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LETTER OF DEVELOPMENT POLICY

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Mr. David R. Malpass
President
World Bank

Dear Mr. President

On behalf of the Government of Indonesia, we would like to provide an update on our medium-term reform agenda and to request the International Bank for Reconstruction and Development/World Bank through the First Indonesia Financial Sector Reform Development Policy Loan (DPL), which would support our objectives towards achieving a deep, efficient and resilient financial sector.

Allow us to also use this opportunity to express our appreciation for the technical assistance provided by the World Bank Group on financial sector reforms in support of this development policy series, alongside development partners from the governments of Switzerland, Canada and the Bill and Melinda Gates Foundation.

This DPL operation entails an important package of support that would significantly contribute to Indonesia's medium-term economic development, poverty alleviation and shared prosperity objectives. As the current Government enters its second term, we remain focused on these reform agenda. A sound and well-functioning financial sector is critical to sustain Indonesia's growth and to achieve the Government's shared prosperity goals. The Government continues to advance the ambitious agenda, to promote financial sector deepening and to strengthen financial oversight and crisis management pursued in the recent years. Despite making some notable progress in terms of financial inclusion and financial stability, much remains to be done in order for the Indonesian financial sector to sufficiently fund development needs or boost inclusive economic growth. The Government needs to implement critical reforms that would increase the financial sector's depth, improve its efficiency and strengthen its resilience to financial and non-financial shocks.

Economic and social context

Indonesia has made remarkable development progress over the last 20 years and has emerged as a middle-income economy with macroeconomic and political stability. An average GDP growth of 5% p.a. in the last 5 years has been sustained primarily by private consumption thanks to a large and growing domestic market. Stable inflation, low unemployment, and narrow fiscal deficits coupled with robust GDP growth have enabled Indonesia to absorb the impact of the recent decline in commodity prices and the current economic and financial uncertainties. The poverty rate fell to a single digit for the first time on record to 9.8 percent in March 2018. It has continued to decline, registering 9.4 percent in March 2019. Inequality, which had been increasing throughout the 2000s, has also been on a distinct, albeit somewhat modest, downward trend since 2015.

Yet there are key challenges to sustaining and deepening this progress. The pace of poverty reduction has started to stall. The income of approximately 20 percent of the entire population hovers marginally above the national poverty line, keeping them exposed to the risk of falling into poverty following a financial or non-financial shock. Moreover, despite not being in poverty or vulnerability, almost half of the population is yet to achieve the economic security and lifestyle of the middle class. Securing a robust pathway to the middle class for this “aspiring middle class” group is vital to the realization of Indonesia’s aspirations of becoming an upper middle-income country.

In all this, deepening and broadening the financial sector plays a crucial role in addressing the key gaps in terms of infrastructure financing, human capital and institutional capacity that undermine the ability of maintaining economic growth and generate higher quality jobs in greater numbers. A program of reforms of this kind requires to focus on broadening opportunities for individuals and firms through the acceleration of financial sector deepening, efficiency, and inclusion without compromising macro- and micro-prudential standards. The Government recognizes that 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.

The Indonesian financial sector is still characterized by a substantial presence of the State and of financial conglomerates and a narrow domestic institutional investor base. The low level of bank intermediation efficiency has undermined financial development. Financial inclusion of both households and SMEs, while making good progress, is still lagging behind. 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 remains important, but it exposes Indonesia to a volatile external environment and requires vigilance towards mitigating external refinancing risks.

Competition in the delivery of banking services is core to containing costs and thereby to harnessing the role of the financial sector in allocating scarce resources to their optimal uses and to enhancing outreach to marginal users. To this aim, the analysis of competition in the banking sector initiated in cooperation with the World Bank is expected to shed light on this important area, which can translate into critical policy recommendations going forward.

Financial Sector Reform Agenda for the Medium-Term

One way of assessing the Indonesian financial sector is through the lenses of financial depth, efficiency and resilience. *A deep financial system* is needed to increase availability of funds and access opportunities. *An efficient financial system* is needed to channel savings into the most productive investment opportunities in a less costly, faster, safer and more transparent way. Finally, *a resilient financial system* is needed to withstand financial and non-financial shocks and protect consumers and investors. The Government's financial sector reform program is aligned with these reform drivers as outlined below.

Increasing the depth of the financial sector

Increasing outreach of financial services. Despite recording the largest account ownership increase of any developing economy in East Asia, Indonesia still has the fourth largest unbanked population in the world and ninety-five million adults (and two thirds of the poorest adults) remain financial excluded. The Government through the issuance of Presidential Regulation 82/2016 on the national financial inclusion strategy and Presidential Regulation 63/2017 on non-cash social assistance distribution has taken important steps towards increasing outreach of financial services. The harmonization of the two main agent network programs currently existing in Indonesia, starting from the issuance of a joint policy framework between BI and OJK for implementing the programs is a key priority and will provide clear directions to the industry in terms of advancing the agent banking networks and will also help the industry to develop stronger business cases. This in turn will promote the introduction of more agents in the market, bringing more access points closer to consumers.

Broadening financial markets products. 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 presents challenges in funding certain strategic sectors, such as infrastructure, which require a wide variety of fixed income instruments and structured products. Deepening capital markets is a key priority in the Government's agenda and efforts have been made to introduce various capital market instrument and reforms to facilitate a more effective market. The National Strategy for Financial Market Deepening (SN-PPPK) 2018-2024 contains a detailed and comprehensive plan of action for developing seven financial markets. The Government has started by enabling a cost-effective issuance of financial instruments, particularly debt securities, through a regulation that facilitates safe issuance of debt securities in private placement market, strictly to professional investors. The tax environment needs also to be conducive for facilitating the introduction of new instruments (e.g. infrastructure funds, project bonds) and the Government is committed on establishing a tax level playing field. Finally, the Government wants to trigger a flow of foreign investment into local currency financing by providing risk hedging instruments that will help to broaden the scope for mobilizing long-term IDR financing.

Mobilizing long-term savings. Shallow capital markets put a constraint in commercial and private long-term financing for development needs, such as for the infrastructure sector. A small domestic institutional investor base goes along with thin capital markets and would not be able to provide a competitive alternative to funding provided by banks, nor could they intermediate sufficient longer-term funding. The institutional investors currently tend to hold significant assets in the form of bank deposits and state-related bonds. As a result, there is a dearth of funding to help bridge Indonesia's sizeable infrastructure gap where the capacity of both banks and the government to step in is already constrained. The Government has started to tackle this critical issue by introducing regulations that facilitate more long-term oriented

investment by pension funds and insurance companies and is planning to continue this path of reforms by looking at the risk management framework for defined benefit pension funds to include a long-term funding risk and introducing default age-relevant investment options to encourage longer term investment for younger participants. This process will also include a combination of improved tax policies and procedures to incentivize pension and social security participants to contribute and disincentivize withdrawals from pension and old age savings. These reforms will lead to an increased pool of savings in the pension and insurance industries, and eventually increase their contribution to long-term investments in Indonesia.

Improving the efficiency of the financial sector

Strengthening insolvency and creditor rights. A good insolvency and creditor rights framework is critical for both financial stability and financial inclusion as it can lead to an increase in banks' recovery rates and a reduction on NPLs, which in turn will lead to an improvement of access to finance. More efficient and affordable access to restructurings will lead to more companies filing for insolvency procedures, eventually avoiding bankruptcy/liquidation and shutting down informally. The Government, following key recommendations also contained in the 2017 Financial Sector Assessment Program (FSAP) has introduced a reform to establish a clearer and more effective supervision regime for insolvency administrators. The next step will be to improve the existing system of remuneration of receivers and administrators and to complete the revision of the 2004 Bankruptcy Law, that improves reorganization provisions and protects creditors' rights.

Protecting consumers and personal data, and enhancing transparency. Financial markets, if not properly supervised and regulated in their market conduct practices can pose potential risks to consumers, while also diminishing the benefits of financial inclusion. In addition, Indonesia does not have a comprehensive legal framework on personal data protection and privacy with general applicability. With the rapid growth in Indonesia's digital economy and increasing use of data for service delivery in the financial and many other sectors – and the associated risks to privacy and security of this data, such as misuse, abuse and leaks – Indonesia should urgently introduce fundamental legal and regulatory safeguards that information is collected, managed, stored, used and disclosed appropriately. To this aim, the Government is committed on passing a key reform to promote a more robust consumer protection practice in Indonesia, through a bill on general data protection and privacy of personal data as well as the issuance of regulations establishing specialized market conduct supervision. The data protection reforms are expected to define and provide legal clarity on how personal data is collected, managed, used and shared, which will provide safeguards to people's privacy and help build confidence and trust in Government and the financial and other sectors as responsible data processors and controllers.

Promoting interoperability. 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. To do this 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. In this context, interoperability is key as it can considerably increase the convenience of both customers and merchants in making and receiving digital payments. The Government, through Bank Indonesia, has embarked on a reform path underpinned by the Payment System (IPS) 2025 Visions, representing a major step towards a modern payment system designed to ensure that the current trend of digitalization develops within a conducive digital economic and financial ecosystem. The issuance of quick response (QR) codes standards by Bank Indonesia has been a first step to

broaden acceptance and advance interoperability of digital payment instruments and the Government is committed to advance further as the IPS 2025 Visions moves into implementation.

Strengthening the resilience of the financial sector

Strengthening the framework for deposit insurance and resolution of troubled, non-viable banks. Enhancing the mechanisms for insured deposit payouts and resolution of non-viable banks will ultimately contribute to financial stability. The Government has supported the issuance of an LPS regulation on the Single Customer View (SCV) which will enable LPS to enhance the timeliness and accuracy of its deposit payout function by gaining better access to banks' records. This will help maintaining depositor confidence and avoiding disruptions to financial activities in the event of a bank failure. The reform path will then continue with the establishment of a separate resolution fund that will be funded by a levy from the banking industry, which would be accessible in the event of a financial crisis as declared by the President, and the issuance of an LPS regulation on resolution planning and resolvability assessments that will require the preparation of resolution plans for systemic banks and the resolution authority (i.e. LPS) to assess whether or not the banks are resolvable under those plans.

Supervision of financial conglomerates. Given the key role played by financial conglomerates (FCs) in Indonesia, it is crucial to ensure that they are adequately supervised and that the relevant legal and supervisory framework is aligned with the international standards to ensure the stability of the financial sector. The Government intends to coordinate closely with OJK on this important subject going forward to identify a reform path aimed at strengthening the legal, institutional and operational aspects of integrated supervision.

Implementing sustainable finance practices. Efforts to mitigate and adapt to climate change are critical for Indonesia, being the world's largest archipelagic country, as it is extremely vulnerable to natural disasters exacerbated by the climate change. Indonesia has a goal to reduce greenhouse gas emissions both by 2020 and 2030 under the Paris Agreement while maintaining strong economic growths. The financial services industry plays an integral role in all market sectors and therefore it is inherently susceptible to climate change risks. The Government, through OJK, is committed to implement sustainable finance practices (i.e. practices that integrate environmental, social, and governance (ESG) risks and criteria in business and financing (lending or investment) decisions) in line with the OJK Regulation (POJK) 51/2017 on Implementation of Sustainable Finance Practices for Financial Services Institutions, Issuers, and Public Companies. To this aim, OJK has issued guidelines for banking supervisors to enable the implementation and supervision of sustainable finance practices by banks. Going forward it will be crucial to focus on monitoring the implementation of sustainable finance principles through the sustainability reports to be provided to OJK by all commercial banks.

Establishing disaster risk finance mechanisms. The new Disaster Risk Financing and Insurance Strategy launched in 2018 is the roadmap that the Government is committed to implement. To improve coordination, efficiency, and governance of post-disaster expenditures (including international assistance), the Government decided to develop a dedicated disaster risk finance mechanism (a 'pooling fund'). The Government has received mandate to establish a pooling fund through the KEM PPKF 2020, that includes a financial mechanism to protect the budget against disaster shocks as a priority topic. The next step will be the establishment of the pooling fund through a presidential decree and the adoption of

appropriate regulation and procedures for its governance and management. The Government is also committed to support the adoption of a policy to set up pre-arranged disbursement channels directly linked to the pooling fund management for more effective disaster response.

Strengthening and harmonizing the regulatory framework for financial sector. The Government is undertaking a major mapping exercise of all the laws related to the financial sector with the aim of strengthening, modernizing and harmonizing the relevant regulatory framework possibly through the use of an Omnibus Law on Financial Sector. The Omnibus Law will have objectives related to economic growth, development and strengthening of financial sector, widening network, products and investors, promoting long-term investment, increasing competition, enhancing investor and customer protection, strengthening governance and law enforcement. The formulation of the Omnibus Law policy is expected to achieve a comprehensive regulation, in particular for institutions that are responsible to regulate and supervise the special and/or new financial sectors (e.g. Fintech, derivative market, etc) and improvement on the existing regulations which are identified as an obstacle of the development of the financial sector.

Conclusions

In summary, the Government is firmly committed to implement the program of financial sector reforms as set out above. We are pushing ahead in implementing proactive measures with the main objectives of increasing the depth, improving the efficiency and strengthening the resilience of the financial sector, in support of inclusive economic growth.

The Government greatly values the support provided by the International Bank for Reconstruction and Development/World Bank over the years to finance Indonesia's development priorities and the provision of technical assistance that is helping us to identify issues and develop a comprehensive and well-coordinated financial sector reform program. We look forward to your continued engagement and support in the coming years.

Minister of Finance
Republic of Indonesia



☞ Sri Mulyani Indrawati ☞

Cc:

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2. Director General of Budget Financing and Risk Management, Ministry of Finance
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