BASIC INFORMATION

A. Basic Project Data

<table>
<thead>
<tr>
<th>Country</th>
<th>Project ID</th>
<th>Project Name</th>
<th>Parent Project ID (if any)</th>
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<tbody>
<tr>
<td>Indonesia</td>
<td>P170940</td>
<td>Indonesia First Financial Sector Reform Development Policy Financing (P170940)</td>
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<tr>
<th>Region</th>
<th>Estimated Board Date</th>
<th>Practice Area (Lead)</th>
<th>Financing Instrument</th>
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<tr>
<td>EAST ASIA AND PACIFIC</td>
<td>19-Mar-2020</td>
<td>Finance, Competitiveness and Innovation</td>
<td>Development Policy Financing</td>
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<th>Borrower(s)</th>
<th>Implementing Agency</th>
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<tr>
<td>Republic of Indonesia</td>
<td>Fiscal Policy Agency, Ministry of Finance</td>
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Proposed Development Objective(s)

The program development objective of this programmatic operation is to support financial sector reforms that will assist the Government of Indonesia (GoI) in achieving a deep, efficient and resilient financial sector. The proposed operation is the first in a series of three programmatic operations.

This programmatic DPL series is structured around the following three pillars and set of objectives:

- **Pillar A**: Increasing the Depth of the Financial Sector. Pillar objectives: to expand the size of the financial sector by increasing outreach, broadening financial market products and mobilizing long-term savings.
- **Pillar B**: Improving the Efficiency of the Financial Sector. Pillar objectives: to lower the costs for individuals and enterprises by strengthening the insolvency and creditor rights framework, protecting consumers and personal data and promoting interoperability of payment systems.
- **Pillar C**: Strengthening the Resilience of the Financial Sector. Pillar objectives: to strengthen the capacity of the sector to withstand financial and non-financial shocks by strengthening the resolution framework, implementing sustainable finance practices and establishing disaster risk finance mechanisms.

Financing (in US$, Millions)

<table>
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<th>SUMMARY</th>
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<tr>
<td><strong>Total Financing</strong></td>
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<th>DETAILS</th>
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<tr>
<td><strong>Total World Bank Group Financing</strong></td>
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<td>World Bank Lending</td>
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B. Introduction and Context

Country Context

This proposed Financial Sector Reform Development Policy Operation (DPO) for the Republic of Indonesia is the first in a programmatic series of three IBRD loans and is intended to support a reform program aimed at (i) increasing the depth, (ii) improving the efficiency and (iii) strengthening the resilience of the financial sector.

As the largest economy in South East Asia and 16th largest in the world, Indonesia has maintained an average GDP growth of 5% p.a. in the last 5 years. To sustain these levels of growth Indonesia needs to close three key gaps: an infrastructure gap, estimated at over $1.5 trillion; a human capital gap, which places Indonesia in the third quartile of the HCI with some of the highest stunting rates in the world at over 30 percent; and an institutional gap, which leads to restrictive and unpredictable regulation and lack of capacity, coordination and leadership in delivering public services and implementing public policies to enhance inclusive growth. Closing these three gaps, while maintaining the foundations of macroeconomic stability, will require collecting more and spending better, improving the decentralization framework and service delivery at local levels, promoting openness and competition within a stable regulatory environment and deepening and broadening the financial sector.

A sound and well-functioning financial sector is critical to sustain Indonesia’s growth and to achieve the Government’s shared prosperity goals. Financing the infrastructure gap and broadening opportunities for individuals and firms require an acceleration of financial sector deepening, efficiency, and inclusion without compromising macro- and micro-prudential standards. The authorities recognize this necessitates stronger coordination between agencies to formulate a coherent policy framework and evaluate its impact as well as to monitor financial risks across sectors and for the broader economy. An ambitious agenda to promote financial sector deepening and to strengthen financial oversight and crisis management has been pursued by the Government of Indonesia in the recent years. However, to date, the Indonesian financial sector is not yet sufficiently able to fund development needs or boost inclusive economic growth.

The operation recognizes Indonesia’s continued sound macroeconomic management in the context of global financial volatility in 2018 and elections in 2018 and 2019. Indonesia’s macroeconomic fundamentals remain strong, with robust economic growth, stable inflation and strong labor market conditions, narrow fiscal deficits and low debt. Proactive monetary policy, together with coordinated prudent fiscal and exchange rate policies, have successfully maintained macroeconomic stability during times of large capital outflows from emerging markets. Indonesia’s sovereign credit is considered investment grade by four major credit ratings agencies, corroborating the country’s improved economic environment, fiscal management, and overall creditworthiness. The poverty rate fell to a single digit for the first time on record to 9.8 percent in March 2018. It has continued to decline, registering 9.4 percent in March 2019. Inequality, which had been increasing throughout the 2000s, has also been on a distinct, albeit somewhat modest, downward trend since 2015.

But there are several challenges to sustaining and deepening this progress. First, the pace of poverty reduction has started to stall, suggesting that it may be getting progressively harder to reach and uplift the remaining poor, who are more likely to be entrenched in chronic forms of poverty associated with lagging and remote rural regions, or social groups.
Second, protecting economic gains for those who escape poverty remains a challenge: the income of approximately 20 percent of the entire population hovers marginally above the national poverty line, keeping them exposed to the risk of falling into poverty following a financial or non-financial shock. Third, despite not being in poverty or vulnerability, almost half of the population is yet to achieve the economic security and lifestyle of the middle class. Securing a robust pathway to the middle class for this “aspiring middle class” group is vital to the realization of Indonesia’s aspirations of becoming an upper middle-income country. Going the last mile on eliminating poverty, continuing to address the economic vulnerabilities of the population, and unlocking the productive potential of the economy to make the pathway to the middle class available to all Indonesians represent the three main challenges facing the country.

Relationship to CPF

The proposed DPO is fully aligned with the World Bank’s Country Partnership Framework (CPF) for Indonesia, which operationalizes the SCD’s findings and recommendations. The FY16-20 WBG CPF for Indonesia draws on the Systematic Country Diagnostic (SCD) which identified three pathways for the elimination of extreme poverty and increasing shared prosperity: i.e. creation of better jobs, improving equality of opportunity, and helping Indonesia manage its vast endowment of natural resources in a sustainable way. The present DPO supports the FY2016-20 WBG Country Partnership Framework through two supporting beams (Supporting Beam I: “Leveraging the Private Sector - Investment, Business Climate and Functioning of Markets” and Supporting Beam II: “Shared Prosperity, Equality and Inclusion”. The recent CPF Performance and Learning Review (PLR) confirmed the relevance of the financial sector technical assistance program that is supporting most of the proposed reforms under this DPO. In parallel, a more prominent role for financial sector activities could be envisaged as part of the preparation process of the next CPF.

C. Proposed Development Objective(s)

The program development objective of this programmatic operation is to support financial sector reforms that will assist the Government of Indonesia (GoI) in achieving a deep, efficient and resilient financial sector. The proposed operation is the first in a series of three programmatic operations.

This programmatic DPL series is structured around the following three pillars and set of objectives:

• Pillar A: Increasing the Depth of the Financial Sector. Pillar objectives: to expand the size of the financial sector by increasing outreach, broadening financial market products and mobilizing long-term savings.
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• Pillar C: Strengthening the Resilience of the Financial Sector. Pillar objectives: to strengthen the capacity of the sector to withstand financial and non-financial shocks by strengthening the resolution framework, implementing sustainable finance practices and establishing disaster risk finance mechanisms.

Key Results

The expected results are for Pillar A: an increase in outreach through (i) the harmonization and coordination of the two major agent network programs (Laku Pandai and LDK) regulated by OJK and BI respectively and (2) the digitization of Government to Person transfers, particularly non-cash G2P social assistance payments; the establishment of broader and deeper financial markets, represented by the size of IDR-denominated private debt securities and an increase of longer-term investments and accompanying decrease in the proportion of short-term investment (cash and equivalent) held by pension funds and insurance companies. For Pillar B: a more efficient
financial sector would be supported by an increase in the number of insolvency cases that are opened by the court every year, by making the process more transparent and affordable; consumer protection reforms are expected to contribute to the quality dimension of financial inclusion indicated by the increased number of market misconduct cases detected through enhanced supervisory activities undertaken by dedicated market conduct supervisors in a year while the data protection reforms are expected to define and provide legal clarity on how personal data is collected, managed, used and shared, which will provide safeguards to privacy and help build confidence and trust in Government and the financial and other sectors as responsible data processors and controllers; and promoting interoperability will contribute to an increased usage of financial services, particularly retail payment products evidenced by an increase in the number of payment services providers (bank and non-bank financial institutions) facilitating QR payments. Finally, for Pillar C: the introduction of a single-costumer view (SCV) reporting system will help maintaining depositor confidence and avoiding disruptions to financial activities in the event of a bank failure. Implementation of SCV reporting will require all deposit insurance member banks to improve their customer information files and core systems and would require removal of all impediments to fast and efficient reimbursement processes; the results intended from the sustainable finance reforms are to strengthen the institutional capacity of banks and supervisors in dealing with sustainable finance ensuring that a substantial majority of entities supervised by OJK are in compliance with the requirements for sustainable finance practices; finally the integration of a pooling fund for disaster risk financing within the 2020 Fiscal Planning Document (KEM-PPKF) and 2020 State Budget Law (APBN) allows the Government to proceed with the establishment of a disaster risk finance mechanism and the allocation of funds to it. This is expected to lead to improved pre-arranged financing for disaster response by providing the government a more stable funding source.

D. Project Description

Deepening the financial sector allows to increase its size (both in terms of outreach and assets) and hence the availability of funds and access opportunities. About half of the adult Indonesian population does not have access to transaction accounts leaving them with limited opportunities to invest in their future and to protect themselves from unexpected shocks. Physical distance from the nearest financial access point was cited by a third of the population as a key barrier preventing individuals living in remote areas to use financial services. At same time the limited breadth and types of financial products and services available to investors, customers and to the public do not appear to be fully aligned with their needs. This exposes individuals and institutions to face the financial consequences of unexpected events due to the lack of risk management instruments and limits investment opportunities in critical sectors (such as infrastructure) due to the lack of incentives for long-term savings. A more vibrant institutional investor base and deeper capital markets which offer appropriate investment instruments, reliable price benchmarks, strong investors protection, and active hedging markets, can help bridge the infrastructure finance gap and reduce the need for domestic firms to seek foreign funding. In the current operation, financial deepening is centered around a set of coordinated policy actions aimed at increasing physical and digital access to financial services; broadening financial markets products and mobilizing long-term savings.

Making financial practices more transparent, reliable and technology-oriented allows to channel savings into the most productive investment opportunities in a less costly, faster and safer way. Credit intermediation in Indonesia is low compared to peers and the cost of intermediation is high. Such inefficiencies can in part be addressed through (i) the establishment of an adequate insolvency and creditor rights (ICR) regime to ensure that valuable assets are recycled into productive use and to increase investor confidence; (ii) the application of transparent financial standards and practices to protect the consumers and help them making responsible financial decisions; (iii) the use of interoperable, digital financial services to increase usage of accounts. Less than 30 percent of the population in Indonesia has sufficient financial capability to make responsible financial decisions and almost a third of the financially included population do not actively
use their accounts. On one hand this exposes a large share of the population to potential risks related to financial markets and limits the benefits of financial inclusion; on the other hand, it is necessary to make it easier for people to access and use transaction accounts and payments services by providing the interoperable use of different payment platforms. Enterprises are also affected by the inefficiency of the system: weaknesses in the ICR framework impede banking efficiency as Indonesian creditors expect lower NPL recovery rates which raises lending rates and restricts supply, particularly for SMEs. It also inhibits capital market development through diminished investor demand for private instruments. The DPO program therefore supports reforms in the areas insolvency and creditor rights, consumer and data protection and interoperability of payment systems.

**Strengthening the resilience of the financial sector allows to increase its capacity to withstand financial and non-financial shocks.** The banking sector remains well capitalized and highly profitable, and system-wide liquidity is ample. However further efforts are needed to strengthen financial oversight and crisis management. There is a need to strengthen and clarify objectives, responsibilities and accountability across the financial sector authorities. Despite the establishments of OJK as the integrated supervisory agency in 2011 and LPS as the deposit insurance and resolution authority in 2004, there is still a significant overlap of responsibilities between BI and OJK on banking supervision given BI’s mandate on payments system and macroprudential, and OJK’s on micro prudential policies. The agencies’ cooperation with LPS for resolution of troubled banks also needs to be strengthened. Furthermore, the current mandates and practices of BI and OJK place as much emphasis on financial development as on financial stability, which should be their primary mandate. At the same time, strengthening resilience in a country like Indonesia, exposed to frequent natural disasters exacerbated by the climate change, requires also promoting sustainable finance practices for financial services institutions, issuers and public companies. A line of reform on strengthening disaster risk financing is also included in this operation given the importance of establishing a financial risk mitigation mechanism in case of natural disasters. This is nowadays one of the government priorities and will ultimately help to protect Indonesia’s people and assets against disaster shocks and strengthen comprehensive disaster resilience of the country.

**E. Implementation**

Institutional and Implementation Arrangements

**Progress on the results indicators will be monitored and evaluated by the Recipient.** The Fiscal Policy Unit (BKF) under the Ministry of Finance will be the executing agency for the proposed operation while BI, OJK, LPS, MoLHR, Bappenas and Kominfo will act as implementing agencies. The BKF team is well-coordinated, and given their experience in implementing DPOs with the World Bank, they are increasingly well prepared to obtain and share data to monitor implementation against the agreed results indicators. The World Bank closely follows this progress through supervision activities.

**F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects**

Poverty and Social Impacts

**The prior actions associated with the planned reforms are likely to have no adverse poverty and social impacts.** If anything, the direct and indirect impacts of the actions are likely to be broadly positive. The link between financial sector stability and poverty is well known in Indonesia. During the 1997–1998 Asian financial crises, the employment rate in the formal sector employment fell steeply, negative economic growth (at around 13 per cent in 1998) were recorded and food prices rose substantially, causing the poverty rate to increase from 17.5 per cent in 1996 to 24.2 per cent in 1998. The Government has made important strides in establishing economic stability since the crises. These proposed policy actions aimed at increasing financial depth, improving financial efficiency and strengthening financial resilience further bolster
the government’s efforts. Overall, the policy actions are expected to contribute to creating a favorable economic environment that will stimulate growth and thus have positive social effects and help reduce poverty.

Environmental, Forests, and Other Natural Resource Aspects

Two of the proposed prior actions will have positive effects on the environment. Embedding sustainability in the practices of the financial services industry, with emphasis on climate change, will contribute to disaster prevention, disaster risk mitigation, climate change adaptation, and environmental management in Indonesia. Moreover, the reform on disaster risk finance has the potential to lead to significant positive effects on the natural and human/built environment. This is because the national Disaster Risk Finance and Insurance (DRFI) Strategy recognizes that disaster management financing is needed for three periods – non-disaster, emergency response, and rehabilitation/reconstruction. Within the non-disaster period, pre-disaster financing is to be used, inter alia, for disaster risk mitigation activities or programs, disaster prevention programs, and education on disasters. Whether the potential for positive effects is realized or not will depend in part on the extent to which adoption of the DRFI Strategy leads to pre-disaster financing, and in part on other activities and programs of national and regional governments. The latter may include climate change resilience, disaster-resistant infrastructure, upgraded building codes, and early warning systems. None of the other prior actions will have positive or negative effects on environment, forest, or other natural resources. They will not result in construction, development or operation of facilities that could generate solid or liquid wastes or air emissions, conversion of natural habitat, damage to cultural heritage, loss of biodiversity, or changes in management policies or practices affecting forests or other natural resources.

G. Risks and Mitigation

The overall risk rating for the operation is ‘moderate’ with two main sources of risk indicated as “substantial”. The two substantial risks are (i) technical design and (ii) institutional capacity for implementation and sustainability. The design requires the coordination of several different counterparts and, given the relatively tight timeline for the completion of critical reforms, a deep commitment from all the relevant stakeholders to abide to the agreed milestones is required. The influence of the Ministry of Finance as executing agency on some of the implementing agencies might be limited and therefore requires a solid policy dialogue with each implementing agency to make sure there is full alignment on the achievement of the proposed reforms. Institutional capacity needs continuous support through the ongoing TA to make sure that the agreed reforms can be completed on time and according to the required quality standards. The ongoing TA program underpinning each of the proposed reforms is an important mitigating factor against the risks related to institutional capacity for implementation and sustainability. The potential benefits of the proposed operation outweigh the residual risks and warrant IBRD’s assistance.

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**APPROVAL**

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<th>Francesco Strobbe</th>
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**Approved By**

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<tr>
<th>Country Director:</th>
<th>Rolande Simone Pryce</th>
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<td>10-Dec-2019</td>
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