Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 24-Apr-2021 | Report No: PIDA31970

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Indonesia	P173232	Indonesia Second Financial Sector Reform Development Policy Financing (P173232)	P170940
Region	Estimated Board Date	Practice Area (Lead)	Financing Instrument
EAST ASIA AND PACIFIC	10-Jun-2021	Finance, Competitiveness and Innovation	Development Policy Financing
Borrower(s)	Implementing Agency		
Republic of Indonesia	Fiscal Policy Agency, Ministry of Finance		

Proposed Development Objective(s)

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

This programmatic DPL series is structured around the following three pillars and set of objectives:
• Pillar A: Increasing the Depth of the Financial Sector. Pillar objectives: to expand the size of the financial sector by increasing outreach (including to youth and women), broadening financial market products and mobilizing long-term savings.
• Pillar B: Improving the Efficiency of the Financial Sector. Pillar objectives: to lower the costs for individuals and enterprises by strengthening the insolvency and creditor rights framework, protecting consumers and personal data and strengthening payment systems.
• Pillar C: Strengthening the Resilience of the Financial Sector. Pillar objectives: to strengthen the capacity of the sector to withstand financial and non-financial shocks by strengthening the resolution framework, implementing sustainable finance practices, establishing disaster risk finance mechanisms and advancing the effectiveness of financial sector oversight.

Financing (in US$, Millions)

SUMMARY

Total Financing	400.00

DETAILS

Total World Bank Group Financing	400.00
World Bank Lending	400.00

Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

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

The COVID-19 pandemic has caused the worst recession in Indonesia, the world's largest island country, since the 1997-98 Asian Financial Crisis. Indonesia became an upper middle-income country in 2020 and aspires to become the 5th largest economy in the world by 2030. With approximately 265 million people living in over 6,000 islands, the country has maintained macroeconomic and political stability over the last two decades. However, Indonesia has been reeling under the impacts of the COVID-19 pandemic, a twin supply and demand shock with serious and potentially long-lasting financial, fiscal, and social ramifications. The economy contracted by 2.1 percent in 2020 whilst poverty is estimated to have risen. Recent national surveys document the huge fallout of the crisis also for firms and households: a large fraction of firms experienced reduction in sales or limited cash/ability to pay at least one production cost as of late 2020; nearly a half of working breadwinners of a household experienced significantly lower income than before the start of the pandemic.

The financial sector remains overall sound and resilient although loan forbearance measures may be temporarily masking the true extent of vulnerabilities. With a level of financial sector assets of 77 percent of GDP (as of December 2020), Indonesia's financial system is still small relative to the economy and compares poorly to other ASEAN countries. The banking sector continues to dominate the financial system, much more than capital markets, with an asset share of about 78 percent of total financial system assets as of 2020Q4, making the banking sector critically important for the overall financial stability. The system-wide non-performing loan (NPL) ratio edged up slightly since the beginning of the pandemic and the capital adequacy ratio remains well above the regulatory minimum. The loan-to-deposit ratio stood at to 82 percent while the short-term liquidity ratio is close to 24 percent, indicating relatively ample liquidity in the banking system. However, loan forbearance measures, immediately deployed in response to the pandemic and currently extended until March 2022, may be deflating the level of NPLs and inflating real capital ratios. There has been a sharp increase of restructured loans and special mention loans since the beginning of the pandemic. Nonetheless, a notable decline in bank credit growth is observed at the end of 2020, which may hamper the economic recovery from the pandemic.

The operation recognizes the Indonesian authorities' timely policy interventions to address the socio-economic hardship inflicted by the COVID 19 pandemic, but macro-financial risks need to be managed. Bank Indonesia (BI) loosened monetary policy and deployed a large local currency government bond purchase program to further stabilize the economy and finance the fiscal deficit. BI bond purchases have helped maintain financial stability amid high capital flight to safety during the second quarter of 2020 and contributed to lowering long-term local currency government bond yields. But the program involves macro-financial tradeoffs, and it would be important to ensure that BI bond purchases are temporary, time-bound, well communicated. Together with BI, financial authorities forcefully responded to the pandemic. As of end

2020, a total of 41 COVID-related financial sector policy measures for banks, non-bank financial institutions, market liquidity and payment systems had been introduced by different authorities.

The DPO programmatic series remains highly relevant for supporting the Government's response to COVID-19. The package of supplemental and regular DPOs of the programmatic series complements the Government's efforts in cushioning the COVID-related crisis by supporting the real economy and managing second round effects related to the deterioration of asset quality and banks' balance sheets. These reforms are particularly important as financial sector resilience – one of the key development objectives of the DPO program – is being tested, with local banks facing pressures as volatile financial markets weigh on funding to the real sector and the risk of SME bankruptcies is likely to impact banks' balance sheets. While the banking system is well capitalized, and profitability is high, the lack of depth in the Indonesian financial markets, with a high share of government bonds being held by non-residents and a narrow institutional investor base, increases the country's vulnerability to external shocks. The reforms supported by this DPO series aim to address financial sector vulnerabilities heightened by the COVID crisis: reforms to develop new long-term instruments to broaden Indonesia's investor base and deepen its capital markets are critical in rendering Indonesia's asset market less vulnerable to foreign portfolio outflows; reforms to increase the number of payment channels are crucial for the implementation of large-scale social assistance payments to protect livelihoods during the crisis; reforms to strengthen the resolution framework for troubled banks and establish a clear funding mechanism, are a key element of a recovery strategy.

Relationship to CPF

The proposed DPO is fully aligned with the proposed FY 21-25 Country Partnership Framework (CPF) for Indonesia. In line with the four pathways to overcome the constraints to poverty reduction and shared prosperity identified in the Systemic Country Diagnostic (SCD) Update, the new CPF is structured according to four proposed engagement areas: (i) strengthening economic competitiveness and resilience, (ii) improving supply of and access to sustainable infrastructure services, (iii) nurturing human capital and (iv) strengthening management of natural assets, natural resource-based livelihoods and disaster resilience, as well as one supporting beam: collecting more; spending and governing better. The proposed operation directly contributes to the first CPF engagement area on strengthening economic resilience and competitiveness that contains a specific objective focused on increasing the depth, improving the efficiency and strengthening the resilience of the financial sector. Moreover, through the reforms on the taxation of capital markets instrument and on disaster risk finance, it also contributes to the supporting beam on collecting more and spending better and to the engagement area on the natural assets and disaster resilience.

C. Proposed Development Objective(s)

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

The expected results are for Pillar A: an increase in outreach through the establishment of the Financial Inclusion Council [which includes representatives of BI and OJK[1]] to strengthen the coordination of financial inclusion activities and a mandate to collect and made public available sex-disaggregated financial inclusion data; the establishment of broader and deeper financial markets, represented by the size of IDR-denominated debt securities and an increase of longer-term investments and accompanying decrease in the proportion of short-term investment (cash and equivalent) held by pension funds and insurance companies (represented by the size of institutional investors' assets to the GDP). For Pillar B: a more efficient financial sector would be supported by an increase in the number of insolvency cases that are opened by the court every year, by making the process more transparent and affordable; consumer protection reforms are expected to contribute to the quality dimension of financial inclusion indicated by the increased number of financial services providers undergoing financial consumer protection examinations (offsite or onsite) each year; and the strengthening of payment system will contribute to an increased percent of adults making and receiving digital payments. For Pillar C: the expansion of the mandate of LPS[2] as a resolution authority and the establishment of LPS regulatory framework for resolution planning and resolvability assessments will help maintaining depositor confidence and avoiding disruptions to financial activities in the event of a bank failure; the intended results from the sustainable finance reforms are to strengthen the institutional capacity of banks and supervisors and to ensure a substantial majority of entities supervised by OJK are in compliance with the requirements for sustainable finance practices; the adoption of the legal mandate for establishing the pooling fund and nomination of an agency for its establishment allows the Government to proceed with the establishment of a disaster risk finance mechanism and the allocation of funds to it. This is expected to lead to improved pre-arranged financing for disaster response (including climate-related disasters) by providing the government a more stable funding source; finally, narrowing down the definition of financial conglomerates allows more risk based and effective supervision of financial conglomerates as only the 14 conglomerates with systemic impact are subject to the three-level rating process. The remaining 35 conglomerates will be supervised in a more proportionate manner.

D. Project Description

Deepening of the financial sector allows to increase its size (both in terms of outreach and assets) and hence the availability of funds and access opportunities. About half of the adult Indonesian population does not have access to transaction accounts, leaving them with limited opportunities to invest in their future and to protect themselves from unexpected shocks. Physical distance from the nearest financial access point was cited by a third of the population as a key barrier preventing individuals living in remote areas to use financial services. At same time the limited breadth and types of financial products and services available to investors, customers and to the public do not appear to be fully aligned with their needs. This exposes individuals and institutions to the financial consequences of unexpected events due to the lack of risk management instruments and limits investment opportunities in critical sectors (such as infrastructure) due to the lack of incentives for long-term savings. A more vibrant institutional investor base and deeper capital markets which

[1] Otoritas Jasa Keuangan (OJK) is the Indonesia Financial Services Authority.
[2] Lembaga Penjamin Simpanan (LPS) is the Indonesia Deposit Insurance Corporation.

offer appropriate investment instruments, reliable price benchmarks, strong investors protection, and active hedging markets, can help bridge the infrastructure finance gap and reduce the need for domestic firms to seek foreign funding. In the current operation, financial deepening is centered around a set of coordinated policy actions aimed at increasing physical and digital access to financial services, broadening financial markets products and mobilizing long-term savings.

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

Strengthening the resilience of the financial sector allows to increase its capacity to withstand financial and non-financial shocks. The banking sector remains well capitalized and highly profitable, and system-wide liquidity is ample. However further efforts are needed to strengthen financial oversight and crisis management. As the deposit insurance agency and resolution authority, LPS plays a key role towards pursuing financial stability, protecting depositors and ensuring the continuity of systemically important financial services. LPS' statutory mandates have been set out in the LPS and PPKSK [3]Laws. Yet the legal framework has not yet facilitated an effective resolution regime, in particular with regards to assigning LPS with clear roles and responsibilities of a resolution authority and this has become critical to effectively contain the possible COVID-19 impact on the financial sector. At the same time, strengthening resilience in a country like Indonesia, exposed to frequent natural disasters exacerbated by the climate change, also requires the promotion of sustainable finance practices for financial services institutions, issuers, and public companies. A line of reform on strengthening disaster risk financing is also included in this operation given the importance of establishing a financial risk mitigation mechanism in case of natural disasters (including climate-related disasters). This is nowadays one of the government priorities and will ultimately help to protect Indonesia's people and assets against disaster shocks and strengthen comprehensive disaster resilience of the country. Finally, another line of reform on financial conglomerates is being added to this operation, which will ensure more risk based and effective supervision of financial conglomerates by narrowing down their definition and ensuring a more effective use of supervisory resources.

E. Implementation

Institutional and Implementation Arrangements

[3] Pencegahan dan Penanganan Krisis Sistem Keuangan (PPKSK) Law is the Financial Safety Net Law.

Progress on the results indicators will be monitored and evaluated by the Borrower. The Fiscal Policy Agency (BKF) under the MoF is the executing agency for the DPO series while BI, OJK, LPS, Ministry of Law and Human Rights (MoLHR) and Ministry of National Development Planning (Bappenas) act as implementing agencies. The BKF team is well-coordinated and given their experience in implementing DPOs with the World Bank, they are increasingly well prepared to obtain and share data to monitor implementation against the agreed results indicators.

The World Bank closely follows this progress through supervision activities: an implementation support mission for DPO1 was completed in February 2021. The mission rated the M&E and program management as Satisfactory in light of the continued policy dialogue that has led to the preparation of DPO2 and has allowed the team to closely monitor the implementation of the reforms initiated under DPO1. Two of the original indicators (e.g. Number of financial product marketing violations detected per year, under reform area #5 and number of payment services providers facilitating QR payments for reform area #6;) have already bypassed their 2022 target ahead of time. Other six indicators are on track for achieving the target on time, while for the remaining three indicators (i.e. two related to reform area #1 and one related to reform area #4) no updated information could be collected during the mission. Of these three indicators, the two under reform area #1 have now been replaced to better align them to their respective reforms. The target timeline for all indicators has been moved to end-2023 to allow sufficient time for measuring the impact of the supported reforms after the completion of DPO3.

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

Poverty and Social Impacts

The results from the Poverty and Social Impacts Analysis (PSIA) for DPO1 still apply in the context of the coronavirus pandemic, with no immediate adverse impacts for the poor and vulnerable and benefits likely to emerge in the long run. The link between financial sector stability and poverty in crises is well-established in Indonesia. During the 1997-1998 Asian Financial Crisis, steep declines in employment, negative economic growth and rising food prices caused the poverty rate to increase from 17.5 percent in 1996 to 24.2 percent in 1998. While the ongoing pandemic is fast-evolving and much remains uncertain about its duration and depth of impact in Indonesia, as described in section 1, many of the same adverse impacts in terms of lost earnings, declines in employment and a small increase in poverty were felt in 2020 across the country. The DPO series aims to increase the depth of the financial sector and improve its efficiency and resilience, which contributes to a more favorable economic environment for growth and sustained poverty reduction in the long run. As such, the program's objectives promote financial stability and gain in significance in the context of the ongoing pandemic.

Environmental, Forests, and Other Natural Resource Aspects

Two of the prior actions will have positive effects on the environment. Embedding sustainability in the practices of the financial services industry via Reform Area #8, with emphasis on climate change, will contribute to disaster prevention, disaster risk mitigation, climate change adaptation, and environmental management in Indonesia. Reform Area #9 has the potential to lead to significant positive effects on the natural and human/built environment. This is because the Disaster Risk Finance and Insurance (DRFI) Strategy recognizes that disaster management financing is needed for three periods – non-disaster, emergency response, and rehabilitation/reconstruction. Within the non-disaster period, pre-disaster financing is to be used, inter alia, for disaster risk mitigation activities or programs, disaster prevention programs, and education on disasters. None of the other prior actions will have positive or negative effects on environment, forest, or other natural resources.

G. Risks and Mitigation

The overall risk level is moderate, with three sources of risk rated as "substantial". The pandemic has elevated macroeconomic risks compared to the first operation. Moreover, the risks on the technical design of the program and on institutional capacity remain rated as substantial. Macroeconomic risks are substantial due to the potential negative impacts of the COVID-19 crisis on the PDO. The ongoing crisis poses risks to the resilience (PDO C) and depth (PDO A) of the financial sector. This operation is contributing to mitigating these risks by supporting improvements in the insolvency regime (reform area #4), in strengthening the resolution framework (reform area #7) and financial sector oversight (reform area #10) as well as, in the medium term, by supporting the mobilization of long-term savings and expansion of the investor base (reform area #3). With an array of technical assistance and analytical works, the World Bank remains strongly engaged in policy dialogue with the government and financial authorities to address critical reforms and policy actions.

The implementation of the reforms supported by this DPO series requires strong collaboration among a large number of implementing agencies and strong coordination by the MoF as executing agency. Moreover, the proposed reforms require intense technical work to guarantee their completion and the sustainability of their results. The DPO mitigates this risk by providing strong technical support to each implementing agency under a parallel advisory service and analytical program in close coordination with the international development partners. The technical assistance program will be flexibly adapted to new emerging priorities related to the impact of COVID-19 and the policy dialogue on key reform areas will be shaped accordingly.

The potential benefits of the proposed operation outweigh the residual risks and warrant IBRD's assistance.

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APPROVAL

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