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## FINANCIAL SECTOR ASSESSMENT

# REPUBLIC OF INDONESIA

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FINANCE & MARKETS GLOBAL PRACTICE
EAST ASIA AND PACIFIC REGION VICE PRESIDENCY

A joint IMF-World Bank mission visited Jakarta during September 21 – October 5, 2016 and February 1 – 16, 2017 to conduct an assessment under the Financial Sector Assessment Program (FSAP). The mission assessed financial sector vulnerabilities, developmental issues, and their interlinkages.[1]

The team was led by Erik Feyen (World Bank (WB)) and Ulric Erickson von Allmen (IMF), and comprised Mariano Cortes (WB deputy mission chief) and Javier Hamann (IMF deputy mission chief), Prasad Ananthakrishnan, Mariam El Hamiani Khatat, Caio Ferreira, Phakawa Jeasakul, Heedon Kang, Jonathan Pampolina, Jongsoon Shin, Nobu Sugimoto, and Daina Vasermane (all IMF); Geoff Mortlock (IMF expert); John Laker (WB-IMF expert); Nagavalli Annamalai, Laura Ard, Ana Maria Aviles, Pietro Calice, Anderson Caputo Silva, Jose Antonio Gragnani, Harish Natarajan, Rajeev Swami, Mahesh Uttamchandani, and Igor Zuccardi (all WB); Stefanus Handoyo (IFC); and Anthony Randle (WB expert).

The mission met with the Minister of Finance Sri Mulyani Indrawati, then-Minister of Finance Bambang Brodjonegoro, Bank Indonesia Governor Agus Martowardojo, Indonesia Financial Services Authority (OJK) Chairman Muliaman Hadad, Indonesia Deposit Insurance Corporation (LPS) Chairman Halim Alamsyah, other high-ranking public officials, and senior representatives of local and foreign banks, insurance companies, credit rating agencies, auditors, law firms, non-bank payment service providers, fintech firms, and industry associations.

[1] The mission's work encompassed an evaluation of: the supervision and regulation of banks and conglomerates; organizational arrangements for integrated supervision; corporate governance of financial conglomerates; the observance of Insurance Core Principles (ICP); the crisis management, resolution, and safety nets framework; macroprudential policies; systemic liquidity management; selected AML/CFT issues; capital market development and infrastructure finance; insolvency and debtor/creditor rights; financial inclusion and digital financial services; accounting and auditing practices for banking; and intermediation efficiency of the banking sector.

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## GLOSSARY

| | |
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| AML/CFT | Anti-Money Laundering/Combating the Financing of Terrorism |
| BCP | Basel Core Principles for Effective Banking Supervision |
| BI | Bank Indonesia (central bank) |
| BI Law | Law regarding Bank Indonesia, No. 3 1999 and No. 4 2004 |
| BoC | Board of Commissioners |
| BoD | Board of Directors |
| BRP | Bank Restructuring Program |
| DFS | Digital Financial Services |
| D-SIB | Domestic Systemically Important Bank |
| ELA | Emergency Liquidity Assistance |
| EWI | Early Warning Indicators |
| FATF | Financial Action Task Force |
| FC | Financial Conglomerate |
| FMI | Financial Market Infrastructure |
| FSAP | Financial Sector Assessment Program |
| FSB | Financial Stability Board |
| FX | Foreign exchange |
| G2P | Government to person |
| GDP | Gross Domestic Product |
| GoI | Government of Indonesia |
| IAIS | International Association of Insurance Supervisors |
| ICP | Insurance Core Principles |
| IRS | Interest rate swap |
| Key Attributes | FSB Key Attributes of Effective Resolution Regimes for Financial Institutions |
| KSSK | *Komite Stabilitas Sistem Keuangan* (Financial System Stability Committee) |
| KUR | *Kredit Usaha Rakyat* (People's Business Loan Program) |
| LKD | *Layanan Keuangan Digital* (Digital Financial Services) |
| LP | Laku Pandai (Digital Financial Services) |
| LPS (IDIC) | *Lembaga Penjamin Simpanan* (Indonesia Deposit Insurance Corporation and also bank resolution agency) |
| LPS Law | Law regarding the Indonesia Deposit Insurance Corporation, No. 24 2004 |
| MoF | Ministry of Finance |
| MoLHR | Ministry of Law and Human Rights |
| MSME | Micro, small and medium-size enterprise |
| NBFI | Nonbank financial institution |
| NPL | Nonperforming loan |
| OJK | *Otoritas Jasa Keuangan* (Indonesia Financial Services Authority) |
| OJK Law | Law regarding the Indonesia Financial Services Authority, No. 21 2011 |
| PPKSK Law | Law regarding the Prevention and Resolution of Financial System Crisis, No. 9 2016 |
| P2P | Peer to peer |
| SOE | State-owned enterprise |
| SNKI | *Strategi Nasional Keuangan Inklusif* (National Financial Inclusion Strategy, Presidential Regulation No. 82 2016) |

## EXECUTIVE SUMMARY

**Indonesia has exhibited strong macroeconomic performance, but developmental needs remain significant.** To raise the living standards of a large population dispersed over thousands of islands, Indonesia has to address several key challenges, including a sizeable infrastructure gap, relatively low productivity, and rising inequality. The authorities recognize that the financial sector needs to play a central role in overcoming such challenges.

**The authorities have been pursuing an ambitious agenda to promote financial sector deepening and to strengthen financial oversight and crisis management.** In 2011, OJK was established as an integrated regulator to oversee the entire financial sector and is now implementing its Financial Services Sector Master Plan. The authorities launched the National Financial Inclusion Strategy in 2016 and various initiatives to boost access to transaction accounts, microcredit, and lending to individuals and small and medium-sized enterprises (SMEs). The licensing of private credit bureaus and the transition to an online moveable collateral registry are also important steps towards lower lending rates and broader inclusion. BI and OJK have facilitated the expansion of Digital Financial Services (DFS) which hold great promise to overcome geographical challenges, decrease costs, and promote inclusion. Basel III implementation has begun, a new insurance law has been adopted, and supervisory practices have strengthened across sectors. Furthermore, the framework for crisis management and resolution, and safety nets was bolstered under the 2016 Prevention and Resolution of Financial System Crisis Law (PPKSK Law).

**Despite substantial progress since the last FSAP, the financial sector is not yet sufficiently able to fund development needs or boost inclusive economic growth.** The financial system remains shallow and dominated by banks which are part of financial conglomerates. Banks' intermediation efficiency and financial inclusion of both households and SMEs trail peers. Although money markets have become more active, they remain shallow and segmented. Capital markets do not yet provide sufficient funding nor do they represent a competitive alternative to banks. In the absence of a domestic investor base that is willing and able to provide longer-term financing, the role of foreign funding is important, but it exposes Indonesia to a volatile external environment and requires vigilance regarding external refinancing risks. The challenges of managing the associated risks and boosting investor demand are compounded by the absence of active hedging markets.

**The banking system is profitable, well-capitalized and appears resilient to severe shocks.** Nevertheless, due to the economic slowdown in recent years, asset quality has deteriorated and loan growth has decelerated. Profitability has also fallen, but remains relatively high. Smaller banks are more vulnerable to funding shocks given their reliance on short-term, volatile deposits. The largest banks, which typically are state-owned, have the strongest buffers and highest net-interest margins and profitability.

**The FSAP has identified important areas for further improvement, including:**

- **Institutional mandates.** Recent reforms have led to somewhat unclear and conflicting institutional mandates and a duplication of activities across agencies. While some overlap is expected at this early stage of reform, it will be important to strengthen and

clarify objectives, responsibilities, and accountability to foster trust and collaboration across agencies. Importantly, mandates and actual practices of OJK and BI place similar priorities on financial development and financial stability goals—unequivocal primacy should be given to stability.

- **Legal protection.** Recent reforms have not sufficiently strengthened the legal protection for staff, agencies, and contractors involved in oversight and crisis management which falls short of international best practice; improving legal protection was also a key recommendation in the 2010 FSAP. Weak legal protection may cause inaction bias and discourages exercise of professional judgment.

- **Crisis management framework**. The PPKSK Law formally establishes the Financial System Stability Committee (KSSK). However, the KSSK should be a coordinating body only, without the power to direct its members (MoF, OJK, BI, and LPS) in their respective responsibilities which could risk dilution of agencies' accountability and a delay in decision-making. The President's powers to declare a crisis situation and make additional tools available to the resolution authority (LPS) appear overly broad. Rather, the authorities should consider limiting the President's role to decisions regarding access to public funding in the case of systemic resolution. Currently, the law explicitly rules out public funding in any circumstances. This may prove too limiting in practice, especially in systemic crises, and it is recommended that a public funding mechanism be incorporated into law, with robust safeguards and ex-post recoveries from industry. Weaknesses in the emergency liquidity assistance framework—including the absence of a clear link to a financial stability objective, a tightly framed requirement for bank compliance with OJK capital requirements, and the existence of coordination issues between OJK and BI—may render it unpractical.

- **Financial conglomerate (FC) corporate governance.** OJK has made good progress by recently issuing integrated regulations, including on corporate governance. However, the conglomerates' response has so far been more compliance-oriented. They should be encouraged to proactively strengthen group-wide governance and risk management structures. Further, the Company Law should be brought in line with international best practice as it currently blurs the roles and accountabilities of administrative bodies. Risk management, internal audit and compliance functions have primary reporting lines to the Board of Directors instead of the Board of Commissioners (BoC) which compromise their independence. The corporate governance framework is in need of review to ensure the BoC clearly has the responsibility and proper tools to effectively oversee and address management and bank performance. Lastly, the government is evaluating plans to consolidate state-owned banks into a holding company structure; the authorities should carefully consider the market impact and ensure a strong corporate governance framework.

- **Micro-prudential supervision.** OJK has managed the transition well, but further efforts are needed to break supervisory silos and harmonize regulation and supervisory approaches across sectors. Despite recent progress, challenges remain to conduct effective supervision of FCs. Going forward, OJK needs a thorough appraisal of its organizational structure if it is to become a truly integrated supervisor. Lack of a legal

provision for licensed non-operating holding companies further impedes effective FC supervision. More generally, the authorities should more rigorously evaluate financial institutions' risk management and internal audit functions and the quality of supervisory reporting information, particularly given potential gaps in banks' credit risk identification and control processes.

**To promote sustainable financial sector deepening and inclusion, the authorities could consider a more coordinated, cross-cutting approach by addressing root causes.** To promote inclusive economic growth and strengthen financial markets, the authorities pursue a diverse policy mix which includes: expansion of the KUR credit guarantee program with an interest subsidy add-on; a deposit interest rate ceiling; requirements for non-bank financial institutions to hold debt issued by the government and state-owned enterprises; and moral suasion to lower bank lending rates. However, these measures may not prove effective in achieving sustainably higher growth and financial deepening. Rather, building on existing efforts, an integrated "roadmap" should target root causes, including:

- **Inter-agency collaboration.** The challenges to develop capital markets are interrelated and require a more integrated approach with stronger inter-agency collaboration. The recently established Financial Market Coordination Forum (FKPPPK) and the national financial inclusion steering committee both provide promising high-level coordination platforms. To allow DFS to reach scale and commercial viability, OJK and BI should collaborate more closely in various areas, including strengthening joint oversight, addressing gaps in interoperability, and formulating an appropriate pricing framework.

- **Insolvency and creditor rights (ICR).** Weaknesses in the ICR framework impede banking efficiency and inclusion through higher intermediation costs and inhibit capital market development through diminished investor demand for private instruments; ICR deficiencies were also flagged in the 2010 FSAP. Laws and practices need significant enhancement to avoid the over-use of informal procedures. Insolvency practitioners are perceived as regularly failing to perform their duties.

- **Other regulatory and tax impediments.** There is a need to review the legal and regulatory framework to facilitate an active investor base and promote infrastructure finance. Similarly, a comprehensive revision of the tax framework to enhance harmonization and eliminate distortions would contribute to capital market development and infrastructure finance. Also, a review of regulation may support judicious growth of DFS through leveraging franchisee and distribution networks.

- **Corporate governance.** As mentioned in the context of FCs, weaknesses in the Company Law and corporate governance regulations not only affect financial institutions, but also raise funding costs for non-financial firms and inhibit capital market development by eroding investors' confidence.

- **Accounting and auditing.** Practices are generally adequate, but various factors reflect poorly on auditors' oversight—passage of the Financial Reporting Act will help.

| Table 1. Key Recommendations | Timeline |
| --- | --- |
| **Institutional and legal arrangements** | |
| Revise OJK Law to give primacy to stability objectives, BI Law to include a stability and macroprudential policy mandate focused on systemic risks, with access to data; and LPS Law to focus objectives on financial stability, continuity of critical functions, protection of insured deposits, and minimization of resolution costs. | Medium term (MT) |
| Amend the Insurance Law to specify policyholder protection as principal objective of OJK. | MT |
| Bring legal protection of supervisors and officials of all agencies involved in financial oversight and crisis management in line with global standards. | MT |
| **Governance of financial conglomerates (FCs)** | |
| Revise the Company Law and strengthen corporate governance practices within the financial system to enhance the BoC's oversight roles and responsibilities. | MT |
| Introduce legal provisions for licensed non-operating financial holding companies. | MT |
| Require FCs' related party and intragroup transactions identification and reporting process to be externally audited. | Near term (NT) |
| Require FCs to: prepare plans to achieve an integrated approach to FC-wide oversight and management; consider scenario analysis and contingency planning; and consider risks posed by non-financial entities. | MT |
| **Financial sector oversight** | |
| Reduce OJK's silo structure, including by revising the OJK Law to remove the responsibilities of individual Commissioners for the supervision of specific sectors. | MT |
| Strengthen the banking supervision approach and continue enhancing supervisory practices for FCs. | NT |
| Further strengthen the enforcement of credit and risk management regulations. | MT |
| Revise the insurance supervision framework ("three strikes"-approach) to allow prompt corrective actions. | MT |
| **Crisis management and resolution, and safety nets** | |
| Revise the PPKSK Law to clarify the role of the KSSK as solely a coordination body; limit the involvement of the President to approving public funding. | MT |
| Adjust the emergency liquidity assistance (ELA) framework to ensure it is effective. | NT |
| Amend the relevant laws to ensure that resolution powers can be exercised over financial conglomerates. | MT |
| Develop resolution options and implementation guidelines for banks, and resolvability assessment and resolution planning frameworks for D-SIBs. | NT |
| **Financial integrity** | |
| Integrate key ML/TF risks in the priorities and operations of relevant agencies. | NT |
| Finalize and implement risk-based AML/CFT supervisory tools. | NT |
| **Capital markets** | |
| Review the overall tax framework for financial products. | MT |
| Eliminate distortions in institutional investors' regulations to enhance their potential role in capital markets. | MT |
| Develop interest rate swaps and foreign exchange derivatives markets. | MT |
| Enhance government bond yield curve by reducing debt fragmentation and improving secondary markets. | MT |
| Improve financial literacy of issuers and investors. | MT |
| **Insolvency and creditor rights** | |
| Allow registration of security interests (of multiple creditors) over moveables; remove excessively formal steps in the security granting process; and provide greater flexibility of asset sales once moveable security is enforced. | MT |
| Provide clearer and more effective regulation for the monitoring of insolvency practitioners. | NT |
| Re-design the insolvency practitioner remuneration framework to reduce both the level of discretion of the supervisory judge and incentives to liquidate the debtor. | MT |
| Reform the Bankruptcy Law to enhance creditor rights and transparency in the corporate restructuring process. | MT |
| **Accounting and Auditing** | |
| Pass the Financial Reporting Act (FRA). | MT |
| **Financial inclusion and digital financial services (DFS)** | |
| Develop an integrated roadmap to promote financial deepening and inclusion. | MT |
| Raise awareness in the unbanked population of agent-based financial services. | NT |
| Create separate agent category for transactional services only to leverage franchisee and distribution networks. | NT |
| Strengthen BI-OJK coordination of DFS oversight and expand collaboration. | NT |
| Make contracting process for payment service providers of social benefit transfers and other Government programs more competitive. | NT |

# I. CONTEXT

## A. Developmental Challenges

1. **Since the 2010 FSAP, the Indonesian economy has performed well and weathered a challenging external environment (Appendix I).** Economic growth has remained strong at around 5-6 percent, underpinned by a sound macroeconomic policy framework. The economy withstood the 2013 Taper Tantrum, sharp declines in commodity prices, and other bouts of global financial markets instability. Although of diminishing relative importance in the last few years, the commodities sector still plays a significant role in Indonesia's economy. Declining commodity prices contributed to an economic slowdown which bottomed out in 2015.

2. **Indonesia's medium-term challenges include raising per capita income and reversing growing inequality.** [2] Despite sustained economic growth over the last 15 years that saw the poverty rate fall by more than half to 11 percent in 2014, inequality has risen.[3] To achieve a durable increase in per capita income and a reduction in inequality and poverty, structural reforms are required, including closing the infrastructure gap. Addressing the inequality of opportunity in the development of skills and in the access to higher productivity jobs and wealth has also been identified as a key driver.

3. **The government launched an ambitious infrastructure development program.** The plan comprises investments of roughly US$450 billion (about 50 percent of GDP) during 2015-19. Given the program's size and limited fiscal capacity, this requires mobilizing significantly more private longer-term capital from foreign and domestic sources.

## B. Structure of the Financial System

4. **Indonesia's financial system is relatively shallow and bank-centered, with a substantial presence of the State and a narrow domestic institutional investor base.** At end-2015, total financial sector assets amounted to 72 percent of GDP, three quarters of which represents banks (Table 1). The insurance sector is the fastest growing segment and drove the expansion of total system assets by 8 percentage points of GDP during 2005 - 15.

    - *Banking sector (Tables 2 and 3).* At end-2015, commercial banks' assets stood at 55 percent of GDP. State-owned and regional development banks combined have a sizeable presence, with holdings of close to 50 percent of the banking sector's assets and dominating certain credit segments (e.g. microloans).[4] Banks mostly

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[2] Also see "Development Policy Review 2014—Indonesia: Avoiding the Trap", World Bank and "Republic of Indonesia—Inequality and Shared Prosperity: Indonesia's Rising Dive: why inequality is rising, why it matters and what can be done", June 2015, World Bank.

[3] The Gini coefficient rose over the period from 30 to 41, faster than in most regional peers.

[4] While the four largest banks—three of which are majority-owned by the government—account for almost half of banking system assets, most other banks are medium-sized or small, and it takes slightly more than 20 banks to capture a market share of 80 percent. Private banks are diverse in terms of size, business models, and ownership, with nine foreign subsidiaries and 31 foreign branches.

lend to large corporates and need to comply with MSME credit targets. Bank loan maturities are relatively short, suggesting banks are not able to provide sufficient amounts of longer-term capital to support housing, investment, and other developmental needs. Despite progress made, interbank and money markets remain segmented and relatively shallow.

- *Non-bank sector.* Insurance companies and multi-finance companies are the distant second and third largest segments of the financial system, accounting for about 10 and 5 percent of financial sector assets, respectively. Mutual funds, pensions funds, and microfinance entities remain small (several banks are also active in microfinance).

- *Financial conglomerates (FC).* At end-2015, The forty-four identified financial groups accounted for about 66 percent of financial sector assets, with banks within FCs comprising 84 percent of banking sector assets. The majority of insurers belong to conglomerates. More than one half of FCs have a horizontal structure with a non-regulated holding company that controls the group. Given their size and the risks that they pose, such groups must be overseen, by OJK and the groups themselves, in an effective manner to safeguard financial stability.

- *State holding company.* The government plans to create a holding company for state-owned financial institutions before the end of 2017.[5] The holding company will bring together the four state-owned commercial banks, a financial entity specializing in SME lending, and a payment switch provider.

5. **The financial sector lags peer countries in several areas (Figure 1), although it is not systematically out of line with countries at a similar level of economic development.**

- *Bank credit.* At about 40 percent to GDP, credit intermediation is low, but broadly in line with other countries with similar GDP per capita. Net-interest margins, a proxy for bank efficiency, have structurally exceeded peers. Inefficient credit intermediation is affected by high costs, in part due to weaknesses in the "enabling environment" which comprises insolvency and creditor rights framework and credit information systems—both compare poorly internationally.

- *Equity markets.* The stock exchange market capitalization, at 41 percent of GDP, is in line with expectation but underperforms the median of peers by roughly 30 percentage points of GDP.

- *Fixed income markets.* The fixed income market segment is underdeveloped relative to peers in both the public and private segments. Private debt securities outstanding are about 2.5 percent of GDP with banks and finance companies

[5] In principle, the rationale for the establishment of the bank holding company is two-fold: (i) focus each state bank more finely on a given market segment and banking products/services, and (ii) achieve cost efficiencies by consolidating certain operational aspects (processing, IT, etc.) of the banks.

accounting for 63.5 percent of outstanding holdings. While deeper, outstanding tradeable government securities amounted to just 13 percent of GDP.

- *Domestic institutional investors.* Asset holdings by institutional investors remains low, with outstanding assets under management of pension funds at just below 2 percent of GDP and double that level for insurance companies. Each type of investor trails peers by a wide margin.

- *Foreign investors.* In the absence of a large domestic investor base, non-residents play a large role, also compared to peers. Almost 40 percent of government securities and 54 percent of equities is held by foreigners. Corporate debt in foreign currencies is about 45 percent of total corporate borrowings of which about 60 percent is held by non-residents.

- *Financial inclusion.* Household access to the formal financial sector as measured by the percentage of adults holding a transactional account is only 36 percent[6], below the 69 percent regional average. At 27.4 percent, the fraction of firms with a line of credit is below peers.[7]

### C. Implications for FSAP Scope

6. **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.

7. **The structure of the financial system points to various inter-related financial development priorities which set the stage for the remainder of this report.**

    - *Efficiency and inclusion.* The relatively small size and high intermediation costs of the banking system impede financial deepening and inclusion (Section V). Inefficiencies can in part be addressed through the use of digital financial services to overcome geographical challenges and strengthening the "enabling environment" which includes insolvency and creditor rights frameworks and sound accounting standards and practices (Section V)—this will also contribute to sustainable financial sector growth and allow it to reap scale economies which will further help reduce costs.

    - *Supervision and corporate governance.* Given their size and importance, FCs require strong group-wide corporate governance frameworks and practices and an effective supervisory approach across sectors by the newly created integrated supervisor OJK which is still in transition (Section III). In addition to in-depth analysis of these issues, the FSAP also followed up on key deficiencies identified

[6] Based on 2014 World Bank Global Findex which does not reflect any recent progress made.
[7] 2016 World Bank Enterprise Survey.

in the assessment of *Basel Core Principles for Effective Banking Supervision* (BCP) in the 2010 FSAP (Section III)—relatively little progress was made in some areas (Appendix III).

- *Capital markets.* The current combination of shallow capital markets and high foreign participation can act as a shock amplifier. 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 (Section V). More developed capital markets can also impose competitive pressure on the banking sector to innovate, become more efficient, and sustainably reach out to new segments.

- *Insurance.* In the context of insurance being the fastest growing sector and various weaknesses identified in the 2010 FSAP, the FSAP undertook the first detailed assessment of compliance with the *Insurance Core Principles* (ICP) (Section III).

## II. Risks and Resilience

8. **Reported bank capital ratios have increased in recent years and are currently well above regulatory minima (Figure 2 and Appendix II).** Banks' aggregate capital ratio was 20.6 percent in the third quarter of 2016, well above regulatory requirements, including for Domestic Systemically Important banks (D-SIBs). High profitability, despite relatively weak credit intermediation efficiency, is a contributing factor. Over 90 percent of capital is in the form of high-quality common equity tier-1 capital.

9. **Asset quality has deteriorated as economic activity decelerated, and headline numbers may understate the extent of the deterioration.** Nonperforming loans (NPLs) have increased, particularly in the commodity-related and manufacturing sectors, from 1.7 percent in 2013 to 3 percent in late 2016. In addition, special-mention loans have remained high in recent years (around 4 - 5.5 percent of total loans), and there has been an increase in restructured loans to about 2.5 percentage points of total loans since June 2015, most of which are not classified as NPLs. These trends are cause for vigilance particularly given weaknesses identified in the internal risk control and management functions of banks and FCs. They also put a premium on improving the insolvency and creditor rights framework. Both issues are discussed in more depth in Section V.

10. **Larger banks tend to have lower NPLs and stronger profits, although the profitability of some D-SIBs is relatively low.** Liquidity indicators of the larger banks, including state-owned banks, also appear solid, while those of smaller banks look weaker on average. Structurally, banks rely on short-term deposits for funding; nearly 90 percent of deposits have a maturity of less than 90 days.

11. **Measures of systemic risk are low and stress tests suggest the banking system is broadly resilient to shocks even under the most adverse scenarios:**

- *Solvency.* High capital and strong profitability allow most banks to manage credit and market losses. However, a significant capital depletion for many banks (including some D-SIBs) may induce a credit crunch if banks abruptly deleverage. Domestic contagion through interbank or common exposures is limited.

- *Liquidity.* Although at the system-wide level there is ample liquidity, severe liquidity stress tests show that smaller banks may experience liquidity shortfalls, including in foreign currency, but the amounts needed are manageable.

12. **Corporate vulnerabilities have remained broadly in check, but some risks remain.** Corporate leverage remains moderate, along with a slight decline in foreign-currency denominated debt, partly aided by the implementation of BI hedging regulations. Yet important vulnerabilities remain in the form of (i) relatively high debt-at-risk, particularly in the commodities, construction, and transportation sectors, (ii) a high share of foreign currency-denominated debt securities, and (iii) rising rollover needs. In this context, further development of local currency bond markets is welcome (Section V).

## III. OVERSIGHT

### A. Institutional Setup

13. **The supervisory landscape changed with the establishment of OJK as an integrated supervisor in 2011.** The underlying rationale for the establishment of OJK was the perceived complexity of the financial system and the increasing presence of large, complex FCs with activities across sectors. OJK assumed oversight responsibilities over nonbank financial institutions (NBFIs) from end-2012 and over banks from end-2013; previously, these responsibilities were held by Bapepam-LK and BI, respectively. OJK's responsibilities include prudential and conduct supervision of banks, insurers, pension funds, FCs, finance companies, and securities firms.

14. **OJK has successfully negotiated the initial "settling-in" period, but transition challenges remain.** The need to replace a loss of supervisory skills and experience due to the recent return of about one-third of the supervisors who came from BI, has added to the challenge of capacity building. Other legacy issues associated with the creation of OJK are the "ownership" of prudential tools and data, and the potential overlap of supervisory activities between OJK, BI and the Indonesian Deposit Insurance Corporation (LPS) which is an ineffective use of resources and could adversely affect accountability and information sharing. Additional clarity on mandates and closer cooperation between BI and OJK regarding macroprudential oversight is needed (Box 1).

15. **The OJK Law should be revised to place unequivocal primacy on financial stability objectives and bring legal protection in line with international best practice.** OJK's mandate and practices place similar priorities on macroeconomic, financial development and financial stability goals. OJK should have financial stability clearly established as its primary goal to ensure its independence and accountability. In addition, the legal

framework should further enhance conditions for timely supervisory action by aligning the legal protection for agencies, supervisors, and contractors against lawsuits for actions taken or omissions made in good faith with international standards.

**Box 1. Macroprudential oversight**

The current macroprudential policy framework is broadly adequate but some aspects need to be strengthened. The current setup derives from the OJK Law, which makes BI responsible for macroprudential policy. BI has:

- issued regulations to guide macroprudential policy;
- made organizational changes, including creating a macroprudential policy department;
- developed analytical tools to assess systemic risk;
- introduced macroprudential instruments, such as limits on loan-to-value ratios and loan-to-funding ratio-linked reserve requirements, over which it has direct control by regulation; and
- recently introduced a countercyclical capital buffer on banks.

The BI Law should be amended to include a macroprudential mandate, focused on systemic risk and covering the entire financial system, not just banks. Provisions should be made to grant BI access to the nonbank financial data needed for systemic risk monitoring.

Closer cooperation between BI and OJK is needed. BI and OJK currently coordinate their operations in the context of a technical micro-macroprudential forum. Effective coordination between BI and OJK is required to ensure that the implementation of each institution's respective mandates and tools does not lead to conflicting or counterproductive policies. Over the medium term, the authorities should consider elevating the micromacroprudential forum to a policy level forum.

16. **The silo-based governance arrangements embedded in the OJK Act impede the transition towards a fully integrated supervisory agency**. The responsibilities of individual Commissioners for the supervision of specific sectors should be removed from the OJK Law as it effectively enshrines sector silos. This governance structure is mirrored in OJK's organizational structure which inhibits the harmonization across sectors of supervisory practices (e.g. licensing, risk assessments, rating criteria, research) and regulations (e.g. definition of capital, credit risk management, and some qualitative prudential requirements). The resulting un-level playing field increases the scope and incentives for regulatory arbitrage.

17. **Notwithstanding progress towards an approach which "looks" through the structure of entities, OJK needs an ambitious review of its organizational structure**. Recent steps towards a more integrated supervisory approach, including the creation of the Integrated Supervisory Department and the issuance of integrated regulation for FCs, are welcome. Yet, going forward, OJK's organizational structure should be reviewed to maximize the benefits from skills cross-fertilization through the centralization of supervisory support functions and with the aim of assigning responsibility for the supervision of each FC to a single team.

## B. Solo and Conglomerate Supervision

### Banks

18. **OJK's legal framework provides appropriate powers to regulate and supervise institutions on a solo basis**. The OJK Law allows OJK to issue legally binding regulation on a broad set of issues and to collect the necessary information from regulated entities. Moreover, OJK can take appropriate corrective and sanction actions.

19. **The supervisory approach allows for comprehensive analysis of inherent risk and risk management processes but needs further strengthening in the following areas:**

- *Intensity of supervision.* There is scope for supervisors to more intrusively challenge industry practices in areas such as risk management, corporate governance, credit classification process, and capital adequacy.

- *Holistic view of bank's risk management systems.* In some cases, the results of supervisory reviews of the effectiveness of the bank's risk control systems are not clearly consolidated into conclusions about the adequacy of the bank's control systems and the ability of the bank's BoC and BoD to effectively oversee bank operations, particularly given observed governance challenges noted elsewhere.

- *Validation of banks' supervisory information.* The internal functions (e.g. risk management) that generate such information (e.g. credit classification and trend information) should be regularly reviewed during onsite reviews, and the information and risk control process explicitly tested and validated. The results of such testing and validation should feed into the supervisor's assessment of the adequacy of corporate governance and establish the level of reliance supervisors can place on banks' systems and their ability to proactively respond to risks. This, then, directly influences the supervisory strategy established for each institution.

- *Focus of supervisory examinations.* Examination activities are not always clearly linked to the key risks identified in the risk assessment and do not consistently evaluate the bank's ability to identify and address risks.

20. T**he regulation and framework for assessing and managing credit risk are appropriate, but implementation and enforcement can be strengthened.** Areas requiring more supervisory rigor include the need for: strengthening BoC oversight of critical controls functions, more independent credit risk review and surveillance processes in banks, and more thorough assessment of the accuracy and integrity of credit quality reports generated by business lines. In this regard, the function and organizational position of credit risk management within banks requires strengthening to enable the function to independently evaluate and reasonably ensure accurate loan classification and provisioning. These findings suggest a cautious interpretation of reported asset quality figures and the need to be vigilant about loan restructuring practices (Section III).

21. **OJK has improved the capital adequacy framework for FCs by establishing regulatory capital requirements, but further steps are necessary.** The proposed methodology is unable to limit the down-streaming of proceeds from parents to financial subsidiaries and their potential to generate undetected excessive leverage

**Insurance**

22. **Insurance regulation and supervision have improved since the establishment of OJK and the enactment of the new Insurance Law in 2014.** For example, OJK issued a number of new regulations, gradually introduced risk-based supervision through active use of its supervisory powers including revocation of licenses and enhanced regulations for corporate governance and risk management.

23. **However, an assessment against the IAIS Core Principles (ICP) for Effective Supervision has identified important areas for further improvement:**

    - *Lack of effective group regulation and supervision.* This was also identified for FCs. While OJK has implemented regulations related to risk management and group capital, intra-group transactions are not sufficiently taken into account and thus double gearing within insurance entities and investment arbitrage between insurance entities and non-financial entities may exist.

    - *Mandates and legal protection.* The ICP assessment affirms the need to improve legal protection of OJK and its staff and provide primacy to financial stability and policyholder protection.

    - *Corporate governance.* Similar to observations made for banks and FCs, stronger independence and reporting lines of key control functions are required to improve the effectiveness of corporate governance and risk management.

    - *Skills.* OJK faces an insurance skills and experience gap (e.g. actuary) which impedes both OJK and the industry transitioning smoothly from a compliance-based culture to a risk-based approach.

    - *Supervisory approach.* OJK needs to revise the "three strikes" approach to ensure prompt corrective actions.

**Financial conglomerates**

24. **The large and complex financial conglomerates (FCs) that dominate the financial system of Indonesia require rigorous consolidated supervision.** These FCs pose group-specific risks (e.g., capital double gearing, conflicts of interest, risks of contagion, related-party lending, and concentration of exposures) that go beyond sector-specific supervision.

25. **Weaknesses in corporate governance and complex structures impede effective supervision of FCs.** These issues compound the implementation challenges associated with the early stages of an integrated supervisory approach. Further, the concept of a

licensed holding company currently does not exist in Indonesia. As such, most FCs do not operate under a regulated entity with the full ability to monitor and manage group-wide risks.

26. **In the absence of holding companies, OJK requires FCs to appoint a Lead Entity, but this creates its own set of challenges.** OJK has required FCs to appoint a Lead Entity (typically the bank within the group) which is responsible for preparing a consolidated view of its respective group. However, the effectiveness of this approach crucially depends on the Lead Entity's ability to reach across ownership lines and impose compliance with OJK's integrated regulations.

27. **The law should be amended to allow OJK to license non-operating holding companies which would then be responsible for group-wide oversight.**

### C. Conglomerate Corporate Governance

28. **Consistent group-wide governance, risk management, and capital management arrangements must be in place at the highest levels of the FC.** The implementation of OJK's recently issued risk management regulation, which requires consolidation of risk measurement and management on a group-wide basis, places high demands on management, staff, and financial resources. As such, each group's roadmap for and progress toward achieving these goals should be evaluated by OJK, in light of the size and nature of the group's operations.

29. **OJK regulations have accomplished the important objective of initiating BoC and BoD thinking about how group-wide risks should be measured and managed.** However, many FCs have responded to the regulations on more of a compliance basis and have yet to embrace the concept of and recognize the need for more advanced governance and risk management processes. Companies should be encouraged to proactively strengthen both, not only to achieve compliance with OJK regulation, but also because they are necessary from a business perspective.

30. **In particular, FC and parent company scenario and stress analysis and contingency planning in case of business interruption or failure are not well conceptualized.** This is key to understanding how the financial arm of the group, or surviving companies within a FC, would respond and be safeguarded in such a case. Within this context, intragroup transactions and exposures also deserve specific attention.

31. **These challenges are compounded by weaknesses in the legal framework, including:**

    - *A lack of holding companies.* From a practical managerial perspective, the FC's Lead Entity faces challenges similar to the challenges faced by OJK regulation as it attempts to reach across the FC in the absence of a regulated holding company, as discussed elsewhere.

- *Blurring roles of administrative bodies.* Currently, the Company Law restricts the authority of the BoC at all levels in the FC to appoint the BoD, to approve and supervise key management decisions, and to hold the BOD accountable. The corporate governance framework should be reviewed to ensure the BoC clearly has the responsibility and proper tools to effectively oversee management and bank performance.

32. **Legislation, as well as practices, direct that risk management and the internal auditor have primary responsibility to the BoD and *not* to the BoC—this compromises the independence of control functions.** It also undermines the BoC's ability to independently evaluate management performance and to be apprised of risk issues. This further diminishes the capacity of both OJK and the FC itself to ensure consistent group-wide oversight and risk management.

33. **Discussions with a range of stakeholders suggest BoC members do not always have sufficient technical skills and time.** While members are required to take and pass a qualifications test prior to finalizing their appointment to the BoC, this cannot replace experience and skills accumulated over time.

34. **As mentioned, the government plans to establish a holding company for the state-owned bank. Careful consideration should be given by the authorities to the market impact and institutional design.** Such a holding company could diminish banking competition by streamlining operations and consolidating the market. However, on the flip side, if based on strong governance principles, such an arrangement could facilitate greater distance from political influence, thereby allowing greater independence and professionalism of oversight and operations.

35. **In conclusion, while important steps have been initiated by both the FCs and OJK, FCs have a long way to go to truly implement governance and risk management processes that can trigger proactive and prudent management of the business.** While OJK has stated its plans to strengthen FC risk management through its *Roadmap of Integrated FC Supervision*, it is ultimately the responsibility of the FCs themselves to plan for and manage their risk and capital position.

## D. Financial Integrity

36. **The authorities have made substantial progress in addressing AML/CFT deficiencies identified in the 2008 Mutual Evaluation Report of the Asia Pacific Group on Money Laundering (APG).** Amendments to the AML law in 2010 and passage of the CFT law in 2013 broadly addressed key deficiencies, including by criminalizing money laundering (ML) and terrorist financing (TF) in line with the revised Financial Action Task Force (FATF) standard, and extending AML/CFT requirements to money value transfers services (including remittance service providers). New procedures for freezing terrorist assets under United Nations Security Council Resolutions contributed to Indonesia's exit from the FATF's monitoring in 2015. The authorities also completed a comprehensive National ML/TF Risks Assessment in 2015 with broad participation from relevant stakeholders, and co-led a multi-country risk assessment on

TF for the South-east Asian region. The APG is scheduled to assess Indonesia's AML/CFT regime in late 2017.

37. **But some shortcomings remain, including aligning the AML/CFT framework more closely with the revised FATF standard.** Specifically, AML/CFT supervision should be conducted on a risk basis and relevant agencies need to align their AML/CFT priorities according to the identified ML/TF risks. The authorities should enhance the capabilities of law enforcement agencies to conduct financial investigations and strengthen mechanisms for exchanging information with foreign counterparts. The authorities are also encouraged to introduce a legal requirement for reporting entities to identify, assess, and understand their broader ML/TF risks. Finally, the targeted financial sanctions regime for terrorism and TF should be implemented without delay.

## IV. SAFETY NETS AND CRISIS MANAGEMENT

### A. Institutional Setup

38. **The authorities have revamped the framework for crisis management and resolution**.[8] The Prevention and Resolution of System Financial Crisis Law (PPKSK Law) enacted in 2016 clarifies the responsibilities of the agencies involved in crisis management and widens the resolution tool kit. It also establishes the KSSK, comprising the Finance Minister (coordinator) and the heads of BI, OJK, and the LPS (as a non-voting member). KSSK's responsibilities include dealing with the distress or failure of D-SIBs and systemic banking crises and recommending to the President of Indonesia to declare a status of financial system crisis that in turn would open a wider range of resolution powers (particularly bail-in).

39. **The new framework represents a substantial improvement over previous arrangements but should be better aligned with international principles:**[9]

- *Mandates.* As mentioned, agencies involved in crisis management and resolution should have *primary* financial stability mandates in their respective laws.[10]

- *Legal protection.* Although the PPKSK Law has strengthened legal protection across the agencies involved in crisis management, further strengthening is needed, including in the relevant agencies' laws, to provide legal protection as envisioned

[8] The framework is still work-in-progress, and at the time of the FSAP, the authorities were working on regulations required under the new law, including on emergency liquidity assistance (ELA), recovery planning, systemic bank resolution, the Bank Restructuring Program (BRP), and non-systemic bank resolution.
[9] Particularly the Key Attributes for Effective Resolution Regimes for Financial Institutions, but also the BCP and the ICP.
[10] The OJK Law should give unambiguous primacy to OJK's financial stability objective (consistent with the PPKSK Law); the LPS Law should specify more clearly LPS' statutory objectives, focusing on the maintenance of financial stability and continuity of critical functions, protection of insured depositors and minimization of the costs associated with resolution; and the BI Law should include financial stability assessment and macroprudential policy as part of BI mandates.

in international guidelines. Inadequate legal protection creates a risk of crisis management decisions being delayed or even avoided due to concerns over potential liability.[11]

- *Role of the KSSK.* To avoid the risk of diluted responsibility, accountability, and delayed decision making, the Law should limit the role of the KSSK solely to that of a coordination body and remove its power to direct member agencies in their respective areas of responsibility. It would also be desirable to set out more detailed guidance on the role of KSSK and each agency in a decree, as is proposed by the authorities.

- *Role of the President.* The President, on a recommendation from the KSSK, decides whether to formally declare a status of financial system crisis and whether to invoke the Bank Restructuring Plan (BRP), under which the LPS is allowed to use a broader set of resolution tools. This risks diluting LPS' responsibility and the KSSK to deal effectively with resolution issues, and could also create a risk of politicizing resolution decisions. It also limits the use of some resolution powers, especially bail-in, to a situation where the President has invoked the BRP, which is overly limiting. Thus, the authorities should consider revising the Law to focus the President's role on decisions on the use of public funding, as discussed below.

## B. Crisis Management and Resolution

40. **OJK is able to respond promptly to emerging stress and it has new powers to implement regulations for D-SIB recovery planning.** OJK has the ability to respond promptly to emerging stress in banks, insurers and financial market infrastructures[12] (FMIs), including:

    - *A range of corrective action powers*.

    - *Early warning indicators* (EWIs) to detect emerging stress in banks and, to some degree, insurers and FMIs. Further refinement is recommended, including deeper integration into corrective action frameworks and extending EWIs to FCs.

    - *Regulation on recovery planning for D-SIBs*, as required by the PPKSK Law. Over the medium term, recovery planning should be extended to FCs and medium-sized banks and, in the longer term, also to large and medium-sized insurers, FMIs, and remaining banks.

41. **The LPS has many of the powers needed for the resolution of banks, but the framework can be improved in several areas, including:**

[11] The main shortcomings in the PPKSK Law are that the test for legal protection is "misuse of authority" rather than the internationally recognized "good faith", that it applies only to actions taken in situations of near-crisis or crisis, and it does not extend to the institution itself and persons acting on its behalf.
[12] Central clearing counterparties and custodians in particular.

- *Legal framework.* The PPKSK Law and the LPS Law should be amended to specify triggers for invoking resolution, empower LPS to require banks to implement changes to facilitate resolution in accordance with resolution plans, and enable LPS to apply bail-in without Presidential approval.

- *Financial conglomerates.* Resolution powers over FCs should be strengthened and robust safeguards be established for the application of resolution powers (including compensation for creditors left worse off than under a winding up).

- *Resolution.* The authorities should develop guidance on resolution options applicable to banks (differentiating by size as appropriate), and develop frameworks for implementing resolvability assessments and resolution plans for D-SIBs.

- *Bail-in.* A deposit-dominated funding structure and a lack of a clear creditor hierarchy will make bail-in challenging to implement. The recovery planning regulation for D-SIBs will help by requiring D-SIBs to issue debt capable of contractual bail-in. The authorities need to develop guidance on how bail-in powers might apply to deposits and other instruments without bail-in clauses.

## C. Safety Nets

42. **There is a need to improve the deposit insurance payout process and align the ceiling with international norms while still covering the vast majority of households**. LPS needs stronger legal and technical capacity to be able to calculate reliably and quickly the eligible amounts for payout and to process the payouts rapidly. Moreover, at Rp 2 billion (about US$150,000), the deposit insurance limit is excessively high relative to average retail deposits and per capita GDP, giving rise to moral hazard risks and weakening market discipline on banks. The high limit also increases the risk of funding shortfalls relative to LPS obligations and reduces the scope for bail-in.

43. **The new crisis management framework rules out the use of public funding in resolution, other than in a limited context related to LPS funding.** Instead, the new framework will involve a new LPS-administered, industry-financed funding mechanism (under development) that would be used for systemic bank resolution situations once the BRP has been triggered.

44. **The PPKSK Law should be amended to increase the practical feasibility of a levy-funded systemic resolution fund.** Specifically, the Law should enable levies to be made on the banking industry to build up a systemic resolution fund without the need for the BRP to be invoked.

45. **The authorities should also consider amending the PPKSK Law to allow for the use of public funding, subject to strong safeguards.** Notwithstanding legitimate moral hazard concerns that motivated precluding the use of public funds, eliminating this option altogether is overly constraining, especially in systemic crises. A public funding mechanism that complements the industry-financed fund recognizes that some systemic

bank resolutions could require public funding or the provision of guarantees. Public funding should only be allowed in limited circumstances justified by systemic stability considerations and subject to the President's approval and robust safeguards, including preconditions for use and processes for ex-post recovery from the banking industry.

46. **The ELA framework will need to be modified to ensure its effectiveness, which is important given the liquidity risks discussed earlier.** BI can, under the BI Law and the PPKSK Law, provide ELA to any solvent bank but the criteria for providing liquidity to banks experiencing funding difficulties are too restrictive and risk making it ineffective. Specific areas for improvement include:

- *ELA eligibility.* Consider allowing emergency lending to a bank that is assessed by OJK as viable even if its capital is temporarily below minimum requirements.

- *Coordination.* Further work is also needed on the coordination among agencies (OJK, BI, and LPS) on solvency assessment and on eligible collateral to ensure that ELA is practicable when it is likely to be needed.

- *Indemnity.* When BI is not satisfied with a bank's solvency and viability, or with the collateral, it should be able to request an indemnity from the government, subject to appropriate safeguards. The law should be amended to enable the government to provide such indemnities.

## V. DEVELOPMENT AND INCLUSION

### A. Banking Efficiency

47. **Bank intermediation efficiency is relatively low, which holds back financial development and, ultimately, inclusive and sustainable economic growth (Figure 3)**. Net-interest margins have been structurally higher in Indonesia than in peers. The small size of the banking system, weaknesses in the institutional environment, high market power, and operational inefficiencies contribute to weak intermediation efficiency.

48. **Given the central importance of banks, the authorities have taken several policy initiatives to boost credit growth and intermediation efficiency, including:**

- *Deposit rate caps.* Initially introduced to address a shortage of liquidity in 2013, OJK has been enforcing deposit rate caps for the largest banks, effectively a transfer from savers to borrowers and banks.

- *Single digit lending rates.* OJK has been using moral suasion to induce all banks to lower lending rates to single digit levels, particularly for the corporate and mortgage segments.[13]

- *Portfolio exposure targets.* Despite differences in their products, services, clientele, risk appetite and sectoral know-how, BI requires all banks to meet minimum MSME exposure targets.

- *Loans-to-Funding ratio range (LFR).* Banks need to comply with a 80-92 percent LFR range for both prudential and developmental purposes.

- *Guarantees and interest rate subsidies.* The government's expansion of the KUR program to boost MSME and micro lending distorts the market, given KUR's credit guarantee and interest rate subsidy.

49. **A more coordinated, cross-cutting approach addressing root causes of weak intermediation efficiency is required; this section lays out various suggestions.** The above-mentioned measures may not prove effective in achieving sustainable higher growth and financial deepening and could have unintended consequences. Rather, building on existing efforts, the authorities could consider formulating an integrated roadmap focused on cross-cutting financial sector fundamentals such as legal, tax and regulatory frameworks to enhance capital markets, insolvency and credit rights regimes, and the impact of digital financial services.

## B. Capital Markets

50. **Indonesia's capital markets can play a larger role in advancing economic growth and reducing vulnerabilities.** Deeper local currency markets and a stronger domestic investor base would help reduce the exposure to currency shocks and capital outflows due to the currently large role of foreign investors. Moreover, as discussed earlier, Indonesia faces a challenging long-term finance and investment gap, particularly in infrastructure (Box 2). The development of capital markets to mobilize private, long-term finance is needed to supplement and reduce the reliance on banking and fiscal sources.

51. **The authorities have made good progress in enhancing inter-agency coordination[14] which is necessary to develop Indonesia's shallow capital markets. Going forward, efforts should focus on common root causes across market segments and comprise:** (i) a review of the tax framework; (ii) improvements in creditor rights; (iii) elimination of regulatory hurdles affecting investors; (iv) development of interest rate swap (IRS) and foreign exchange (FX) derivatives; and (v) further improvements in financial literacy of issuers and investors. The recently established high-level Financial Market Coordination

[13] The instruction to move to single digits was set out in a letter from OJK to banks, not in regulation. Discussions to reach "single digits" take place during annual supervisory reviews of banks' business plans.

[14] Examples of cross-agency coordination include the high-level Financial Market Coordination Forum (FKPPPK), the Bond Market Development Team (TPPSU), and the Capital Market Infrastructure Development Team (TPIPM).

Forum (FKPPPK) and lower-level technical platforms provide promising coordination vehicles to ensure an integrated approach.

**Money markets**

52. **Efforts are needed to develop money markets—these will also help spur a robust market for interest rate derivatives.** The authorities are pursuing various approaches to deepen money markets which are currently shallow and segmented. However, greater urgency should be given to developing a liquid IRS curve.

53. **This requires a strategic decision on the money market reference rate** that would best fit the requirements for IRS contracts and the design of additional measures to improve the underlying market infrastructure, standardization, and liquidity of the market.

**Government bond markets**

54. **While government bond markets are relatively developed, there is scope to enhance liquidity and the price referencing role of its yield curve.** MoF should endeavor to enhance liquidity of its benchmark and off-the-run securities, particularly since a growing number of instruments (e.g. T-Bills, T-Bonds, Sukuk) and larger holdings of buy-and-hold investors may adversely impact liquidity along the curve.

55. **Actions in two areas are especially relevant:**

- *Benchmarks.* A strategy for primary markets is needed to reduce fragmentation and to increase the standardization and size of benchmarks.

- *Infrastructure.* Improve the secondary market architecture, including the introduction of an electronic trading platform with actual "hit and trade" quotes.

### Box 2. Infrastructure Finance via Capital Markets

Infrastructure financing via capital markets has been predominantly done using simple corporate financing vehicles. Issuers are mainly SOEs using plain vanilla bonds with full recourse to the issuer. Project finance, non-recourse, structures are absent in Indonesia's capital markets.

Private sector participation remains subdued due to two sets of constraints related to:

- *Public-private partnership (PPP) framework.* This relates to legal and regulatory complexity; involvement of multiple government agencies and lack of clarity of their roles and responsibilities, resulting in overlaps and a lack of coordination; difficulties in securing land and environmental safeguards clearances; and limited capacity of government contracting agencies to prepare, structure, and implement projects.
- *Capital markets.* General impediments include the small size of the domestic institutional investor base; the short-term investment culture; the lack of hedging instruments; and the need for improvements in creditor rights, especially to expand access for private sector issuers and to attract investors.

In addition to these general capital market development issues, specific measures are required for project finance:

- *Legal and regulatory framework*. There is a need to strengthen the framework for special purpose vehicles (SPVs) and their tax treatment; improve the regulatory framework for bond issuance (e.g. offering regime for qualified investors); and align investment regulation of institutional investors with the framework for offering and listing of bonds.
- *Project financing instruments and guarantees.* Several capital market structures are being used and tested internationally in project financing. In Indonesia, institutions such as SMI, IIGF and IIF could be instrumental for the development of such solutions.

## Corporate bond markets

56. **Corporate bond markets are particularly shallow although they have grown recently.** Bank loans are still the preferred, and sometimes the only, funding option for companies. While the outstanding amount is still low by international standards, corporate issuance growth has been high. Most instruments are plain vanilla bonds, in part due to the incipient stage of market development, limited investor literacy, and tax and regulatory impediments for certain products (e.g. infrastructure bonds). Importantly, investors appear to prefer to invest in SOE instruments due to the perception that SOEs provide less risk or higher expected recovery ratios compared to non-SOE issuers, even in cases where both have similar credit ratings.

57. **Wide-ranging actions are required to accelerate the number of private issuers and instruments to mitigate the apparent preference for SOE instruments, including:**

- *Issuance framework.* Expedite the approval process of public offers and implement a new special offering regime to qualified investors.
- *Captive demand for SOE instruments.* Review regulation that creates captive demand such as investment requirements in state and SOE instruments for NBFIs.

- *Creditor rights.* Improvements in creditor rights and default resolution would boost investor demand and could be especially important to reduce the valuation and demand gap between SOE and non-SOE instruments.

- *Legal and regulatory framework.* The framework requires updating to support a greater diversity of products, especially infrastructure project bonds (see Box 2).

- *Secondary market liquidity.* Potential solutions could focus on market making requirements and the introduction of an organized call market.

**Equity markets**

58. **Equity markets have improved, but constraints on attracting new listings remain.** Some firms are reluctant to list for a variety of reasons including the prevailing ownership control culture in family-owned businesses, the unwillingness to operate in a fully transparent and public manner, and the time and cost of IPOs—the public offering process is still relatively long and costly compared to funding via bank loans.

59. **Further actions are required to strengthen issuers' balance sheets and boost investor diversification, firm listings, and trading activity, including:**

    - *Tax framework.* A review of the framework for investors (e.g. the merit of tax exemptions for transactions below a maximum amount), in the context of an overall review of the taxation of financial instruments.

    - *Securities firms.* A strategy to strengthen securities firms' qualifications.

    - *Investor base.* A strategy to diversify the pool of IPO investors.

    - *Governance.* Enhancements in the Company Law and corporate governance frameworks are required to build confidence of minority shareholders.

    - *Literacy.* Measures to improve financial literacy and education of both target firms and (retail) investors are particularly important.

**Derivatives**

60. **The absence of a deep and liquid market to hedge interest rate and foreign exchange fluctuations is a prime impediment to capital market development.** Hedging markets facilitate long-term financing and help investors manage duration and currency mismatches which is key given Indonesia's reliance on foreign capital.

61. **An integrated approach is required which encompasses, inter alia:**

    - *Coordination.* Better inter-agency and cross-segment coordination is required regarding money markets (e.g. to provide a liquid reference rate), and the government's issuance policy (e.g. to match maturity dates of futures contracts).

- *Regulatory and tax framework.* The framework should be reviewed to stimulate the participation of a broad range of market participants (e.g. allow derivatives trading on the exchange, remove double taxation).

- *Infrastructure.* Speed-up the implementation of the necessary upgrades in OTC derivatives, in compliance with G-20 commitments.

**Investor base**

62. **Additional efforts are necessary to grow the domestic institutional investor base and enhance their market participation.** The authorities have implemented measures to mobilize savings, such as the recent social security reform, and enhance regulations of different capital markets products, but scope for improvement remains. Greater participation of domestic institutional and retail investors in capital markets require, inter alia, improvements in:

    - *Tax framework*. The framework currently deters broader participation in different investment products (e.g. by pension funds in mutual funds).

    - *Regulation*. Current features drive pension investments into short-term products and restrict pension funds' ability to use derivatives to manage their portfolios.

    - *Investor literacy.* There is a need to address a conservative investor culture and judiciously increase participation in capital market products.

    - *Hedging instruments*. These instruments would allow banks and institutional investors to manage longer-term exposures and duration mismatches.

## C. Insolvency and Creditor Rights

63. **Adequate insolvency and creditor rights (ICR) regimes increase access to credit, particularly for SMEs, and contribute to financial stability.** Well-functioning insolvency regimes channel failed enterprises to liquidation to ensure that valuable assets are recycled into productive use, and help restructure distressed but viable enterprises. This lowers the cost of credit, enhances enterprise growth, and creates and preserves jobs. Moreover, insolvency regimes are key for investor confidence and NPL management and act as a "safety valve" for corporate distress by avoiding cascading corporate failures.

64. **Partly as a result of the weaknesses in the ICR system, credit intermediation in Indonesia is low compared to peers and the cost of intermediation is high.** Indonesian creditors expect lower NPL recovery rates which raises lending rates and restricts supply, particularly for SMEs.

65. **Current ICR legislation represents a significant improvement over pre-2004 laws:**

    - *Moveables.* Security over moveable property enables coverage of tangible or intangible moveables. A fiduciary transfer of ownership over moveable tangible or

intangible property does not require physical delivery of the assets and allows for the creation of interests in after-acquired or future property.

- *Bankruptcy Law.* The Law contemplates two procedures which can both be initiated by the debtor or any of its creditors, and once initiated are both overseen by a dedicated commercial court. In liquidation, an insolvency practitioner is appointed to liquidate the debtor's assets for the creditors' benefit.

66. **However, both the laws and the *implementation* of legislation still require some improvement[15], particularly regarding the costs of using formal procedures.** The commercial courts report extremely low usage of formal insolvency, particularly by SMEs which make up 99 percent of businesses in Indonesia. This is because the loan collateral given by SMEs is often in the form of inventory and formal procedures relating to inventories do not seem favorable to SMEs.

67. **Specifically, insolvency practitioners are widely perceived as regularly failing to perform their duties effectively while their fees appear excessive.** It was widely and consistently reported by stakeholders that insolvency practitioners may not always behave with integrity and are not sufficiently supervised. The height of the fees also accounts, in part, for the high cost of insolvency proceedings in Indonesia.

68. **There is an over-reliance on out-of-court negotiation and loan restructuring as the chosen method to address corporate distress.** In this context, some banks report that a settlement is often reached with a defaulting borrower. Banks also report, consistent with the court data, that use of formal proceedings under the Bankruptcy Law is relatively rare. In this context, OJK has provided guidance to banks on debt restructuring. Market participants widely perceive the judiciary as being unable to adequately adjudicate bankruptcy cases.

69. **While an important tool, out-of-court restructuring cannot fully replace formal procedures.** Most restructurings amount to debt re-scheduling (e.g., extension of maturity, postponement of interest payments) that does little to address the fundamental operational and financial weaknesses of debtor firms.

### D. Accounting and Auditing

70. **The quality of accounting and auditing for banks is a fundamental pillar for financial sector development and stability.** High-quality financial data, particularly related to the measurement of impaired assets, allows for the early identification of risks and effective supervision. Moreover, it results in higher transparency and public trust which can help lower operational costs, deepen the sector and expand access.

[15] Revision of MLHR Regulation No. 11, 206 concerning Curators and Administrators has been proposed and in the medium and long-term, consideration is being given to revision of bankruptcy and insolvency laws by the National Law Development Agency (BPHN). For example, the Bankruptcy Law does not provide a robust framework for post-commencement financing or clear provisions on the priority of claims in bankruptcy.

71. **Banks' application of PSAK 55 (IAS 39)—recognition and measurement of impaired assets—is largely adequate.** The requirements under the national standard PSAK 55 are the same as those under IAS 39. Application of and adherence to this standard is largely consistent across large banks and foreign banks. FSAP analysis of external audit reports for these banks suggest they comply in practice. "Clean" audit opinions for medium and small banks (which do not need sophisticated impairment modeling) suggest they are also able to comply as required.

72. **However, various factors reflect poorly on auditors' oversight.** Pressure exists to reduce audit costs which may lead to weak assessments and could explain the clean audits of small banks.[16] Additionally, the draft Financial Reporting Act (FRA) should be passed to require, inter alia, that a certified accountant sign the financial statements—this is currently not the case. Smaller and medium-sized banks are often not able to recruit certified accountants which poses a risk of misstatement in their financial statements.

73. **Rural banks follow a different accounting and financial reporting standard—its adaption is desirable.** These banks follow a Tier-2 standard for accounting and financial reporting, based on the 2012 IFRS for SMEs. Challenges exist in the effective application of this standard and OJK noted that not all rural banks are subject to an annual external audit. Adaption of this standard is desirable so that rural banks can produce higher quality financial statements with greater consistency.

74. **The transition from PSAK 55 to IFRS 9 provides an opportunity to address discrepancies between accounting and tax regulations**. IFRS 9 is expected to become effective in 2019. Currently, there is an inconsistency between the accounting standards for provisioning (impairment) and specific tax regulations on the treatment of losses. In part, tax policy does not recognize IAS 39 and treats collateral differently, capping the maximum value of assets that can be used against potential loss. This reduces provisioning expenses allowed for income tax purposes, thereby inflating taxable income.

## E. Inclusion and Digital Financial Services

### Overview

75. **In a context of geographical challenges, access to the formal financial system is relatively low, although it has improved recently.** Only 36 percent of adults have a transaction account with a formal financial institution compared to 69 percent in the East Asia and Pacific region; however, it is an improvement from 20 percent in 2011.[17] Given Indonesia's large population and relatively low access rate, the unbanked population is the third largest in the world.

76. **The new National Financial Inclusion Strategy (SNKI) has raised the profile of the financial inclusion agenda.** The SNKI has an ambitious goal to reach 75 percent of adults with a transaction account by end-2019. The policy profile of financial inclusion

[16] One factor which may also have contributed was the mandatory audit firm rotation which no longer exists.

[17] World Bank Global Findex 2014.

has been raised by appointing the President to be the head of the national steering committee. The strategy will help provide coordination and guidance to the policy initiatives and actions of official and private sector stakeholders.

**MSME finance**

77. **MSMEs play an important role in Indonesia's economy.** As of 2013, there were 57.9 million micro, small and medium-sized enterprises (MSMEs), which accounted for more than 99 percent of all firms in all economic sectors, employed over 114 million people (over 97 percent of total employment in the private sector) and contributed about 60 percent of GDP and 16 percent of non-oil and gas exports.[18]

78. **Bank credit is focused on large corporates and state-owned companies, while MSMEs remain largely underserved (Table 3).[19]** Indonesian MSMEs face significant challenges in accessing financing, mainly due to the stringent operational, reporting and collateral requirements of commercial banks. Notwithstanding various government initiatives discussed earlier, the share of MSME loans to total bank loans stands at around 20 percent.[20] The World Bank estimates the MSME financing gap at US$330 billion.

79. **The Government intervenes in the MSME loan market mainly through the "People's Business Loan" (KUR) program (Box 3).**[21] The KUR program dates from 2007 and has recently been transformed from a partial credit guarantee program that aims to enhance access to loans for borrowers without bankable collateral, to a subsidized credit program that provides inexpensive loans to predominantly low-income micro enterprises. Interest rates are set by the Government far below market rates.

[18] According to data from the Ministry of Cooperatives and SMEs.
[19] According to the 2015 World Bank Enterprise Survey, 14.9 percent of small businesses and 23.5 percent of medium-sized enterprises reported access to finance being the main constraint to their growth; the corresponding figures for the region were 11 percent and 15.5 percent, respectively.
[20] In Thailand, for instance, this figure stands at 32.8 percent, whereas in Korea it is 40.5 percent. In both of these countries, the percentage of SMEs is comparable to Indonesia.
[21] Also see World Bank Indonesia Economic Quarterly (March 2017).

**Box 3. The "People's Business Loan" (Kredit Usaha Rakyat, KUR) program**

The Government of Indonesia established the KUR program in 2007 in order to enhance MSMEs' access to bank loans through the provision of subsidized, partial credit guarantees covering 70 to 80 percent of the loss.

By the end of 2014, the value of total outstanding loans supported by KUR was IDR 49.5 trillion, accounting for approximately 14 percent of all outstanding MSME loans. The Nonperforming Loan (NPL) ratio of these supported loans was 3.3 percent.

Between 2009 and 2014, the 34 participating banks concluded around 12.5 million loan contracts with MSMEs and disbursed IDR 179 trillion in KUR-supported loans. The majority of the program—85 percent of total KUR-backed disbursements—was channeled through three state-owned commercial banks: BRI, Mandiri, and BNI. BRI alone disbursed IDR 117 trillion between 2009 and 2014, or 65 percent of the whole KUR program.

Under the new KUR program, the Government provides interest subsidies to participating banks allowing them to lend to MSMEs at capped interest rates. The number of eligible sectors has also increased. At the same time, the determination of the guarantee fee is now more market based. The new KUR program featured prominently in the Government's economic reform packages announced in late 2015 with the objective to: (i) increase the disbursement of loans to productive businesses; (ii) increase the competitiveness of MSMEs; and (iii) support economic growth and employment.

In 2016, the total loan amount disbursed through the KUR program was IDR 94.4 trillion. Government targets for 2017 are set even higher, coming close to IDR 110 trillion. When compared to the total outstanding stock of loans to micro (IDR 182 trillion by end 2016) and small (IDR 241 trillion) businesses, it is clear that the KUR program is of central importance for the entire market segment.

80. **The new KUR program dominates the MSME loan market with high disbursement targets, resulting in market distortions and a significant fiscal burden.** In conjunction with the ambitious disbursement target of Rp 100-120 trillion in 2016, the program reflects a significant market intervention that puts pressure on interest rates and may crowd out commercially viable lending, particularly in the micro segment.[22] Moreover, it is not clear if the program is achieving lending to new and credit-constrained borrowers (i.e. "additionality") rather than higher indebtedness of existing borrowers.[23]

81. **As such, unless significant benefits from the KUR program can be documented, there is a need to reconsider subsidized lending to MSMEs.** To improve efficiency and fiscal sustainability[24], the authorities should consider better focusing the new KUR program by better targeting, for example, first-time borrowers and MSMEs in remote areas and underserved priority sectors. More broadly, strengthening the financial infrastructure (e.g., ICR regimes, credit information, collateral registries) and pure partial credit guarantees are likely more effective and sustainable interventions.

[22] The Coordinating Minister for Economic Affairs issued regulation in 2016 regarding to The Guidelines of KUR Disbursement to prevent crowding out in microfinance's industry, but its impact remains to be seen.
[23] Under the new KUR program, the requirement of lending additionality has been removed. Repeat borrowers, former KUR borrowers, and former commercial borrowers, can now also apply.
[24] The redesign of the KUR program has led to an estimated ten-fold increase in fiscal costs in terms of both direct and indirect subsidies, which sum up to roughly IDR 12.3 trillion per year over 2016-2017.

82. **The authorities have improved the use of movable collateral by transitioning to an online collateral registry in 2013.** The transformation from manual to online resulted in a huge increase in the number of total registrations. Since its launch, the registry has facilitated over US$30 billion in financing for more than 200,000 small-scale businesses. In total, there were 19.3 million registrations of corporates, MSMEs, and consumers in the three years since the launch, compared to only three million registrations in total during the ten years of operation of the manual registration system that preceded it.

**Digital Financial Services**

83. **A key element of the National Financial Inclusion Strategy is the development of Digital Financial Services (DFS).**[25] Recent reforms allow e-money issuers (banks and nonbanks) and banks providing basic saving accounts and other financial services to engage agents (LKD and Laku Pandai, respectively) to expand service delivery outreach. Agents are now present in all provinces and in 99 percent of the districts. LKD agents can open registered e-money and provide access to cash-in, cash-out, bill payments and transfers services through registered e-money. Laku Pandai (LP) agents offer similar services for basic saving accounts and open new accounts. Almost 50 percent of LP agents are currently only offering basic bank accounts. However, depending on their classification, LP agents can facilitate the micro loan applications loans and provide access to other types of saving accounts and other financial services (e.g, micro insurance and LKD). By end-2016, 20 banks were offering LP services to around 3.7 million customers through 275,916 agents representing 4- and 6-fold year-on-year growth rates, respectively.

84. **The government is shifting transfers to persons (G2P) from cash to non-cash** through a "Combo Card" (i.e. Basic Saving Account and registered e-money in one card). At present non-cash G2P is only disbursed through state-owned banks.

85. **BI and OJK view the rapid developments of the FinTech[26] sector positively and with the potential to address the financing gap in Indonesia.** The FinTech market has expanded in the recent years, with over a hundred companies operating in Indonesia—total Fintech investment was estimated to be USD 15 billion in 2016. BI has established a FinTech office and OJK has established an internal cross-departmental group to monitor developments. OJK recently issued regulation on peer-to-peer (P2P) lending and plans to establish a FinTech incubator. BI issued regulation on payment transaction processing which also applies to FinTech players and intends to establish a regulatory sandbox.

86. **Despite good progress, there are some concerns over the financial sustainability of LKD and LP accounts services provisions to the unbanked.** At present, the cost of

[25] The term DFS is defined as tailored financial services and products delivered through channels other than traditional bank branches. This is how this term is used in Indonesia.

[26] FinTech is defined as innovative usage of technology introducing new ways to the provision of financial services and products. BI categorizes FinTech firms into: (i) payment, clearing and settlement; (ii) deposit, lending and capital raising; (iii) market provisioning; and, (iv) investment and risks management. BI analysis shows 42 percent of FinTech firms are in payment services and around 32 percent in P2P lending.

servicing those accounts, given current volume of transactions and fee structure, is estimated to exceed receipts. Issues undermining financial viability of DFS and the attainment of financial inclusion targets through DFS include:

- *Regulation.* Regulation requires banks and non-banks to engage individual agents directly which could impede cross-selling opportunities of some financial services and weakens the business case for agents and non-banks. Also, regulation requires banks to treat franchisees of existing distribution networks as individual agents instead of being as part of the group—this impedes growth of the agent network.

- *Interoperability.* Challenges to payment system interoperability impedes agent network expansion.

- *Combo Card.* G2P payments are currently only through state-owned banks which creates an unlevel playing field.

- *Credit reporting.* Low credit information coverage forces credit decisions to be based on transaction patterns; however, usage of banking products is low. Higher coverage could therefore support cross-selling opportunities for DFS agents.

- *Infrastructure.* Weaknesses in the communication infrastructure, particularly in remote and rural areas, may pose operational risks which could adversely affect agent and customer confidence in DFS.

87. **To address these concerns, the authorities could consider the following:**

- *Awareness.* In partnership with banks and nonbank PSPs, the authorities could launch a nationwide campaign to spread awareness on LKD, LP and financial services.[27]

- *Regulation.* A separate category of agents which is only allowed to provide cash-in or cash-out services could be created. Their lower risk profile allows for the relaxation of the current requirement that franchisees of existing distribution networks be treated as individual agents instead of being as part of the group.

- *Oversight.* BI and OJK will need to step up their oversight activities of DFS and expand collaboration to monitor and ensure safety, efficiency and reliability.[28]

- *Collaboration with stakeholders.* BI and OJK need to strengthen engagements with the telecom regulator and payment system operators to enhance operational reliability and create a different pricing structure for LKD and LP accounts.

[27] OJK has a plan to conduct a nationwide campaign.

[28] There are plans for joint onsite examination between BI and OJK supervisors.

- *Interoperability*. The ongoing efforts to establish a National Payment Gateway (NPG) to bring full interoperability for e-money and payment cards should be intensified. LKD and LP agent and account mechanisms should be standardized.

- *Government procurement.* As planned, the Government should allow qualifying private banks to offer "Combo Card" services as well and transition to a more transparent commission-based model to compensate the banks. More generally, the process for contracting payment service providers should become more competitive.

## Table 1. Financial System Structure

| | Size | | | | | | Number of institutions | | |
|---|---|---|---|---|---|---|---|---|---|
| | In percent of GDP | | | In percent of aggregated assets of financial institutions | | | | | |
| | 2005 | 2010 | 2015 | 2005 | 2010 | 2015 | 2005 | 2010 | 2015 |
| **Financial institutions: Total assets** | **63.4** | **59.9** | **71.7** | **100.0** | **100.0** | **100.0** | **3,258** | **3,103** | **3,671** |
| Deposit-taking institutions | 52.0 | 45.6 | 55.4 | 82.1 | 76.1 | 77.3 | 2,143 | 1,828 | 1,755 |
| Of which, commercial banks | 51.3 | 44.9 | 54.5 | 81.0 | 75.0 | 76.1 | 134 | 122 | 118 1/ |
| Of which, stated-owned banks | 18.7 | 16.3 | 20.0 | 29.5 | 27.1 | 28.0 | 5 | 4 | 4 |
| Other non-bank financial institutions | 11.3 | 14.3 | 16.3 | 17.9 | 23.9 | 22.7 | 1,115 | 1,275 | 1,916 |
| Insurance companies | 4.4 | 5.9 | 7.2 | 6.9 | 9.9 | 10.0 | 157 | 142 | 137 |
| Pension funds | 2.2 | 1.9 | 1.8 | 3.5 | 3.2 | 2.5 | 312 | 272 | 260 |
| Mutual funds | 1.0 | 2.2 | 2.4 | 1.5 | 3.7 | 3.3 | 293 | 559 | 1,091 |
| Financing intermediaries | 3.2 | 3.4 | 4.1 | 5.0 | 5.7 | 5.7 | 236 | 194 | 266 |
| Other non-bank financial institutions | 0.7 | 0.9 | 0.8 | 1.1 | 1.5 | 1.2 | 117 | 108 | 162 |
| **Financial markets: Market values** | | | | | | | | | |
| Outstanding debt securities | 15.5 | 14.1 | 15.7 | ... | ... | ... | ... | ... | ... |
| Stock market capitalization | 26.0 | 47.2 | 40.8 | ... | ... | ... | ... | ... | ... |
| **Memo item:** | | | | | | | | | |
| Sharia financing | 0.7 | 1.4 | 2.6 | 1.1 | 2.4 | 3.6 | 21 | 34 | 34 |
| Sharia banks | 0.6 | 1.2 | 1.8 | 0.9 | 1.9 | 2.6 | 3 | 11 | 12 |
| Conventional banks with Sharia financing units | 0.1 | 0.3 | 0.7 | 0.2 | 0.4 | 1.0 | 18 | 23 | 22 |

Sources: OJK; Bloomberg; BIS Debt Securities Statistics; and FSAP Team estimates.
1/ One foreign bank branch was closed at the end-February 2017, and the number of commercial banks is now 117.

## Table 2. Structure of the Banking System

(In percent of banking system assets; as of 2016Q3)

| | Top four | All D-SIBs | Medium-sized 1/ | Small-sized 1/ | Micro-sized 1/ | Total |
|---|---|---|---|---|---|---|
| Private bank | 10.1 | 26.6 | 10.2 | 6.4 | 2.4 | 45.6 |
| o/w: Foreign bank subsidiary | 0.0 | 10.2 | 5.5 | 4.1 | 0.4 | 20.2 |
| State-owned bank | 35.4 | 38.5 | 0.0 | 0.0 | 0.0 | 38.5 |
| Regional development bank | 0.0 | 0.0 | 3.8 | 3.8 | 0.9 | 8.5 |
| Foreign bank branch | 0.0 | 0.0 | 5.8 | 1.5 | 0.1 | 7.4 |
| Total | 45.5 | 65.1 | 19.7 | 11.8 | 3.4 | 100.0 |

Sources: OJK; and FSAP Team estimates.
1/ Medium-size, small-size, and micro-size banks comprise banks whose total assets are between 40 billion and 100 billion, 10 billion and 40 billion, and less than 10 billion rupiah as of 2016Q3, respectively.

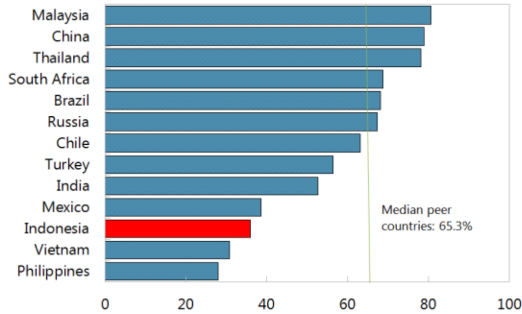
## Table 3. Asset Allocation of Banks

(In percent of banking system assets; as of 2016Q3)

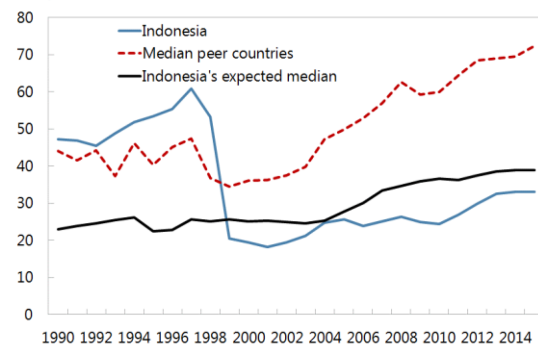
| | Large corporate | MSME | Mortgage | Retail |
|---|---|---|---|---|
| Total | 52.5 | 19.8 | 9.1 | 18.6 |
| Private bank | 60.1 | 17.4 | 8.1 | 14.4 |
| o/w: Foreign bank subsidiary | 57.1 | 12.7 | 17.4 | 12.9 |
| State-owned bank | 46.4 | 26.3 | 11.9 | 15.4 |
| Regional development bank | 13.1 | 16.3 | 6.6 | 63.9 |
| Foreign bank branch | 89.9 | 0.7 | 0.4 | 9.0 |
| D-SIBs | 51.0 | 22.5 | 11.3 | 15.2 |
| Medium-sized | 62.0 | 11.3 | 4.4 | 22.3 |
| Small-sized | 50.5 | 15.5 | 5.9 | 28.2 |
| Micro-sized | 32.8 | 33.5 | 3.5 | 30.2 |

Sources: OJK; and FSAP Team estimates.

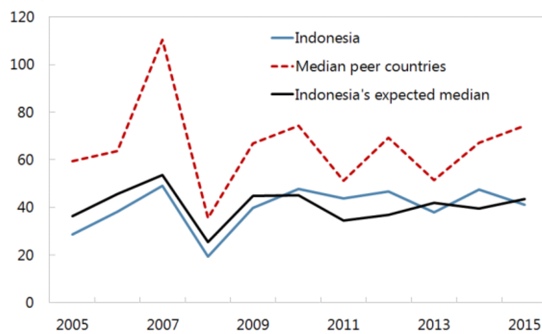
## Figure 1. Indonesia: Benchmarking Key Features of Financial System



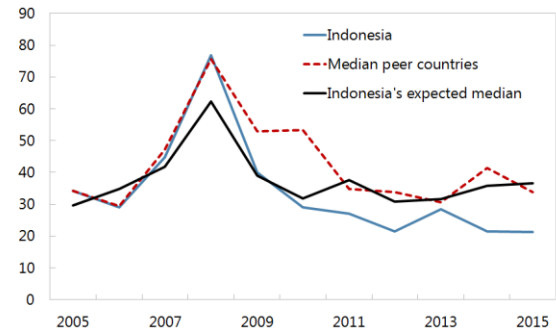

Sources: WB Global Findex
1/ Percentage of respondents with an account at a financial institution or post office including respondents who reported having a debit card.




Sources: WB Finstats*



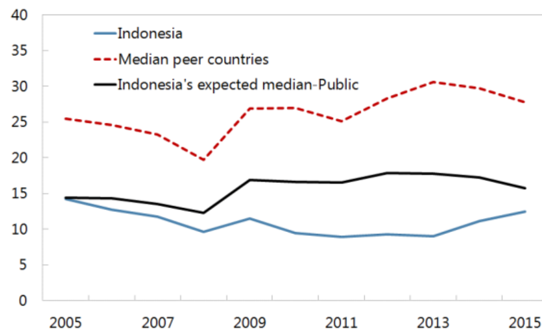

Sources: WB Finstats*



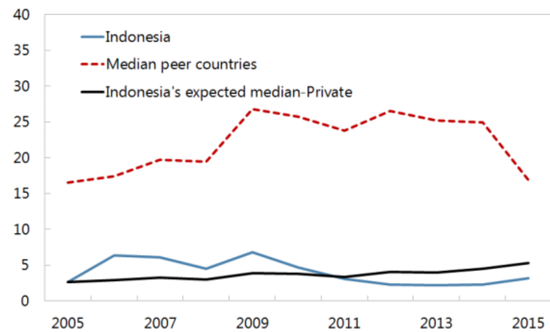

Sources: WB Finstats*

* Peer countries are Brazil, Chile, China, India, Mexico, Malaysia, Philippines, Russia, Thailand, Turkey, Vietnam, and South Africa. The expected median is a statistical benchmark based on a quantile regression applied to a global country database for the period 1980-2015 using a country's structural characteristics such as its income, population size and density, age distribution, and whether it is an oil exporter or offshore financial market.

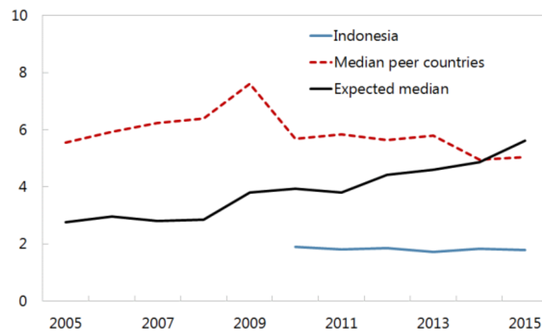
# Figure 1 (Continued). Indonesia: Benchmarking Key Features of Financial System



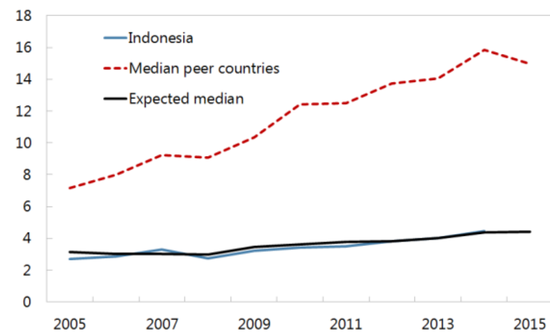

Sources: WB Finstats*




Sources: WB Finstats*




Sources: WB Finstats*

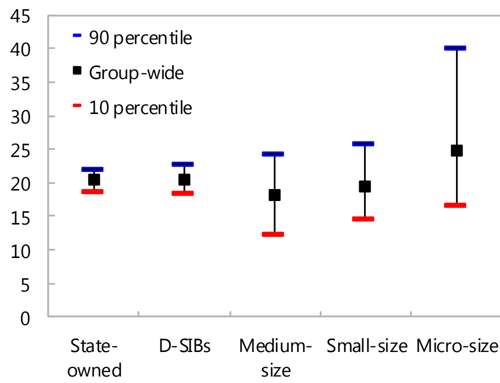


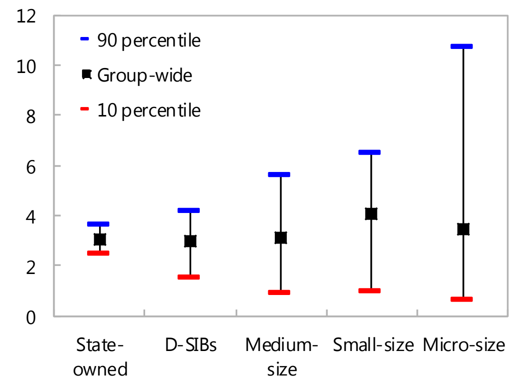

Sources: WB Finstats*

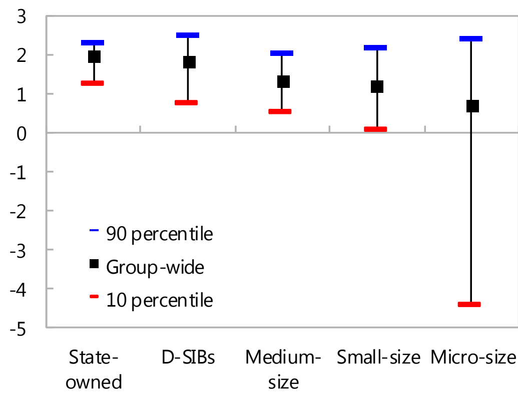
* Peer countries are Brazil, Chile, China, India, Mexico, Malaysia, Philippines, Russia, Thailand, Turkey, Vietnam, and South Africa. The expected median is a statistical benchmark based on a quantile regression applied to a global country database for the period 1980-2015 using a country's structural characteristics such as its income, population size and density, age distribution, and whether it is an oil exporter or offshore financial market.

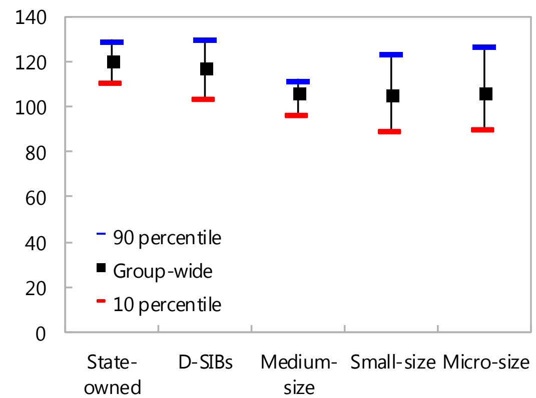
**Figure 2. Banking Financial Soundness Indicators by Group of Banks**

(In percent; as of 2016Q3)



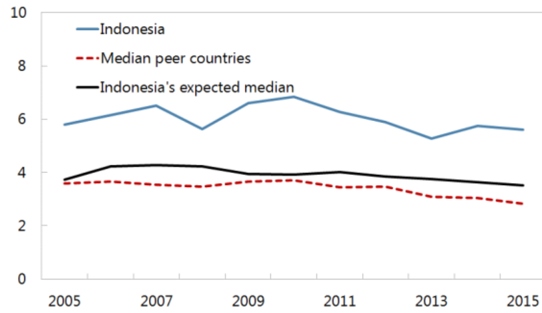



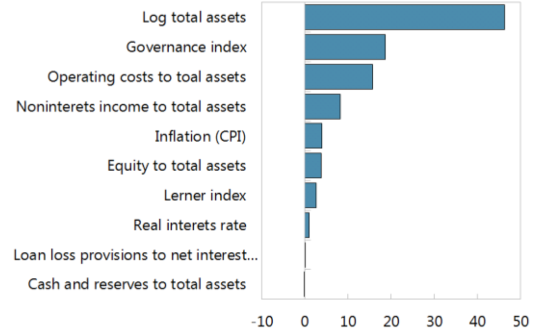



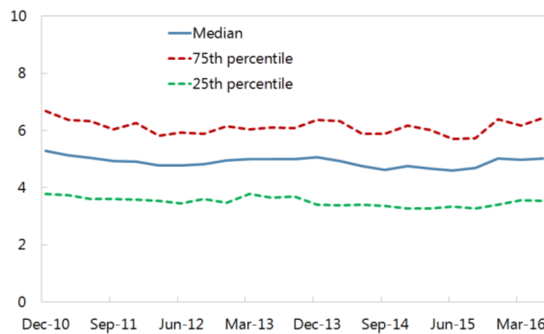



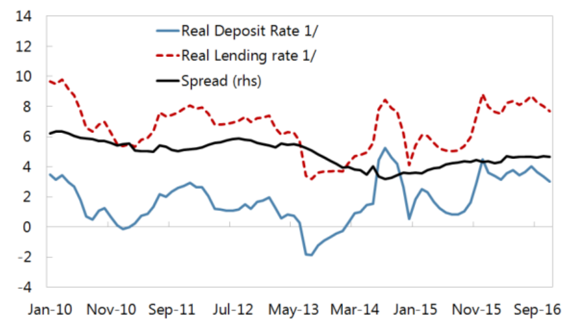

Sources: BI; and FSAP team estimates.

# Figure 3. Banking System Intermediation Efficiency




* Peer countries are Brazil, Chile, China, India, Mexico, Malaysia, Philippines, Russia, Thailand, Turkey, Vietnam, and South Africa. The expected median is a statistical benchmark based on a quantile regression applied to a global country database for the period 1980-2015 using a country's structural characteristics such as its income, population size and density, age distribution, and whether it is an oil exporter or offshore financial market.

# Appendix I. Selected Economic Indicators

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| | | Est. | | Proj. | | |
| Real GDP (percent change) | 5.0 | 4.8 | 5.0 | 5.1 | 5.3 | 5.4 |
| Domestic demand | 5.0 | 4.4 | 4.7 | 5.1 | 5.2 | 5.4 |
| *Of which:* | | | | | | |
| Private consumption 1/ | 5.3 | 4.8 | 5.0 | 5.1 | 5.2 | 5.3 |
| Gross fixed investment | 4.6 | 5.1 | 4.6 | 5.4 | 5.7 | 6.0 |
| Change in stocks 2/ | 0.4 | -0.5 | 0.2 | 0.0 | 0.0 | 0.0 |
| Net exports 2/ | -0.3 | 0.9 | 0.0 | 0.1 | 0.2 | 0.2 |
| Statistical discrepancy 2/ | 0.4 | -0.4 | 0.4 | 0.0 | 0.0 | 0.0 |
| Output gap | 0.1 | -0.1 | -0.4 | -0.2 | -0.1 | -0.1 |
| Saving and investment (in percent of GDP) | | | | | | |
| Gross investment 3/ | 34.6 | 34.6 | 35.0 | 35.0 | 35.1 | 35.2 |
| Gross national saving | 31.5 | 32.5 | 33.0 | 33.0 | 32.9 | 33.0 |
| Foreign saving (external current account balance) | 3.1 | 2.0 | 2.0 | 2.0 | 2.1 | 2.2 |
| Prices (12-month percent change) | | | | | | |
| Consumer prices (end period) | 8.4 | 3.4 | 3.2 | 4.5 | 4.4 | 4.2 |
| Consumer prices (period average) | 6.4 | 6.4 | 3.5 | 4.4 | 4.5 | 4.3 |
| Public finances (in percent of GDP) | | | | | | |
| General governemnt revenue | 16.5 | 14.9 | 14.5 | 14.3 | 14.2 | 14.2 |
| General governemnt expenditure | 18.6 | 17.4 | 17.2 | 16.7 | 16.7 | 16.7 |
| General government balance | -2.1 | -2.5 | -2.7 | -2.4 | -2.5 | -2.5 |
| General governemnt primary balance | -0.9 | -1.1 | -1.2 | -0.8 | -0.8 | -0.8 |
| General government debt | 24.7 | 26.8 | 28.0 | 28.4 | 28.7 | 29.2 |
| Central government revenue | 14.7 | 13.1 | 12.7 | 12.5 | 12.4 | 12.4 |
| *Of which* : Non-oil and gas tax revenues | 10.0 | 10.3 | 10.5 | 10.2 | 10.2 | 10.3 |
| Central government expenditure | 16.8 | 15.7 | 15.3 | 14.9 | 14.9 | 14.9 |
| *Of which* : Energy subsidies | 3.2 | 1.0 | 0.8 | 0.6 | 0.5 | 0.5 |
| Development expenditure | 2.3 | 2.7 | 2.3 | 1.5 | 1.5 | 1.5 |
| Central government balance | -2.1 | -2.6 | -2.7 | -2.4 | -2.5 | -2.5 |
| Balance of payments (in billions of U.S. dollars) | | | | | | |
| Current account balance | -27.5 | -17.6 | -18.1 | -19.9 | -23.4 | -25.8 |
| In percent of GDP | -3.1 | -2.0 | -2.0 | -2.0 | -2.1 | -2.2 |
| Trade balance | 7.0 | 13.3 | 15.1 | 16.3 | 17.5 | 18.0 |
| In percent of GDP | 0.8 | 1.5 | 1.6 | 1.6 | 1.6 | 1.5 |
| *Of which* : Oil and gas (net) | -11.8 | -6.5 | -5.6 | -6.4 | -6.4 | -6.2 |
| Service balance (in percent of GDP) | -1.1 | -1.0 | -0.8 | -0.9 | -0.9 | -0.8 |
| Overall balance | 15.2 | -1.1 | 11.8 | 5.1 | 4.7 | 5.2 |
| Gross reserves | | | | | | |
| In billions of U.S. dollars (end period) | 111.9 | 105.9 | 117.8 | 122.9 | 127.6 | 132.8 |
| In months of prospective imports | 8.1 | 8.1 | 8.4 | 8.3 | 8.1 | 7.8 |
| As a percent of short-term debt 4/ | 188.8 | 190.9 | 217.3 | 231.3 | 244.5 | 259.7 |
| Total external debt | | | | | | |
| In billions of U.S. dollars | 293.3 | 310.1 | 317.3 | 325.1 | 337.7 | 351.0 |
| In percent of GDP | 32.9 | 36.1 | 34.1 | 32.3 | 30.6 | 29.3 |
| Memorandum items: | | | | | | |
| Oil production (thousands of barrels per day) | 794 | 800 | 820 | 815 | 770 | 740 |
| Indonesian oil price (period average, in U.S. dollars per barrel) | 96.5 | 49.2 | 41.3 | 50.2 | 51.7 | 52.1 |
| Nominal GDP (in trillions of rupiah) | 10,566 | 11,541 | 12,401 | 13,612 | 14,971 | 16,456 |
| Nominal GDP (in billions of U.S. dollars) | 891 | 859 | … | … | … | … |

Sources: Data provided by the Indonesian authorities; and IMF staff estimates and projections.

Note: 1/ Includes NPISH consumption.
2/ Contribution to GDP growth.
3/ Includes changes in stocks.
4/ Short-term debt on a remaining maturity basis.

# Appendix II. Financial Soundness Indicators

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016Q3 |
|---|---|---|---|---|---|---|---|
| **Capital adequacy** | | | | | | | |
| Regulatory capital to risk-weighted assets | 16.2 | 16.1 | 17.3 | 19.8 | 18.7 | 21.3 | 20.6 |
| Regulatory Tier-1 capital to risk-weighted assets | 15.1 | 14.7 | 15.7 | 18.3 | 17.8 | 18.8 | 20.6 |
| Capital to assets | 10.7 | 11.0 | 12.2 | 12.5 | 12.8 | 13.6 | 15.0 |
| Large exposures to capital | 1.4 | 0.5 | 0.5 | 0.8 | 1.0 | 0.4 | 0.6 |
| Net open position in foreign exchange to capital | 3.0 | 3.0 | 3.3 | 1.7 | 2.4 | 0.9 | 1.8 |
| Gross position in financial derivatives to capital | 3.8 | 3.5 | 3.2 | 8.7 | 4.9 | 5.1 | 3.8 |
| **Asset quality** | | | | | | | |
| Nonperforming loans to total gross loans | 2.5 | 2.1 | 1.8 | 1.7 | 2.1 | 2.4 | 3.0 |
| Specific provisions to nonperforming loans | 57.1 | 60.7 | 52.0 | 50.9 | 50.8 | 51.5 | 51.8 |
| Nonperforming loans net of provisions to capital | 6.1 | 4.7 | 4.7 | 4.6 | 5.5 | 5.9 | 6.1 |
| Sectoral distribution of total loans (in percent of total) | | | | | | | |
| Domestic economy | 99.6 | 99.6 | 99.6 | 99.6 | 99.6 | 99.5 | 99.5 |
| Depository institutions | 1.4 | 1.2 | 1.1 | 1.3 | 1.6 | 1.5 | 1.4 |
| Other financial institutions | 4.4 | 4.8 | 4.7 | 5.0 | 4.9 | 4.9 | 4.5 |
| Nonfinancial corporations | 43.5 | 42.3 | 43.7 | 46.1 | 45.6 | 47.8 | 48.2 |
| Other domestic entities | 49.6 | 50.6 | 46.4 | 44.6 | 44.3 | 44.4 | 44.4 |
| **Earning and profitability** | | | | | | | |
| Return on assets | 2.7 | 2.9 | 3.1 | 3.1 | 2.7 | 2.2 | 1.7 |
| Return on equity | 25.9 | 25.4 | 25.3 | 24.5 | 21.3 | 17.3 | 11.7 |
| Net interest income to gross income | 60.5 | 59.8 | 65.0 | 68.8 | 69.0 | 70.3 | 68.4 |
| Trading income to gross income | 4.6 | 3.5 | 3.2 | 3.2 | 2.7 | 2.8 | 4.0 |
| Noninterest expenses to gross income | 49.2 | 49.0 | 48.8 | 49.2 | 50.3 | 50.0 | 46.3 |
| Personnel expenses to noninterest expenses | 37.3 | 36.0 | 40.5 | 41.3 | 40.0 | 40.7 | 44.4 |
| **Liquidity and funding** | | | | | | | |
| Liquidity assets to total assets | 27.2 | 26.2 | 25.7 | 23.5 | 22.9 | 23.9 | 22.1 |
| Short-term liabilities to total liabilities | 95.2 | 94.2 | 80.2 | 87.9 | 78.7 | 78.8 | 79.5 |
| Liquid assets to short-term liabilities | 32.1 | 31.2 | 36.4 | 30.5 | 33.3 | 35.0 | 33.1 |
| Non-interbank loans to customer deposits | 81.6 | 85.5 | 94.1 | 100.5 | 99.9 | 100.4 | 99.2 |
| **Sensitivity to market risk** | | | | | | | |
| Foreign-currency loans to total loans | 15.6 | 16.6 | 15.2 | 17.0 | 16.3 | 15.6 | 14.2 |
| Foreign-currency liabilities to total liabilities | 16.5 | 16.3 | 18.6 | 24.4 | 22.9 | 24.1 | 20.5 |
| **Exposure to real estate activity** | | | | | | | |
| Real estate loans to total loans | 13.8 | 14.2 | 13.8 | 14.3 | 15.1 | 15.6 | 16.2 |

Sources: IMF, Financial Soundness Indicator database; Bank Indonesia; and IMF staff estimates.

## Appendix III. Implementation Status of 2010 FSAP Recommendations

| Key Recommendations | Status |
|---|---|
| **Banking Issues** | |
| Issue revised regulation to strengthen the quality of capital by bringing risk weights to at least Basel I levels and tightening the accounting definition of Tier 1 capital. | I |
| Issue revised regulations to strengthen the regulatory definition of exposure, including related-party exposure. | PI |
| Issue revised regulation to strengthen asset classification and provisioning norms, including treatment of restructured loans. | PI |
| Issue regulations and supervise interest rate risk on banks' banking book. | PI |
| Establish regular contacts with domestic and foreign supervisors to strengthen consolidated supervision and home-host cooperation and information exchange relationships. | I |
| Submit to the House of Representatives (DPR) draft prompt corrective action legislation to achieve timely corrective measures, to remove discretion from the process, and limit the time banks can spend under intensive supervision. | I |
| Maintain capital adequacy requirement in line with the Basel I norms until Pillars 2 and 3 of the Basel II framework are operational; more generally, handle the transition to Basel II and new accounting standards carefully to ensure the right balance between various interactive elements. | I |
| Strengthen BI and banks' stress testing capability. | I |
| Revise the law to give SOCBs more flexibility in dividend payout, debt restructuring, and management of capital structure and business risks. | PI |
| **Regulatory Structure** | |
| Review financial sector supervision and regulation to ensure micro-macro prudential coordination while reforming the financial supervision framework. | PI |
| **Central Banking** | |
| Strengthen BI's balance sheet by agreement with the government to restructure zero interest government debt into market interest bearing debt. | PI |
| Improve the selection process of BI's Board members. | PI |
| Further clarify BI's policy objective and develop a mechanism to eliminate the discrepancy between the official inflation targets announced by the Ministry of Finance and the targets used by BI. | I |
| Disclose criteria for selecting counterparties in FOREX market. | I |
| **Deposit Insurance** | |
| Increase the deposit insurance fund commensurate with the increased size of deposits covered, through higher premiums or capital injection. | NI |
| Improve cooperation between BI and the LPS. | PI |
| Adopt more transparent market-based ceiling rates on insured deposits, with a plan to review the effectiveness of the system going forward. | NI |
| **Capital Markets** | |
| Amend the capital market law to augment regulators' independence and enforcement powers, including the power to assist foreign regulators and gain more expeditious access to bank accounts. | PI |
| Encourage SOEs to list in the stock market or issue fixed income instruments to help capital market development. | I |
| Expand the institutional investor base. | PI |
| Develop educational programs and professional training. | I |
| Improve the price discovery mechanism of government bond trading. | I |

| Insurance | |
|---|---|
| Pass an insurance law. | I |
| Deal with insolvent insurance companies to avoid systemic failure. | PI |
| Explore options to develop the insurance sector. | I |
| Develop micro and Sharia insurance products for low-income households. | I |
| **Legal Protection Issues** | |
| Amend the Bank Indonesia Act (BI Act) and the Capital Markets Law to enhance the scope and strength of legal protection of bank supervisors and securities regulators. | PI |
| Enact crisis management legislation including protection for officials involved. | PI |
| **Market Infrastructure** | |
| Consider measures to increase access to finance (A2F) and improve the quality of branch services. | I |
| Regulate and supervise Sharia finance to bring its capital requirement in line with those governing conventional commercial banks. | PI |
| Improve the national credit bureau; consider private credit bureaus. | PI |
| Improve the certainty and speed of execution of collateral and of bankruptcy proceedings. | NI |
| Strengthen and enforce registration of companies and filing of financial statements using unique identification. | I |
| Address weaknesses in laws governing payments systems, including finality of payments, delivery-versus-payment (DVP). Clarify who has access to the payment system and to enforce the regulatory and oversight responsibilities of BI and Bapepam-LK. | I |
| Promote efficient sharing of infrastructure and the adoption of standards and support sharing in BI's oversight of the payments system. | PI |
| Establish countrywide infrastructure that supports electronic payments and educates consumers about the benefits of electronic means of payment. | PI |
| Ensure banks' compliance with PSAK 55 (IAS 39). | I |
| Increase the number of qualified accountants and actuaries. | I |
| Transfer oversight of auditors and public accounts to Bapepam-LK. | PI |
| Enact new financial reporting and accountants' laws. | I |
| Build the capacity of accountancy organizations. | PI |
| Speed up convergence to International Financial Reporting Standards (IFRS) by an assessment of constraints and actions to deal with them. | I |
| Enforce the law requiring audited consolidated accounts for major corporations. | PI |
| Status: I = Implemented; PI = Partially Implemented; NI = Not Implemented | |