SECTOR ASSESSMENT (SUMMARY): FINANCE (INCLUSIVE FINANCE)

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. Financial services providers. As of the end of 2019, formal financial service providers included 110 commercial banks (including 24 regional development banks), 1,709 rural banks, 221 microfinance institutions, and 151 insurance companies. Many banks, but most notably Bank Rakyat Indonesia and Bank Tabungan Pensiunan Nasional, engage in micro lending and take small deposits. Banks also dominate the payments landscape in Indonesia and they are by far the most important category of financial institution.

2. Progress in financial inclusion. Indonesia has made significant advances in improving financial inclusion in recent years as measured against its targets and prior to the onset of the coronavirus disease (COVID-19) pandemic. However, different surveys provide different narratives regarding the degree of success achieved. Using the internationally comparable Global Findex data of 2017, Indonesia has made the most progress across East Asia and the Pacific in bringing its citizens into the formal financial system. This survey reports that the proportion of the population with a bank account increased to 49% in 2017. This is a marked improvement from 36% in 2014 and 20% in 2011. In addition, the recent national Financial Inclusion Insights (FII) survey has recorded significant progress in increasing the level of financial inclusion across socioeconomic sectors. The account ownership at formal financial institutions increased from 35.1% in 2016 to 55.7% in 2018. In 2016, 31.6% of women and 38.4% of men owned an account at a formal financial institution. By 2018, this gap had narrowed, with 55.6% of women and 55.7% of men owning accounts at a formal financial institution. Also, there has been a narrowing of the urban–rural divide. The percentage of rural dwellers with an account has nearly doubled, from 24.7% in 2016 to 48.9% in 2018. Account ownership by urban dwellers also increased to 61.2% from 44.8% over the same period. During 2016–2018, adults living below the poverty line and owning an account increased to 50.2% in 2018 from 26.0% in 2016. Yet, despite this improvement, Indonesia is still lags behind neighboring Malaysia (85%) and Thailand (82%) in terms of financial inclusion in 2017.

3. Measuring and monitoring financial inclusion. The two official national surveys, the FII by the National Council for Financial Inclusion (DNKI) and the Financial Literacy and Inclusion Survey (SNLIK) carried out by the Indonesian Financial Services Authority (OJK), return consistently different levels of financial inclusion. The SNLIK typically reports higher numbers. For example, the second SNLIK showed that financial literacy was 29.66% and financial inclusion 67.82% in 2016. However, the FII indicated that in 2018 70.30% of the population had used a product or service offered by a formal financial institution; the third SNLIK reported a figure of 76.19% (2019). While surveys can systematically generate large data sets showing progress over time, survey results are often insufficiently detailed to determine whether real financial needs are being met. In addition, most of the data and accompanying analysis focus on easily quantified data points, like account openings and volume of credit. These metrics provide little insight into the quality or appropriateness of the financial services being offered in meeting the real needs of poorly served or excluded individuals, households, and micro, small, and medium-sized enterprises (MSMEs). Further, there is no systematic collection of data or analysis related to the investment needs of small and growing businesses or MSMEs, including those that are owned or led by women, young people, or farmers. In fact, even the financial needs of these underserved

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population segments are not well understood because of the gaps in data measurement. Data collection, analysis, and monitoring systems related to financial inclusion need to be improved.

4. **Intergovernment coordination on financial inclusion.** Presidential Regulation No. 82 of 2016 established the DNKI to coordinate, implement, and monitor all financial inclusion efforts in Indonesia. The DNKI is chaired by the President of Indonesia and led by the Coordinating Ministry of Economic Affairs in collaboration with 13 other implementing agencies. The DNKI is supported by a secretariat and seven working groups. However, there needs to be better coordination and cooperation between the OJK, Bank Indonesia, and other stakeholders to understand and deliver impactful initiatives to improve financial access and literacy.

5. **Access to finance by micro, small, and medium-sized enterprises and marginalized segments.** Based on the latest available government data, there were 64 million MSMEs in Indonesia in 2018. Most MSMEs are very small, are family owned, and are not legally registered. A study by the International Finance Corporation in 2016 estimated that 50% of Indonesian MSMEs are owned by women, with an unmet financing demand of $8 billion. Excluding micro enterprises, the data also shows there are 816,000 small and medium-sized enterprises (SMEs) employing nearly 8 million people and accounting for 27% of gross domestic product. Yet, SMEs receive only 16% of total bank lending and only 39% of SMEs access bank financing. To address these needs, the government required banks to lend up to 20% of their portfolios to MSMEs. The Kredit Usaha Rakyat program was launched in 2017 and provides interest subsidies to participating financial institutions that lend to MSMEs at below market interest rates. Based on the OJK regulations in response to COVID-19, these loans are now under forbearance, and it is unclear when borrowers will be able to start making repayments. Further, the government has not yet established the basic financial infrastructure needed to promote commercial enterprise lending, and thus alleviate the need for less efficient top-down subsidized lending programs. For example, enhanced MSME credit data can help expand access to affordable commercial financing for MSMEs. In addition, the framework for using alternative credit scoring could be strengthened to help meet the credit needs of MSMEs and the underserved segments including women, youth, and farmers.

6. **Consumer protection, data privacy, and financial literacy.** In 2013, the OJK established five principles of consumer protection that are applied in Indonesia’s finance sector: (i) transparency, (ii) fair treatment, (iii) reliability, (iv) consumer privacy, and (v) complaint handling and settlement. Any person or entity that stores data electronically is considered an electronic service provider and is subject to regulations by the Ministry of Communication and Information. However, a mix of laws, regulations, and agencies deal with consumer protection, data privacy protection, and cybersecurity in Indonesia. For example, both Bank Indonesia and the OJK have regulations that mirror the Ministry of Communication and Information framework. However, privacy regulation in financial services is only applicable to licensed financial institutions, while privacy regulations for financial technology entities (fintechs) apply only to peer-to-peer (P2P) lenders. The OJK maintains the Financial Customer Care system, a system that tracks and traces consumer complaints. Regulations require consumer complaints to be handled first by the financial institution, and if no agreement is reached the dispute can go through the courts or via the Alternative Dispute Settlement Institution. All licensed financial institutions must be members of this institution. As Indonesia’s economy becomes digital and financial services and forms of business rapidly go online, there is a need for more robust systems and frameworks to ensure ethical behavior and data custodianship, and to manage technology risks, which is particularly

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important for fintechs. Also, with the onset of crises like the current COVID-19 pandemic, financial fraud increases and market conduct monitoring and supervision require even greater prioritization. The use of electronic know your customer (e-KYC) technology based on the national identification system project (e-KTP) in Indonesia also argues for stronger data privacy laws, rules, and policies that protect personal biodata. The emerging technology-led, customer-driven financial services sector needs to be served by firms fully capable of managing technological risks while protecting the customer and their data. Financial and digital literacy need to be further improved to ensure responsible use of financial services, including digital financial services.

7. **Financial technology and financial inclusion.** The fintech industry has grown dramatically over the past 5 years. In April 2020, the OJK counted 362 registered fintech entities, including 158 in lending services and 63 payment providers. Three fintech industry associations were set up, and were recognized by the OJK during 2019. Despite their promise, most P2P operators cluster around major urban areas and focus on existing bank customers. Some P2P lenders, however, provide “productive” lending to MSMEs and farmers, and these models are highly promising. There have been some downsides to fintech development, as predatory online money lenders have emerged. The OJK is working with the Asosiasi Fintech Indonesia and Asosiasi Fintech Pendanaan Bersama Indonesia to develop a code of conduct to which registered P2P lenders must adhere, and is looking to the industry to operate on the basis of being self-regulatory. Financial regulators need to develop new approaches and technologies to enhance their capacities to effectively regulate and supervise the fintech industry, like regulatory technology and supervisory technology. The OJK has adopted a creative approach to allowing the fintech industry to develop, though substantial risks are evident in this approach. Fintech can promote financial inclusion but introduces new risks at the same time. Strong leadership is needed in the development of robust regulatory regimes for fintech, and the current COVID-19 pandemic has further demonstrated the importance of digital financial services during challenging times.

8. **The potential of technology.** Smartphone ownership is rising rapidly, with 45.7% of adults owning a smartphone compared with 28.0% in 2016; 70.2% of Indonesia’s population had some kind of phone by the end of 2018. In 2016, less than 1.0% of surveyed adults had used mobile e-money, while by the end of 2018 that figure had risen over four times to 4.7%. The rapid development of Indonesia’s agent banking networks is a major achievement that has enabled the expansion of basic savings accounts. Digitization of government-to-person (G2P) payments linked to basic savings accounts has provided a large boost to the level of financial inclusion. However, the country would be better served by a single set of agent banking regulations supported by both Bank Indonesia and the OJK, complemented by adequate supporting infrastructure to fully integrate the unbanked and underbanked segments into the formal financial system. In addition, removing barriers to e-KYC could help streamline the customer onboarding process and enhance the efficiency of account opening for financial institutions. Further, it is essential to leverage growing account ownership to promote the use of account-based digital payments. The national payment system needs to be enhanced to improve interoperability and facilitate the digitalization of all types of payments. However, this will require a major upgrade to Indonesia’s payment system as the main payment switch is overburdened and increasingly obsolete. Geographic information systems could also facilitate access to finance.

2. **Government’s Sector Strategy**


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presidential decree in 2016, pledged to achieve financial inclusion for 75% of the population by the end of 2019. This focus on financial access led to a series of novel financial inclusion initiatives, most notably by the National Team for Poverty Alleviation, which devised new G2P programs. These are essentially revamped and expanded conditional cash transfer (CCT) mechanisms to provide support to Indonesia’s low-income population. To facilitate new G2P programs, the government launched the e-KTP program in 2011. Within a year of launching, the program had successfully registered and collected biometric data for over 100 million Indonesians. This initiative largely accounts for the more than 20 point jump identified in the FII survey (para. 2), as approximately 26 million (68.4%) of the 38 million new accounts opened since the 2016 FII survey were opened for CCT beneficiaries. The FII survey also found that 32.4% of government assistance beneficiaries do not have a basic savings account. This highlights the opportunities to expand account ownership through CCT programs, which also supports effective delivery of financial aid during crises such as the COVID-19 pandemic. Looking ahead, Bank Indonesia is implementing the National Payment Gateway, an initiative to make the payment system more efficient, inclusive, and interoperable. The bank introduced the standardized quick response codes to enable widespread use of low-cost electronic payments. However, the current payments infrastructure is based on an outdated ATM switching network that is inadequate to support high volumes of micro payments. As such, Bank Indonesia is interested in developing a new real-time retail payment system to facilitate low-cost payments. The OJK oversees agent banking under its Laku Pandai program. In parallel, Bank Indonesia regulates e-money issuers under its Layanan Keuangan Digital program. The latest data shows 1,202,890 Laku Pandai agents serving 25 million basic savings accounts. Bank Indonesia reports that there are 407,137 Layanan Keuangan Digital agents across the country now. The OJK has the main responsibility to promote financial literacy and education. All financial institutions have an obligation to conduct financial literacy programs, which becomes even more important during a crisis as a vital part of protecting consumers from abusive industry practices, which tend to thrive in such times.

3. ADB Sector Experience and Assistance Programs

10. ADB has been supporting the government’s financial inclusion agenda through policy-based loans and technical assistance (TA). The programmatic Financial Market Development and Inclusion Program was approved in August 2015. Subprogram 3 of the program, approved in March 2019, set the stage for a dedicated financial inclusion program by supporting enhanced access to financial services by deepening financial inclusion in Indonesia. A parallel policy and advisory TA project, Enhancing the Regulatory Framework of Financial Sector Development and Oversight, provided support to the government on a variety of issues related to financial inclusion. The TA helped establish the OJK’s International Center for Microfinance and Financial Inclusion, improved the methodology for the SNLIK survey, and developed the Program for International Student Assessment for financial literacy. Subsequently, the Promoting Innovative Financial Inclusion TA was approved as ADB’s first dedicated financial inclusion TA to Indonesia. The TA has been helping increase access to financial services through innovative approaches, including fintech and digital financial services, broaden financial and digital literacy, and enhance consumer protection frameworks in close collaboration with the Ministry of Finance and the OJK.

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Impact

High level of poverty, income inequality, and uneven economic growth

Effects

Large segments of the population including MSMES are unbanked and underbanked and thus economically excluded

Finance sector has a limited ability to respond to new and emerging consumer needs

Core Problem

Finance sector is not inclusive or responsive

1. Underdeveloped tools and infrastructure compromise planning
   - Limited availability of adequate, up-to-date, and disaggregated data impedes planning and coordination.
   - Absence of sex-disaggregated and other granular data compromises the development of targeted and effective financial inclusion solutions.
   - Outdated payment, digital identity verification, and other information systems prevent the adoption of digital solutions for access to finance.

2. MSMEs and marginalized groups have limited access to finance
   - Lack of credit information on MSMEs and inability to pledge movable collateral raise the costs and risks of lending to MSMEs.
   - Limited private sector collaboration and innovation discourage alternative solutions to increase access to finance.
   - Lack of dedicated programs for marginalized groups (e.g., women and youth) limits efforts to broaden financial inclusion.
   - Financial service providers are geographically concentrated and exclude rural and remote areas.
   - Ineffective use of existing provincial assets to inform national decision making.

3. Supervision, literacy, and consumer protection frameworks are incomplete
   - Inadequate supervision of fintech elevates risks to consumers.
   - Fragmented alternative dispute resolution centers complicate resolution and decrease confidence in the finance sector.
   - Lack of awareness on availability, access, and use of financial products, especially amongst youth and students, perpetuates financial exclusion.

4. Inadequate coordination, and technical and leadership capacity of stakeholders
   - Inadequate leadership and coordination capacity of DNKI
   - Nonexistence of national strategy beyond financial institutions to drive stakeholders’ participation for financial deepening
   - Inadequate technical capacity of stakeholders to implement impactful financial inclusion initiatives

DNKI = National Council for Financial Inclusion, fintech = financial technology; MSMEs = micro, small, and medium-sized enterprises.