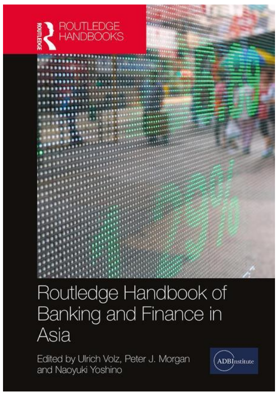

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DEVELOPMENT AND SHORTCOMINGS OF INDONESIA'S FINANCIAL SECTOR

Iwan J. Azis

Introduction

Nothing is surprising when, after going through a major financial crisis like in 1997, efforts have been made to strengthen the financial sector. This has always happened in all crisis-affected countries. Being one of them, Indonesia is no exception. In several areas since the crisis, the country's financial sector has made some improvements. Yet a combination of side effects of a liberalized system, misguided policy, and failure to diversify especially during the period of strong growth and ample liquidity still makes the country vulnerable to external shocks. Boundless complacency prevails due to weaknesses and policy. While the sector has grown steadily, supported by improvements in the regulatory and supervisory work, shortcomings remain.

In this chapter, the development and the structure of Indonesia's financial sector are put in the context of a changing external and domestic environment, from which shortcomings are identified, and risks and uncertainties are highlighted. It is argued that in a liberalized and open financial system, where the financial sector is still small and shallow like in Indonesia, vulnerabilities to external shocks bound to ascend. The sequence of episode is typical: vulnerabilities preceded by a period of massive capital inflows. This time, the surge of inflows is prompted by the ultra-easy money policy in developed economies, while the vulnerabilities are reflected in elevated risks of pro-cyclicality and reversals of capital flows.

Risks in Indonesia are further heightened by the absence of formal financial safety nets until only recently when a draft law was passed by the parliament. Struggling to safeguard financial stability amid growing ineffectiveness of standard monetary policy, policymakers and regulators came up with various initiatives and measures, some of which are controversial.

After discussing the country's structure of financial sector, followed by issues surrounding the regulatory and supervisory framework and the financial sector challenges, in the last section before the summary the chapter focuses on the recent development, externally and domestically, and presents the resulting risks in conjunction with the changing policy and institutional arrangements with respect to crisis management.

Financial structure: banks, non-bank financial institutions, equity market, bond market

The total assets of Indonesia's financial sector are around 75% of GDP, relatively smaller compared to the neighboring Association of Southeast Asian Nations (ASEAN) countries. As in many developing and emerging market economies, the country's financial sector is dominated by the banking sector, which constitutes 80% of the entire financial system (Figure 5.1).

Out of 118 commercial banks (11 of which are Islamic banks), more than 40% are state-owned including regional development banks.[1] Private commercial banks constitute a roughly similar share, and the remaining 15% are foreign banks branches and joint ventures.[2] By the end of 2015, the total assets of commercial banks are recorded at IDR 6,530 trillion (less than USD 500 billion), with a persistently high concentration where 47% of total assets belongs to the top five banks: Bank Mandiri, Bank Rakyat Indonesia, Bank Central Asia, Bank Negara Indonesia, and Bank CIMB Niaga.

Indonesian banks are highly segmented. The formal classification, based on BUKU, is the following:[3] BUKU-1 consists of banks with core capital of less than IDR 1 trillion; BUKU-2 between IDR 1 trillion and IDR 5 trillion; BUKU-3 between IDR 5 trillion and IDR 30 trillion; and BUKU-4 with more than IDR 30 trillion.[4] Those under BUKU-4 can have a wider range of business activities and are allowed to enter into domestic or offshore equity investment with ownership not more than 35%.

The average capital adequacy ratio (CAR) of the banking system is around 20% (some 90% of available capital is tier 1 category), where foreign banks have the highest ratio. Although return on assets (ROA) is still above the average in emerging markets with around 2.7%, banks' net interest margin (NIM) is notoriously high. At 5.3%, it is the highest among ASEAN-6.[5] Table 5.1 displays data per December 2015 of CAR, ROA, NIM, and other indicators for different categories of banks. A high NIM captures the spread between the interest earned on the

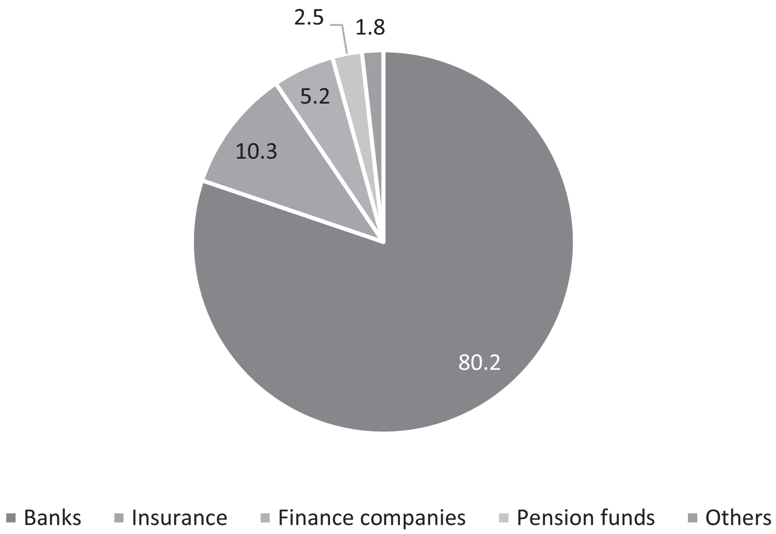

Figure 5.1 Structure of financial system, 2016

Table 5.1 Set of indicators for different categories of banks (as of December 2015)

		Conventional Banks	*Forex*	*Non-Forex*	*BPD*	*Mixed*	*Foreign*
ROA	%	2.3	1.8	1.6	2.4	1.0	1.7
Total Asset	IDR billion	6,129,357	2,363,516	193,149	475,696	313,570	473,336
NPL	%	2.5					
CAR	%	21.3	18.1	21.2	20.6	20.4	46.5
LDR	%	92.1	86.9	86.0	92.2	132.8	131.5
NIM	%	5.4	4.9	5.1	6.7	3.4	3.6
BOPO	%	81.5	84.8	86.8	79.6	87.5	92.7
Deposit/ DPK	%	46.0	52.5	84.8	36.4	58.7	31.7
Number of banks		118	39	27	26	12	10

Notes: CAR = capital adequacy ratio. LDR = loan-to-deposit ratio. NIM = net interest margin. NPL = non-performing loan. ROA = return on assets.

Source: Compiled by author.

bank's assets and the interest costs on its liabilities; it is supposed to reflect the asset and liability management. However, NIM in Indonesia is more numerator driven. That is, the persistently high NIM is driven more by the high lending rates.[6]

Also, NIM should not be confused with profitability as banks earn significant income from fees and service charges, none of which are affected by interest margins. Banks' profitability remains good although it has started to decline. A sizeable untapped market and growing number of middle class continue to make the appetite of foreign investors to either acquire banks or set up operations in Indonesia strong.[7] With the commencement of ASEAN Economic Community last year, and the issuance of ASEAN Banking Integration Framework as part of ASEAN Framework Agreement on Services, the opportunity for ASEAN banks to operate in Indonesia is bigger. Realizing the absence of a level playing field and different sizes among banks in ASEAN – the 10 largest belong to Singapore, Malaysia, and Thailand – and considering the current level of Indonesian banks' efficiency, there is a fear of competition asymmetry. This explains why at this stage the Indonesian authorities are still reluctant to allow neighboring banks to come with the strength and speed they wish.[8]

High interest rates translate into bond yields. The Indonesian bond market is largely sovereign and in local currency, as the corporate bond market is still in its infancy. Per December 2015, the outstanding value is recorded at IDR 1,650 trillion or USD 126 billion with the following breakdown: IDR 1,410 trillion government bond and IDR 249 trillion corporate bond (Table 5.2). The bond market is relatively young as it began to grow only since the issuance of recapitalization bond following the 1997 Asian financial crisis (AFC). Several banks receiving such bonds during the crisis, some of them are now foreign owned, continue to hold them, generating interest incomes until today.[9]

The largest holders of bond are banks. Bond holding by corporates (mostly banks) is four times larger than the amount of bonds outstanding. This has an important implication on the link between monetary policy and financial stability. Any changes in yield – hence price of bond – driven by changes in the interest rates would have repercussions on bank's balance sheet (Azis and Shin 2015). Particularly in a high interest rate environment like Indonesia, a

Table 5.2 Assets of non-bank financial institutions (as of December 2015)

	Total
Insurance (IDR billion)	803,715
Gross premium of insurance (IDR billion)	261,087
Pension fund (IDR billion)	206,593
Financing companies (multi finance, venture capital, infrastructure financing companies, SOE financing)	10,576
Others (Indonesia Eximbank, SOE pawnshop, guarantee institutions (IDR billion)	138,652
Capital Market (as of December 2015)	
Number of companies listed	521
Market capitalization (IDR billion)	4,796,800
NAV mutual funds (IDR billion)	268,447
Outstanding of local currency bonds	
– Government bonds (IDR billion)	1,410,000
– Corporate bonds (IDR billion)	249,000
Issuance of local currency bonds	
– Government bonds (IDR billion)	311,790
– Corporate bonds (IDR billion)	62,420
Daily trading (IDR billion)	5,768

Source: Compiled by author.

rate increase may harm the quality of banks' balance sheets and hence financial stability. The situation when net foreign capital inflows turned to net foreign capital outflows in 2015 provides an illustration of this vulnerability (for the turnaround of capital flows, see Azis 2016). Despite the fact that movements of capital have been driven more by the push/supply factors (external), less to do with domestic interest rates, Bank Indonesia (BI) was adamant to keep the outdated thinking of setting high interest rates believing that it could deter outflows. On the one hand, the policy was ineffective; on the other hand, keeping high interest rates caused banks' net worth to deteriorate through falling bond prices.[10] Smaller banks were particularly affected.

Offering highest yields in ASEAN-6, the market has attracted foreign investors especially during the period of ultra-easy money policy including the quantitative easing in advanced economies after the 2008 global financial crisis. Almost 40% of local currency bond in Indonesia is foreign-owned. As this happens while market is shallow and not liquid, any shock that may change investors' perception could easily rattle the market. The episode of taper tantrum in summer 2013 provides a clear example. Compared to the bond market in, say, Malaysia, where foreign ownership is also relatively high but domestic investors' base is large, Indonesia's bond market is more vulnerable to market volatility due to investors' change in perception.

The equity market is also less developed than in other major ASEAN countries. The number of companies listed has not changed much over the years; per December 2015 only 521 companies are listed, with market capitalization around IDR 4,800 trillion or USD 370 billion, less than 50% of the country's GDP. The concentration ratio is high: 50 companies constitute almost three-quarters of total market capitalization. In the case of mutual fund, the net asset value is only less than IDR 270 trillion, albeit growing. The share of foreign ownership, around 60%, is even higher than in the bond market, and it is more volatile.

The asset size of non-bank financial institutions (NBFIs) is recorded at IDR 1,160 trillion (USD 89 billion), where insurance companies and pension fund dominate (around 87%). The remaining NBFI assets belong to financing companies such as multi-finance, venture capital, infrastructure financing companies, pawnshops, Export-Import or Exim Bank, and so forth (see again Table 5.2).

Regulatory and supervisory framework

Fragmented regulatory structure and framework not all in line with international best practices are among the most notable features of Indonesia's financial regulatory and supervision. In such circumstances, a lack of diversity in capital market is expected.

The absence of formal policy about future direction and strategy of the country's banking sector makes it unclear as to what direction the banking industry would take in the long term. Only when such a policy is in place a proper regulatory and supervision can be designed. This prompted the authority to launch the Indonesian Banking Architecture (Arsitektur Perbankan Indonesia, or API).[11] Since then, some improvements have subsequently been made particularly in areas related to the specific strategies for development of rural banks, SMEs including micro enterprises, and in institutional strengthening of rural banks (Bank Perkreditan Rakyat, or BPR) and Shariah banks.[12] The authority sought to build constructive cooperation with the relevant stakeholders in the API programs to generate a sound, strong, and efficient banking industry to secure financial system stability. Obviously, this can be achieved only when backed by a strong regulatory and supervisory work, on which a major institutional change has occurred in Indonesia (Financial Stability Board 2014).

Until 2012–2013, BI was responsible for regulating and supervising banks, while the Capital Market and Financial Institution Supervisory Board (Badan Pengawas Pasar Model or Bapepam-LK) was responsible for non-bank financial institutions and the capital market. Issued in 2011, Law 21 stipulates that the regulatory and supervisory work for the entire financial sector, not just banks, will be transferred to the financial service authority OJK (Otoritas Jasa Keuangan 2016). For non-bank financial institutions and capital market, the actual transfer began at the end of 2012, and for banks at the end of 2013.[13] BI will retain regulatory responsibilities for macroprudential policies. An important reason behind the move was the growing public dissatisfaction with BI's handling of the AFC and the subsequent corruption scandals.

But questions have been raised as to whether OJK will be better prepared to deal with financial crises and be independent from political and other pressures. Another yet more fundamental question is whether separating monetary policy from bank supervision is the optimal and appropriate strategy for Indonesia, especially since there is no global consensus on the optimality of such a strategy.

Nonetheless, the decision has been made. In practice, the transfer of responsibility was not easy; the process has been far from smooth. Lack of accurate data and information about the operations of non-banks and capital market, and uncertainties surrounding the status of staffs responsible for bank regulation and supervision, add to the difficulties. By the end of 2015, some BI staffs who were lent to OJK opted to return to BI. This poses a challenge for OJK to conduct the work more optimally, considering this happens in the midst of growing economic uncertainty. One could only envisage what would have happened if the country's financial sector was hit by a major external shock at the time. Fortunately, that did not happen, and the growth performance of the Indonesian economy was still relatively strong, although a large part of it was due to the primary sector boom driven by the People's Republic of China's (PRC) strong demand. That favorable condition ended in late 2014 when commodity prices continued to fall, the PRC's boom ceased, and capital flows began to reverse (Azis 2016).

Like in many other emerging markets, the focus of the regulatory and supervisory work has been to maintain financial stability, at least on paper, while at the same time insuring that the financial sector is supportive to economic growth. The latter becomes more urgent in the current environment of growth slowdown. In this context, the policy to put a cap on deposit rates by the OJK cannot reflect better the overlap and confusion over the regulatory-cum-supervisory action and monetary policy.

Easing monetary policy in a slowing-growth environment is expected. This would have reflected in a fall of interest rates. However, while BI began to lower the rates only since early 2016, the effects on deposit and lending rates have been limited.[14] OJK tried its own approach to change that by introducing deposit rate caps effective 1 October 2014. The regulation is aimed at alleviating the competition among large banks for term deposits and bring down lending rates.

It is true that in a highly segmented market only a small number of big banks (BUKU-4 category) dominate and become the real movers of the rates. But putting a cap on interest rates could limit banks' ability to adjust to liquidity shocks via interest rate flexibility and reduce bank's ability to mobilize not only large deposits but also small ones. One possible outcome is that banks will resort to keeping more liquidity rather than extending credits. Such a measure also encroaches on BI's policy signals and operations that could distort policy transmissions. The line separating supervisory and regulatory work from monetary policy is blurred. Many wonder whether it represents controls on interest rates since the deposit rates offered are not allowed to go beyond a level that satisfies a pre-determined spread around the BI rate.[15] Is the country's financial system resorting to financial repression?

Still on the effort to stimulate growth, BI introduced reserve requirement averaging to reduce the need for banks to hold high precautionary reserves. This policy is expected to ease the liquidity constraint and deepen the money market. Indeed, the money market in Indonesia is shallow and needs a further boost. In this context, OJK launched the Global Master Repurchase Agreement to help develop the collateralized interbank market.

BI also took another move on its policy rate by replacing the BI Rate with the seven-day (Reverse) Repo Rate effective on 19 August 2016. In the announcement, improving the effectiveness of monetary policy transmission was cited as the primary goal of the change. It is also expected – along with other measures – that it will help support financial market deepening as it will encourage transactions and develop interbank rate structure for 3–12 months. It is unclear, however, how the seven-day repo rate will have any meaningful difference with the previous BI rate in terms of its effectiveness to lower the lending rates, especially that more fundamental reasons for the ineffectiveness have not changed.

On capital market, the Indonesian Capital Market Law was promulgated in 1995, before the AFC.[16] The regulation made no provision for safe havens, implying no exemption and different treatment for sophisticated investors. It was not until 1997 that a set of new rules was introduced, allowing foreign companies considering dual listing or an initial public offering to issue Indonesian depository receipts. One of the biggest regulatory challenges at the moment concerns the possibility that foreign companies will be allowed to be listed on the Jakarta stock exchange. Such development is increasingly inevitable as the ASEAN Economic Community has officially commenced, yet there is no specific regulation to support it so far.

Now that OJK has been designated as the sole institution in charge of bank and non-bank supervision, a consolidated framework for risk-based supervision of banks and non-banks is needed. More importantly, it is imperative for OJK to have the appropriate capacity to implement the consolidated system.

Challenges

Indonesia's financial sector faces fundamental and contemporary challenges. The fundamental ones are generally linked to the underdeveloped stage and shallowness of the sector. Not only the size is small – barely higher than the size of the country's economy – but the dependence on the banking sector is also the highest among the ASEAN-6 countries. Decades of open capital account make such conditions vulnerable to the volatility of capital flows, and clear and robust crisis management protocols were not in place until recently.

In the banking sector, the high cost of intermediation indicated by a low penetration ratio and inefficiency continue to shape the country's capacity to finance investment and consumption. Sources of funds are predominantly short term (more than 90% having one-month maturity), and about half of them are traditional current and savings accounts. The banking system is highly segmented, and the dominant source of banks' funding comes from the deposits of large corporations. Banks of BUKU-4 category alone absorb 60% of the entire banks' current and saving accounts. Small banks, on the contrary, have to rely on higher-cost funding. The interbank and money markets are not functioning optimally, and the policy rate set by the central bank (BI rate) has been also getting less and less effective in influencing the market interest rates.

Another fundamental challenge related to the segmentation is with regards to state-owned and regional development banks that control around half of the entire banking market. Unlike domestic private banks, these banks receive favorable treatments from the government, such as giving them exclusive rights to deposit financial resources from the central/regional government's institutions. This makes their NIM higher than that of other banks. For domestic private banks, conglomeration is growing and becoming more difficult to monitor. One of the major challenges is for the regulators to put a restriction on the practice of financing own affiliated companies. Such a practice is common particularly among big companies belong to the same people or group who also own the banks.

Still another serious challenge concerns financial inclusion. Only slightly more than one third of Indonesia's population 15 years and older has a financial institution account; this is lower than the average proportion in lower-middle-income countries. Of that category, among the poorest 40%, only 22% have an account. For those living in rural areas, the number is less than 30%. What about access to loans? More than 40% of borrowers get the loans from friends and family. Also, in the current age of technology, where the mobile phone has a great potential to reach low-income people in need for financial access, including those in remote areas, the actual number of adults having mobile accounts is only 0.4%, markedly lower than the average number in lower-middle-income countries (2.5%).

Creating innovative programs and putting in place a more supportive regulation to increase the number of population with financial access, especially among the poor, continues to be among the biggest challenges the financial authority must deal with. A low level of financial literacy and weak consumer protection make such a challenge more daunting.

A further concern is the tiny proportion of population (less than 0.4%) that has access to the capital market. As a result, while a booming capital market may help boost the financing for the national economy,[17] the distribution of benefits is likely skewed. This could exacerbate the already worsening income and wealth distribution.

Contemporary challenges also abound. Increased capital inflows following the ultra-easy money policy in advanced economies since the mid-2000s, coupled with excess savings since the AFC, have provided ample liquidity (Azis and Shin 2014; Azis 2014a). Yet this did not translate into a robust growth in productive sector. The actual spending on infrastructure, for example, remains low. At first, the inflows were largely channeled through the banking system (bank-led flows). Banks' external debt soared during the period, causing their balance sheet to expand. Then, as the US quantitative easing policy began in 2009, a new round of massive inflows took place. This time, however, a large amount went to the capital market (debt-led flows) searching for higher yields (Azis 2016). As a result, the proportion of foreign ownership in the capital market surged, reaching around 60% in the equity market and nearly 40% in the bond market.[18]

As discussed in Azis and Yarcia (2015), those massive inflows changed the behaviors of agents. A more risk-taking behavior was clearly detected as most of the excess liquidity was invested not in the businesses or real sector activities but instead in financial assets. As expected, the latter grew more rapidly than the real sector of the economy (financialization). This suggests that there remain problems in the overall investment climate, while yields and returns from investing in financial assets are lucrative and easier to earn. The long-term growth capacity of the economy declines, and employment elasticity falls as a result. It also exacerbates the income inequality since only the high-income and urban-based households are involved in the financial sector. Indeed, without appropriate compensating measures, financial liberalization and free flows of capital in many emerging markets tend to worsen the income inequality (Azis 2015; Naceur and Zhang 2016).

A combination of shallow financial market and open capital account exposes the economy to volatile capital flows, elevating the risks of financial instability. Bank-led flows increase the risk of pro-cyclicality, and debt-led flows make the system vulnerable to flows reversals. The taper tantrum episode of 2013 demonstrates how financial market could easily turn volatile when investors' perception changed and capital flows reversed. A more recent round of volatility that began in 2015 occurred because financial conditions were tightening, as shown by a sharp decline of credit growth. At the same time, the economic growth has been slowing. Heightened competition for funding in the midst of economic slowdown put more strains on the financial sector.

Another serious challenge is the increase of non-performing loans (NPLs). The uptrend began in early 2014 as many companies struggled to repay debts. One estimate suggests that Indonesia's NPLs could reach 3%–4% in 2016 – a steep increase considering it was only 1.8% in 2013. The expected NPLs for SMEs and for mining-related activities could be as high as 8% – the highest level since the 2008 global financial crisis.[19] This forced banks to increase bad loan provisions. The risk of deteriorating credit quality and margin pressure is likely to heighten, given the weak economic environment.[20]

Segmentation also implies different challenges for different category of banks. Local, state-owned, and Shariah banks clearly face a margin pressure. This is not so much the case for foreign banks. The latter are more concerned with issues like uncertainty related to the use of IT data, banking rules, on-shoring requirements, complex and more demanding domestic and international compliance regime. These factors could affect their ability to leverage global operating models.

Given the current slowdown in the economy and uncertainty in global conditions, the most real and immediate challenge for Indonesia's banking sector is to reduce the cost of funds on the one hand and to develop new revenue sources on the other hand.[21] This has to be done while banks must also meet the regulatory compliance framework in line with Basel III (requiring a stronger capital surcharge). They also have to comply with the recent rule that puts a limit (a cap) on the deposit rate. Such a rule was issued by the financial service authority OJK because, as discussed in the preceding section, beginning in 2014 the responsibility for regulating and supervising banks was transferred from the central bank to OJK.

Policy and crisis management

When the prospect of world economy is uncertain, the growth slowdown in the PRC feeds back negatively to other countries and the global growth, the quandary for an emerging market like Indonesia is multitude.

Having relied too much on the PRC's demand for primary commodities, especially coal and palm oil, the impact of a slower PRC expansion has been significant. After years of enjoying a double-digit improvement in the terms of trade spurred by a strong demand and high price of commodities, the trend began to reverse in 2011. The terms of trade have declined by around 8% since then (IMF 2015). For an economy like Indonesia, where major commodities constitute half of all merchandise exports and where the share of commodities sector is around 10% of GDP, the impact of the turnaround is quite severe. Growth is slowing, risks in financial sector are rising, and firms having a large borrowing in foreign currencies are under severe stress.

It is estimated that the country's GDP growth has been about one percentage point lower because of the 8% decline in commodity terms of trade. Through the reduction of imports and by considering the inter-industry linkages, the current account balance improves. On the other hand, a combination of lower oil prices that cut government revenues through a profit-sharing arrangement, spending for subsidies that remain substantial albeit declining, and purchases of other energy sources, has raised the fiscal deficit and narrow the country's fiscal space.

Equally important to understand is the effect of falling prices of commodities on the revenues and profits of producers and exporters. Through multiplier effects, domestic demand and incomes are affected. Declining incentives to invest in commodity sector or the related activities also cause a contraction. A shift of resources including labor and capital (credits) from primary good tradables to non-primary good tradables is an inevitable outcome. In the process, lenders to commodity-related activities have to bear significant losses. Most loans become NPL or special mention loans (SML) as a growing number of companies have to struggle with debt repayment. The problem of high leverage is further exacerbated by the decline of profitability. A slowdown in the overall economic growth puts further pressures on NPL and SML. It also causes lending growth to fall and asset quality to deteriorate.

In response to slower economic growth, BI loosened the monetary policy and relaxed some of its macroprudential policies. It reduced the interest rates and cut the rupiah primary reserve requirement to enable banks to have additional liquidity, lowering the cost of loanable funds. But given weak demand for credit, it is doubtful that the measure could boost lending and growth. To help banks manage liquidity risk, liquidity coverage ratio requirements have been adopted, as well as the requirement for counter-cyclical capital buffer. From the OJK side, a set of measures are also taken, one of which is specifically intended to facilitate loan restructuring for banks that have a relatively strong risk management capacity.

Even with all those measures, however, systemic financial stability risks remain high. Part of the reason is because risks in corporate sector are also increasing. Another reason is the uncertainty over the procedure and legal framework of the financial safety net system.

Many corporates, especially those affected by commodity price falls and a weak rupiah, are facing growing risks of refinancing or default; the latter could create negative spillovers to the banking system and damage confidence.[22] Another concern is increased conglomeration as discussed earlier. The practice of lending to own affiliated companies is common. If left unattended, it could make the risk not only increasing but also systemic. A severe stress is also felt by corporates with high foreign currency leverage. Debt rollover is unavoidable for some of them. Including foreign exchange debt to banks, foreign currency debt was recorded at 20% of GDP in 2016, twice the level in 2010.

For the policy-makers and regulators, managing such difficult conditions is far from easy since the domestic and external environments are no longer benign. To the extent safeguarding the domestic financial stability is the only choice, efforts in this direction should include strengthening the facility for hedging of the foreign exchange debt, requiring foreign exchange hedging by corporates, and limiting external borrowing to only firms with a strong balance sheet or investment grade firms. Improvements in corporate resolution framework and bankruptcy regime are also urgently needed. The oligopolistic market and large connected conglomerates in Indonesia pose systemic risks that could be dealt only with a strong resolution and bankruptcy framework.

Nonetheless, in a bank-dependent economy like Indonesia, vulnerabilities in the banking sector are more important to watch. They are more likely to elevate risks of systemic financial stability. The central bank's lender of last resort function is important in this regard. In a normal condition, the facility related to such a function is available to illiquid but solvent banks able to provide liquid, high-value collateral. In a crisis situation, however, the primary consideration is the potential for systemic impact in addition to solvency and bank's ability to provide collateral.[23]

Yet, a broader framework that includes the deposit insurance scheme, crisis resolution, and the emergency financial facility is more needed. Together with the directives for crisis prevention, such a framework can hold the key to the country's Financial System Safety Net (FSSN). In 2017, a Draft Law of FSSN has been passed by the parliament.[24] It specifies the following tasks and responsibilities of the relevant institutions involved in the operation of the Safety Net: the Ministry of Finance is responsible for drafting legislation for the financial sector and providing funds for crisis resolution, BI is responsible for safeguarding monetary stability, maintaining a sound banking system and ensuring a secure and robust operation of the payment system, and the Indonesian Deposit Insurance Corporation is responsible for guaranteeing bank customer deposits and resolution of problem banks.

Realizing the seriousness of the risk of moral hazard from adopting a government blanket guarantee despite its merit for restoring public confidence in the banking sector during a crisis, the new FSSN Draft Law does not allow such a scheme. Instead, the Indonesian Deposit Insurance Corporation (Lembaga Penjamin Simpanan or LPS) is expected to be in charge of handling the systematically important banks when they are in trouble. This is on top of the LPS basic responsibility to guarantee bank customer deposits. In executing the rescue task, the first step would be to use a private sector-based solution such as selling the bank to other investors or asking bank owners to provide additional capital and so forth. Only if that early step fails to work will the LPS take over the bank. To ensure the effectiveness of crisis resolution, each relevant institution is assigned clear lines of responsibility and accountability, and to avoid high social and economic costs, the new Draft Law prohibits the use of public money (no more bailout approach).

Now that the FSSN Draft Law has been passed, the subsequent revisions of the laws of BI, LPS, and OJK have to be well coordinated to ensure an overall consistency of the legal framework to the new institutional arrangements. More importantly, since LPS is now given a larger task and responsibility in crisis resolution, it is imperative to strengthen its capacity by granting additional instruments and tools, and greater room for raising more funds.

Summary and final remarks

Indonesia's financial sector is typical of that of many lower-middle-income countries. While it has grown steadily and made improvements in some areas, especially after the 1997 crisis, the sector remains small, bank-dependent, having limited inclusion, and highly concentrated. Almost half of banks' total assets belongs to the top five banks, and three quarters of capital market capitalization is owned by less than 10% of all listed companies. The segmented banking sector combined with small and shallow capital market makes the cost of intermediation high, and interbank market and money market not functioning optimally. The regulatory structure and framework are fragmented, not all in line with international best practices. A lot in the supervisory work still needs to be improved.

Banks' excessive reliance on short-term sources of funding and the illiquidity of capital markets lead to high interest rates, NIM, and bond yields; in all three, Indonesia has the highest among major ASEAN countries. Small market coupled with a large ownership of yield-driven foreign investors poses a challenge to financial stability. A minor perturbation that sparks capital outflows could easily rattle the market. Bank-led inflows expose the system to pro-cyclicality risks, and debt-led inflows makes the system vulnerable to flows reversals.

As capital inflows surged since the mid-2000s, vulnerability increased. The subsequent lack of prudent behavior among agents elevated the risks. Another challenge pertains to the consequences of growing conglomeration where lending to own affiliated companies is a common practice. The resulting risk is not only high but also systemic.

The effectiveness of standard monetary policy is limited because of increased financialization driven by ample liquidity from massive capital inflows on the one hand, and high cost of domestic borrowing on the other. As corporates face increased risks of refinancing and default, the difficulty spillovers to the banking system. A close interlink between banks and capital markets (e.g., banks being the largest holders of bonds) also makes the policy choices more complex. It intensifies the trade-off between achieving the conventional growth-price stability and newly added financial stability. This suggests the need for a more effective macroprudential policy to complement the standard macro policy.

Against such a backdrop, recent slowdowns in the economy and elevated risks of financial instability pose a difficult challenge to policy-makers and regulators. Since efforts to ease monetary conditions by using standard monetary policy have failed to translate into lower lending rates, authorities attempt to take a rather drastic – yet controversial – measure: BI abandons completely the policy rate (BI-rate) and replaces it with seven-day repo rate, OJK imposes a cap on deposit rates, risking a return to financial repression. Before the slowdown, when capital inflows were still large, financial stability got the upper hand. As growth is slowing, the pendulum is swinging back to growth-price stability. The recent loosening of macroprudential policy – along with the monetary ease – is a poster-child of the shift. This could be risky because the ingredients of financial instability still remain, if not amplified; low measured-risks can abruptly turn into high real risks.

Amid heightened uncertainty and elevated risks, for eight years since the onset of the global financial crisis there was no formal procedure and protocols with a strong legal support for crisis resolution. Effective financial safety nets were essentially absent. Only in 2016 the FSSN Draft Law has been passed by the parliament, albeit still prompting questions regarding some of the points (e.g., making LPS almost single-handedly deal with troubled banks, vagueness in BI role as the lender of last resort, and prohibiting the use of public money for rescue operations). Also, a new set of legal and institutional adjustments still need to follow the Draft Law.

Curiously, even during that period of uncertainty the government proceeded with a major institutional shift that led to the establishment of OJK. It could be no other than by sheer luck Indonesia did not experience a major shock triggering a crisis at the time. Given the heightened uncertainties and risks, financial authorities would be wise not to push the luck too far.

Notes

1 The ongoing plan is to consolidate through M&A to reduce the number of banks to 60–70 within the next 10 to 15 years. The intended classification is international, national, and specialized or rural banks.
2 Foreign and joint-venture banks focus more on corporate and commercial-loan segments which they are more knowledgeable about and able to leverage on the networks of their principals.
3 The classification was made by Bank Indonesia through Regulation No. 14/26/PBI/2012 on Business Activities and Office Networks Based on Bank Core Capital, entered into force on 2 January 2013. It regulates the permitted business activities, obligations for the amount of credit a bank must grant as productive financing, and establishment/expansion of branch office networks – all based on the amount of Core Capital. BUKU stands for Bank Umumberdasarkan Kegiatan Usaha or Commercial Bank Based on Business Activities).
4 The classification is part of the Indonesian Banking Architecture or API (Arsitektur Perbankan Indonesia) launched in early 2004 as one of the key programs for promoting national economic recovery.
5 At the time of writing, the NIM of one of the state-owned banks, Bank Rakyat Indonesia (BRI), reaches even more than 8%.
6 Early this year, the Financial Services Authority (OJK) announced its plan to push state-owned banks' NIM to 3%–4% in a bid to lower the lending rates.
7 For example, banks from the People's Republic of China and the Republic of Korea are currently screening for targets to gain a foothold in Indonesia, especially for BUKU-1 category that requires more limited capital for expansion and limited banking activity that can perform. Some Japanese banks are also eying at the opportunity.
8 Also, the implementation of services liberalization under AFAS is scheduled to come into effect only in 2020.
9 Some of them are foreign-owned because after taken over by the government through a specially set-up agency called IBRA banks were subsequently sold to the market.
10 In the past, BI's high interest rates policy also posed problems as foreign and domestic institutions, including local governments, tended to hold the BI certificate (SBI) rather than to invest in the real sector. The burden on BI's liability associated with SBI also increased
11 The launching was in early 2004. API provides the outline of the direction and structure of the banking industry for the next 5 to 10 years, aiming at building a sound, strong, and efficient banking industry in order to create financial system stability for promotion of national economic growth. Note also that setting a long-term direction and development strategy for the banking industry has now become a global trend.
12 Shariah banks are banks managed according to Islamic Shariah law where the collection of interest is prohibited, and charging fees for provided services as well as profit sharing replace charging interest on loaned capital.
13 In the process, BI handed over "Book of Bank Indonesia Function Implementation Report in the Sector of Regulation, Licensing and Supervision of Banks" as an overview of how BI implements the function and supervision duties of banks before the transfer took place.
14 After resisting interest rates reduction despite the supply-driven nature of capital flows and no signs of serious inflation, beginning this year BI started to lower the rates. At the time of writing, three rate cuts in a row has been made. Hoping that the move will translate into lower deposit and lending rates, BI also set an upper limit for deposit rates at 50 basis points above BI rate, and set prime lending rates as reference for interest rates on loans. The intended results, however, failed to materialize.
15 Deposit rates offered on deposits up to IDR 2 billion were capped at the maximum LPS-guaranteed rate, and on deposits above IDR 2 billion were capped at certain bps above the BI rate, where the assigned bps depends on the category of banks (based on BUKU).
16 The law does not allow foreign firms to be listed in the country's bourse; cross-border offerings are also prohibited.
17 The development of capital market, at least in the case of government bond, proves also beneficial for financial safety nets. During the 2008 global financial crisis, for example, a significant portion of the fiscal stimulus conducted by the government was funded through government bond (for detailed discussions on this, see Azis 2014b).
18 These figures are far higher than before the crisis, especially that the bond market was virtually non-existent before the AFC.

19 Like in most countries, SMEs are most vulnerable to economic slowdown. Note also that BI requires banks operating in Indonesia to direct at least 20% of their credit portfolio to SMEs by 2018.

20 So far the strategy to ease margin pressure adopted by some banks, especially Shariah and state-owned banks, has been to increase fee-based products and to focus on SMEs and higher yield products.

21 Another immediate yet perennial challenge often voiced by banks is in human resources. Finding people who meet stringent banking requirements is getting more difficult, and the turnover is high (could reach as high as 15%). On the opportunity side, financing infrastructure and maritime development currently being prioritized by the government is expected to be the "new" revenue sources (based on "Indonesian Banking Survey 2015" conducted by PwC Indonesia).

22 Note, however, that many corporates in Indonesia tend to rely on internal cash flows rather than external financing.

23 Before the passage of the new FSSN Draft Law, to resolve liquidity difficulties with systemic impact the emergency financing facility would have been funded by the government through the state budget under the BI Law (Act No. 23 of 1999, amended by Act No. 3 of 2004). The implementing regulations governing the lender of last resort function are Regulation of the Minister of Finance No. 136/PMK.05/2005 dated 30 December 2005 and BI Regulation No. 8/1/2006 dated 3 January 2006. In the new FSSN law, however, no public money can be used. Such a drastic reversal is the result of a bargain in order to get impunity coverage where officials involved in the rescue effort will not be prosecuted.

24 In 2008, the parliament rejected a proposed financial stability law that contained provisions for a crisis management framework, including emergency lending. This has left a vacuum of decision-making framework and procedures to deal with a systemic crisis, especially that the subsequent presidential decree providing the crisis management framework has lapsed. The new Draft Law, approved early this year, specifies the following components of the FSSN: (1) effective bank regulation and supervision; (2) lender of last resort; (3) adequate deposit insurance scheme; and (4) effective mechanism for resolution of crisis.

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