



# Program Information Document (PID)

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Concept Stage | Date Prepared/Updated: 21-Jun-2019 | Report No: PIDC27174



**BASIC INFORMATION**

**A. Basic Project Data**

Country Indonesia	Project ID P170940	Project Name Indonesia Financial Sector Reform Development Policy Financing (P170940)	Parent Project ID (if any)
Region EAST ASIA AND PACIFIC	Estimated Board Date Mar 31, 2020	Practice Area (Lead) Finance, Competitiveness and Innovation	Financing Instrument Development Policy Financing
Borrower(s) Republic of Indonesia	Implementing Agency 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.

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 through increasing outreach, 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 through a reliable insolvency and creditor rights regime, consumer and data protection and interoperability of 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 through sustainable finance practices, a harmonized legal framework and a stronger resolution framework.

**Financing (in US\$, Millions)**

**SUMMARY**

<b>Total Financing</b>	300.00
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**DETAILS**

<b>Total World Bank Group Financing</b>	300.00
World Bank Lending	300.00

**Decision**

The review did authorize the preparation to continue



## B. Introduction and Context

### Country Context

**This proposed Financial Sector Reform Development Policy Operation (DPO) for the Republic of Indonesia is the first in a 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.**

**As the largest economy in South East Asia and 16th largest in the world, Indonesia has maintained an average GDP growth of 5% p.a. in the last 5 years.** To sustain these levels of growth Indonesia needs to close three key gaps: an infrastructure gap estimated at \$1.5 trillion; a human capital gap, which places Indonesia in the third quartile of the HCI with some of the highest stunting rates in the world at over 30 percent; and an institutional gap, which leads to restrictive and unpredictable regulation and lack of capacity, coordination and leadership in delivering public services and implementing public policies to enhance inclusive growth. Without addressing these three gaps, the potential output is likely to slow in the coming decade and the economy will fail to create higher-quality jobs that will fulfil Indonesians aspirations of enjoying the economic security of the middle-class and going the last mile in reducing poverty and vulnerability in the country. Closing these three gaps, while maintaining the foundations of macroeconomic stability, will require collecting more and spending better, improving the decentralization framework and service delivery at local levels, promoting openness and competition within a stable regulatory environment and deepening and broadening the financial sector.

**A sound and well-functioning financial sector is critical to sustain Indonesia's growth and to achieve the Government's economic growth and poverty reduction goals.** Financing the infrastructure gap and broadening opportunities for individuals and firms require an acceleration of financial sector deepening, efficiency, and inclusion without compromising macro- and micro-prudential standards. The authorities recognize this necessitates stronger coordination between agencies to formulate a coherent policy framework and evaluate its impact as well as to monitor financial risks across sectors and for the broader economy. An ambitious agenda to promote financial sector deepening and to strengthen financial oversight and crisis management has been pursued by the Government of Indonesia in the recent years. However, to date, the Indonesian financial is not yet sufficiently able to fund development needs or boost inclusive economic growth.

**The operation recognizes Indonesia's continued sound macroeconomic management in the context of global financial volatility in 2018 and elections in 2018 and 2019.** Indonesia's macroeconomic fundamentals remain strong, with robust economic growth, stable inflation and strong labor market conditions, narrow fiscal deficits and low debt. Proactive monetary policy, together with coordinated prudent fiscal and exchange rate policies, have successfully maintained macroeconomic stability during times of large capital outflows from emerging markets. Indonesia's sovereign credit is considered investment grade by four major credit ratings agencies, corroborating the country's improved economic environment, fiscal management, and overall creditworthiness. Poverty rates have steadily declined, reaching a record low in 2018. Inequality has also continued to moderate.

### Relationship to CPF

**The proposed DPO is fully aligned with the World Bank's Country Partnership Framework (CPF) for Indonesia, which operationalizes the SCD's findings and recommendations.** The FY16-20 WBG CPF for Indonesia draws on the Systematic



Country Diagnostic (SCD) which identified three pathways for the elimination of extreme poverty and increasing shared prosperity: i.e. creation of better jobs, improving equality of opportunity, and helping Indonesia manage its vast endowment of natural resources in a sustainable way. The present DPO supports the FY2016-20 WBG Country Partnership Framework through two supporting beams (Supporting Beam I: “Leveraging the Private Sector - Investment, Business Climate and Functioning of Markets” and Supporting Beam II: “Shared Prosperity, Equality and Inclusion”). The recent CPF Performance and Learning Review (PLR) confirmed the relevance of the financial sector technical assistance program that is supporting most of the proposed reforms under this DPO. In parallel, a more prominent role for financial sector activities could be envisaged as part of the preparation process of the next CPF.

### C. Proposed Development Objective(s)

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#### Key Results

**The expected results** are for Pillar A: an increase in outreach through (i) the harmonization and coordination of the two major agent network programs (Laku Pandai and LDK) regulated by OJK and BI respectively and (2) the digitization of Government to Person transfers, particularly non-cash G2P social assistance payments; 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 supervisory activities undertaken by dedicated market conduct supervisors in a year while 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 privacy and help build confidence and trust in Government and the financial and other sectors as responsible data processors and controllers; and promoting interoperability will contribute to an increased usage of financial services, particularly retail payment products. Finally, for Pillar C: the results intended from the sustainable finance reforms is that a substantial majority of entities supervised by OJK are in compliance with the requirements for sustainable finance practices; the review and harmonization of the legal framework for the financial sector will lead to a better functioning system, based on international best practices and promote stronger coordination among the relevant agencies based on clearer institutional mandates and updated sectoral laws; finally the resolution fund will put into place a pre-funded



arrangement wherein the banking industry is levied to build up the fund, thereby mitigating to a certain extent the risks of disruption and taxpayers' losses.

#### D. Concept Description

**Deepening 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 face 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 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 use of interoperable, digital financial services to increase usage of accounts. 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 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 interoperability of 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. There is a need to strengthen and clarify objectives, responsibilities and accountability across the financial sector authorities. Despite the establishments of OJK as the integrated supervisory agency in 2011 and LPS as the deposit insurance and resolution authority in 2004, there is still a significant overlap of responsibilities between BI and OJK on banking supervision given BI's mandate on payments system and macroprudential, and OJK's on micro prudential policies. The agencies' cooperation with LPS for resolution of troubled banks also needs to be strengthened. Furthermore, the current mandates and practices of BI and OJK place as much emphasis on financial development as on financial stability, which should be their primary mandate.



At the same time, strengthening resilience in a country like Indonesia, exposed to frequent natural disasters exacerbated by the climate change, requires also promoting sustainable finance practices for financial services institutions, issuers and public companies. A line of reform on strengthening disaster risk financing is also included as an alternative given the importance of establishing a financial risk mitigation mechanism in case of natural 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.

## E. Poverty and Social Impacts and Environmental Aspects

### Poverty and Social Impacts

**There are no adverse poverty and social impacts of the prior actions associated with the reform actions.** The direct and indirect impacts of the actions are likely to be positive. The link between financial sector stability and poverty is well known in Indonesia. During the 1997-1998 Asian financial crises, the employment rate in the formal sector employment fell steeply, negative economic growth (at around 13 per cent in 1998) were recorded and food prices rose substantially, causing the poverty rate to increase from 17.5 per cent in 1996 to 24.2 per cent in 1998. The Government has made important strides in establishing economic stability since the crises. These proposed policy actions aimed at increasing financial depth, improving financial efficiency and strengthening financial resilience further bolster the government's efforts. Overall, the policy actions are expected to contribute to creating a favorable economic environment that will stimulate growth and thus have positive social effects and help reduce poverty.

### Environmental Impacts

**Two of the proposed prior actions will have positive effects on the environment.** Embedding sustainability in the practices of the financial services industry, with particular emphasis on climate change, will contribute to disaster prevention, disaster risk mitigation, climate change adaptation, and environmental management in Indonesia. Because Indonesia is a major emitter of greenhouse gases and this reform should reduce the amount, this prior action will also lead to positive global effects. The prior action on Disaster Risk Finance and Insurance (DRFI) – has the potential to lead to significant positive effects on the natural and human/built environment. This is because the 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. Whether the potential for positive effects is realized or not will depend in part on the extent to which adoption of the DRFI Strategy leads to pre-disaster financing, and in part on other activities and programs of national and regional governments. The latter may include climate change resilience, disaster-resistant infrastructure, upgraded building codes, and early warning systems. None of the other prior actions will have positive or negative effects on environment, forest, or other natural resources. They will not result in construction, development or operation of facilities that could generate solid or liquid wastes or air emissions, conversion of natural habitat, damage to cultural heritage, loss of biodiversity, or changes in management policies or practices affecting forests or other natural resources.



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**APPROVAL**

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**Approved By**

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