See <http://www.insol.org/>.

**Chartered financial analysts.** There are 37 chartered financial analysts (CFAs) in Indonesia.<sup>8</sup> CFAs in the investment industry can set high standards of professional excellence and ensure market transparency. The present number of CFAs is entirely inadequate.

**Table 1.5: Number of Actuaries in Various Countries, 2006**

Country	Number of actuaries	Number of actuaries per million
Argentina	195	5.23
Australia	1,243	73.92
Brazil	665	4.45
Canada	2,443	95.97
Chile	9	0.79
China	58	0.05
Colombia	25	0.84
Croatia	49	10.91
Czech Republic	58	5.60
Denmark	291	56.76
Egypt, Arab Rep. of	8	0.14
Estonia	18	12.99
Finland	132	26.33
France	1,880	32.60
Ghana	1	0.05
Greece	76	7.41
Hong Kong (China)	298	45.54
Hungary	137	13.21
Iceland	18	74.69
India	150	0.17
Indonesia	134	0.6
Israel	105	29.06
Italy	258	4.55
Jamaica	16	6.37
Japan	1,077	8.69
Kenya	5	0.25
Korea, Rep. of	27	0.59
Latvia	17	6.76
Lebanon	10	3.67
Malaysia	42	1.96
Mauritius	10	8.82
Mexico	405	4.52
New Zealand	130	39.33
Nigeria	5	0.05
Norway	257	60.59
Philippines	77	1.06
Poland	11	0.29
Russian Federation	3	0.02
Singapore	114	43.07
Slovenia	36	18.03
South Africa	693	20.09
Spain	1,497	41.16
Sri Lanka	2	0.12
Sweden	306	35.51
Taiwan (China)	199	10.70
Thailand	17	0.35
United States	16,696	68.29
Venezuela, R. B. de	2	0.09
Vietnam	8	0.10
Zimbabwe	4	0.34

Source: International Actuarial Association of Actuaries

<sup>8</sup> CFA Institute, formerly the Association for Investment Management and Research (AIMR), offers the CFA designation and global membership.

**Table 1.6: Number of Appraisers in Select Countries, 2006**

Country	Number of appraisers	Number of appraisers per million population
Albania	170	52.1
Australia	4,963	295.2
Bulgaria	128	15.3
Canada	4,500	176.8
Czech Republic	300	29.0
Denmark	644	125.6
Estonia	80	57.7
France	850	14.7
Greece	350	34.1
Hungary	110	10.6
India	12,000	13.3
Indonesia	1,800	9.1
Italy	1,200	21.2
Latvia	72	28.6
New Zealand	3,000	907.7
Norway	920	216.9
Philippines	100	1.4
Poland	3,000	78.2
Romania	5,900	254.2
Russian Federation	3,000	20.4
South Africa	2,000	58.0
Spain	6,000	165.0
Sweden	800	92.8

Source: International Valuation Standards Committee

There is a strong correlation among the base of skills, the growth of non-bank financial intermediation, and the stability of the financial system. It is reasonable to conclude that poor practices and performance of NBFIs are linked to limited skills and human capital in the financial services sector. While effort is needed to strengthen the regulatory framework and enforcement capacity in the NBFIs sector, there is an equal need to strengthen the capacity of the private financial sector. What can be done? Effort is required along three dimensions: First, regulations are needed to facilitate the growth of the financial services professions. It is important to establish and promote minimum uniform standards of education and minimum qualifications. Professionally recognized training and certification programs should be mandated as well to ensure the professional expertise, integrity, and responsibility of the various professions. Second, as the development of domestic skills is a time consuming process, consideration should be given to opening the professions to foreign competition at least temporarily, as domestic skills developed. Third, innovative approaches for improving skills using private sector initiatives should be pursued. The recent launch of the Institute of Risk Management and Insurance (STIMRA) which provides focused education and training in insurance is an example of step in the right direction.

## KEY SECTORAL ISSUES AND RECOMMENDATIONS

### Equity market

Private sector-led economic growth requires well-functioning equity and corporate bond markets as a source of risk capital to encourage entrepreneurship and to provide the corporate sector with an alternative to bank finance. Sound capital markets also reduce the vulnerability of the economy to stresses in the banking sector. Currently, Indonesian capital market is not a major source of risk capital.

Indonesia's equity market has risen steadily since 2002, and Jakarta Composite Index was among the top performers in the region in 2004 and 2005. As of December 2004 and 2005, total market capitalization was Rp 680 trillion (30% of GDP) and Rp. 801 trillion (29.4% of GDP), respectively (about the same as that of a single medium-size firm in the U.S. equity markets). About 336 companies are listed on the exchange. The market is largely an institutional market with few individual investors having accounts.

Stock markets have three roles: first as a source of risk capital, permitting firms to mobilize equity; second, as a store of value for assets; and third, as a means to price risk capital adequately. The Indonesian stock market is small, highly concentrated, and relatively illiquid and does not yet efficiently undertake these functions. As initial public offerings are not a significant source of corporate funding, the equity markets are not a major source of risk capital. With the exception of 2004, when US\$1.1 billion was raised, mostly through the privatization of state-owned banks, little new equity has been raised since the crisis.

There are an estimated 100,000 retail accounts in Indonesia – in a country of 220 million people. They hold barely 5 percent of equities in their accounts. Although a larger number could be participating through omnibus accounts with securities brokers, the overall view is that the equity market is not a retail market – and is not seen as a store of value for assets.

Finally, in order to be able to price risk appropriately, a key requirement is liquidity. The Indonesian market is dominated by a handful of companies—10 of the 336 listed companies account for more than half of market capitalization and nearly 55 percent of trading volume. The stock exchange is characterized by a substantial lack of liquidity and low turnover in which only a few companies are responsible for a large percentage of the total trading. Many stocks are dormant; out of 336 stocks, only about 30, mostly blue chips, are actively traded. One of the reasons that liquidity is so limited in many emerging markets is the low level of free float (the percentage of shares available for sale to the public). Even those companies that decide to go public do not sell a significant portion of their shares to the public. At present the free float in Indonesian equity markets for the top 20 companies by market capitalization is about 39.4 percent.

Based on independent assessments (Report on the Observance of Standards and Codes), the enforcement of transparency, information disclosure, and corporate governance are still weak in Indonesia's equity market, administrative sanctions for violation are particularly inadequate, although there are some efforts at improving the quality and timeliness of information and increase the level of liquidity in the securities markets. Robust disclosure (disclosure rules, monitoring and enforcement, and information dissemination) is positively associated with market liquidity. However, in order to enforce such discipline, the Indonesian securities regulator faces important constraints in resources and staff. Limited and unclear powers of the securities regulator also lead to significant shortcomings in its ability to oversee the markets, supervise market participants, and enforce issuer compliance.

In a large country such as Indonesia – and with economic growth rates in the 5 plus percent range being sustained over several years now and likely to build further momentum in future, there is clearly potential for strong equity markets to support corporate growth. However, decisive policies are needed, both by the government and by the stock exchange, to enable the market to reach its full potential. The following recommendations deserve top priority:

Chapter 2 provides a fuller discussion of the issues in addition to laying out the context and rationale for reforms. Key issues and recommendations that deserve top priority include:

- **Improve corporate governance.** Ultimately, investors invest in good companies in which they have confidence. Good governance goes hand in hand with good finances to attract investors.

To encourage good corporate governance, Jakarta Stock Exchange and Bapepam & LK may want to create a separate board or have a “quality certificate” with more stringent listing requirements for entities that have implemented exemplary governance practices<sup>9</sup>. Securities of the companies listed on such a board could be bought by mutual and pension funds or banks or could be bought on margin. The following actions are recommended to improve corporate governance: (a) establish nomination committees to strengthen the process for nominating and selecting independent commissioners, (b) conduct training and promote awareness among stakeholders as part of changing the business culture, (c) enhance the roles, responsibilities, and skills of independent board members and audit committees, (d) promote the separation of management from the owners and appoint professional managers, and (e) allow minority shareholders a greater voice in the selection of commissioners (that is, though cumulative voting).

- **Improve and expand the role of Bapepam & LK in supervision.** Bapepam & LK may want to take over the direct supervision of broker-dealers. After all, it currently supervises all capital market participants, not just broker-dealers. As the market matures, broker-dealers may venture into activities beyond securities and futures trading that are more appropriately supervised by Bapepam & LK. However, the present method of funding Bapepam & LK—out of the government budget—may have to be changed. In many countries, the Bapepam & LK-equivalent organization is funded primarily out of a levy on the transactions effected on the exchange. This method would lend more credibility to the view that Bapepam & LK is an independent organization.
- **Improve market infrastructure.** Global markets are moving toward greater automation and the use of higher or advanced technology systems in order to expand market operations and control. Exchanges are also merging worldwide to take advantages of economies of scale and to leverage resources. More efficient market operations also lower operational costs, improve regulation, and improve liquidity within the market. To accomplish these, it is suggested that Indonesia (a) demutualize and merge the Surabaya and Jakarta stock exchanges (b) complete the move to remote trading at an early date and (c) improve trading systems and implement improved straight-through-processing between market participants and infrastructure market organizations. However, after the merger it would be helpful to have the possibility of alternative trading system or Electronic Communication Networks (ECNs) to function to keep the contestability of the market.
- **Improve corporate health.** Investors benchmark companies globally and invest in the best companies in their respective industries. Ultimately, a market is only as good as the corporates listed in the market. Comparisons across the region consistently indicate that corporate leverage and profitability have improved in Indonesia since the crisis, but not nearly enough to be competitive globally. Indonesia therefore should treat corporate restructuring as an ongoing process. Consistent enforcement of existing securities laws as well as corporate financial monitoring programs can help corporations reach standards commensurate with international norms. While good macroeconomic management and improvements in the overall investment climate are essential to achieve sustained growth, they may not be enough. Increased productivity at the corporate level is also necessary. Detailed sector and industry level work to determine specific constraints and further improvements in the competition framework, business practices, labor productivity, and trade regimes that may be holding back productivity should be undertaken and recommendations implemented.

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<sup>9</sup> The New Market of Bovespa in Brazil lists companies that have voluntarily committed to adopt higher standards of corporate governance than those prescribed by laws and legislation.

## Bond market

The bulk of long-term financing for government bonds, infrastructure projects, and for investments in corporate growth will have to come from debt finance. Banks are a key source of debt finance, but given the liability structure - where 90 percent of bank deposits are less than one month in maturity - banks provide mostly short-term finance. Bank loans alone are therefore neither sufficient nor desirable to meet all the financing needs of the Indonesian economy. More diversified funding sources are required. Indonesia's debt market currently consists of government debt, corporate debt, and bank debentures. Institutional investors such as mutual funds, pension funds, and insurance companies are a critical source of demand for bonds.

On the supply side of instruments, Indonesia has achieved significant progress in building the core government bond market. As the market for government bonds has been growing rapidly, the rest of the market remains underdeveloped. At end-2005, tradable government bonds outstanding amounted to Rp 389 trillion (14 per cent of GDP)<sup>10</sup>. Corporate bonds outstanding amounted to only Rp 63 trillion, representing 2 percent of GDP. Consumer debt has been growing rapidly but corporate debt growth has been relatively slow, largely as a result of the reluctance of banks to finance corporations given the credit risks, the weak legal framework and judiciary for enforcing collateral and stagnant demand within corporations themselves. Nevertheless, the sustained growth of the economy is accelerating the corporate demand for long-term financing, and this trend is likely to continue. As a result, the volume of corporate bonds outstanding has tripled in the past few years, albeit from a small base. Despite the significant potential of mortgage-backed and other asset-backed securities, the domestic market for these instruments is nearly non-existent at present. The recent decentralization agenda has devolved significant investment decisions to local governments. While many local governments are still absorbing their increased funding and responsibilities and not yet focusing on long-term investment and financing, local government finance as well as infrastructure financing is likely to become increasingly important going forward.

On the demand side, banks are the largest investors in government bonds - holding 71 percent of all government bonds, including recap bonds. Insurance and pension funds hold about 14 percent of government bonds. With the crash of the mutual fund industry in 2005 (see below), overseas investors have stepped in to take significant positions in the market - and owned about 12 percent of all outstanding government bonds as of April 2006. In terms of the corporate bonds, mutual funds were the largest holders with 49% at the end of 2004. However, in 2005, mutual funds holdings of corporate bonds decreased significantly due to the redemption run.

Chapter 3 provides a fuller discussion of the issues in addition to laying out the context and rationale for reforms. Key issues and recommendations that deserve top priority are:

- **Improve coordination between Bank Indonesia, Bapepam & LK, and the Ministry of Finance.** Policy issues involved in debt market development cut across the lines of authority of the Ministry of Finance, Bank Indonesia, and Bapepam & LK, so improving coordination is imperative. Developing the market also requires implementation of interdependent tasks requiring appropriate prioritization and sequencing. Yet effective coordination often does not automatically emerge - even among regulators - and thus strong leadership is necessary to lead and coordinate relevant efforts effectively. At senior levels, officials indicate that there has been improvement over time, but serious gaps persist in coordination at the operational level. Differences in perceptions regarding OJK as well as differences in skills across institutions make substantive coordination difficult. A high-level inter-institutional committee

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<sup>10</sup> Including non-tradable bonds at the central bank, government debt amounted to Rp 648 trillion, or 24 percent of GDP.

needs to be formed and empowered to discuss and resolve issues that cut across jurisdictions in bond market development. The tripartite meeting among the Ministry of Finance, Bank Indonesia, and Bapepam & LK should continue.

- **Enhance the certainty of issuance.** The Government has already in place policies to announce the issuance calendar in advance. The key next step is to be a price taker in the auctions i.e. auctions should not be canceled ex post (after receiving price quotes) based on political views regarding the price. Developing long-term credibility and predictability in this area is a cornerstone of developing the debt market.
- **Improve market infrastructure for government bonds.** Primary issuance conducted through the BI-SSSS (Bank Indonesia's real-time gross payments system) system should be used for bond buybacks as well and be made more inclusive to attract a wider base of investors. Money market liquidity should be encouraged via repo transactions. The decision to have KSEI (Kustodian Sentral Efek Indonesia; Central Securities Depository) participate in BI-SSSS as a sub-registry should be implemented.
- **Clarify the regulatory requirements for credit-rating agencies.** The basis for authorizing credit-rating agencies is not clear, as Bapepam & LK rules do not stipulate specific requirements for the establishment and operation of a rating agency. Bapepam & LK rules should entail clear procedures for ratings and require qualification of credit analysts and a sound ownership structure that does not compromise its independence (for example, diversified and collective ownership by a group of banks or brokers, individuals without interest in major issuers, established foreign rating agencies, and potentially international investors and partners). The agencies should also have diversified sources of income beyond bond credit rating so that they are not tempted to issue ratings that please the issuers who pay their fees. Bapepam & LK is currently drafting new rules.
- **Improve the collection of secondary-market pricing information.** In 2005, the Surabaya Stock Exchange was charging providers of such information, which creates a disincentive to report prices. Instead, it should charge users for the information. Next, Bapepam & LK should mandate reporting of over-the-counter transactions to enhance post-trade price transparency.

## Mutual funds

Until early 2005, the Indonesian mutual fund industry grew rapidly – growing from assets under management (AUM) of Rp. 8 trillion in 2001 to nearly Rp. 104 trillion in December 2004. The industry's growth was driven by the shift of individuals out of rupiah time-deposit accounts in commercial banks and into mutual funds that invested mainly in rupiah-denominated government securities, principally recapitalization bonds. The majority of investors are individuals, with institutional investors accounting for less than a quarter of AUM.

However, massive redemptions rocked the industry subsequently, and assets under management fell to Rp 29.4 trillion (US\$3 trillion, 1.1 percent of GDP) by December 2005. The main causes for the debacle were a sudden rise in interest rates that caused the value of "fixed income" mutual funds – which were the vast majority of funds – to fall, leading investors into a panic. Investors had been mis-sold these products as deposit substitutes – with a higher return – and had not been adequately informed of the risks of such investment. In addition, enforcement by Bapepam & LK of mark-to-market regulations was weak. All in all, the role and importance of the mutual fund industry in Indonesia has declined dramatically in the recent past.

Despite this however, the mutual funds industry remains an important element of Indonesia's financial sector, providing individuals and institutions with a vehicle for managing risk and saving. Mutual funds can also be significant investors in government and corporate bonds. It is therefore critical to understand the causes for the debacle – and to implement appropriate reforms that can ensure that such episodes are not repeated. With a sound, well enforced regulatory framework,

the potential for growth is large. Even at its peak, penetration of the mutual fund industry in Indonesia was low: a scant 0.14 percent of the total population in Indonesia owned a mutual fund compared with 48 percent in the United States.

Currently, Indonesia's mutual fund industry is small compared with regional and global markets, and the fundamentals are weak. The current structure of the industry is skewed toward fixed-income mutual funds, and the range of available products is limited. In part, this is due to the limited universe of investible assets available in Indonesia. In part, this could also be because of poor governance in some mutual funds – which resulted in the 2005 debacle. Creating an environment that would encourage mutual funds to invest in other types of products would help to diversify risk and attract a wider base of investors. The government has established an extensive regulatory structure for custodian banks and outlined their responsibilities, but the absence of an explicit fiduciary obligation to protect investors is a source of concern. Despite extensive rules, disclosure is inadequate in the areas of investment policy and the calculation of net asset value and sales procedures are poor. Some of the largest mutual funds did not follow norms of valuation laid out by Bapepam & LK and enforcement was weak.

Going forward, regulation and supervision of the industry need to be tightened and brought into line with international practices. Coordination between mutual fund products and unit-linked insurance products is needed, and deficiencies in disclosure and valuation need to be addressed. An important agenda for the near term should be an education campaign to develop the base of individual investors.

Chapter 4 provides a fuller discussion of the issues in addition to laying out the context and rationale for reforms. The following issues and recommendations deserve top priority:

- **Restructure the mutual funds industry.** This is the top priority for Bapepam & LK. Investor confidence is the most important element that underlies a sound mutual fund industry composed of credible fund family companies. Only when the industry is run by credible operators can the industry benefit from fast and sustainable growth. The role of the regulator is to provide a climate that encourages sound operators to participate in the industry. In this context, a re-licensing process including a review of fit-and-proper qualifications as well as financial soundness is needed to enhance the development of mutual funds. A re-licensing process is needed for all funds, without grandfathering provisions.
- **Strengthen enforcement and market discipline.** The crisis in the mutual funds industry in 2005 was due to poor selling, poor enforcement, and weak valuation guidelines. Therefore, stronger enforcement is a top priority. In this regard, the authority has to be firm in enforcing rules and imposing sanctions to uphold market discipline and build investor confidence. Recent anecdotal evidence suggests that compliance among investment managers is low, indicating that Bapepam & LK should be more willing to use its enforcement power.
- **Address the challenges of net asset valuation.** The 2005 redemption run strongly suggests that the mutual fund industry is confronting fundamental issues in marked-to-market asset valuation. In the current system, fund managers report bond prices to custodians and often overstate the bond prices to get higher net asset values. The reporting of bond prices must include bonds dealers and banks that are active players in the market to better represent actual prices in the market. Furthermore, a framework is needed to determine the securities for which “readily available market quotations” are available; for those that are not, there is a need to establish a basis for determining fair value. There are several acceptable methods for determining fair value of illiquid securities, and several methods would potentially be appropriate as long as it is enforced consistently and uniformly.

## Pension funds

The pension industry is part of the national strategy for providing financial security in retirement for the population as a whole. A typical framework for such a strategy often consists of three basic pillars: (1) a publicly financed and managed pay-as-you-go system to provide basic income protection, (2) a mandatory funded individual account system linking contributions with benefits, and (3) voluntary individual or occupational pension savings. In addition, many systems typically encompass noncontributory social assistance for the life-long poor, and family and intergenerational support for the elderly. In the context of this framework, Indonesia does not have the first pillar, except to the extent that poverty alleviation programs constitute such a system. Jamsostek, a mandatory, defined-contribution scheme for private sector employees and state-owned enterprises, could be considered a second pillar, except that it provides lump-sum payments at retirement rather than income replacement; it is a state-owned enterprise. Although participation is mandatory, coverage is poor: less than a quarter of the formal private sector labor force participates. Nevertheless, the assets are invested in ways similar to privately managed funds. Indonesia's employer-sponsored programs and individual arrangements clearly fall in the third pillar.

The oversight of the pension industry – and therefore the responsibility for reforms – is scattered. The MoF is directly responsible for TASPEN – the civil service pension scheme and the private pension schemes (the financial institution and employer sponsored pension funds). Jamsostek is under the overall oversight of the Department of Manpower and Transmigration, although the MoF also plays a role in supervision. Asabri – the armed forces pension fund – is under the Ministry of Defense. Different laws govern each of these types of scheme. Therefore, while this section – and Chapter 5 – addresses issues related to all pension schemes, the authorities to which some of these messages are addressed are different – and extend beyond the MoF. However, to the extent that the MoF is ultimately responsible for financing any shortfalls from pension funds, -even those not directly under its oversight- the key messages are clearly relevant to it as well.

In Indonesia, the pension sector is small, controlling in total less than 4.7 percent of GDP in assets, compared with Thailand (8.4 percent), Malaysia (57 percent), and Australia (75 percent). There is great potential to mobilize domestic resources, especially if certain key reforms restructuring the industry were to be implemented and the government and the industry itself were to promote pension funds.

The two defined-benefit plans—Taspen (for civil servants) and Asabri (for the armed forces)—are poorly funded relative to the promised benefits and already require budgetary support<sup>11</sup>. A large portion (22 and 43 percent, respectively) of their assets is invested in time deposits. Both these pension funds and Jamsostek suffer from a lack of transparency and disclosure, weak management information systems, high expense ratios, and poor internal governance. An accurate picture of the financial state of these funds is not available. The fastest-growing segment of the pension fund industry is the financial institution pension funds (DPLK): the number of employers using such funds more than tripled over the past five years to nearly 2,417, covering nearly 800,000 employees with Rp. 3.9 trillion in assets. 1,758 employer pension funds – covering 1.8 million employees – constitute the last segment of the pension industry with Rp 53.4 trillion in assets.

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<sup>11</sup> Taspen was in a cash-flow deficit (excess of payouts over contributions) of Rp 1.1 trillion in 2002, while Asabri was in a cash-flow deficit of Rp 200 billion in the same year. These deficits are funded out of the government's general budgetary resources and are expected to grow dramatically in the coming years.

A major uncertainty to the pension system in Indonesia is the new social security law (Law 40/2004). The law mandates a national defined benefit social security system – with management of assets seemingly confined to the incumbent public sector providers. For formal sector workers, Law no. 40/2004 makes participation compulsory and obliges employers and participants to contribute a certain percentage of wages. For non-wage earners, nominal amounts are stipulated. There are no stipulations about minimum or maximum amounts of benefits or contributions or other parameters; such details are to be stipulated by regulations – which have yet to be issued. The situation created by Law no. 40 and the timing of its implementation are still very fluid, making it difficult to assess the impact on the pension industry. The new law permits two possibilities. If implemented well with the objective of providing basic income protection to all Indonesians – this could very well be an overall positive and provide genuine social security. However, if implemented with much more generous benefits, the law has the potential to seriously adversely impact government finances. The role of the public and private sector also need to be clearly defined. If the National Social Security System aims to achieve a high income-replacement ratio, it will crowd out the private sector and drain the available savings. If the coverage is more basic, the private sector could play a complementary role, especially for the higher-paid fraction of the labor force.

Some positive steps to improve the private pension industry are in progress. A shift to risk-based supervision is under way, which eventually should alleviate unnecessary burdens and reward good governance. The creation of OJK, an integrated supervisory authority for the financial sector, is expected to improve the efficiency and capacity of supervision. In addition to implementing these changes as soon as possible, critical review and clarification of the legislation are advisable, and an adequate mechanism for the exchange of information is needed. A major challenge will be deciding how to treat the large informal sector.

A comprehensive approach to reforming and strengthening all types of pension funds is a priority. A coherent strategy—or architecture—of what sort of social security system (and in that context what kind of pension funds) Indonesia wishes to provide for its citizens, in the context of the social security law is urgently needed. As evidenced by several countries in Latin America and other parts of the world, the ultimate result of a poorly managed and designed system is usually a government bailout, with attendant fiscal costs.

Chapter 5 provides a fuller discussion of the issues in addition to laying out the context and rationale for reforms. The following issues and recommendations deserve top priority:

- **Formulate a coherent master plan.** A master plan is needed to provide a framework for the provision of retirement income in a fiscally sustainable way, define the roles of public and private sectors, minimize fiscal costs, limit political capture of funds, and achieves long-term asset accumulation and sound investment policies.
- **Undertake an audit and reform of Taspen before addressing funding issues.** In the current circumstances and state of weak governance of Taspen, it is not advisable for the government to think about funding its civil service pension obligations, although funding the program should be the long-term goal, after institutional issues have been addressed. Instead, the Ministry of Finance should (a) undertake an actuarial assessment of TASPEN's liabilities (b) adopt reporting and accounting on the basis of full funding (c) continue the financing on a pay-as-you-go basis but recognize unfunded pension liabilities as part of government debt and (d) undertake a comprehensive institutional restructuring and streamlining of TASPEN.
- **Encourage outsourcing of activities at Jamsostek to improve efficiency.** Jamsostek's poor performance and governance adversely affects the image of the whole pension industry. As long as participants view their pension contributions as a tax – and not as an investment – the pension industry will find it difficult to grow. One way to improve Jamsostek's performance is

to introduce competition through outsourcing to improve its efficiency and hold it accountable to a comparable benchmark. As a first step, the management of a small part of Jamsostek's assets – say 5 percent – could be outsourced to one or more private companies on a competitive basis.

- **Improve the asset allocation of private pension funds.** Private pension funds would also benefit from better asset allocation and investment policies and lower costs. On top of this, they would benefit significantly from reform of the public pension system, which would improve the credibility and attractiveness of the entire sector.

## Insurance

This study focuses largely on the life insurance industry as it is a potential source of long-term resources. The non-life insurance sector is not dealt with in detail.

The Indonesian insurance industry is small – with total assets of Rp. 75 trillion (US\$ 7.7 billion) – 2.8 percent of GDP. Insurance penetration in Indonesia—premiums as a percent of GDP—is low, with premiums equal to 1.4 percent of GDP (life, 0.8 percent; non-life 0.6 percent). Insurance density – premium per capita – is US\$ 14.5 per capita (life - US\$ 6.4 per capita, and non-life, US\$ 8.1 per capita). The industry is highly fragmented – with a large number of relatively small players in both life and non-life insurance sectors. There are large insurance companies in the industry that are widely considered to be insolvent and posing a potential systemic risk.

While life insurance is traditionally an industry that produces long-term savings, in Indonesia this potential is not yet being fulfilled. Poor sales practices, and inappropriate products result in a high lapse rate i.e. many policies are not renewed. More than half of new sales replace business lost during the year, and of the business lost, close to 95 percent of terminations are due to lapses in payment and surrenders. Indonesian consumers also indicate a lack of confidence in long-term commitments such as life insurance contracts.

Many small insurers are undercapitalized and unlikely to withstand stiffer market competition in the future. In addition, several firms have been identified as being unable to meet stricter capital requirements that have been imposed gradually since 2000, and their operating licenses have been withdrawn; however, these firms have not physically been closed yet. Resolving insolvent firms is linked to the development of a framework to protect policyholders – and this has not yet been developed. Analysis of insolvent insurance companies and design of an action plan on that basis is also required. International experience indicates that costs of resolution increase consistently as a resolution decision is delayed.

The regulatory and supervisory regimes as well as institutional capacity of the regulator are in need of modernization and upgrading. A coherent strategy is needed for prioritizing the development of regulatory and supervisory policies and practices. Tasks on the agenda include (a) developing a flexible approach to supervision that emphasizes risk management and consumer protection and strives for greater market discipline in achieving desired regulatory outcomes; (b) developing a harmonized approach to risk-based capital management and application across all prudentially supervised industries, including a framework for assessing market-related risks; and (c) reviewing the approach to reinsurance. At present, reinsurance companies are treated essentially the same as property and casualty insurance companies, despite the significant differences in their risk profiles. Consideration also should be given to whether the supervisory approach to life and property and casualty companies is in need of greater differentiation. In particular, a sustained effort is needed to improve the quality and reliability of actuarial reports.

Chapter 6 discusses these in greater depth. The following recommendations deserve top priority:

- **Rationalize the industry.** Several insurance companies in Indonesia are weak, marginal, or bankrupt. Weak companies are a dead weight on the economic system that stifles development through numerous channels. Poorly performing insurance companies are both a symptom and a cause of economic malaise, and their activities lead to structural problems in the economy. First, poorly performing insurance have poor underwriting skills and enter into unproductive investments. Poorly performing companies distort competition by creating an uneven playing field that disfavors good companies, which end up subsidizing them. The longer and more protracted the problem becomes, the harder it is for both the government and the industry to make the tough decision to resolve failing companies. Such companies should not be protected from normal market discipline. The first step in rationalizing the industry is to remove the grandfathering capital clause for existing insolvent companies and devise an active merger or exit strategy for them. Subsequently, a capable insolvency apparatus is needed to resolve the companies that do not meet risk-based capital requirements. The first priority is to assess the extent of problems in and devise an action plan for the large insolvent life insurance companies– if market views and expert opinion is confirmed - potentially pose a systemic risk.
- **Improve enforcement.** The enforcement of the present regulatory regime is clearly deficient. The regulators are aware that several companies are insolvent, and have withdrawn licenses in some cases, but these have not yet been closed. The regulator needs to adopt consistent, even-handed, and transparent enforcement, including expanded risk-based examinations and stronger, simpler, rapid escalation procedures.
- **Promote the industry.** A key second-generation issue is the development of the industry. The Bureau of Insurance and the industry and professional organizations, including the Indonesia Life Insurance Association, the General Insurers Association, and the Indonesian Association of Actuaries, need to jointly launch a sustained educational campaign to educate and promote the benefits of the insurance industry and of its products. The establishment of joint government-industry high-level committee to develop future action plans for the industry is also an important step.
- **Involve Indonesian regulators in IAIS.** The IAIS represents insurance regulators and supervisors of some 180 jurisdictions in more than 130 countries, constituting 97 percent of the world's insurance premiums. The leading insurance companies in the world are observers. The IAIS aims to contribute to improved supervision of the insurance industry on a domestic as well as on an international level in order to maintain efficient, fair, safe, and stable insurance markets for the benefit and protection of policyholders. Active Indonesian participation in the work of the IAIS would demonstrate to the entire world that Indonesian authorities are committed to improving the workings of the insurance industry in Indonesia.

### **Other NBFIs: Leasing and Venture Capital Companies**

Leasing and factoring services can play a big role in providing access to finance for small and medium enterprises. Venture capital is a critical element of fostering innovation and entrepreneurship. Further development of these industries is necessary to support Indonesia's future growth.

The Indonesian NBFIs sector includes "multifinance" companies (which provide leasing, factoring, consumer finance and credit card services) and venture capital companies. These are not deposit-taking institutions. Leasing offers a financing vehicle for, among others, new, small, and medium firms that cannot meet the credit history and collateral requirements for traditional bank loans. It broadens competition for financial services and introduces businesses and financiers to innovations such as cash-flow-based credit analysis. Venture capital companies also support small and medium enterprises as well as entrepreneurship with risk capital financing.

From 1988 until the financial crisis of 1997–8, the industry grew strongly, with the majority of financing in the form of leasing and factoring. The sharp rise in interest rates during the crisis adversely affected the growth and performance of multifinance companies. However, since 2001 the industry has recovered, and consumer finance has become the main driver of growth. As of September 2005, there were 237 multifinance companies, which had extended financing amounting to Rp 66.9 trillion. Consumer finance dominates the business (66 percent), followed by leasing (29 percent), credit cards (3 percent), and factoring (2 percent).

Further development of these industries in Indonesia depends on several factors. The current regulations need to be reviewed and updated. Efforts are needed to stimulate the demand for services, and incentives are needed to encourage finance companies to support small and medium businesses.

Chapters 7 and 8 deal with Multifinance and Venture Capital Industries respectively. The following recommendations deserve top priority:

- **Put in place light level of regulation and supervision.** In most developed countries, leasing companies are not subject to prudential regulation. The lack of regulation relies on the argument that as long as leasing companies do not engage in deposit taking, there is no role for public regulatory authorities. However, there are strong arguments favoring light regulation to provide a more credible sector, especially during the initial phases of development as in Indonesia. Experience in developing countries has shown that some degree of prudential norms is desirable to prevent excessive risk taking, which hinders development of the industry. For instance, in the East Asian crisis, numerous leasing companies failed due to currency and maturity mismatches, setting back the development of the industry. The government should consider regulation and supervision of the leasing sector in the areas of entry requirements (licensing and relicensing, minimum capital requirements), balance sheet restrictions (maximum leverage ratios, single client and group exposure, limitations on insider transactions, provisioning requirements, asset-liability matching in terms of currency and maturity), associations among institutions, liquidity requirements, accountability requirements, insurance and support schemes, absolute minimum capital requirements, capital ratios, legal lending limitations on exposure to a single client, foreign currency and maturity mismatches, and reporting requirements. Equally, supervision should rely on off-site financial analysis, complemented by periodic risk-based examinations.
- **Allow depreciation of leased assets.** The authorities should allow lessors to depreciate the leased asset under a financial lease and include depreciation in the calculation of tax for finance lease transactions. Doing so would reduce the costs of leasing. The government has announced its support for small and medium enterprise financing, and such an amendment would be consistent with that objective.
- **Widen the base of financing.** In the present situation, the future funding of the industry depends largely on liquidity in the banking sector. Therefore, it is understandable that multifinance companies are seeking alternative sources of financing. From the perspective of the authorities, whose task is to maintain stability in the financial sector, decoupling the multifinance industry from the banking sector might be desirable in order to create a more competitive and diversified financial sector. Multifinance companies currently do not have access to public funds in the form of deposits – and this is appropriate. It is desirable to consider other alternatives, such as encouraging the participation of foreign equity capital and long-term funding from domestic institutional investors, such as pension funds and insurance companies.
- **Develop credit information systems.** It is highly recommended that the government and Bank Indonesia allow private sector participation in consumer credit information systems. Private credit bureaus can better manage professional processing of bank data and retail

information in a format that facilitates the use of risk assessment and standardized pricing models by banks and multifinance companies. This in turn can help individuals and SMEs build a valuable asset – their credit history – which can then improve their access to finance.

- **Support corporate restructuring through private equity funds.** The corporate restructuring process in Indonesia, while advancing, is not complete. The positive aspects of private equity vehicles—restoring companies to going-concern value rather than liquidation, removing the financial and management burdens from the banking sector, allocating resources more efficiently, improving the prospects to realize values—suggest that private equity can have a significant role to play in the corporate restructuring process. This fundamentally sound idea could be refined and implemented in Indonesia. Indonesia lacks a wide base of financial expertise to restructure medium-size companies. Therefore, considerable effort is needed to attract and build domestic expertise in financial engineering. If necessary, foreign expertise could be attracted as well.
- **Separate the operation and management of venture capital funds.** The one-tier structure of venture capital operations runs counter to best practices, in which the ownership and management of capital are separated. It hinders the ability of venture capital companies to raise funds from investors. Allowing the management company to be separate from the venture capital company would facilitate the use of management expertise. The government will have to assess carefully the regulatory and supervisory implications of such a change. One possible route is to create venture capital funds using the legal and tax framework of a trust. This would provide a convenient entry point for institutional investors such as insurance companies and pension funds, as well as wealthy individuals, to invest in the equity of private growing companies.
- **Develop trust vehicles.** In countries with a civil law tradition, such as Indonesia, the concept of trust, which separates management from beneficial ownership, is not recognized, and special legislation has to be passed. First, trusts need to be recognized as a legal vehicle. Second, the tax code needs to be made neutral for trusts, and there should be no sale, transfer, duty, or value added taxes.

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## ANNEX 1. MAJOR FINDINGS IN THE NBFi SECTOR IN INDONESIA

Area	Equity & Fixed-Income Markets	Mutual funds	Pension funds	Insurance	Leasing	Venture capital
Structure	<ul style="list-style-type: none"> <li>Market is relatively small, highly concentrated, and relatively illiquid. IPOs are not a significant source of corporate funding</li> <li>Elaborate system of corporate governance rules exist, but practice falls short of international norms</li> </ul>	<ul style="list-style-type: none"> <li>Market dominated by fixed income mutual funds, sensitive to the interest rate environment</li> <li>Most funds structured as collective investment contracts with low investor protection</li> </ul>	<ul style="list-style-type: none"> <li>There are four types of pension programs, catering to different clientele; government employees (Asabri, Taspen), mandatory formal sector employees (Jamsostek), employer pension funds and financial institution funds</li> <li>Pension fund sponsors have invested in expensive, wage-indexed systems, commonly prevalent in government and state-owned enterprises</li> </ul>	<ul style="list-style-type: none"> <li>Industry is small and highly fragmented</li> <li>Insurance penetration and density is low</li> <li>As retention ratios are low, the industry mobilizes limited long-term savings</li> </ul>	<ul style="list-style-type: none"> <li>Leasing is a part of the multifinance industry, which includes factoring, credit cards and consumer finance. The last dominates the business</li> <li>Only about half of the licensed companies are actively operating</li> </ul>	<ul style="list-style-type: none"> <li>Most companies are not genuine venture capital companies as the industry is in the business of lending and rarely provides equity capital</li> <li>Most companies are owned by the Government or business groups</li> </ul>
Regulatory	<ul style="list-style-type: none"> <li>On an overall basis, the regulatory structure is reasonable for equity and fixed income markets. Although, for government bonds there are co-ordination issues between Bank Indonesia, BAPEPAM &amp; LK and the MOF</li> <li>There is no mandated reporting of secondary market trades</li> </ul>	<ul style="list-style-type: none"> <li>The current system applies inconsistent regulations and supervision on mutual funds, pension funds, and unit-linked insurance</li> <li>Investor protection and disclosure are weak.</li> <li>The framework for eligibility, qualifications, and codes of conduct of investment managers is inadequate</li> <li>Having individual agents sell mutual funds makes it difficult to monitor and</li> </ul>	<ul style="list-style-type: none"> <li>National Social Security System Law is vague on details regarding benefits, contribution rates, major strategic policy options, and financing</li> <li>Half of pension assets do not produce retirement income, being payable as a lump sum at retirement or earlier</li> <li>Ambiguity in the laws and regulations has discouraged the creation of occupational pension plans: employers comply with mandatory programs before contributing to a voluntary program.</li> </ul>	<ul style="list-style-type: none"> <li>There is no regulation covering mutual insurance companies, although one of the largest insurance firms in Indonesia is a mutual firm</li> <li>Regulation for winding up and liquidation of insolvent insurance companies is weak</li> <li>Regulations governing unit-linked insurance products and mutual funds are not consistent</li> </ul>	<ul style="list-style-type: none"> <li>Clear, simple, and effective legal procedures are needed for reclaiming assets and enforcing business contracts</li> <li>Leasing companies need access to other types of funding besides bank loans, preferably direct investment</li> <li>The industry is too fragmented, and various regulations are not conducive to consolidation, including the restrictions on foreign ownership, investment size, and amount of paid-up capital</li> </ul>	<ul style="list-style-type: none"> <li>Regulations do not recognize profit-sharing financing, a common practice in the industry</li> <li>The regulatory capacity is weak</li> </ul>

Area	Equity & Fixed-Income Markets	Mutual funds	Pension funds	Insurance	Leasing	Venture capital
		regulate the conduct of agents				
Enforcement	<ul style="list-style-type: none"> <li>Rules and standards regarding disclosures, appropriate use of funds, accuracy of periodic reporting, and internationally consistent accounting standards exist. However, enforcement of these issues in both markets is slack</li> </ul>	<ul style="list-style-type: none"> <li>Inadequate enforcement of regulations; particularly in net asset value regulation, and disclosure of material information</li> </ul>	<ul style="list-style-type: none"> <li>Enforcement of mandatory contributions under Jamsostek is lax</li> <li>There is weak enforcement of timely payment of employer contributions into pension funds</li> </ul>	<ul style="list-style-type: none"> <li>Enforcement of regulation across industry participants is not consistent and has protected small, marginal and unviable companies from normal market discipline</li> </ul>	<ul style="list-style-type: none"> <li>Difficulties in enforcement of leasing contracts is a key limitation facing the industry</li> </ul>	<ul style="list-style-type: none"> <li>Enforcement of reporting requirements is weak</li> </ul>
Skills	<ul style="list-style-type: none"> <li>Quality of auditors needs improvement</li> <li>There is a limited supply of high quality securities and financial analysts</li> <li>The MoF's cash management capacity is weak, which is one of the reasons for the lack of a treasury bill market</li> </ul>	<ul style="list-style-type: none"> <li>Training and skills of individual sales agents are inadequate</li> </ul>	<ul style="list-style-type: none"> <li>PAI standards on pension work are below international norms leading to low professional quality of actuarial reports</li> <li>Lack of management experience and knowledge, results in poor quality and high-cost products and services and poor asset allocation</li> </ul>	<ul style="list-style-type: none"> <li>Low retention rate highlights the weak skills of the sales force</li> <li>Actuarial skills are low as indicated by the quality and reliability of actuarial reports. Practices are not in accord with international best practices</li> <li>Enforcement of tax policy is unreliable and unpredictable</li> </ul>	<ul style="list-style-type: none"> <li>Project appraisal skills are weak</li> <li>Lack of skills in assessing credit risk discourages multifinance companies from offering products other than in consumer financing</li> </ul>	<ul style="list-style-type: none"> <li>The industry needs further training to assess cash flows and future prospects, rather than collateral, as is the current practice</li> </ul>
Taxes	<ul style="list-style-type: none"> <li>Corporate dividends are subject to double taxation, which discourages companies from using the optimal mix of financing mechanisms</li> <li>Transfer of assets from debt originator to SPV is considered a sale and hence</li> </ul>	<ul style="list-style-type: none"> <li>Fixed income mutual funds enjoy favorable tax treatment; returns from mutual funds are tax exempt for the first five years. This incentive is being re-evaluated in the proposed amendment</li> </ul>	<ul style="list-style-type: none"> <li>There is no harmonized tax policy covering all types of retirement savings</li> <li>EET treatment is not fully implemented and double taxation is common.</li> <li>The tax on capital transferred from a registered pension fund to an insurance company to purchase an annuity makes annuities relatively unattractive.</li> </ul>	<ul style="list-style-type: none"> <li>Tax policy is broadly in line with international norms but there are some areas of problems; such as, annuities are not attractive because single premiums paid out of a private pension fund to purchase a life annuity at</li> </ul>	<ul style="list-style-type: none"> <li>There is no coherent tax policy on leasing. For example, neither lessor nor lessee can claim depreciation on the leased asset in a financial lease</li> <li>Tax regulations create an uneven playing field for different types of business in</li> </ul>	<ul style="list-style-type: none"> <li>Current tax incentive structure is misaligned with the products offered by the industry</li> </ul>

Area	Equity & Fixed-Income Markets	Mutual funds	Pension funds	Insurance	Leasing	Venture capital
	subjected to taxes. The asset-backed securities market is therefore undeveloped.	s to the tax law		retirement are taxable, ending the tax shelter <ul style="list-style-type: none"> <li>Non-life companies are penalized more than life companies by the non-deductibility of IBNR reserves, which are 40 percent of non-life liabilities</li> <li>Current tax treatment for life insurance is TTE versus the international norm of EET</li> </ul>	the industry	
Competition landscape	<ul style="list-style-type: none"> <li>There is little competition from firms to list as there is a limited benefit for listing</li> <li>The current structure of the two exchanges is not conducive to competition</li> <li>Only Himdasun members participate in government bond auctions, limiting the degree of competition in the market</li> </ul>	<ul style="list-style-type: none"> <li>The industry is characterized by high fees and lack of comparative performance information</li> </ul>	<ul style="list-style-type: none"> <li>The state has a dominant role in the pension industry. To this extent, the playing field between the private sector and public sector is uneven. For example, voluntary plans have to compete with mandatory public programs</li> <li>Under the National Social Security System Law there is no room for participation of the private sector or regional governments in the five mandatory programs</li> </ul>	<ul style="list-style-type: none"> <li>Differential capital requirements for incumbents and new players fosters an uneven playing field and hinders competition</li> </ul>	<ul style="list-style-type: none"> <li>The growth opportunities for the industry are limited by the fact that banks are the primary source of capital for the industry. Only those companies affiliated to banks have significant growth opportunities</li> </ul>	<ul style="list-style-type: none"> <li>The industry ends up competing against commercial banks, due to the practice of providing debt products. This limits opportunities for growth</li> <li>Traditional providers of capital, such as pension and insurance companies, do not participate actively in this market</li> </ul>
Access	<ul style="list-style-type: none"> <li>Access to equity and bond markets is relatively open; however foreign investors account for more than half of the market capitalization of the Jakarta Stock Exchange and there is limited</li> </ul>	<ul style="list-style-type: none"> <li>Investors comprise of a small number of affluent individuals. Institutional investors have very limited exposure in equity funds and prefer to invest directly in companies.</li> </ul>	<ul style="list-style-type: none"> <li>Coverage of the pension system is low</li> <li>In principle access to the pension system is open to formal sector employees, which is only a third of the overall workforce. Less than a fifth of the formal sector actually participates in the pension system. Reasons for this</li> </ul>	<ul style="list-style-type: none"> <li>Access to insurance products is not perceived to be a problem, although the low per capita income and pricing of insurance products limits the demand for insurance products</li> </ul>	<ul style="list-style-type: none"> <li>The majority of leasing company portfolios consists of relatively larger companies. SMEs have lower access to leasing due to problems of collateral availability, reputational risk, and</li> </ul>	<ul style="list-style-type: none"> <li>Genuine venture capital financing is limited. Conversely, demand for equity financing from SMEs is low due to a cultural preference to retain control</li> </ul>

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	<p>interest amongst domestic investors</p> <ul style="list-style-type: none"> <li>▪ Secondary market in government bonds is accessible directly only to BI-SSSS participants. Others have to use the services of these participants for a fee</li> </ul>		<p>range from low per capita income to lack of trust in the institutions</p>		<p>credit risks</p>	
Developing investor base and investor education	<ul style="list-style-type: none"> <li>▪ Investors have a poor understanding of risk in both equity and fixed income markets. The Jakarta Stock Exchange has had limited success with its investor education programs</li> </ul>	<ul style="list-style-type: none"> <li>▪ Investors are not well informed about the risks in mutual funds investing</li> </ul>	<ul style="list-style-type: none"> <li>▪ Majority of workers and employers are not educated about the need for financial security in retirement and the advantages of building income-generating assets early in their career</li> <li>▪ Companies regard pension plans as an expense rather than as a tool for human resource planning and an efficient component of compensation</li> </ul>	<ul style="list-style-type: none"> <li>▪ Investors have limited knowledge about the financial protection that insurance products offer</li> <li>▪ Private sector ratings of insurance companies are not available.</li> <li>▪ Actuarial skills are limited and affect both insurance and pensions industries.</li> </ul>	<ul style="list-style-type: none"> <li>▪ SMEs are not necessarily well informed about leasing possibilities. This is compounded by the access issues.</li> </ul>	<ul style="list-style-type: none"> <li>▪ There is a need to educate small and medium enterprises and entrepreneurs about the potential uses of venture capital and to increase awareness of the industry. There is also a need to educate venture capitalists so that they understand the difference between venture capital funds and bank loans and begin to rely more on cash flow assessments than on collateral assessments</li> </ul>