Indonesia: Financial Market Development and Integration Program
NOTE

In this report, “$” refers to US dollars.

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### PROGRAM BASIC DATA

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ADB = Asian Development Bank, ADF = Asian Development Fund, IED = Independent Evaluation Department, IESP = Sector and Project Division, OCR = ordinary capital resources, PCR = program completion report.

*Team members: F. De Guzman (Senior Evaluation Officer), H. Hettige and C. Dingcong (Consultants).

### I. PROGRAM DESCRIPTION

#### A. Rationale

1. The support of the Asian Development Bank (ADB) for the development of Indonesia’s financial sector began in 1988. During the first 10 years of engagement, ADB helped develop the sector’s basic legal, regulatory, and supervisory frameworks while, at the same time fostering competition among financial institutions. During the Asian financial crisis of 1997–1998, ADB assisted in restoring financial sector health and in initial efforts to strengthen supervision of the finance sector. In 2002, ADB supported the implementation of nonbank finance subsector reform

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and formulation of a plan to create the Integrated Financial Services Authority (OJK). This program was followed in 2007 and 2009 by ADB’s program clusters supporting the development of the capital market.\(^4\)

2. The impact of ADB-supported reforms improved the fundamentals of the country’s capital markets. In 2011, Indonesia had the most long-dated maturity structure of any government bond market in emerging East Asia with about 40% of its bonds issued with tenors of more than 10 years.\(^5\) Furthermore, Indonesia bonds outperformed its peers in Southeast Asia with a year-on-year growth of 28% in corporate issuance and yield of 20% on an unhedged local currency basis.\(^6\) Despite these, Indonesia’s local currency government and corporate bond markets comprised less than 15% of the gross domestic product (GDP) compared with regional peers, such as Malaysia and Thailand, where bond markets are greater than 65% of GDP. The contractual savings subsector also remained small comprising less than 2% of GDP. In view of the significant role of contractual savings in fostering economic development,\(^7\) there was a need to boost the subsector as source of potential demand for capital market products.

3. The capital markets also lacked risk management tools. Regulatory requirements were burdensome, and transparency was limited. Domestic participation was narrow mainly due to low domestic investor confidence and high volatility brought about by dominant levels of foreign participation. There was a need to address these constraints and, at the same time, modernize the regulatory structure.

4. The Financial Market Development and Integration Program\(^8\) (the program) was formulated to support the government’s key reforms under the Capital Market and Nonbank Financial Industry Master Plan (CMNMP) 2010–2014. The CMNMP aimed to deepen the capital market, expand access to nonbank financing, and broaden the investor base. The plan’s functional focus was increasing linkages among the contractual savings subsector, and funding arrangements that are compliant with Islamic sharia law and the traditional capital markets. The program built on the accomplishments of the post-program partnership framework (also called P3F) of subprogram 2 of the Capital Market Development Program Cluster.\(^9\) The program was a result of ADB’s long-standing engagement with Bapepam-LK, the country’s supervisory agency for capital markets and nonbank financial institutions. The program’s value addition was the transformation of the Bapepam-LK into OJK, a unified and independent regulator of the finance sector. A stand-alone policy-based modality was used to support the costs of transitional arrangements that arose from the government’s reform agenda.

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\(^3\) ADB. 2002. Report and Recommendation of the President to the Board of Directors: Proposed Cluster, First Loan and Technical Assistance Grant to the Republic of Indonesia for the Financial Governance and Social Security Reform Program. Manila (Loan 1665-IN).  
\(^4\) ADB. 2007. Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance to the Republic of Indonesia for the Capital Market Development Program Cluster (Subprogram 1). Manila (Loans 2379-IN); and ADB 2009. Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to the Republic of Indonesia for the Capital Market Development Program Cluster (Subprogram 2). Manila (Loan 2577-IN).  
\(^8\) ADB. 2012. Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan to the Republic of Indonesia for the Financial Market Development and Integration Program. Manila (Loan 2895-IN).  
\(^9\) Footnote 4, Loan 2577-IN.
B. Expected Impacts, Outcomes, and Outputs

5. The program’s expected impact was an expanded nonbank financial sector supporting increased intermediation. Its envisaged outcome was increased domestic participation in the nonbank financial sector. The program had three outputs that reflected the primary objectives of the CMNMP. These were (i) strengthened regulatory oversight, (ii) deepened capital market providing expanded access to nonbank financing, and (iii) increased mobilization of long-term savings through a broadened investor base.

C. Provision of Inputs

6. The program was implemented from September to December 2012 when several of the reforms were already initiated. It was approved as a single-tranche loan on 21 September 2012 and the loan became effective on 18 December 2012. It was closed on 31 December 2012. ADB provided a loan of $300 million, which was disbursed on 20 December 2012.

7. A capacity development technical assistance (TA) of $1 million was processed separately to build on the key reforms that were initiated under the program. The TA provided capacity development to the OJK as a newly transformed, independent, and unified finance sector regulatory agency. The TA also supported the development of the OJK into an effective and internationally accepted regulatory body. Capacity development support was also provided to the Fiscal Policy Office (FPO), which became the government’s designated agency to coordinate finance sector development strategies after the creation of the OJK. The TA was assessed successful in the TA completion report because the envisaged outcome of enhanced finance sector development was achieved.

8. The program was classified category C for involuntary resettlement, indigenous peoples, and the environment.

D. Implementation Arrangements

9. As envisaged in the design, the Capital Market and Financial Institution Supervisory Agency (Bapepam-LK) and the FPO were the executing agencies of the program. Bapepam-LK was responsible for carrying out all policy actions and was executing agency until 31 December 2012. It was transformed into a unified and independent regulator of the finance sector, which became OJK. On 1 January 2013, FPO assumed the sole responsibility as executing agency and continued the policy dialogue and other reforms initiated under the nonbinding medium-term framework. This arrangement was appropriate since Bapepam-LK could no longer function as an executing agency when it was transformed as an independent agency or as OJK. FPO took over the responsibility of stabilizing the finance sector and broadening its development.

10. The implementing agencies were the (i) Bapepam-LK, the Directorate General of Debt Management, and the Directorate General of Taxation, all under the Ministry of Finance; (ii) Bank of Indonesia; (iii) Indonesian Stock Exchange; (iv) Indonesian Clearing and Guarantee

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12 The Financial Services Authority Law was enacted in 2011. Implementation of its functions to regulate the capital market and nonbank financial institutions began in December 2012.
Corporation; (v) Indonesian Central Securities Depository; and (vi) Indonesian Financial Transaction Reports and Analysis Center.

11. The government achieved the 41 policy actions under the program,\(^\text{13}\) of which 11 were policy triggers. The policy triggers included legislative actions, capacity development, and mechanism to strengthen regulatory oversight. To expand access to nonbank financing, the triggers included (i) adopting the CMNMP; (ii) promoting a liquid, short-term government securities market; (iii) finalizing the draft Global Master Repurchase Agreement; (iv) issuing rules for fund managers; and (v) finalizing the concept of the Securities–Market Investor Protection Fund. To broaden the investor base, the policy trigger entailed providing incentives in pension funds.

12. Of the 41 policy actions, 22 (54%) were substantive, directly affecting policy, legislation, regulation, and institutions. The other 19 actions were administrative and process oriented. The eight loan covenants, which basically outlined the responsibilities of the borrower under the program, were all complied with.

II. EVALUATION OF PERFORMANCE AND RATINGS

A. Relevance of Design and Formulation

13. The program completion report (PCR) assessed the program relevant (footnote 11). The design of the program was closely aligned with the priorities set out in the government’s National Medium-Term Development Plan 2010–2014 and with the supporting CMNMP. These reform priorities were in line with the ADB country partnership strategy for Indonesia during 2012–2014, which included the strategic pillar of inclusive growth.\(^\text{14}\) This validation recognizes that the implicit emphasis was primarily to support growth rather than the inclusiveness of the financial sector. The focus on deepening the capital markets was consistent with the ADB Financial Sector Operational Plan.\(^\text{15}\)

14. The program, together with the TA support, was a timely response during a critical time of transition—from multiple regulators to a unified and independent regulator for capital markets and nonbank financial institutions. It built on the achievements of previous ADB engagements and was properly sequenced in the series of reforms in the finance sector (paras. 1 and 4). The policy actions supported the significant structural changes within the government stemming from the transition of Bapepam-LK to OJK, focusing on essential regulatory supervision, strengthening the capital market, and broadening investor base. The constraints to deepening the capital market, mobilization of long-term savings, and broadening the investor base were addressed, but constraints to financial inclusion were implicitly postponed to the future. The single-tranche, policy-based modality was appropriate in view of the transition of Bapepam-LK to OJK and the dissolution of the former at the end of the program.

15. This validation shares the view of the PCR that the indicators selected for the envisaged outcome of increased domestic participation in the nonbank finance subsector were too broad to expect from the outputs delivered by the policy actions (footnote 15, paras. 41–44). Market volatility, brought about by global and domestic risk factors, can affect the appetite for domestic

\(^{13}\) One of the policy milestones was only partially completed. It involved the launch by Bepapam-LK of a database and user-friendly website to provide information on the capital markets and nonbank financial institutions. This action did not have significant impact on program performance since any information had to be migrated to OJK after December 2012. The OJK website that ensued had information on capital markets and statistics.


participation beyond the control of the program. This validation has the same view as the PCR that the outcome indicators selected should have been based on direct connection to the program reforms rather than on a financial system aggregate that can be influenced in the short and medium terms by external factors. The design and monitoring framework (DMF) could have benefited from a properly defined set of outcome indicators more closely linked to the program policy actions. Notwithstanding this weakness in the outcome indicators, the program on the whole was appropriately designed to address the identified constraints in the capital markets and nonbank finance sector. This validation assesses the program relevant.

B. Effectiveness in Achieving Project Outcomes and Outputs

16. The PCR assessed the program less than effective. The expected outputs under the program were fully achieved or exceeded. However, the envisaged outcome of increased domestic participation in the nonbank finance subsector was not fully attained. The two outcome indicators specified in the DMF were not met in view of two reasons. First, the level of domestic ownership of tradable government securities decreased to 67% in December 2012 from the 2010 baseline of 70%, less than the targeted 73% increase. Second, the proportion of government bonds held by the domestic contractual savings subsector decreased to 20% in December 2012 from the 2010 baseline of 28%, which is below the targeted 28% increase. The failure to meet these outcome targets were explained in the PCR as mainly due to extraordinary external events rather than due to program design or government commitment. In particular, the assumption that economic conditions would remain positive and conducive for business expansion was negated by the conditions in the United States (US). It led to “hot money” flows arising from quantitative easing by the US Federal Reserve, which crowded out local investors and rendered the government’s efforts to increase domestic participation in local currency bond markets ineffective. The indicators selected were financial system aggregates that can be significantly affected by external and sovereign risk factors that could increase or reverse trends in the short to medium term (para. 15).

17. The two indicators to strengthen regulatory oversight (output 1) were fully met. First, members of the OJK’s Board of Commissioners were selected in June 2012, as planned. Second, the first OJK budget for 2012 was approved in October 2011 in the amount of $163 billion. Output 2 targets on a deepened capital market providing expanded access to nonbank finance were exceeded. In December 2012, total local currency bonds outstanding increased to $111.3 billion, exceeding the target of $105 from a baseline of $90 billion in 2009. For the same period, government bid-ask spreads decreased by 75%, significantly exceeding the target of 15% decrease. However, this validation notes that the share of local currency bond market to GDP in 2016 remained low at 17.7%, which was substantially below the average of 68.5% for emerging East Asia. The target for total daily average trading volume of shares on the Indonesian Stock Exchange was also exceeded, with shares increasing to 121,712 in December 2012, higher than the target of 120,000 shares. This target on trading volume of shares was met. However, this validation notes that Indonesia’s value of stock traded, as percentage of GDP, has lagged behind

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16 During 2009–2011, the US Federal Reserve engaged in three rounds of quantitative easing in response to the 2008 global financial crisis. First, the Federal Reserve bought $600 billion in bonds on 2 November 2009. Second, on 3 November 2010, the Federal Reserve announced plans to buy $600 billion in bonds. Third, on 20 September 2011, the Federal Reserve lowered interest rates on consumer loans with a $400 billion debt-swap program. The Federal Reserve increased its balance sheet to an unprecedented $4 trillion, flooding the market with US dollar notes, which in turn caused investors to move cash elsewhere and likely found a favorable climate in Indonesia. The historically low savings nominal interest rates in Indonesia of 3.0% in 2009 to 1.8% in 2012 reinforced further the magnitude and effect of the “hot money” flows.

17 These actions of the Federal Reserve increased its balance sheet to an unprecedented $4 trillion, flooding the market with US dollar notes, which in turn caused investors to move cash elsewhere and likely found a favorable climate in Indonesia. The historically low savings nominal interest rates in Indonesia of 3.0% in 2009 to 1.8% in 2012 reinforced further the magnitude and effect of the “hot money” flows.

its regional peers. In 2016, Indonesia’s value of stock traded, as percentage of GDP, was only 9.7%, which was lower than Malaysia (33.2%), the Philippines (11.8%), Viet Nam (11.0%), and Thailand (79.9%).\footnote{World Bank. n.d. Financial Sector Indicators. https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS.} Lastly, the targets for output 3 on increased mobilization of long-term savings through a broadened investor base were fully achieved. The number of companies conducting initial public offerings in 2012 increased to 23 in December 2012, significantly achieving the target of 50% increase from a baseline 13 in 2009. For the same period, the annual corporate bond issuance increased by an average of 33% each year, substantially exceeding the target of 15% each year. However, this validation notes that in 2016, corporate bonds comprised only 2.5% of GDP, significantly lower than the average of 24.3% for emerging East Asia (footnote 19). Likewise, the target for life insurance premium was achieved with volume increasing to 1.7% of GDP from a baseline of 1%. In 2016, this ratio slipped slightly to 1.39%.\footnote{World Bank. Global Financial Development Database. https://data.worldbank.org/data-catalog/global-financial-development (accessed May 2017).} The number of individuals covered by a private pension fund increased to 3.3 million in December 2012, exceeding the target of 3.0 million.

18. The policy actions under the program were achieved and all outputs were achieved or exceeded. However, these did not result in the full achievement of the envisaged outcome of increased domestic participation in the nonbank finance sector due to extraneous factors that were not fully anticipated (para. 16). On the whole, there was no clear evidence of significant improvement in the domestic participation of Indonesia’s nonbank sector relative to its peers in the region. In view of these, this validation also assesses the program less than effective.

C. Efficiency of Resource Use

19. The PCR assessed the program efficient. It was completed on schedule and the policy actions were completed within the agreed time frame. The transition of regulatory responsibility from Bepapam-LK to OJK was handled appropriately with no significant delays. The unification of regulatory functions in OJK contributes to efficiency in regulatory oversight. The single-tranche, policy-based approach was efficient, with the actions properly sequenced.

20. The costs associated with reforms were conservatively estimated at $304 million, which included the costs the government needed to absorb to strengthen the regulatory framework and upgrade the information systems. The costs were modest when compared to the opportunity costs of not strengthening the finance sector. The benefits derived by the finance sector from the loan were significant in terms of reducing financial instability and improving efficiency in intermediation. This validation also assesses the program efficient.

D. Preliminary Assessment of Sustainability

21. The PCR assessed the program sustainable. The policy actions achieved under the program established the foundation for the development and growth of OJK going forward. The parallel TA support for the program helped build OJK’s institutional and staff capacity to continue with the reforms. The achievements of the program were followed through by the Financial Market Development and Inclusion Program (FMDIP),\footnote{ADB. 2015. Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan to the Republic of Indonesia for Subprogram 1 of the Financial Market Development and Inclusion Program. Manila (Loan 3274-INO).} thus, are likely to be sustained. Subprogram 1 of FMDIP focused on OJK’s mandate and on increasing its capacity to function effectively, which is a prerequisite for stability in the financial market. Subprogram 2 continued to strengthen OJK’s
capacity and expanded the focus of reforms to a more inclusive finance sector, stipulating specific measures to reduce financial exclusion.\footnote{22}{ADB. 2017d. Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan to the Republic of Indonesia for Subprogram 2 of the Financial Market Development and Inclusion Program. Manila (Loan 3541-INO).}

22. In 2014, OJK absorbed the bank and regulatory supervision functions from the Bank of Indonesia, completing its mandate under the law. Subsequently, the information and communications technology were migrated from the Bank of Indonesia to OJK. In addition, measures were taken toward the fiscal autonomy of OJK. In 2016, OJK became fiscally autonomous through levies collected from the industry. In 2015, the government and OJK completed key measures for the adoption of international standards that could provide a more enabling environment for the finance sector. On capital market, OJK completed the requirements for membership in the International Organization of Securities Commissions\footnote{23}{This is the international body that brings together the world’s securities regulators and is recognized as the global standard setter for the securities sector.} and joined the Islamic Financial Services Board.\footnote{24}{The Islamic Financial Services Board is the standard-setting body for Islamic banking, capital market, and insurance based on Islamic finance principles.} To strengthen corporate governance, OJK (i) adopted the ASEAN Corporate Governance Scorecard, (ii) launched Indonesia’s corporate governance road map for public listed companies, and (iii) issued corporate governance regulations for public listed companies. Lastly, measures were taken to diversify the capital market products and to reform the contractual savings sector. These included introducing the global master repurchase agreement, clarifying the rules on the issuance of capital market products, and enacting the Law on Insurance (footnote 11)\footnote{25}{The PCR (para. 8) indicates that the revised law on Capital Market was pending at the time the report was written.} in 2014 to strengthen policyholder protection and OJK’s oversight functions. These actions support the institutional development achievements of the program. However, the sustainability of the program remains uncertain given that outcomes were not reached and that increased domestic participation in the nonbank finance sector has made only marginal improvements as of 2016—remaining below regional peers. The continuous ADB (FMDIP) support, while likely to continue to advance institutional development, is less than likely to sustain the growth of domestic participation in the nonbank finance, which is slow moving and lagging behind other countries in the region. Hence, this validation assesses the program less than likely sustainable.

III. OTHER PERFORMANCE ASSESSMENTS

A. Preliminary Assessment of Development Impact

23. The PCR provided information on improvements in Indonesia’s finance sector but did not rate the development impact of the program. The PCR noted that at approval, it was aligned with the strategic pillar of inclusive growth, yet financial exclusion remains a problem in Indonesia.\footnote{26}{Based on data from the 2015 Global Findex, only 36% of Indonesia’s adult population has a formal bank account.} In addition, the envisaged impact of nonbank finance subsector supporting increased intermediation was not achieved. In December 2014, the assets of the nonbank finance subsector were 56% of GDP, which was short of the 65% of GDP target and below the 2010 baseline of 60%. The overall finance sector assets during 2012–2016 achieved a respectable average annual growth of 12.8%. However, it cannot be solely attributed to the program as there are other factors that affect the finance sector. This validation assesses the impact on supporting increased intermediation less than satisfactory.
24. The policy actions of the program helped build a foundation for OJK as the new unified and independent regulator. In particular, the enactment of the Insurance Law and introduction of risk-based supervision to the pension industry strengthened the agency’s legal framework and supervisory capacity. In recognition of the importance of regional integration, Indonesia’s corporate governance standards were harmonized with that of the region with the introduction of the ASEAN Corporate Governance Standards to public listed companies. To enhance the supporting infrastructure, the Indonesia Stock Exchange upgraded its trading system to enable increased trading volumes and introduced new products such as derivatives. In view of these achievements, this validation assesses the impact on institutional development satisfactory. On the whole, this validation preliminarily assesses the program’s development impact satisfactory due to the institutional development achievements.

B. Performance of the Borrower and Executing Agency

25. The PCR assessed the performance of the borrower and executing agency satisfactory. It noted that the government’s commitment to establish an independent regulator was demonstrated by the achievement of all policy triggers and actions. The shift in responsibility of executing agencies from Bapepam-LK to FPO also demonstrates the government’s commitment to the direction of the reforms. This validation adds that government’s ownership of the program and commitment to the reforms enabled the effective implementation of the program. Thus, this validation also assesses the performance of the borrower and executing agency satisfactory.

C. Performance of the Asian Development Bank

26. The PCR assessed the performance of ADB satisfactory. It noted that ADB’s involvement in the creation of an independent regulatory authority actually started way back to 1999. The policy actions under the program reflected ADB’s close collaboration with the government over the years. ADB engaged the government in policy dialogue and was closely involved in developing policy reforms and policy actions under the program. ADB has been an effective partner in finance sector development and its partnership with the government remained strong as shown by the subsequent policy loans (para. 21). On the DMF, ADB could have done better in formulating the outcome indicators (paras. 15–16). This validation also rates the performance of ADB satisfactory.

IV. OVERALL ASSESSMENT, LESSONS, AND RECOMMENDATIONS

A. Overall Assessment and Ratings

27. The PCR assessed the program successful. This validation rates the program less than successful. The program is assessed relevant since it addressed the identified constraints in the capital markets and nonbank finance sector. The program was a timely response during a critical time of transition from multiple regulators to a unified regulator for capital markets and nonbank financial institutions. The program is assessed less than effective. The policy actions under the program were achieved and all outputs were realized or exceeded. However, the envisaged outcome was not fully achieved due to extraordinary factors that were not fully anticipated. It is assessed efficient. It was completed on schedule and significant benefits in the finance sector were derived from the loan. The program is less than likely sustainable. The sustainability of the program remains uncertain since outcomes were not reached and domestic participation in the nonbank finance is slow-moving and lagging behind other countries in the region.
Overall Ratings

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B. Lessons

28. This validation agrees with the following lessons pointed out by the PCR:

(i) **Country-level lesson.** In developing reform programs, it is important to take a long-term view—that making changes to legal, regulatory, supervisory frameworks and developing institutional capacity and human resources take time.

(ii) **Sector-level lesson.** The capital market is complex, and it is important to look not just at the quantity of growth but also the quality.

(iii) **Project-level lessons.** The unique nature of executing agencies and the transition happening during the program required adapting to the needs of the government, which made a single-tranche, policy-based loan more appropriate.

(iv) Selection of key policy measures should focus on the biggest bottlenecks that will help ensure stronger impact and outcome.

(v) The program benefited from the TA support, which indicates the key role of TA to achieve the reforms.
29. This validation adds the following lessons:
   (i) **Country-level lesson.** Sustained policy dialogue with government over the years, ownership, and long-term commitment of the government to reforms are key factors for success.
   (ii) **Project-level lesson.** Outcome indicators need to be properly defined and linked to the reform program actions.

C. **Recommendations for Follow-Up**

30. The recommendations of the PCR are appropriate. ADB should continue to engage the government and the OJK in policy-based lending accompanied by strategically focused TA support. More expertise from within and outside Indonesia should be brought in for the TAs. This validation also suggests continued monitoring of the reforms and policy dialogue to identify remaining issues and further support needed. Indonesia continues to lag behind its peer countries in several capital market indicators. ADB needs to review the reasons for the limited results in several key areas in its long-term engagement in capital market development.

V. **OTHER CONSIDERATIONS AND FOLLOW-UP**

A. **Monitoring and Reporting**

31. Monitoring of the program was based on the agreed policy matrix and the DMF. The government complied with the covenant to furnish ADB with semiannual reports on the program and the accomplishment of policy actions and targets. As earlier noted, the outcome indicators specified in the DMF were too broad to accurately reflect the effectiveness of the policy actions (para. 16). The output indicators were clearly specified and measurable.

B. **Comments on Program Completion Report Quality**

32. This validation rates the PCR quality satisfactory. The report is clear and provided adequate evidence to substantiate the ratings. The discussion on program outputs was exhaustive and the graphs to support the analysis in the section on effectiveness were informative and useful. The lessons presented were suitable and recommendations were sound. The appendixes clearly summarized the achievements of the program and the status of policy actions based on the agreed policy matrix. Likewise, the time-series data shown in Appendix 4 provided useful information on the growth of the capital market and nonbank finance subsector.

C. **Data Sources for Validation**

33. Sources used for this validation were the PCR, report and recommendation of the President, review mission reports, and minutes of the staff review and department review meetings.

D. **Recommendation for Independent Evaluation Department Follow-Up**

34. None is recommended.