Towards a Stable, Efficient, and Accessible Financial Sector

Key Messages
1. The government’s focus on maintaining and strengthening the stability of the financial system over the last decade has had demonstrable success.
2. Despite this stability, Indonesia’s financial sector is bank-dominated, and as such financing is dominated by short-maturity financial instruments, typically time deposits. The amount of the long-term financing needed by corporations, infrastructure and SMEs remains very limited acting as a drag on growth. In addition much of the population does not have access to appropriate financial products and services.
3. The time is right to address two major financial sector challenges, efficiency and access.

Key Action
1. Continue to maintain the stability of the banking sector by (i) approving and implementing a financial sector safety net, (ii) strengthening the LPS including by providing the human- and financial resources it needs and (iii) strengthen the framework for rules-based prompt corrective action by Bank Indonesia.
2. Improve the efficiency of Indonesia’s financial sector by diversifying and strengthening non-bank financial institutions (NBFIs). (i) Restructure insolvent insurance and pension companies. (ii) Restructure civil service pension plans and social security schemes to make them fiscally sustainable. (iii) Create supportive institutional and regulatory framework for long-term local currency financing and social security for the people through the development of pension funds and life insurance sectors. (iv) Increase the breadth and depth of equity and bond capital markets through improved enforcement of corporate governance regulations. (v) Strengthen the coordination among financial sector authorities.
3. Enhance access to financial services for low-income households and Micro, Small and Medium Enterprises by (i) broadening the policy focus from the provision of credit to the provision of financial services, (ii) empowering formal micro credit institutions through improved access to funding and targeted capacity building (iii) enacting an appropriate legal framework for non-bank/non-cooperative microfinance institutions, (iv) encouraging venture capital, leasing, and Syariah-based financial products, and (v) providing a clear legal and regulatory framework for innovative/technology-led financial services/products that are key to low-cost financial service provision.

Where Indonesia Stands Now
A well functioning financial sector will accelerate economic growth, make growth more inclusive, reduce poverty, and strengthen Indonesia’s status as a middle-income country.

Maintaining banking sector stability has arguably been the main focus of Indonesia’s financial authorities since the 1997/98 crisis. Banking sector stability was rightly considered an imperative pre-condition for a sustainable economic growth. The authorities implemented a significant reform agenda that included improvement of regulations and supervision, and a strengthened role for law enforcement/anti-corruption to achieve and maintain stability. The success of the program is reflected in a banking sector that is stronger now than it was a decade ago. All indicators of banking sector performance, including non-performing loans (NPLs), return on assets,
capital adequacy ratios, and loan-to-deposit ratios have improved significantly. The return of public confidence has caused the banking sector to grow in recent years.

While the ongoing global financial crisis has affected Indonesia, on the whole its banks have been strong enough to weather the storm. However, Indonesia's banks were segmented into pools of varying liquidity, capital, and risk at the height of the global volatility in late 2008 and there are lingering, concerns about the stability of some smaller banks, two of which were forced to close. NPLs increased through mid-2009 although the longer-term trend of declining NPLs continues. Capital adequacy ratios and loan loss provisions remain within prudent ranges for the system as a whole (Table 1). The rate of credit growth declined in the last quarter, as it did globally. The upward trend in the loan-to-deposit ratios now provides real sector support at post 1997/98 highs (Figure 1). The deposit insurance agency (LPS), created in 2004, covers more than 90 percent of depositors in banking sector with deposits up to IDR2 billion covered. The LPS took over the two small banks that failed during the crisis. Overall, it is noteworthy that the banking sector remains stable despite the global turmoil, evidence of the success the government’s stabilization efforts.

The confidence and trust of the public and the international financial markets in Indonesian financial institutions has grown because of the government’s efforts to improve governance and integrity in the sector. Laws and regulations on compliance, Know Your Customer, Anti-Money Laundering and other regulations have been issued for banks and non-bank financial institutions and are being enforced effectively. Money laundering is being controlled through the credible operation of the Pusat Pelaporan dan Analisa Transaksi Keuangan (PPATK) which has now been in operation for several years.

Policymakers need to now focus on improving efficiency and access to the broader financial sector to accelerate growth. Eighty percent of financial sector assets reside in banks (Figure 2). The banking system cannot mobilize and allocate resources as efficiently as the broader financial sector thus reducing growth and potential poverty reduction. Bank credit to the private sector as a share of GDP remains at about 25 percent – extremely low compared to 85 percent for Thailand, 47 percent for India, and 114 percent for China. Loan-deposit interest rate spreads in Indonesia – at over 500 bps – remains among the highest in the region and among comparable countries and has been at this level for nearly a decade. In terms of access, less than half of all Indonesians have a bank account and less a fifth of the population have ever borrowed from

Table 1. Key Financial Statements of Commercial Banks

<table>
<thead>
<tr>
<th>Year</th>
<th>CAR (%)</th>
<th>NIM (%)</th>
<th>NPL (Gross) (%)</th>
<th>Earning Assets Provision (%)</th>
<th>ROA (%)</th>
<th>ROE (%)</th>
<th>LDR (%)</th>
<th>Total Saving &amp; Deposit</th>
<th>% Increase (Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>19.40</td>
<td>5.88</td>
<td>4.50</td>
<td>175.54</td>
<td>23.03</td>
<td>24.03</td>
<td>49.95</td>
<td>963.1</td>
<td>n/m</td>
</tr>
<tr>
<td>2005</td>
<td>19.30</td>
<td>5.63</td>
<td>5.76</td>
<td>127.25</td>
<td>18.02</td>
<td>17.98</td>
<td>59.66</td>
<td>1,127.9</td>
<td>14.1</td>
</tr>
<tr>
<td>2006</td>
<td>21.27</td>
<td>5.80</td>
<td>6.07</td>
<td>126.88</td>
<td>17.10</td>
<td>17.4</td>
<td>61.56</td>
<td>1,287.1</td>
<td>17.4</td>
</tr>
<tr>
<td>2007</td>
<td>19.30</td>
<td>5.70</td>
<td>4.07</td>
<td>193.95</td>
<td>17.98</td>
<td>17.3</td>
<td>66.32</td>
<td>1,510.8</td>
<td>16.0</td>
</tr>
<tr>
<td>2008</td>
<td>16.76</td>
<td>5.66</td>
<td>3.20</td>
<td>168.12</td>
<td>14.38</td>
<td>16.3</td>
<td>74.58</td>
<td>1,753.3</td>
<td>30.5</td>
</tr>
</tbody>
</table>

Source: Bank Indonesia Monthly Statistic book
a bank. Most do not find that the banking sector provides products and services appropriate for their needs. The Indonesian banking sector while stable, needs significant improvements in its efficiency and access.

**The role of non-bank financial institutions as a competitive alternative to the banking system remains limited.** Non-bank financial institutions provide different types of financing and an ability to take on different types of risks while providing much-needed competition to the banking sector. Indonesian equity markets were among the best performing in the world for several years prior to the global financial crisis, and have rapidly bounced back in recent months. And while capital mobilization through initial public offerings has risen, Indonesia’s equity market capitalization/GDP rate of roughly 40 percent is far below regional comparators (Malaysia 180 percent, Thailand 80 percent, and the Philippines 70 percent) and India (155 percent) and China (190 percent). Corporate governance and minority shareholder protections remain weak despite recent reforms. The government bond market is active and liquid, and given its short history, a remarkable success.

**Insurance companies, pension, and mutual fund industries that offer critical risk management products to individuals and firms, and mobilize long-term resources for investment remain small.** Indonesia still has one of the lowest life insurance penetration ratios in the world – roughly 11 percent – despite several years of rapid growth. There are a number of small, uneconomical, weak and/or bankrupt insurance firms whose satisfactory resolution is a pre-requisite for the rapid development of the industry. Pension funds with total assets of about IDR 90 trillion (end-2007) are extremely small compared to comparable countries. Indonesia also has a weak social security system with inadequate financial protection, particularly for the poor and the aged. Despite growth since 2005, the mutual fund industry remains small, volatile and offers a limited range of products.

**The regulator and supervisor of NBFIs, Bapepam-LK, has significantly strengthened its capacity to design and implement reform.** For a middle-income country however, Bapepam-LK remains capacity-constrained. The government now needs to emphasize the reform of NBFIs as much as it has done the banking sector in the last decade. The goal is strengthen the sector, increase its accessibility, provide appropriate risk management products to its clients, and mobilize long-term funds that can be productively invested to accelerate economic growth.

**Improving access to underserved populations has a significant positive impact on overall economic growth,** equity and poverty reduction. Improved access unleashes the contribution of MSMEs. Indonesian policymakers have long worked to improve access to credit but the focus needs to be on the broader issue of access to financial services including savings.

**Access to and usage of formal financial services is very limited especially for lower income households.** The number of bank branches – one indicator for physical outreach – has increased by 70 percent since 2000 and the absolute number of bank accounts has also increased - both encouraging trends. However, about half of Indonesian households do not have access to formal financial services (World Bank 2009), with those living outside Java having significantly lower access. Nearly 17 percent of households are completely excluded from any form of financial services and an additional 31 percent do not have access to formal financial services. Less than a fifth of the population has ever borrowed from a bank. Although banks have increased their presence, products and services offered are either not appropriate or too expensive. For financially underserved populations, especially in off-Java and in rural areas, financial services and products should be provided in cost-effective manner. Innovative technology-led financial services/products, including mobile phone-based and branchless banking have great potential to reach such populations and should be implemented.

**Microfinance institutions including BPRs, cooperatives, and other NBFIs have limited capacity and face policy constraints that severely limit their ability to provide financial services to underserved populations.** Regulation and supervision of these institutions has important gaps. Non-bank and non-cooperative financial service providers do not have a solid legal framework, which limits their ability to provide services. A microfinance law has been under discussion for nearly a decade but has yet to be finalized and approved. Limited access to financial information and low financial literacy by unbanked populations are also obstacles to accelerating financial inclusion.

**Figure 3. Access to Financial Services in Indonesia**

<table>
<thead>
<tr>
<th>Financially Served - 83%</th>
<th>Financially Excluded</th>
</tr>
</thead>
<tbody>
<tr>
<td>Using Formal - 52%</td>
<td></td>
</tr>
<tr>
<td>Informal &amp; Semi-formal</td>
<td></td>
</tr>
<tr>
<td>Excluded</td>
<td></td>
</tr>
</tbody>
</table>

Policy Priorities in a Rising Indonesia

Despite progress over the last decade, significant elements of the reform agenda remain unfinished. Despite lengthy discussions, there has been limited progress on the financial sector safety net framework and a proposed law remains in draft. Interim institutions such as the Financial Sector Stability Forum have limited scope and capacity to provide effective coordination in the event of a crisis. While the recent resolution of troubled banks indicates improvement in coordination, this area clearly needs much more work. LPS is currently an agency that runs failing banks rather than closing them and paying off depositors. Its resources limit it to taking over no more than a handful of small/medium sized banks. A clear bank resolution strategy that allows banks to fail in an orderly manner will clarify LPS’ role. A more realistic interest cap on covered deposits is needed, preferably linking it to a market interest rate and more information is needed on the conditions of the deposit guarantee. While BI’s supervision has improved dramatically, the ongoing crisis again highlights the importance of a mandatory rules-based framework for prompt corrective action.

Several different policy priorities need to be addressed in a coordinated fashion to improve the efficiency of the financial sector. Indonesia needs to diversify its commercial-bank centric financial sector and establish stronger NBFIs:

- The insurance and pension sectors need to be comprehensively restructured through regulatory action to create a consolidated and efficient industry.
- The government needs to restructure its civil service pension plan that exposes the government to large implicit liabilities. This becomes all the more imperative in the context of proposed Civil Service reforms that involve substantial increases in compensation. The design and implementation of social security schemes also needs improvement to contain future fiscal costs.
- Creation of single citizen identification number will provide part of the infrastructure for a sound social security system.
- The government should continue to provide supportive regulatory and institutional framework for institutions that provide long-term local currency financing, including for infrastructure financing. Bond markets are important for government financing, but provide little corporate financing. Investor confidence in corporate bonds will require the creation of yield curves and a strong legal and corporate governance framework.
- The government should push plans to list minority stakes in state-owned enterprises on the stock exchange to broaden the currently shallow equity market dominated by a handful of firms.
- As a country prone to natural disasters, Indonesia would be a prime candidate to have a formal ex-ante disaster risk financing/disaster insurance framework to reduce the reliance on ex-post budget and donor aid.
As Indonesia attempts to strengthen its middle-income-country status, financial inclusion should be a policy priority. Improving access to broader financial services for a larger share of the population is a key to sustainable growth. These services should extend beyond credit and loans to savings, access to the formal payments system, and non-banking financial services including insurance, and pensions.

♦ Microfinance institutions urgently need a formal legal framework to build institutional capacity and clear issues around savings mobilization. The new microfinance law has been stalled for nearly a decade: it should be a priority.

♦ Encouraging and developing other non bank financial services such as venture capital, leasing, and Syariah-based financing that help meet the needs of the lower income population should also be a priority.

♦ Encouraging and establishing strong public-private partnerships that could develop and pilot new, affordable financial products and services for a broader section of the population. Such partnerships will enable Indonesia to increase access and improve financial inclusion on a sustainable basis.

♦ Access is particularly poor outside Java so there is a need to better identify the “financially underserved” by regions. This would enable targeted interventions to specific segments of the population such as migrant workers with special needs.

♦ To reach underserved regions, encourage innovative/technology-led financial services/products, including mobile phone-based and branchless banking by providing incentives and a clear legal framework.

♦ The financially underserved, poor, and rural populations need access to sound risk management instruments such as insurance and pensions. Globally, micro-insurance is gaining in importance as a risk management instrument for low-income households. Indonesia needs to create the incentives and regulatory framework for the industry.

How The World Bank Can Help

The World Bank will support a (i) medium-term, ongoing program of policy reforms and (ii) will respond to requests from the authorities for help in the event of unexpected events/shocks to the system.

Over the next five years, the World Bank's support to the government’s medium-term financial sector policy reforms will address the following issues:

♦ Analytical and advisory services and technical assistance will be the key instruments through which reform efforts related to financial stability, efficiency, and access will be supported. The upcoming Financial Sector Assessment Program (FSAP) should provide important inputs regarding key stability and efficiency issues. Other analytical work by the Bank – such as the NBFI report and the Access to Financial Services report – have provided inputs on efficiency and access. Further analytical work will be taken up as necessary. Work on strengthening institutional infrastructure will also form part of this support. The World Bank will work closely with the authorities – especially Bapepam-LK, Bank Indonesia, the Coordinating Ministry of Economic Affairs, the Ministry of Finance, civil society, and development partners – in these efforts. Key reforms will also be supported through the Bank's ongoing series of Development Policy Loans (DPLs).

♦ The World Bank can also help provide innovative engagement, structuring, and lending support in areas such as infrastructure finance, capital markets, trade-, sub-national- and Islamic financing.

By its nature, the second area of rapid response support to emerging issues is unpredictable and will be addressed as needed. It will be underpinned by financial sector monitoring that keeps the World Bank informed of key developments and to respond to requests from the government.