

# SUMMARY OF INDONESIA'S FINANCE SECTOR ASSESSMENT

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No. 12

December 2015

## ADB PAPERS ON INDONESIA



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## FINANCE SECTOR ASSESSMENT (SUMMARY)

### A. Sector Performance, Problems, and Opportunities

1. Investment in Indonesia has recovered to pre-crisis levels, but the productivity of capital investment has not. From 2011 to 2014, the incremental capital output ratio (ICOR) in Indonesia since the early 2000's has declined to 6.7 compared to 3.0–4.0 in Singapore, Thailand, Malaysia, and Vietnam.<sup>1</sup> Part of the reason that capital investment levels remain high, despite low economic returns, is the comparatively high returns to passive investment in financial rather than real assets.<sup>2</sup>

2. The services provided by the financial system exert a positive impact on long-term economic growth.<sup>3</sup> Financial sector development is critical for reducing poverty through better access to financial products and services for the poor and low-income families.

3. **Indonesia has an underdeveloped financial sector and a shallow capital market.** The Indonesian financial sector remains small and far more dominated by banks than its regional peers (Figure 1a). In 2013, financial sector assets (bank credit, market capitalization, and bonds) to gross domestic product (GDP) were at 103% compared to approximately 194% for the Philippines, and over 300% of GDP for Malaysia, Singapore, and Thailand. This share of financial sector assets to GDP has been relatively constant in Indonesia since 2010, indicating that little deepening of the financial sector has occurred since the end of the global financial crisis (Figure 1b). Some of the reasons for the small size of the overall financial sector are (i) fragmented regulatory structure, (ii) regulatory framework not in line with international best practices, and (iii) an enabling environment that is less conducive to financial sector development, including lack of diversity in capital market products.

4. In the equity market, although the number of listed companies in the stock market has increased to 506 in 2014 from 440 in 2011, the market capitalization of \$422 billion in 2014 is still lower than its ASEAN peers in Malaysia, Singapore, and Thailand. As a percentage of GDP it is below 50% whereas the ratio of the other ASEAN comparators all exceeded 90% of their respective GDPs. In debt securities markets, illiquidity is the major problem. The government bond market represents only 13% of GDP, compared with an East Asian average of 58%. Turnover in the market is low, and bid-ask spreads have been steadily widening in recent years. At 50 basis points, they are now very high by East Asian standards. Corporate bond markets face similar problems. The market represents just 2% of GDP, compared with an East Asian average of 21%, and the implied illiquidity is adversely affecting pricing. Recent issues at the popular three-year tenor have been priced at around 280 basis points over the government curve. Given that only high quality issuers are able to tap the market, this is a significant margin. The key challenge in this area is to create a more liquid and lower cost capital market.

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<sup>1</sup> The lower the ICOR, the more productive the capital investment.

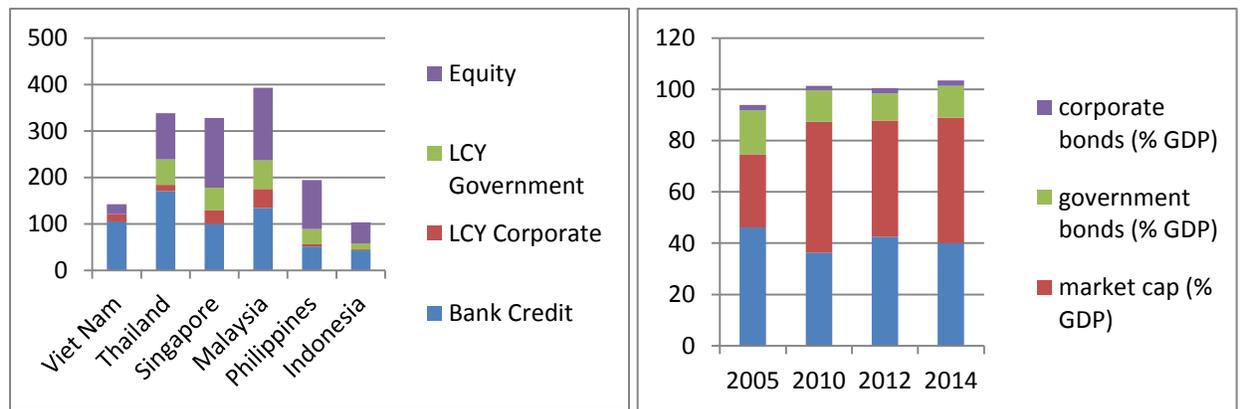
<sup>2</sup> World Bank. 2014. *Development Policy Review: Indonesia: Avoiding the Trap*. Jakarta.

<sup>3</sup> ADB. 2009. *Financial Sector Development, Economic Growth, and Poverty Reduction: A Literature Review*. Manila.

5. Indonesia also has potential to develop an Islamic finance sub-sector, however this too is underdeveloped with only Islamic banking and government sukuk reasonably developed. Corporate sukuk just like its conventional counterpart is almost non-existent. Indonesia, being the largest Muslim country, should have strong demand for Islamic finance, however corporates prefer to lend from banks. This suggests a supply side constraint including burdensome regulations, uneven tax treatment and insufficient number of legal firms to provide advice on documentation required to issue a sukuk.

**Figure 1; Financial Sector Assets to GDP**

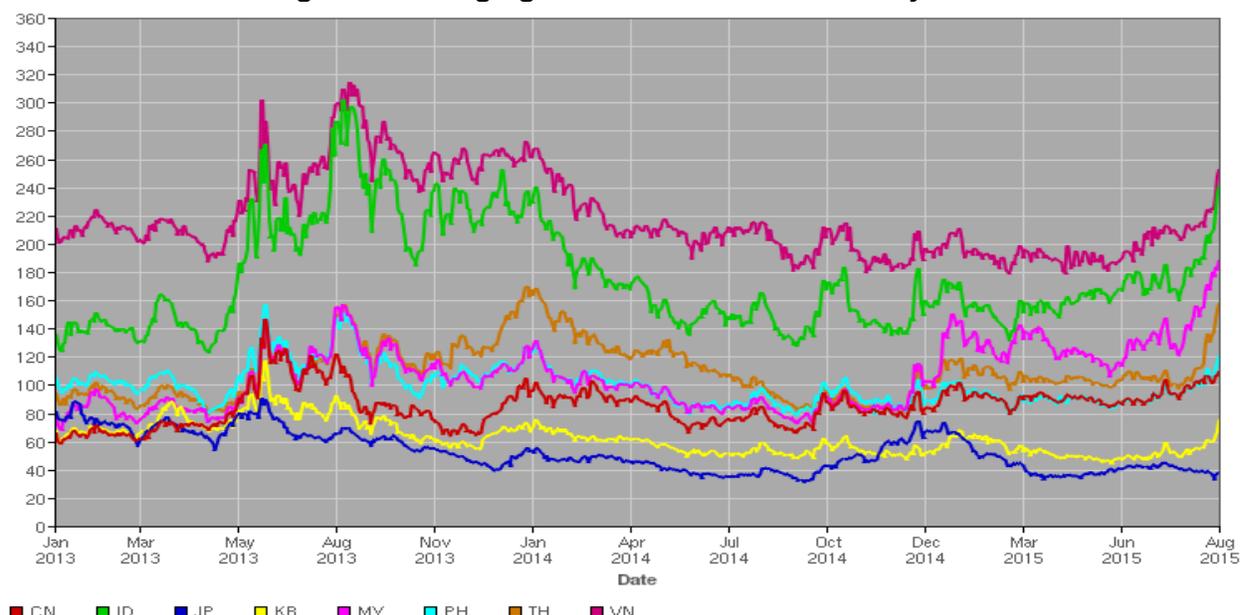
**(a) Regional Comparison in 2013 (b) Indonesia 2010 to 2014.**



Source: Asian Bonds Online and ADB Key Indicators 2014

6. **The financial sector is vulnerable to external financial shocks.** Indonesia has an open capital account, and foreign holdings of bonds and equities are relatively large as a proportion of the whole. This makes the market vulnerable to the risk of sudden capital outflows. Indonesia has experienced sharp reversals in capital flows from external shocks. For example, in June 2013, there was a capital outflow of IDR15.76 trillion in the bond market with foreign investors as net sellers. The price of credit default swap (CDS) increased by almost 60 basis points (bps) from the beginning of April to end of July 2013. This instability resulted in higher cost of borrowing as the 10-year government bond yield increased by 225 bps during the same period. Despite being considered investment grade by Moody's, Fitch, and R&I, the financial sector risks are reflected in the 5-year credit default swaps (CDS) spread of government bonds. Even taking into account the recent spike in the CDS spreads of emerging markets, Indonesia's CDS spread at 240 basis points in August 2015 is the second highest in ASEAN region (Figure 2).

**Figure 2: Emerging East Asia CDS – Senior 5-year**



*Source Asian Bonds Online*

7. This vulnerability is partly due to the shallow financial sector, which is unable to provide a buffer to external shocks. Another key reason for this is that the financial stability framework and crisis management protocols are still being developed. Moreover, Indonesia does not have comprehensive legislation that explicitly clarifies the roles and responsibilities of the authorities during a crisis. Indonesia's higher financial system risks transmit to higher cost of borrowing for domestic investors.

8. **Financial exclusion** is synonymous with an underdeveloped financial sector. Only 21.9% of the poorest 40% of the Indonesian population has savings in a financial institution. Furthermore, over 40% of the population does not borrow, with only 13.1% having borrowed from a financial institution.<sup>4</sup> This means that a sizeable share of the population is excluded from the financial sector, with limited opportunities to lift wealth through savings and mitigate financial risks to their livelihoods from natural calamities and economic shocks. The main challenges in this area are (i) low access to financial services; (ii) impediments to the delivery and usage of non-credit financial products and services; (iii) a low level of financial literacy; and (v) weak consumer protection. Promoting financial inclusion presents an opportunity to address this development problem since increasing basic savings, especially among the poorest population, can raise income level and reduce the gap in income distribution.<sup>5</sup>

<sup>4</sup> Statistics are based on the 2014 Global Financial Inclusion Database, which can be compared over a time series. Other surveys may have different numbers depending on the methodology adopted

<sup>5</sup> Summary Poverty Impact Assessment (supplementary appendix accessible from link documents).

## **B. Government's Sector Strategy**

9. The government has set targets of 8.0% GDP growth and reducing poverty to 7.0%–8.0% in the National Medium-Term National Development Plan 2015–2019. The government recognizes that in order to address these development challenges it is essential to promote financial stability and capital market development and to improve access to financial services for the poor. The plan targets the financial sector assets to grow to at 10.4% per annum by 2019 compared to the baseline of 8.2% in 2014. The government also has a specific target to provide access to financial services to 25% of the poorest 40% of the population by 2019.

10. The government's strategy is complex because the anchor to its longer term financial sector reforms and development is the successful and effective implementation of the mandate of Indonesia's Consolidated Supervisory Authority for Financial Services (Otoritas Jasa Keuangan, or OJK). This requires building its capacity for surveillance, monitoring and mitigating risks to the financial system, and at the same time introducing innovations to deepen the capital market.

11. The reform strategy therefore consists of three pillars: (i) implement the OJK's mandate as an independent unified regulator; (ii) undertake concurrent measures to deepen the capital market; and (iii) improve financial inclusion over the longer term. From January 2014, the OJK took over the banking supervision function from Bank Indonesia and thus became a unified regulator of all three subsectors. Over the next 2–4 years it will move toward fiscal autonomy. To achieve the government's target of growth of the financial sector, the OJK is developing a consolidated financial sector master plan that will identify key priority areas. In the interim, the OJK's reforms include (i) strengthening regulatory structure for financial stability; (ii) deepening of the financial market including the adoption of international standards; and (iii) enhancing access to financial services through branchless banking and microfinance institutions. The government is also finalizing a crosscutting financial inclusion strategy.

# PROBLEM TREE – FINANCIAL SECTOR

