IBC
Indonesian Business Council

4th Research

Financial Development for Strong and Equitable Growth

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Preface

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Chief Executive Officer

In the vibrant landscape of Indonesia's economy, the pursuit of sustainable and inclusive growth is more critical than ever. As we stand on the cusp of transformative change, the Indonesian Business Council (IBC) is committed to fostering a collaborative ecosystem that propels the nation towards its ambitious goals. In this spirit, I am honored to present this forward to the white paper entitled "Financial Development for Strong and Equitable Growth."

Established in February 2023, the IBC serves as a dynamic platform for business leaders and industry pioneers eager to contribute to the greater good. Our mission is to harness the collective power of the government, private sector, and civil society to build a competitive and prosperous Indonesia. By advocating for transparent, healthy, and conducive public policy environments, we aim to elevate Indonesia's economic competitiveness and national prosperity.

The path to economic advancement is fraught with challenges, yet it is paved with immense opportunities. Indonesia has achieved consistent economic growth, averaging 5% annually, with a steadily rising per capita income, positioning it as an Upper Middle-Income country recognized by the World Bank. The nation is making strides in reducing income disparities and poverty and stabilizing its economy, highlighting its potential to overcome the middle-income trap for sustained and inclusive growth.

A key barrier to Indonesia's economic advancement is the limited depth, access, and efficiency of finance for businesses, particularly Small and Medium Enterprises (SMEs). The Indonesian Business Council (IBC) highlights this as a major hindrance to business competitiveness and investment growth. Overcoming these financial obstacles is also crucial for avoiding the middle-income trap. IBC is committed to driving policy reforms for a stronger, more inclusive, and competitive financial system to support strong and equitable development.

As the CEO of IBC, I extend my deepest gratitude to our distinguished resource people for their invaluable contributions to this report. Together, let us embark on this journey to shape a prosperous future for Indonesia, driven by innovation, inclusivity, and sustainability.

Thank you for your continued trust and collaboration.

Sincerely,

Sofyan Djalil

Chief Executive Officer

Abstract

Financial development is an area that IBC members are concerned about due to its significance to economic growth and equity. Financial development is defined broadly by a set of indicators like depth, access, and efficiency of financial institutions and markets. When optimal, financial development will be well positioned to accommodate business needs and allocate resources to sectors that increase Indonesia's business friendliness and competitiveness.

Currently, although there are efforts already by regulators such as omnibus law on financial sector, Indonesia's financial development is not yet optimal as can be seen in low financial institutions and markets' depth, access, as well as efficiency compared to peer countries. M2 to GDP was below 50% while China was at 200%, only around 50% business has access to finance while China was at 85%, and credit interest rate at more than 8% while China was at 3%. This placed Indonesia in less favourable positions in terms of achieving its goal as advanced nation in 2045.

IBC have initially identified that some of the challenges hampering Indonesia's financial development are structural factors. The structural factors are such as (1) export dominance in the middle of absence of innovative products and tax advantages, (2) preference of non-financial savings in the form of land, buildings, and gold, (3) reliance to informal economy, high country risk premium that leads to high policy rate, (4) risk averse behavior in the middle of high credit risk as reflected in Non-Performing Loan (NPL), (7) structure of banks that leads to low competition.

Therefore, IBC conduct a study titled **"Financial Development for Strong and Equitable Growth"** which will thoroughly examine those distinctive factors hampering Indonesia's financial development and come up with strategic approach in the form of policy packages that will become reference for policy makers who shares the vision. In this first report, IBC will explore 7 possible policy ideas that can lead to solutions for our financial sector development. It has used literature review, data analysis, as well as expert interview to make sure an effective impact to increasing Indonesia's financial development level to its optimum level. The expert consists of Moh. Ikhsan (UI), Anton Gunawan (Prospera), Kahlil Rowter (Prospera), Heriyanto Irawan (Verdhana), Harold Tjiptadjaja (Mandiri), Satria Sambijantoro (Samuel), Poltak Hotradero (IDX), Bawono Kristiaji (DDTC), Telisa Aulia Falianty (UI), Bain Indonesia, Francesco Strobbe (World Bank).

Table of Content

List of Figures

List of Tables

Financial Development for Strong and Equitable Growth

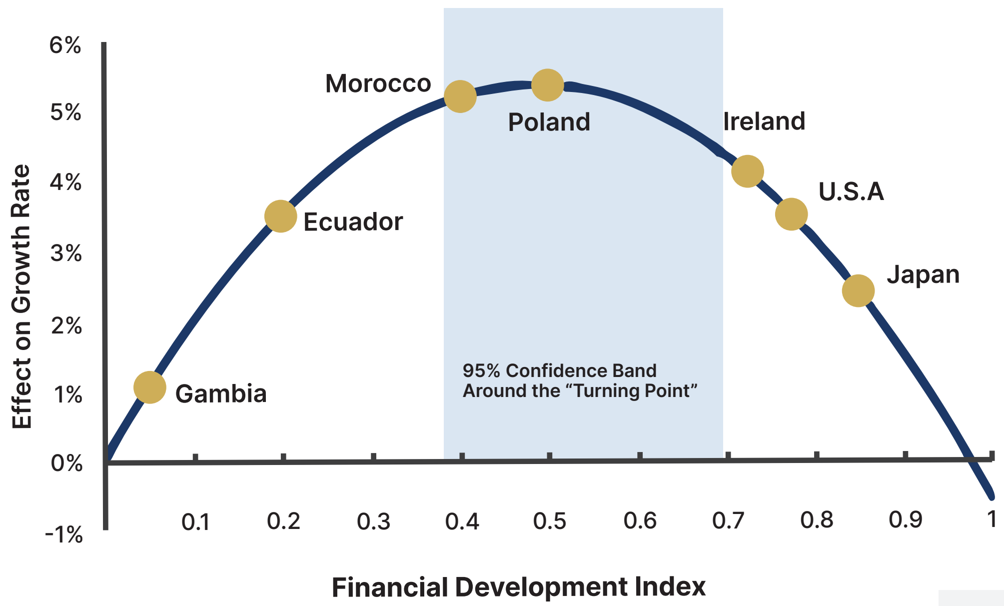
Chapter I | Urgency of Financial Development

The financial sector plays a crucial role in an economy by mobilizing funds from lenders to borrowers and allocating resources as needed. Numerous studies confirmed a strong positive link between financial development and growth, particularly in middle- and high-income countries.[1]

However, some literature had different findings. Some found that economic growth precedes financial development (Robinson, 1979) while Lucas (1988) argues that this positive relationship depends on information symmetry and zero transaction costs, while Wolde-Rufael (2009) and Pradhan et al., (2018) found inconclusive causality.

IMF (2015) overcame this variation by using a broad set of financial development indicators when examining financial development and found a conclusive bell-shaped curve in the relationship between financial development and growth.

FIGURE 1 Financial Development and Economic Growth



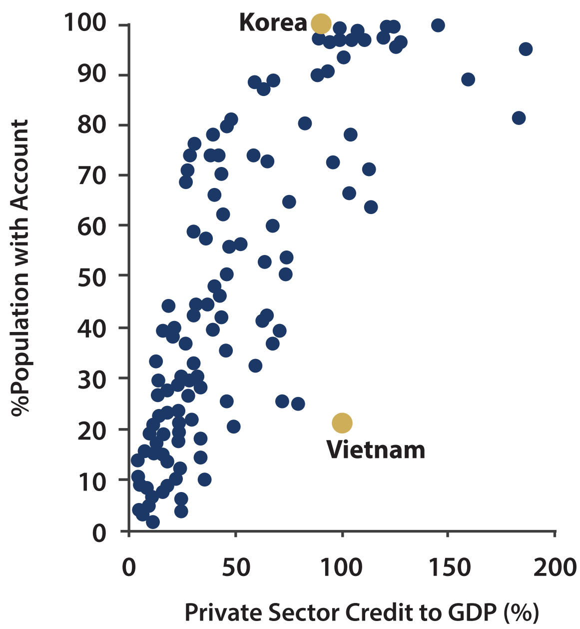
Source: IMF (2015)

Financial development that will be approached by this paper will follow the IMF study, which defines it as a combination of (i) financial depth, (ii) access, and (iii) efficiency of both financial institutions and financial markets. The main argument behind this is that financial depth is not enough when assessing the contribution of this sector to growth.

Figure 2 shows an example that some countries like Vietnam, which are good in financial depth but are not good in other aspects like access, have financial development that does not optimally support their economic development. Many literatures also adopted this comprehensive indicator, such as Nguyen et al. (2022).

[1] (Nguyen et al., 2019; Ang, 2008; Yang, 2018)

FIGURE 2 Financial Depth vs Access

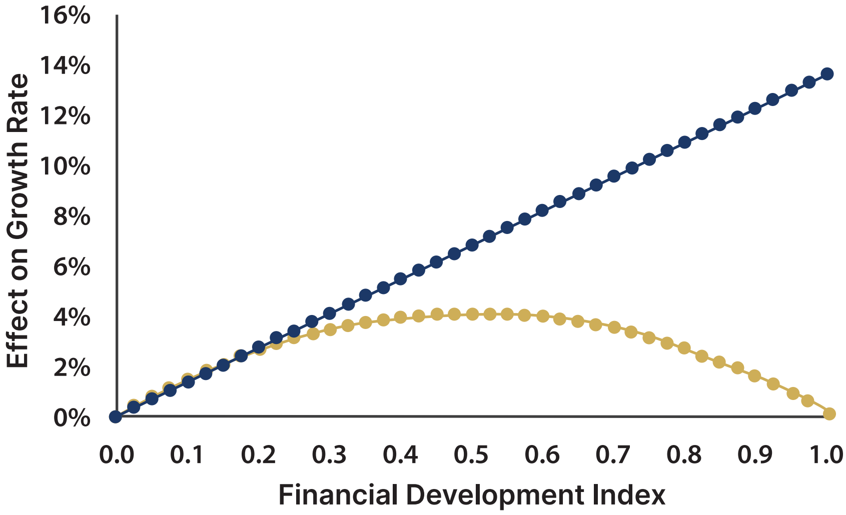


Source: IMF (2015)

The bell-shaped relationship between financial development and economic growth can be best explained in Figure 3. In the Figure, high financial developments will always lead to higher capital accumulation but not always lead to higher levels of total productivity.

The quality of the relationship between capital accumulation and Total Factor Productivity (TFP) peaked at a certain point. After that, allocation may still be correct, but the efficiency in the capital allocation may decrease.

FIGURE 3 Financial Development and Total Factor Productivity

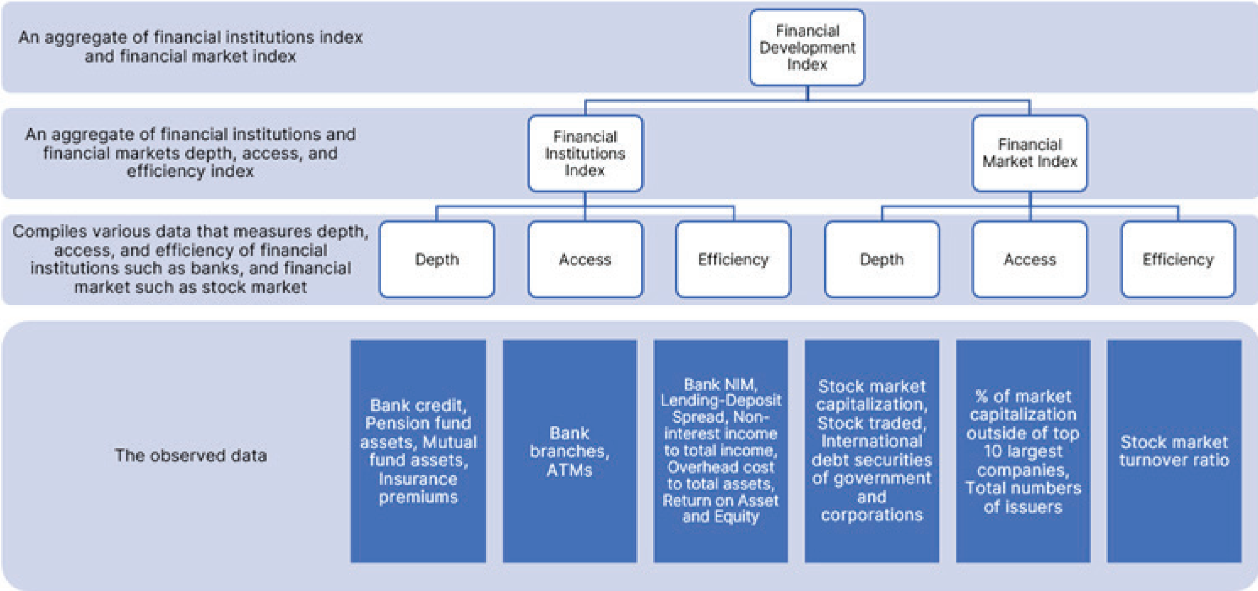


Source: IMF (2015)

Recent literature such as IMF (2015) found that financial development should involve a broad set indicator of depth, access, and efficiency. Depth refers to the size and liquidity of a country's financial markets, indicating the volume of financial activities relative to the economy.

Access measures the ease with which individuals and businesses can utilize financial services. On the other hand, efficiency assesses how well financial markets and institutions provide services at minimal costs and allocate resources effectively.

FIGURE 4 Financial Development Indicator Matrix



Adapted from IMF (2015)

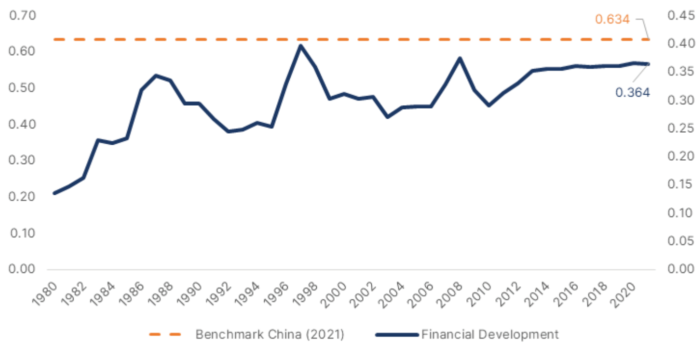
Hence, this paper aims to (i) examine the current condition of financial development in Indonesia using IMF (2015) indicators, (ii) analyze the root causes behind it, and (iii), based on the analysis, formulate a set of policy ideas on how to improve financial development in Indonesia.

Afif Ramdhasuma, Unsplash

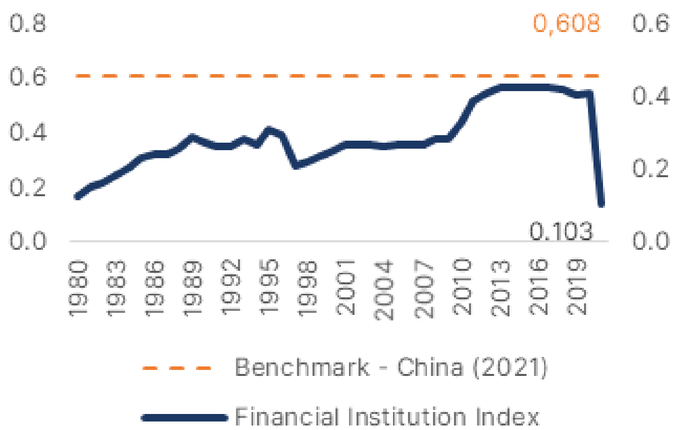
Chapter II | Financial Development in Indonesia

Indonesia's overall financial development has always been low as shown in Figure 5. In 2021, Indonesia's financial development index stood at 0.364, significantly lagging peer countries like China, which scored 0.634. Similarly, in 2020, Indonesia's financial institution index was 0.103, much lower than China's 0.608. Moreover, Indonesia's financial institution index in 2020 was also substantially lower at 0.304 compared to China's 0.635.

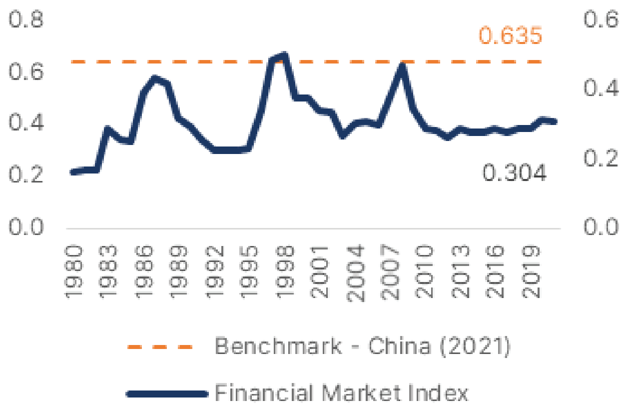
FIGURE 5 **(I) Indonesia's Financial Development Index, (II) Indonesia's Financial Institution Index, (III) Indonesia's Financial Market Index**



(I)



(II)



(III)

Source: IMF (2021)

A. Financial Depth

One of the important indicators of financial development is financial depth. Indonesia's financial depth is significantly low, as evidenced by its low financial institutions and markets' assets to GDP ratio, among ASEAN-5 and BRICS countries, as shown in Table 1. In terms of financial institution depth, Table 1 showed that Indonesia ranked the lowest in its region with its banking sector at 59.5% of GDP,

In terms of financial institution depth, Table 1 showed that Indonesia ranked the lowest in its region with its banking sector at 59.5% of GDP, and its insurance and pension fund assets also among the bottom three at 5.8% and 6.9% of GDP, respectively.

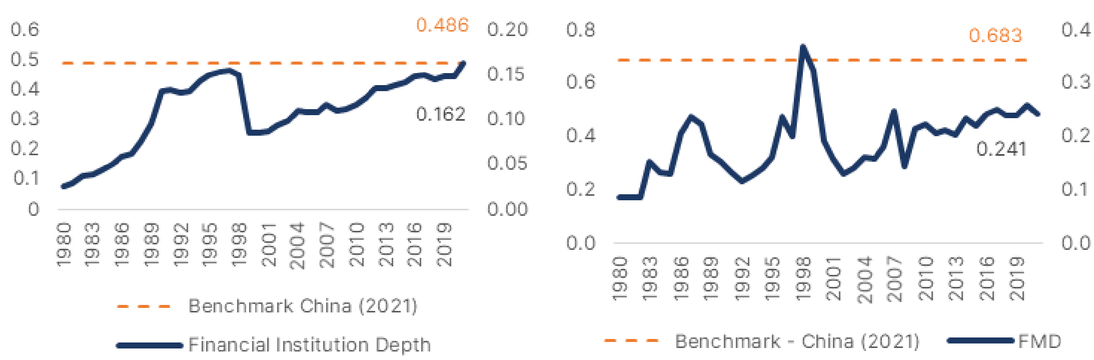
TABLE 1 Financial Depth of ASEAN-5 and BRICS Countries

	Banks Asset (% GDP)	Capital Market Capitalization (% GDP)	Insurance Asset (% GDP)	Pension Fund Asset (% GDP)
Indonesia	59.5	48.3	5.8	6.9
Malaysia	198.6	109.9	20.3	59.9
Philippines	99.2	93.2	8.5	3.5
Singapore	572.1	189.0	47.5	32.2
Thailand	146.6	120.9	23.2	6.9
Brazil	125.82	67.0	17.21	28.2
Russia	25.6	46.5	3.17	6.1
China	214.2	83.2	22.7	2.2
India	72.4	97.2	19.3	9.3
South Africa	74.29	311.5	60.1	92.1

*average latest data 2021-2022

Using IMF index of financial institutions and markets depth, it can be seen that the story is about the same (Figure 6). In 2021, Indonesia's financial institutions depth was0.162, lower than China in 2021 of 0.486 and financial market depth was 0.241, a lot lower than China of 0,683.

FIGURE 6 Indonesia's Financial Institutions and Market Depth



Source: IMF 2021

B. Financial Access

Next indicator to explore on Indonesia's financial development is financial access. From the latest data, Indonesian people's access to financial services was very low compared to ASEAN-5 region and China.

From Table 2, we can see that only 13% of people had access to finance from formal financial institutions like banks. The same findings appear for other types of financial products such as savings.

TABLE 2 Access to Financial Services for Adults in Various Countries (15+ years old)

	Have Account in Financial Institutions	Have Savings in Financial Institutions	Borrow From Financial Institutions
Indonesia	51%	20%	13%
Thailand	94%	52%	28%
Malaysia	88%	47%	13%
Singapore	97%	60%	43%
Philippines	46%	19%	17%
Brazil	84%	23%	41%
Russia	89%	18%	30%
India	77%	13%	12%
China	89%	45%	39%

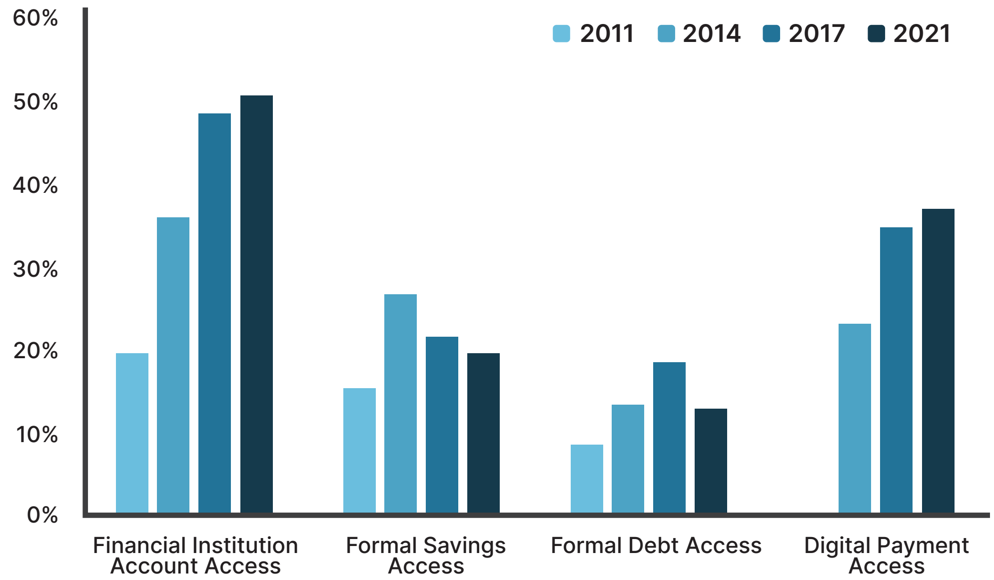
Source: Word Bank (2021)

The financial access problem especially credit in Indonesia is impacted by: (i) the availability of a collateral system that can accommodate movable assets as well as (ii) reliable credit information that typically provided by credit bureaus and registries. Indonesia lacked credit access due to absence of acknowledgement of moveable assets such as machinery, equipment, and receivables as credit collateral (only around 30% of collaterals are movable assets while in advanced countries is around 70%), as regulated in related regulations such as banking and bankruptcy laws.

Next, Indonesia also lacked on credit information which consist of reliable credit bureau among others. If credit information is enhanced, it can (i) reduce information asymmetries, (ii) increase access to credit for small firms, (iii) lower interest rates, (iv) improve borrower discipline and (iv) support bank supervision and credit risk monitoring.

Different with financial depth that is always low, there is an improvement for Indonesia's financial access in the past years. Figure 8 shows that financial access indicators like formal debt have grown moderately from 8% to 13%, respectively. There is potential to increase this, as the trend of other products such as account, savings, and digital payment rise more significantly.

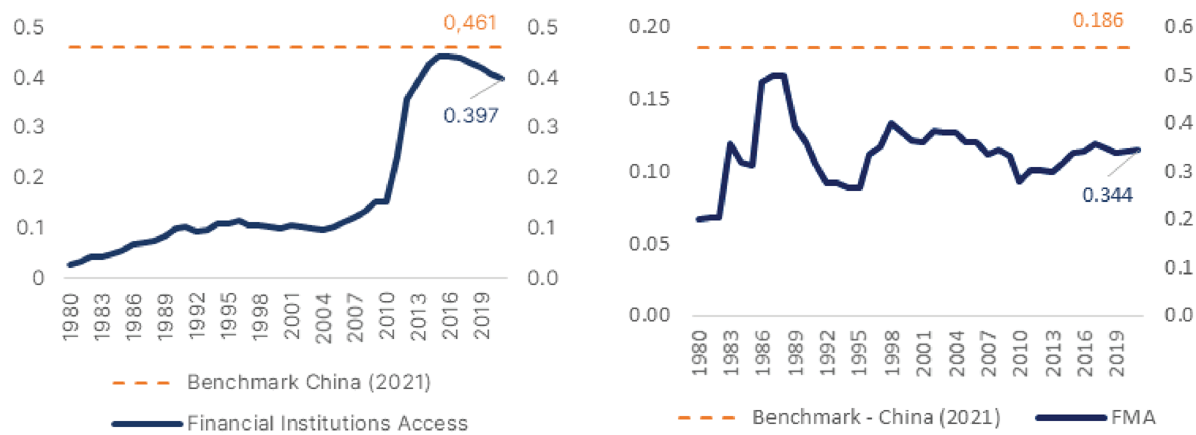
FIGURE 7 Historical Data of Indonesians Access to Formal Financial Services (% of adult)



Source: World Bank (2021)

IMF indicators of access to financial markets and financial institutions also showed a similar story. There is a big improvement on financial access in Indonesia. In 2021, the Indonesian access to financial institutions was 0.397 or lower than 0.461 of China. For the financial market access, the development even already surpassed China in 2021 with index of 0.344 compared to China (0.186).

FIGURE 8 Indonesia's Financial Institutions and Market Access



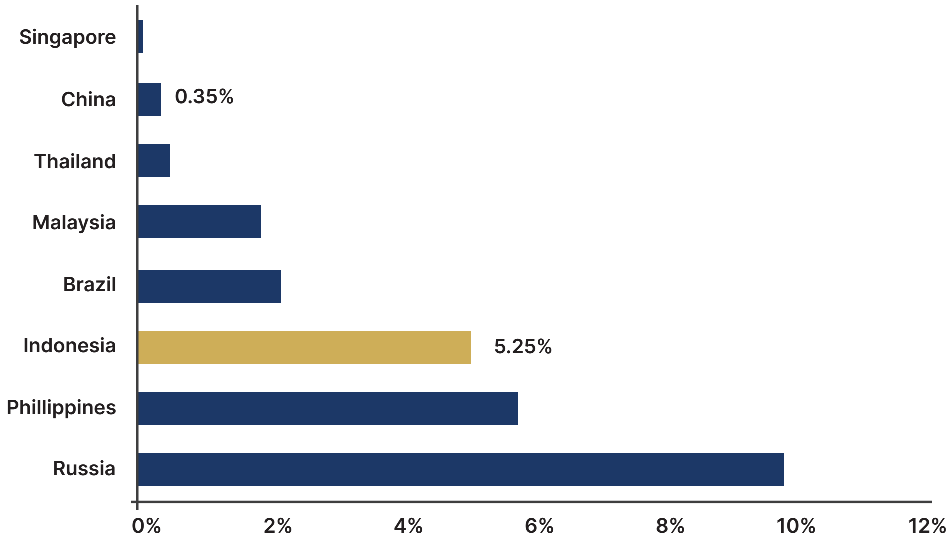
Source: IMF (2021)

C. Financial Efficiency

Indonesia's financial sector efficiency is notably low compared to peers, with a high credit rate of 8.5%, one of the lowest in the ASEAN-5 and BRICS regions. It also has high cost of funds and a high net interest margin (NIM)[2]. In Figure 9, Indonesia's cost of funds, as indicated by its deposit rate, is significantly higher than that of other countries.

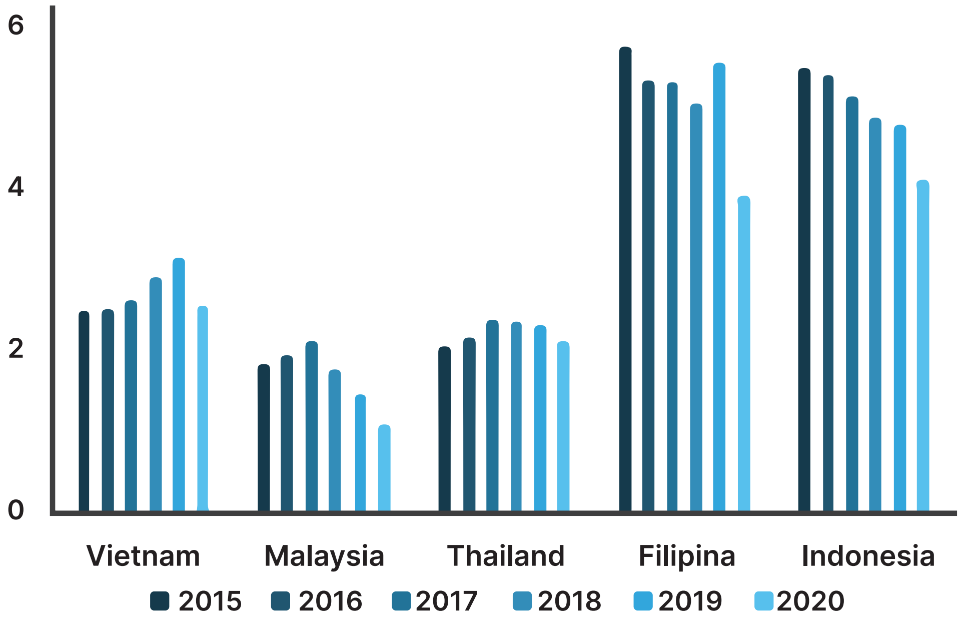
Additionally, while Indonesia's NIM has decreased recently, it remains the highest in the ASEAN-5 region at 4.12%, compared to Thailand's 2.12% and Malaysia's 1.09%, as shown in Figure 10. Consequently, all these factors contribute to Indonesia's lower financial institution and market efficiency than China, as evidenced in Figure 12.

FIGURE 9 Indonesia's Deposit Interest Rate vs ASEAN-5 and BRICS



Source: World Bank, Trading Economies (2020)

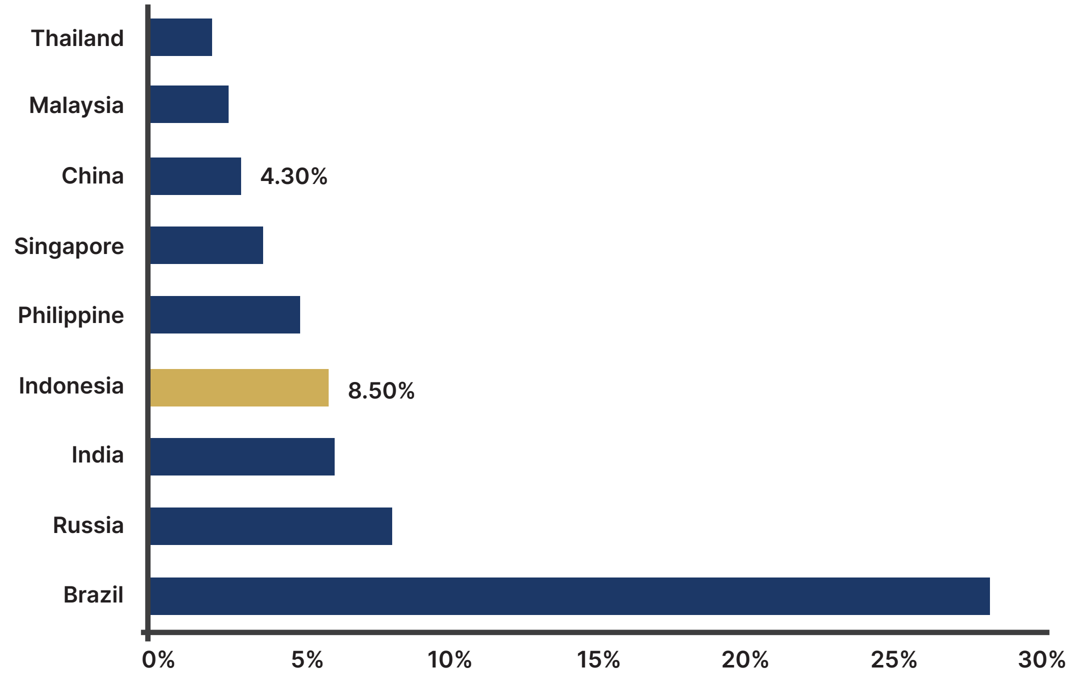
FIGURE 10 Net Interest Margin of ASEAN-5 Countries



Source: CEIC (2023)

[2] a margin of interest between credit paid by debtors and deposits paid to depositors

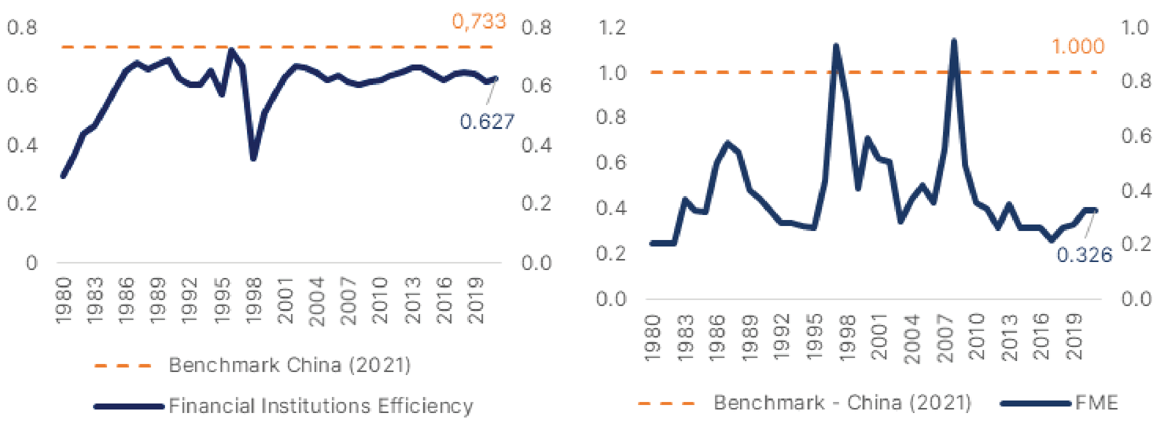
FIGURE 11 **Domestic Banks' Credit Interest Rate in Indonesia vs ASEAN-5 and BRICS**



Source: World Bank (2020)

A different indicator of financial efficiency showed similar findings, where Indonesian current financial efficiency has a room for improvements. Figure 13 compares the financial efficiency of Indonesia against China, using China's 2021 efficiency as a benchmark. Indonesian financial institutions efficiency shows a steady increase in efficiency from 1980 until the early 2000s, followed by a plateau with moderate fluctuations, but still falls short of China's 2021 benchmark, with Indonesia at 0.627 and China at 0.733. In contrast, Indonesia's financial market efficiency is highly volatile, with significant peaks and troughs, and a notable decline after a peak just before 2010. By 2021, Indonesia's financial market efficiency significantly lags behind at 0.326, compared to China's benchmark of 1.000.

FIGURE 12 **Indonesia's Financial Institutions and Market Efficiency**



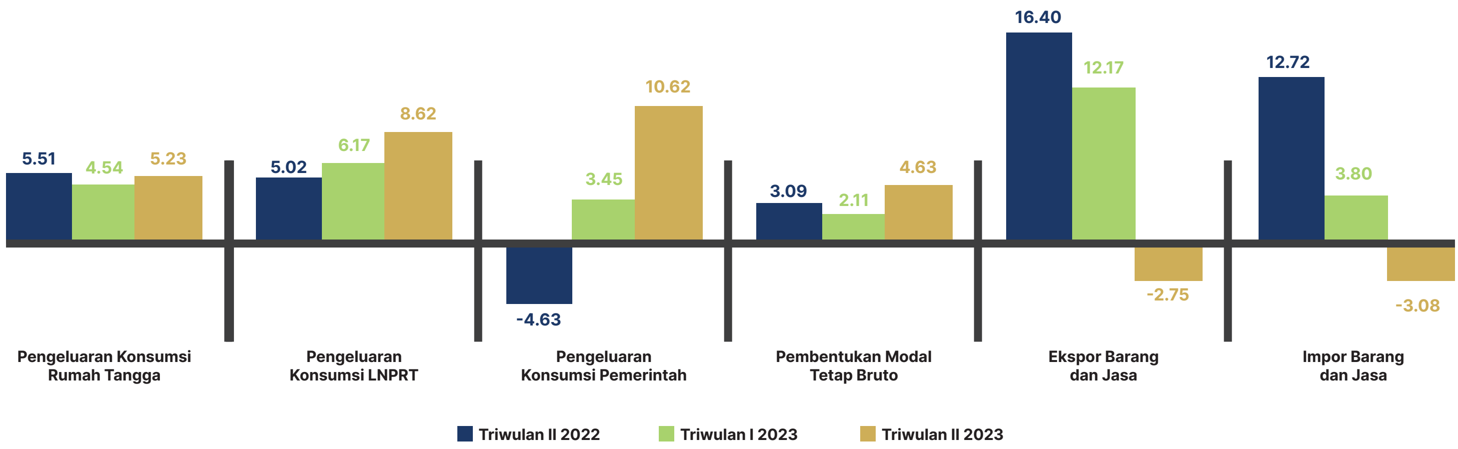
Source: IMF (2021)

Chapter III | Root Causes Analysis

A. Export Dominance: Need for Sophisticated Instruments and Tax Advantage

Export is a major part of Indonesian economy, contributing 22% to the GDP in Q2 2023. Export growth can surpass GDP growth, as seen in Q2 2022 where export growth was 16.4%, over three times the GDP growth. However, this export success doesn't directly boost foreign reserve accumulation or financial sector growth, as evidenced by the single-digit growth in foreign exchange reserves and third-party funds in the banking sector. The impact of export dominance for instance is Indonesia's high reliance on policy tools to mitigate the external factors that affects the export value and volume. A role that policy maker here is to promote financial products that can help exporters cope with those external risks. This is in line with the findings from McKinsey in 2014 where products and tax advantages are the things that offshore investors mention as fundamental factors that Indonesia currently lack in.

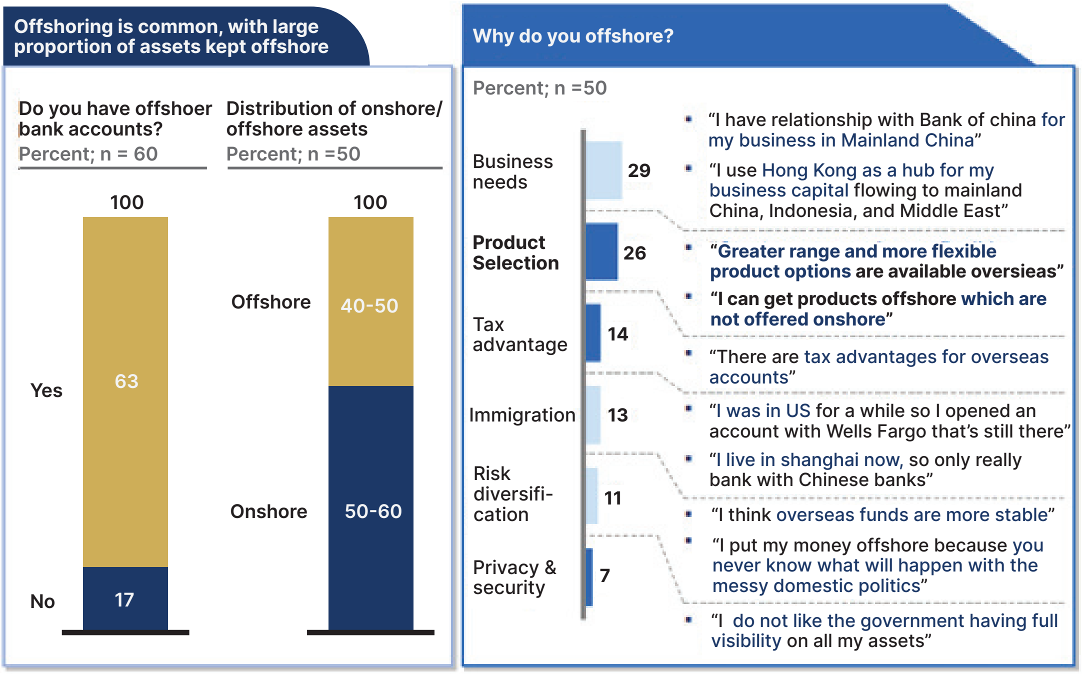
FIGURE 13 Export and Its Contribution to GDP in Indonesia



Source: Indonesian Statistics (2023)

From McKinsey survey in 2016, for example, there were approximately 2016 USD bn Indonesian high net worth individuals who parked their money abroad. One of the main reasons they did that is tax treatment and the unavailability of some financial products onshore.

FIGURE 14 Reasons and Extent of Offshoring Among Asset Holders



Source: McKinsey Global Institute (2016)

B. Preference on Idle/ Speculative, Non-Financial Savings: Urgency for Regulating Informal Savings

Indonesia's low financial depth is due to preference of savings product. This is because the financial depth is low even though our gross savings rate is high. As of September 2023, Indonesian gross savings was at 39%, higher than all ASEAN-5 countries except Singapore. These contrasting figures indicated that Indonesians assets are mostly not in the form of money or other financial assets like banks deposits, etc.

TABLE 3 ASEAN-5 Gross Savings Rate

Country	Gross Savings Rate (%)
Indonesia	39
Malaysia	27
Thailand	30
Philippines	11
Singapore	49

Source: CEIC (2023)

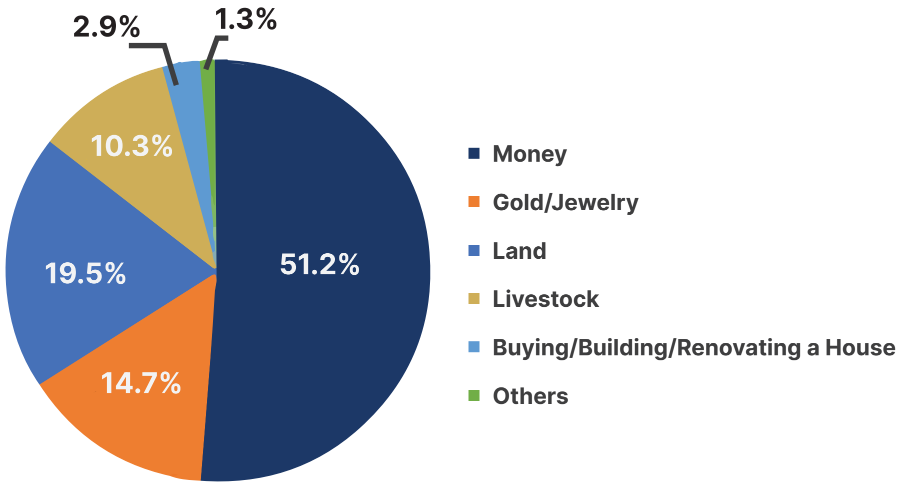
This is in line with the fact that 43.3% Indonesians live outside the cities and 49% do not have access to internet. These characteristics showed that a significant number of Indonesians probably do not use money anyway and use alternatives like in-kind benefits.

This is probably related to the fact that Indonesia's agriculture, forestry, and fisheries sectors have still become big sectors. Based on the latest data, the contribution of this sector is around 13.2%. Besides there are also 40.64 million farmers in Indonesia.

A survey of households conducted by Bappenas similarly showed that Indonesian prefer to save in the form of land, buildings as well as gold or jewelry (Figure 15).

Those who have money also prefer to save it in the form of cash instead of financial assets like bank deposits and so on (Figure 16).

FIGURE 15 Indonesian Preference on Savings

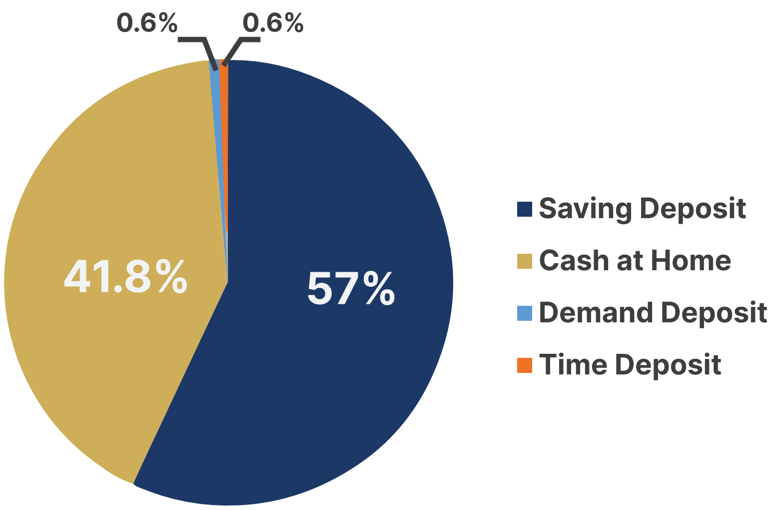


Source: Bappenas (2017)

Savings in the form of land and building type of assets is not a problem when utilized productively. From Kementerian PUPR (2023), Indonesia's real estate sector has significant contribution to GDP, of around 16% with 13.8 million employment every year. It also has correspondingly high interlinkages both forward and backward industries.

In total, there are approximately 185 subsectors that are interlinked with real estate, like materials, furniture, retail, as well as financing. However, land and buildings can be unproductive assets as well when it is not used optimally. If this condition happened, it may hamper the country's financial development.

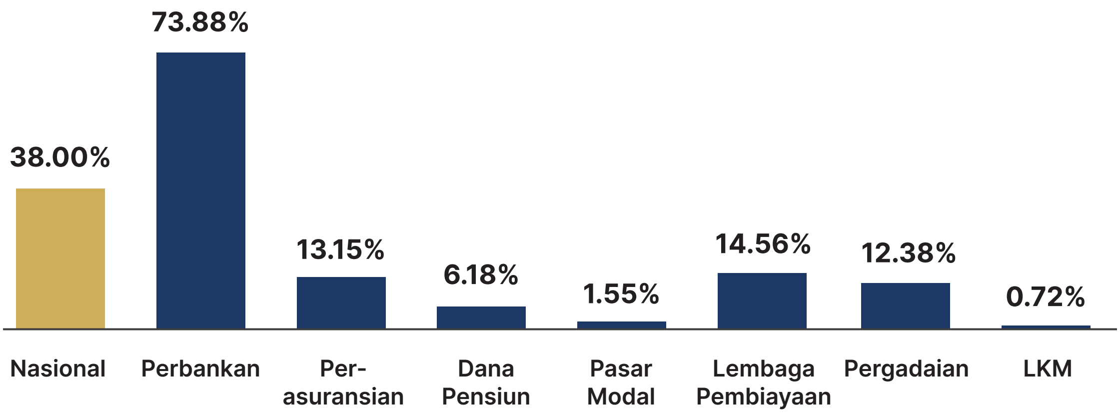
FIGURE 16 Indonesian Preference on Savings



Source: Bappenas (2017)

In line with OJK Survey in 2019, the literacy of Indonesian to various financial products is very low. The highest literacy is banking product which further explains the preference of Indonesian investors in general. Besides, the preference of Indonesia's also driven by the fact that many Indonesians live in suburban area that typically would have problems such as lack of physical and internet infrastructure, Indonesia's low education level, as well as low income per capita.

FIGURE 17 Indonesian People Literacy on Financial Products



Source: OJK (2019)

C. Informal Economies: Need for System that Accommodates

The low development of financial sector access is related with the informality of our economy. Based on BPS, Indonesian labour market is dominated by non-salary workers which is around 83 million people or 60 percent of our working population. This resulted as major constraints when designing a financial product. The ideal case to reflect from is from old age security program. In Indonesia, old age security or Jaminan Hari Tua (JHT) is a mandatory program for employers and employee in the formal sector. However, based on BPJS Ketenagakerjaan data, the coverage of is only less than 50%. For informal workers, the participation rate is much lower of less than 1%. This means that increasing access to finance for an informal sector-reliant economy is a big challenge, and even the existence of a mandatory savings system is not enough.

TABLE 4 Percentage of Pension Fund in BPJS, Taspen, Asabri

Category	Number Of People (Million)	Proportion (%)
Formal Workers	55,1	40,7
Formal Workers Participants	21	38,1
Informal Workers	80,2	59,3
Informal Workers Participants	0,4	0,5

Source: BPJS, Taspen, Asabri (2023)

The informality of the Indonesian economy also creates problems in access to credit. The structure of corporates that is dominated by Small and Medium Enterprises (SMEs) (Table 5) is behind the low Indonesia's getting credit rank in 2020 World Bank EoDB. The report suggested that Indonesia needs to catch up in its banking and bankruptcy laws to accommodate a great collateral system that matches up with business needs.

However, we cannot implement it directly because SME dominance is very high, making it hard to count on the movable collaterals. Add the fact that the Indonesian law system is not yet optimal; the enforcement of these regulations and laws, later changed into more favorable for debtors, should also be highly improved.

TABLE 5 Structure of Indonesian Corporations

Corporates	Units	Labors	GDP	Manufacturing Export	Investment
Micro	98,7% or 64 million	89% or 109% million	37,4% or RP 5.900 T	1,4%	6,7%
Small	1,2%	4,8%	9,5%	2,6%	23,3%
Medium	0,1%	3,1%	13,6%	11,6%	29,9%
Big	0,01%	3,1%	39,5%	84,3%	40%

Source: KemenkopUKM (2023)

D. Market Structure: Urgency for Creating Competition

The structure of banks in Indonesia also creates many challenges to financial sector efficiency. Indonesian commercial banks consist of 4 big banks that hold 60% of total banking sector assets. These are the banks that have ample capital of more than IDR 70 trillion per bank. Table 6 showed interesting findings. The higher the capital, the higher the bank's performance, such as the ability to lower its operational cost.

However, it does not apply to their efficiency. Despite their lower cost, the biggest banks have the highest net interest margin (NIM). This indicated room for improvement. The high concentration risk hinted that there is no competition in the banking sectors, hence urging the big banks to bring down the credit rate as they dominate the market.

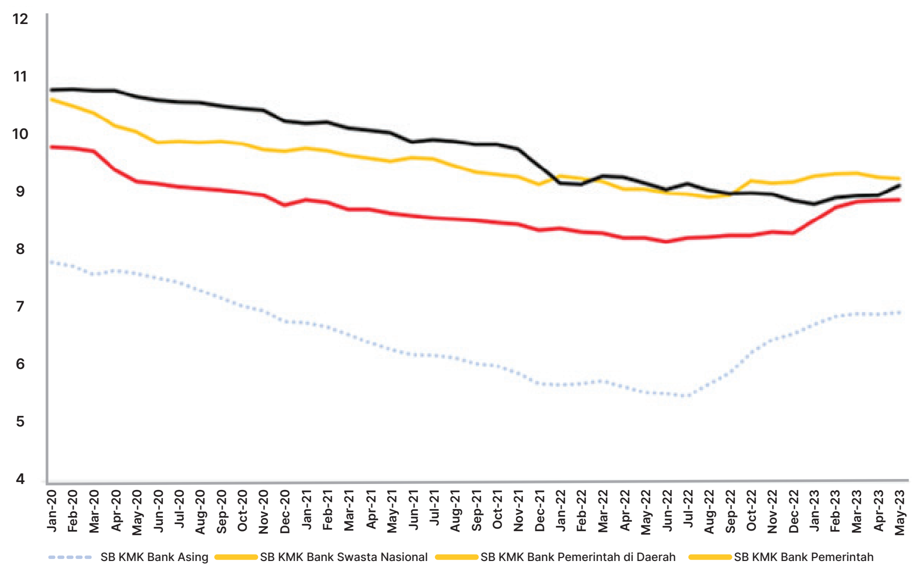
TABLE 6 Capitalization and Performance of Indonesian Commercial Banks

Capitalization		Liquidity	Cost	Efficiency
Core Capital	Number of Banks	Loan to Deposit Ratio (LDR)	Operational Cost/Revenue (BOPO)	Net Interest Margin (NIM)
<6 trillion	68	75,5	88,3	4,9
6-14 trillion	20	82,8	92,6	4,3
14-70 trillion	13	89,9	79,0	3,8
>70 trillion	4	83,9	62,7	5,4

Source: OJK (2023)

A strong competitor can potentially have effect on credit rate. From Figure 18 below, for instance, foreign banks are quite efficient in delivering credit. It even has the lowest credit rate when compared to national banks. However, the competition is probably not big. enough to be considered by the other big market players. The next potentially strong competitor is digital banks whose model of giving credit is probably a lot different with conventional banks that rely very much on collateral instead of prediction of credit worthiness.

FIGURE 18 Credit Rate of Domestics vs Foreign Banks in Indonesia

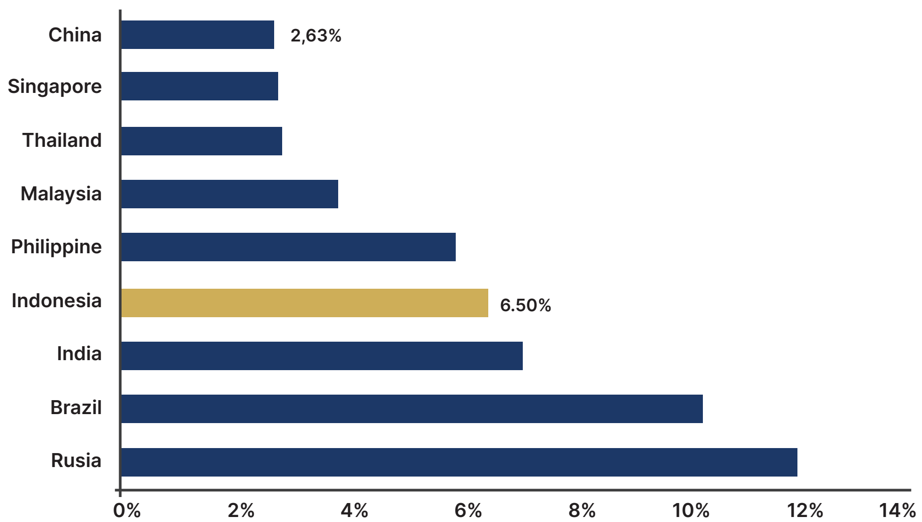


Source: CEIC (2023)

E. Country Risk: Calls for Maintaining Fiscal and Macroeconomic Discipline, Institutional Reform

In term of financial efficiency, the relatively high credit interest rate is related to high risk-free rate. As we know, risk-free rate is the basic cost of funds. Such a high rate is reflected in our high Government bond yield spread from international risk-free rates such as US Treasury Bills. From Figure 19, the Indonesian Government bond yield spread is among the most generous in the region at 6,5%.

FIGURE 19 Indonesian Government Bond Yield Spread vs ASEAN-5 Countries



Source: World Government Bonds (2023)

Based on Pratiwi (2014), this is due to both fundamental and non-fundamental factors. The fundamental factor is the sovereign credit rating. Moody's sovereign scorecard overview suggested there are 4 factors determining the creditworthiness of a sovereign entity, which are economic strength, institutions and governance strength, fiscal strength, and susceptibility to event risk. Currently, Indonesia's rating is low in the region (Table 7).

TABLE 7 ASEAN-5 Sovereign Rating Summary

	Indonesia	Malaysia	Thailand	Philippines	Singapore
S&P	BBB stable	A- stable	BBB+ stable	BBB+ stable	AAA stable
Moody's	Baa2 stable	A3 stable	Baa1 stable	Baa2 stable	Aaa stable

Source: Trading Economics (2023)

FIGURE 20 Sovereign Credit Rating Method by Moody's Rating Agency

Factor	Sub-factor	Sub-factor Weithting	Metric/sub-sub-factor	Metric/sub-sub-factor Weighting
ECONOMIC STRENGTH	Growth Dynamics	35%	Average Real GDP Growth	25%
			MAD volability Real GDP Growth	10%
	Scale of the Economy	30%	Nominal GDP (USD)	30%
	National Income	35%	GDP per Capita (PPP, int. USD)	35%
	Adjustment to factor score	0 to 9 notches	Other	
INSTITUTION AND GOVERNANCE STRENGTH	Quality of Institution	40%	Quality of Legislative and Executive Institutions	20%
			Strength of Civil Society and the Judiacity	20%
	Policy Effectiveness	60%	Fiscal Policy Effectiveness	30%
			Monetary and Macroeconomic Polici Effectiveness	30%
	Adjustment to factor score	0 to 3 notches	Governmenr Default History and Track Records Arreas	
		0 to 3 notches	Other	
FISCAL STRENGTH	Debt Burden	50%[1]	General Government Debt/GDP	25%
			General Government Debt/Revenue	25%
	Debt Affordability	50%[1]	General Government Interest Payment/Revenue	25%
			General Government Interest Payment/GPD	25%
	Adjustment to factor score		Debt Trend Historical Change in Debt Burden	
			Expected Change in Debt Burden	
		0 to 6 notches	General Government Foreign Currency Debt/GPD	
			General Government Public Sector Debt/GPD	
			Fovernment DInancial Assets Including Sovereign Wealth Funds/GPD	
		0 to 3 notches	Other	
SUSCEPTIBILITY TO EVENT RISK	Political Risk	Minimum Function[2]	Domestic Political and Geopolitical Risk	
	Government Liquidity Risk	Minimum Function[2]	Ease of access to Funding	
		0 to 3 Scoring Categories	Adjustment to Sub-Factor Score High Refinancing Risk	
	Banking Sector Risk	Minimum Function[2]	Risk of Banking Sector Credit Event (BSCE)	
			Total Domestic Bank Asset/GDP	
		0 to 2 Scoring Categories	Adjustment to Sub-Factor Score	
	External Vulnerability Risk	Minimum Function[2]	External Vulnerability Risk	
		0 to 2 Scoring Categories	Adjustment to Sub-Factor Score	
	Adjustment to factor score	0 to 2 Scoring Categories		

[1]For more details about how these weights may vary, please refer to our discussion on the "Treatment of Reserve Currency Countries and HIPC/IDA Countries" within the "Fiscal Strenght" Sextion of the methodology

[2]The aggregation of Political Risk, Government Liquidity Risk, Banking Sector Risk and External Vulnerability Risk follows a minimum function, i.e., as soon as one area of risk warrants an assessment of elevated risk, the country's overall Sesceptibility to Event Risk is scored at thar specific, elevated level

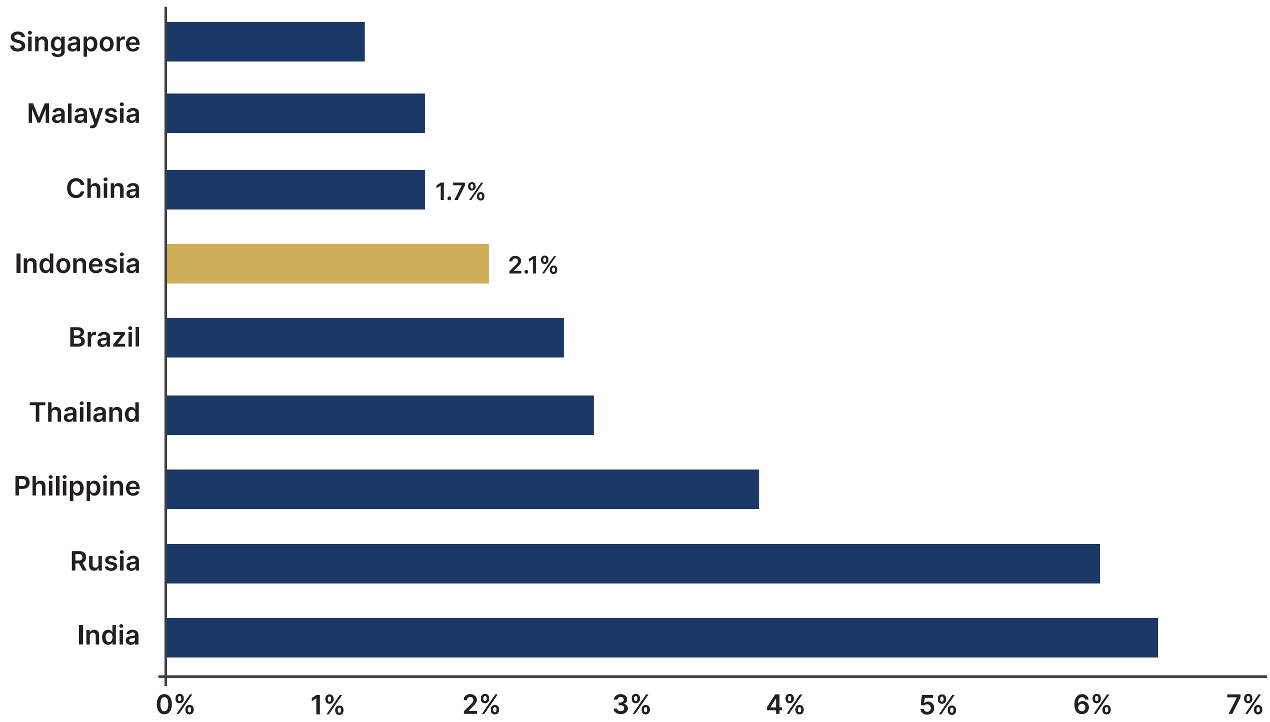
Source: Moody's Investor Service (2022)

F. High Credit risk amidst risk averse behavior: Need to Mitigate Non-Performing Loan

Other significant risk that is usually associated with inefficiency of financial sector is credit default risk. The reason is because credit default risk as measured by Non-Performing Loan (NPL) Rate will affect banks' future risk appetite to credit. This can affect the strategy of banks directly.

Banks could choose to take credits that have high risk of not getting repaid by charging higher price in the form of interest. Based on Figure 21. below, NPL in Indonesia is relatively high although not the highest in ASEAN-5 regions which indicated room for improvement.

FIGURE 21 Indonesian Commercial Banks' Non-Performing Loan Ratio



Source: World Bank (2020)

From chart below, Indonesian banks tend to be very conservative in both funding and financing strategy. From funding strategy side as shown in Figure 22, Indonesian commercial banks enjoy very much mobilizing funds from third party funds of 99% (OJK, 2023).

This leads to their funding product becomes so conventional with most of the funds located in the time deposits, including those big deposits that has more than Rp 5 billion per account (OJK, 2023).

FIGURE 22 Composition of Indonesian Commercial Banks Liability

Source: OJK (2023)

FIGURE 23 Revenue Structure of Commercial Banks in Indonesia

Source: OJK (2023)

Corresponding behaviour happens in the financing side. Most of the revenue source is in the form of bank credit (Figure 23), indicating high reliance. The contribution of other incomes is very small. Another big chunk of revenue is from placement in Bank Indonesia and Government securities which are not directly linked to private sectors

Significant placement in these two securities, indicated that the banks rather put their money in risk-free instruments rather than to bank credit.

Chapter IV | Recent initiatives of financial development: DHE dan P2SK

A. National Showcase of Export Repatriation Fund of Devisa Hasil Ekspor Sumber Daya Alam (DHE SDA)

The Indonesian Government has been working to strengthening ties between the real and financial sectors. Over the last decade, they implemented an export repatriation initiative to link the export business with the financial sector. This policy mandates exporters to repatriate earnings, was first introduced in 2019 and further refined in Government regulation no. 36/2003, with non-compliance resulting in fines.

The Ministry of Finance's 2022 data revealed low compliance with regulations among exporters with outstanding fines.

PP 36/2008 was introduced as a solution, offering more attractive terms such as Bank Indonesia Term Deposits (BI TD Valas)-linked deposits. These deposits provide higher interest rates on repatriated revenues (as shown in Table 4), making them more competitive internationally. Previously, domestic rates for USD-denominated deposits were at 1.75%, significantly lower than the global bank offerings of 4.9%. With the new instruments, the interest rate has become highly competitive at 5.05% after bank margins.

TABLE 8 Current Incentive Scheme for DHE

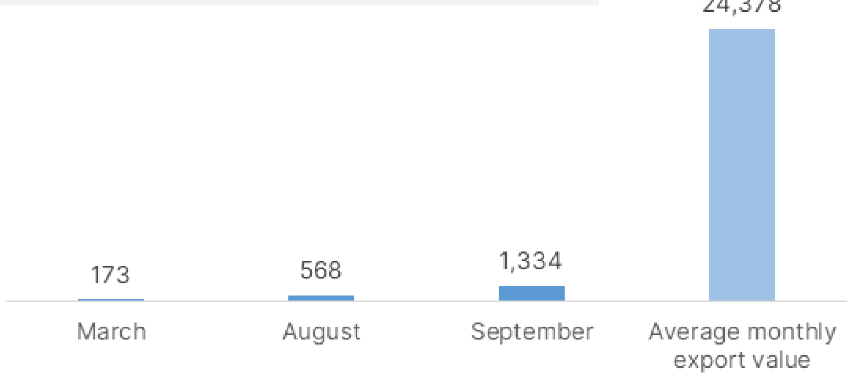
1 – 5 million USD	Special rate BI to bank (%)	Special rate Bank to exporter (%)	Benchmark deposit rate (global banks) (%)	Benchmark domestic rate (domestic banks) (%)
1 month	5,150	5,050	4,930	1,750
3 month	5,370	5,245	5,030	2,250
6 month	5,540	5,390	5,280	2,250

Source: Bank Indonesia (2023)

Despite multiple improvements, the policy's effectiveness remains limited. Following the implementation of PP DHE, Foreign Exchange TD transactions surged by over 100% in a month.

However, the total transactions in the first 6 months post-implementation only accounted for approximately 5.5% of the average monthly export in 2022 (Figure 24).

FIGURE 24 Cumulative Export Repatriated in BI TD Valas



Source: Bank Indonesia (2023)

The number of participating corporates in the FX TD transaction was more than doubled as of September 2023 (a month after implementation). However, this number is still considered very small, less than 1% of total exporters of around 13.000 exporters (DG Customs data, 2023, Figure 25). The paper will therefore explore what the reasons behind this slow development are.

FIGURE 25 Number of Participating Exporters in BI TD Valas

Source: Bank Indonesia (2023)

B. Financial Sector Omnibus Law (FSOL)

The government and DPR RI have passed the Law on the Development and Strengthening of the Financial Sector (UU P2SK) in 2022. This law has an important implication for our financial sector due to the two types of provisions which are (i) authorities' provisions (Table 9), and (ii) industry provisions (Table 10).

The first provision is governing institutions and coordinating authorities in the financial sector to enhance governance and authority.

The second provision addresses industry regulations and their supporting infrastructure, including human resources. While the law's full impact is yet to be determined as implementing regulations are still being drafted, the paper intends to consistently incorporate the FSOL implementation in its analysis of potential policy recommendations.

TABLE 9 Authorities-Related Provisions in FSOL 2022

Subject	Provisions
Bank Indonesia	The objectives, duties and authority of Bank Indonesia are emphasized to include the aim of helping to maintain financial system stability and economic growth, while maintaining independence.
OJK	Integrated OJK supervision aims to support and strengthen the entire financial sector, including banking, capital markets, pension funds, insurance, fintech, and digital asset transactions like crypto.
LPS	The objectives, duties and authority of the Deposit Insurance Corporation are supplemented with the mandate to guarantee insurance policies managed by insurance companies.
Supervision bodies	• OJK and Deposit Insurance Corporation have oversight bodies to enhance performance, accountability, independence, transparency, and institutional credibility in the financial sector. • The P2SK Law prohibits prospective members of key financial authorities from being administrators or members of political parties.
Financial System Safety Net (JPSK)	• Strengthen coordination in the Financial System Safety Net (JPSK), notably through the Financial System Stability Committee (KSSK). The P2SK Law empowers LPS with voting rights in KSSK decisions, enhancing policy synergy in the financial sector. • Emphasize proactive measures to prevent banking issues while avoiding moral hazard. The government supports bolstering LPS's role in minimizing risks with problematic banks. • Enhance coordination and synergy among ministries, institutions, and authorities in the financial sector to drive financial sector development.

Source: Staff's Analyses

Nindya, Unsplash

TABLE 10 Industry-Related Provisions in FSOL 2022

Subject	Provisions
Banking	• Good governance in the banking industry is crucial for achieving the goals of the P2SK Law. A key reform strategy is to enhance industrial efficiency, particularly for Micro, Small, and Medium Enterprises (MSMEs), to provide more affordable access to credit. • To improve efficiency, various strategies are required, including banking consolidation, separation of Sharia Business Units in the financial sector, and lowering bank loan interest rates. The government also supports enhancing the regulation and ecosystem of the sharia banking industry to make Indonesia a global sharia financial center. • The P2SK Law strengthens Rural Banks (BPR), expanding their services to include foreign exchange and fund transfers, and renaming them People's Economic Banks. This transformation aims to enhance their role in supporting MSMEs and the Indonesian economy. In the future, BPRs may play an even more vital role by bolstering capital, improving efficiency and profitability, and implementing good corporate governance, potentially entering the capital market with oversight from BPK.
Capital market	• The legal framework for Special Purpose Vehicles encourages financial instrument diversification via securitization. Regulations also cover Trust Fund Managers, offering asset and wealth management alternatives. Market infrastructure's strategic role is enhanced, including carbon exchanges and demutualization options. • Crypto asset supervision, including digital financial assets, is shifting to OJK to bolster regulation and consumer protection. A smooth transition between OJK and Bappebti is essential to avoid disrupting ongoing crypto asset transactions.
Financial Conglomerates	• Enhance oversight of growing financial services conglomerates to mitigate systemic risks. Clearer regulations are needed, including criteria, scope, materiality aspects, and thresholds to ensure financial system stability. Conglomeration should be monitored to prevent unfair competition practices and avoid monopolistic tendencies in financial services.
Climate Finance	• The P2SK Law enables the financial sector to engage in climate change mitigation and adaptation, fostering green financing ecosystems, including the carbon market.
Non-Bank Financial Institutions	• Governance in the non-bank financial industry, like insurance and pension funds, will be enhanced for faster development while maintaining caution. The insurance sector aims to strengthen public protection through a policy guarantee program. • The P2SK Law improves pension program regulations, both mandatory and voluntary, to ensure stable long-term funding sources. This is crucial for enhancing economic resilience, whether during one's working years or in retirement, and contributes to a more stable, deep, and inclusive national financial system in the long run, as observed in other countries.

Source: Staff's Analyses

TABLE 10 Industry-Related Provisions in FSOL 2022 (continued)

Subject	Provisions
Koperasi Simpan Pinjam (KSP)	• Cooperatives are reemphasized as member-focused entities, contributing to the national economy. Cooperatives engaged in financial services are subject to licensing, regulation, and supervision by OJK, ensuring legal clarity and community protection.
Peer-to-Peer Lending	• The P2SK Law introduces activity-based regulations to accommodate future financing institutions, reflecting government and DPR support for faster and accessible public financing while maintaining prudence.
SMEs	• The P2SK Law bolsters the legal framework for micro financial institutions (LKM), crucial for unbanked communities. Medium-large MFIs will be overseen by OJK, while small MFIs by Regional Governments with enhanced infrastructure and coordinated supervision. MSME access to banking will be cautiously expanded, grounded in robust business analysis and risk management to prevent moral hazard.
Innovation in Financial Sector	• The P2SK Law introduces new financial instruments, including regulations for bullion business activities. • It promotes digital transformation, efficiency in financial and payment systems, and strengthens ITSK associations. It also emphasizes prudence and consumer protection in the future development of Central Bank Digital Currency (CBDC).
Consumer Protection	• The P2SK Law emphasizes stronger consumer protection, particularly in safeguarding the confidentiality of financial service user data, addressing evolving technology in the financial sector.
Law enforcement	• The P2SK Law enhances investor and consumer protection in the financial sector by adapting sanctions, emphasizing the use of criminal penalties as a last resort, and prioritizing restorative justice principles, including recovering losses and illegitimate profits through a disgorgement mechanism.
Literacy, inclusion, innovation	• The P2SK Law promotes financial literacy, inclusion, and innovation while enhancing the quality and quantity of financial sector professionals. It emphasizes the importance of literacy, especially in sharia finance, to protect society from illegal practices. All stakeholders, including supervisory authorities and governments, must contribute to this effort, as literacy is the gateway to the financial sector's benefits for individual welfare.

Source: Staff's Analyses

Chapter V | Policy Ideas

A. Financial product innovation to accommodate sophisticated investor needs: Project Financing for Infrastructure

To increase financial depth sustainably, we need to develop products that can answer the sophisticated needs of private investments. The DHE case indicated that regulation cannot really bring investment from export activities sustainably. After the mandatory retention period of three months, companies bring back most of their investments offshore. Hence, it is important to build a real instrument that can accommodate their needs, such as a real investment opportunity. In OECD study below, an example of financial product innovation that is backed by real investment opportunity is infrastructure-related financial product. Below is a section that discuss how to develop infrastructure-related financial product for emerging country like Indonesia.

Private Financing and Government Support to Promote Long-Term Investments in Infrastructure[3]

The global need for infrastructure investment is both critical and urgent, with estimates ranging from $57-67 trillion by 2030 to meet demands in transport, energy, water, and telecommunications. Traditional public financing models are increasingly untenable, necessitating innovative financing solutions to attract private capital. Project finance has emerged as a pivotal mechanism, with a significant role for public-private partnerships (PPPs) in leveraging private investment. However, barriers to investment and the necessity for government intervention to mitigate risks and provide incentives are evident.

The shift from traditional public infrastructure financing towards private funding and project finance has been driven by a combination of factors, including escalating public debt, budgetary constraints, and a recognition of the efficiencies and capital mobilization capabilities of the private sector. Despite the recognized need to bridge the global infrastructure gap—estimated to require trillions in investment over the coming decades—the current landscape is characterized by significant challenges:

- **Decreased Public Investment Capacity:**
  Many governments face fiscal pressures that limit their ability to finance infrastructure directly, necessitating a pivot towards models that can leverage private sector investment.

- **Market Uncertainties and Regulatory Constraints:**
  The aftermath of the global financial crisis has seen tightened capital requirements for banks and insurers, which, coupled with market uncertainties, has constrained the flow of both public and private capital into infrastructure.

- **Barriers to Private Investment:**
  Potential investors face barriers including complex regulatory environments, political risks, and the challenge of achieving acceptable risk-return profiles, particularly in developing countries where infrastructure needs are greatest.

[3] OECD. (2014). Private Financing and Government Support to Promote Long-Term Investments in Infrastructure. Organisation for Economic Co-operation and Development.

- **Evolution of Financing Instruments:** While traditional project finance, characterized by bank syndicated loans and equity from corporate sponsors, remains central, there's a growing role for alternative instruments like project bonds, direct loans from institutional investors, and public-private partnerships (PPPs).

To overcome these challenges and attract private investment into infrastructure, several policy recommendations are proposed:

1. **Regulatory Reforms to Enhance Financial Stability and Investment:**
   Policies should aim to balance financial stability with the need to attract private capital. This includes revising capital requirement frameworks that currently disincentivize long-term investments in infrastructure by banks and insurance companies.

2. **Risk-Sharing Mechanisms to Attract Private Investors:**
   Developing frameworks for equitable risk-sharing between public entities and private investors in PPPs can make infrastructure projects more attractive. This involves clear delineation of risks that can be better managed by the private sector versus those that should remain with public entities.
   - United Kingdom (PF2 Model): The UK's PF2 model addresses the limitations of traditional PPP/PFI arrangements by ensuring more transparent and efficient procurement processes, along with a balanced risk-sharing mechanism between the public and private sectors. This reform aims to distribute risks more equitably, thereby enhancing the value for money and attracting private sector investment.

3. **Improving Investment Climates through Stable Regulatory Frameworks:**
   A stable, transparent, and predictable regulatory environment is crucial. This reduces the perceived political and regulatory risk, making infrastructure investments more attractive to private and institutional investors.
   - Singapore (Regulatory Environment): Singapore's success in attracting private investment in infrastructure is attributed to its robust regulatory environment, clear rules, and efficient procurement procedures, creating a conducive climate for investment. This example highlights the importance of a stable and transparent investment climate in attracting private capital to infrastructure projects.

4. **Development and Promotion of Innovative Financing Instruments:**
   Encourage the use of project bonds, infrastructure funds, and other innovative financial instruments that provide alternative funding sources and match the long-term nature of infrastructure investments.
   - European Union (Project Bond Initiative): The EU's Project Bond Initiative, offering credit enhancements to infrastructure project bonds, serves as an example of how government support can increase the attractiveness of these instruments to institutional investors. By providing a credit enhancement mechanism, the initiative aims to lower the perceived risk of project bonds, making them a more viable investment option for institutional investors.

5. **Targeted Government Support and Incentives:**

   Implement targeted support measures, such as viability gap funding, tax incentives, and government guarantees, to improve the risk-return profile of infrastructure investments for the private sector.

   - India and Indonesia (Viability Gap Funding): Both countries have implemented viability gap funding schemes to support infrastructure projects that are economically justified but fall short of financial viability. This direct financial intervention approach demonstrates how governments can stimulate private investment by covering a portion of project costs, thereby reducing the investment burden on private entities.
   - USA (TIFIA Program): The TIFIA program in the USA provides loan guarantees and standby letters of credit for infrastructure projects, serving as an example of government support through unfunded options. This back-up support acts as a credit enhancement, improving the bankability of projects and attracting private investment by mitigating risks associated with infrastructure financing.

Addressing the global infrastructure gap requires a concerted effort to attract private investment through a combination of regulatory reforms, innovative financing models, and targeted government support. By striking a balance between financial stability and investment incentives, ensuring equitable risk distribution, and creating a favorable investment climate, policymakers can mobilize substantial private capital for infrastructure development.

B. Tax-Related Proposition

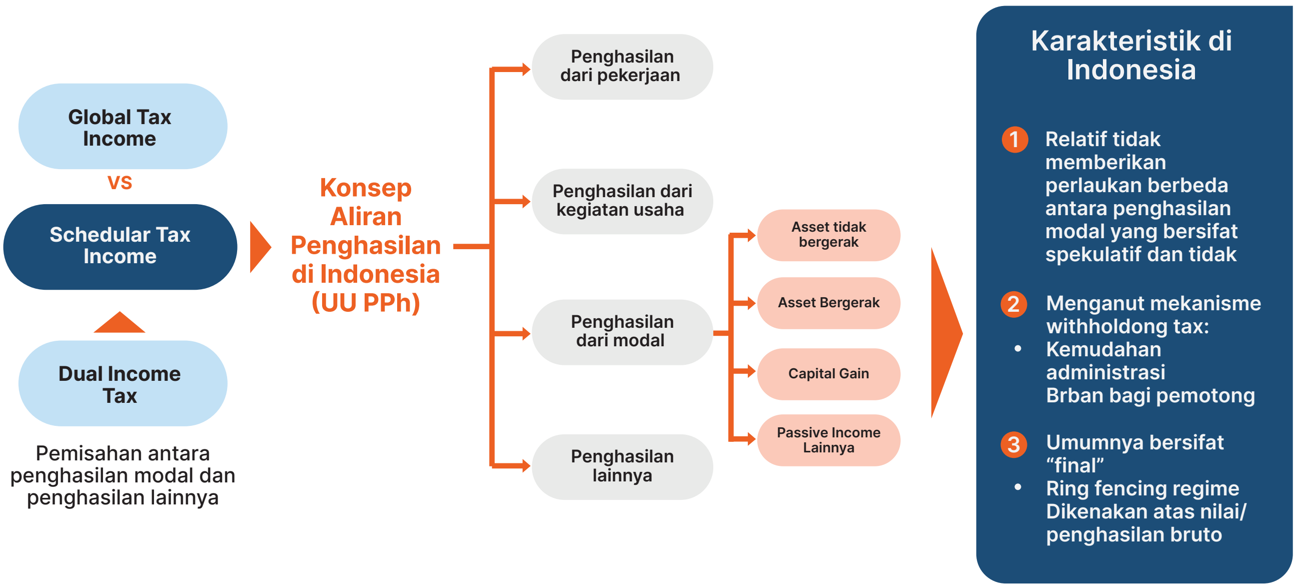
This section outlines Indonesia's strategic use of fiscal policy as a regulatory tool to achieve multiple objectives, including curbing speculative savings through a progressive Land Value Tax (LVT), promoting financial instruments, and ensuring fairness in tax treatment. By distinguishing between speculative and non-speculative capital gains, particularly in land ownership, the proposal aims to stimulate productive land use, address income inequality, and draw lessons from China's real estate bubble to mitigate financial sector exposure to sector-specific risks. The Ministry of Finance Indonesia emphasizes fiscal policy's role in creating a more inclusive, efficient, and fair financial system, underscoring the importance of equalized tax treatments across different capital accumulations, and suggesting reforms in money market development to support these goals.

(i) Regulating Speculative Savings through Progressive Land Value Tax

Indonesia's tax policy categorizes income into four types: income from work, income from business, income from capital, and other income.

Income from capital encompasses immovable assets like land and buildings, movable assets, capital gains, and passive income. It does not distinguish between non-speculative and speculative savings.

FIGURE 26 **Tax Regime for Capital Accumulation**



Source: DDTC (2023)

Indonesia's tax on income from assets should be able distinguish between speculative and non-speculative gains. Hence, in the context that speculative activities in land buying especially can crowd out financial depth, Government should consider a policy that disincentivize idle use of land such as by imposing higher land value tax (LVT) rate for such unproductive land. Right now, all kinds of LVT such as PBB, only looks at the value of the land without considering the value of the building or use of the land. This means that there is no different tax amount, whether the land is used for economic activities or left idle. For idle landowners, LVT should provide a progressive burden because the owner does not have any benefits or income from the land. Thus, the implementation of this tax can encourage better land use allocation.

According to Dye and England (2010), LVT is also neutral because it does not distort decisions on the type and amount of investment in land. In contrast to almost all other taxes, LVT does not inhibit, but instead encourages economic productivity. Apart from that, LVT can prevent speculative activities on land which ultimately makes land prices 'more normal', so that they are still affordable for the average person. Ultimately, this can correct the distribution of land ownership. Lastly, LVT tends to be easier to administer (Mirrlees, 2011). Therefore, the receipt of tax proceeds is more guaranteed. With these various advantages, it is not surprising that more than 25 countries have implemented LVT, which are Mexico, Japan, Denmark, and so on.

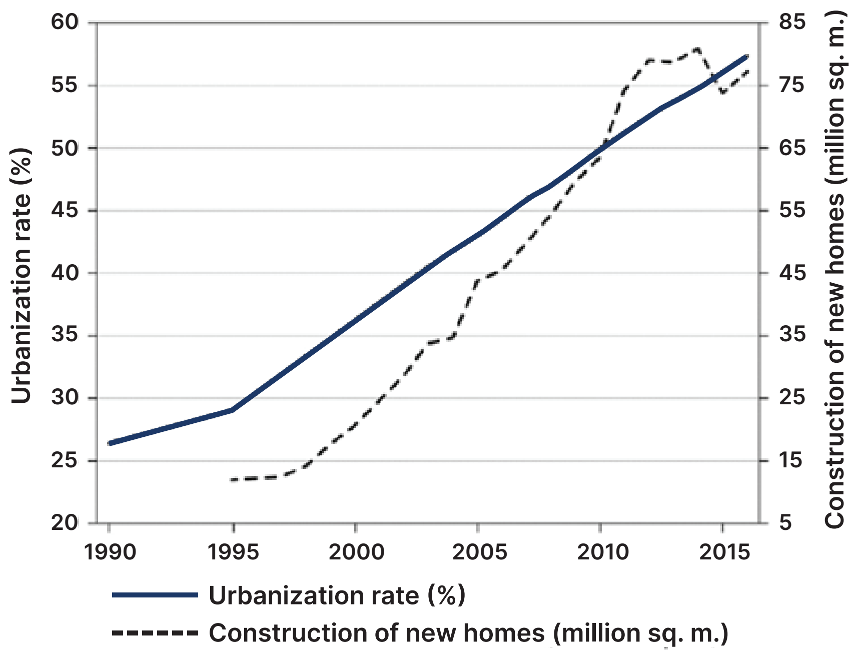
This policy can also increase the effectiveness of tax policy in reducing income inequality. Right now, Indonesia's tax policy is among the worst in the world in addressing inequality. Using tax policy to address inequality is part of Based on a statement from the Minister of Agrarian Affairs and Spatial Planning, Sofyan Djalil (24/9/2016), with the current tax system that does not create optimum disincentive system for idle land, the Gini index for land ownership has reached 0.58. Or in other words, around 58% of the land area in Indonesia is owned by only 1% of the population.

BOX I. Lesson from China's Property Bubble

A good example comes from China real estate development case. Beside relevant due to its starting point as emerging economy, China is a country where economic and finance development is uniquely driven by real estate sector. China's economic growth has been significantly driven by its real estate sector.

In 2017, housing sales contributed to 16.4% of its GDP. This growth aligns with the urbanization rate increasing from 25% to 60% from 1990 to 2017, during which housing constructions rose from 15 million to 75 million. (Figure 27).

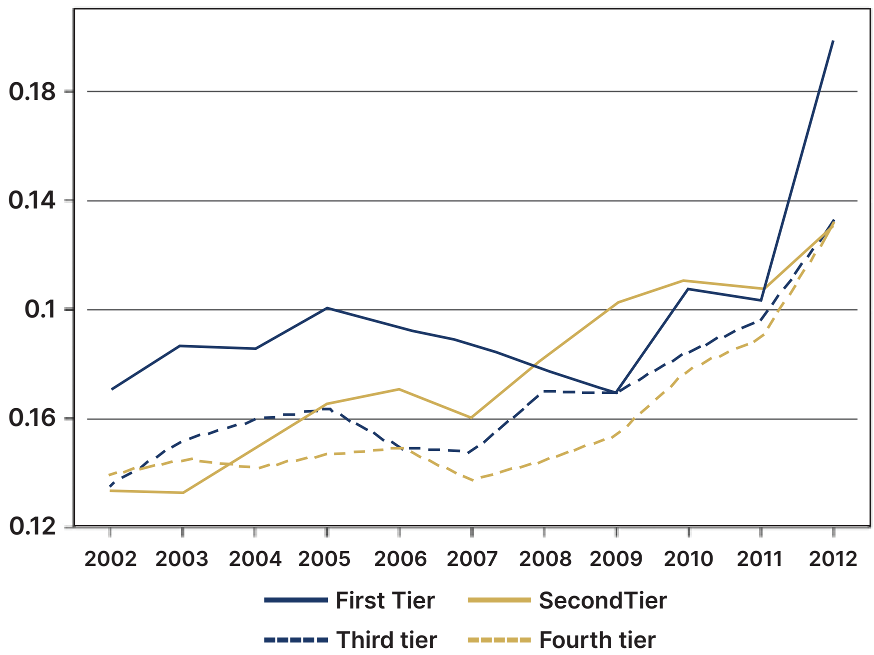
FIGURE 27 Urbanization Rate and Construction of New Homes in China, 1990-2015



Source: China's National Bureau of Statistics (2017)

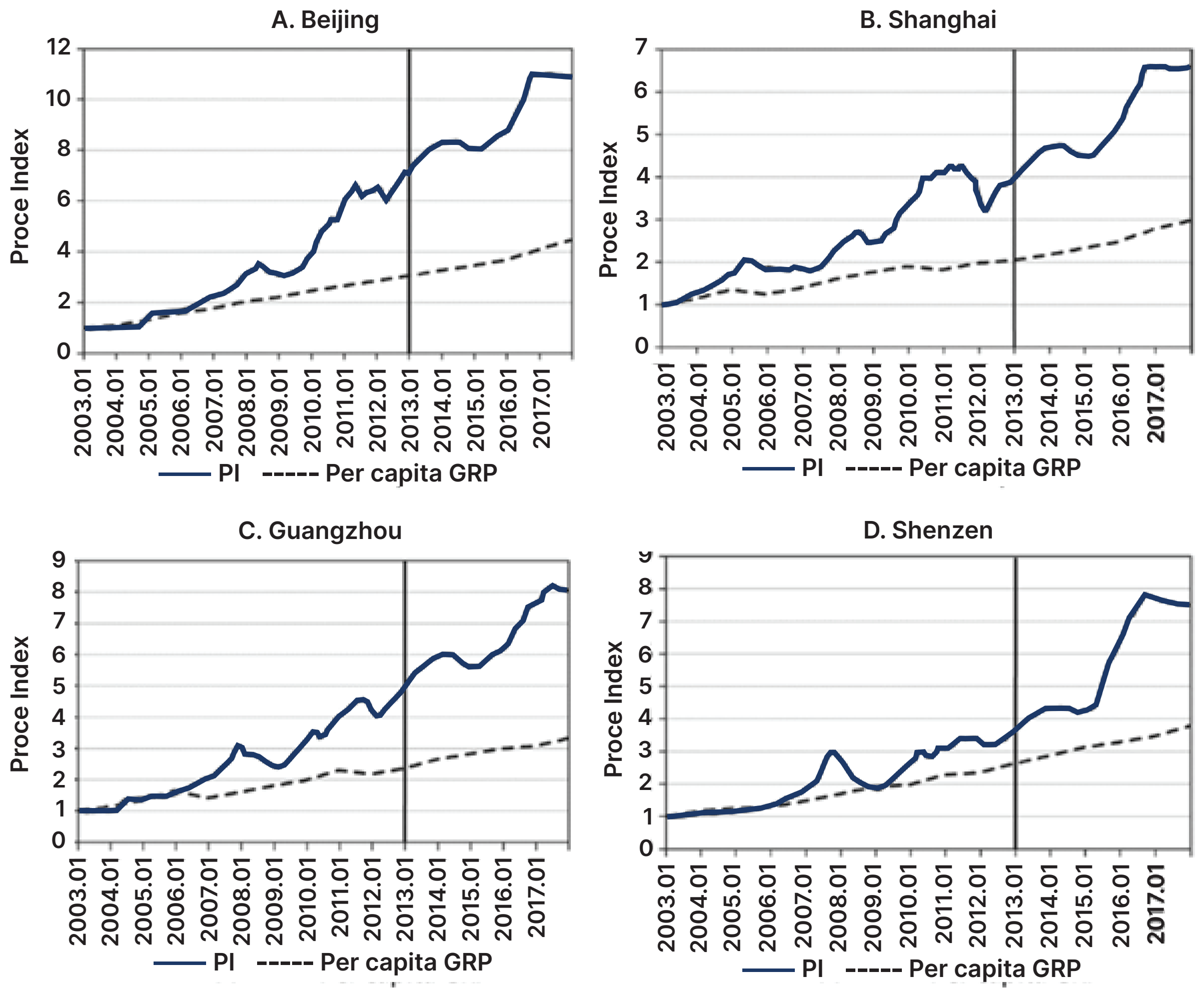
Since 2009, China has seen a rise in residential vacancy rates, signaling a property sector bubble. This bubble has been fueled by the swift infrastructure expansion by local governments and relaxed banking regulations aimed at stimulating economic growth following the 2008 Global Financial Crisis. Additionally, there has been a notable widening gap between price indices and income since 2008.

FIGURE 28 Vacancy Rates for Chinese Cities, 2001-2012



Source: Glaeser et al. (2017)

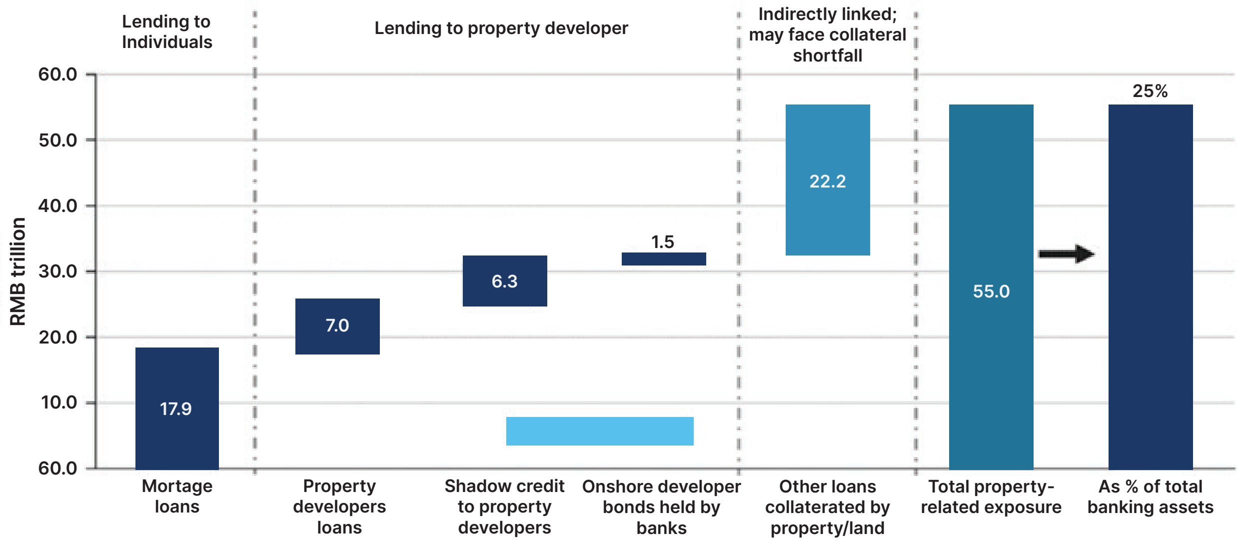
FIGURE 29 Housing Price Indices for China's First-Tier Cities



Source: Fang et al. (2016)

This development is heavily reliant on the financial sector, particularly through significant credit extended by banks. Banks have provided substantial mortgage loans to individuals, a smaller portion to property developers, and many non-mortgage credits backed by real estate collateral. Figure 30 indicates that 25% of the banks' assets are tied to the real estate sector.

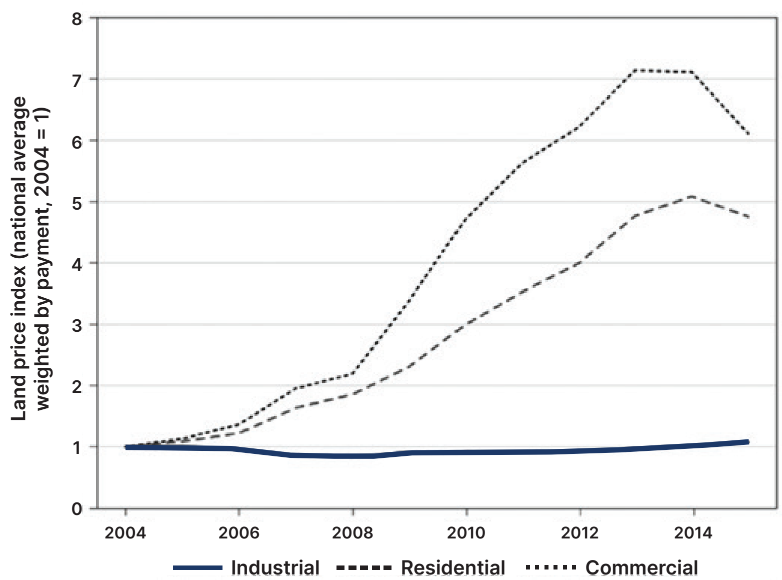
FIGURE 30 Total banking exposure to the property sector in China as of Q3 2016



Source: Chen et al. (2018)

Furthermore, the real estate bubble was confined to residential and commercial land, as industrial land, a significant indicator of total factor productivity, maintained a stable price index trend (Figure 31). This suggests that the capital accumulation in the housing sector has become increasingly inefficient, failing to drive optimal productivity growth in the Chinese economy.

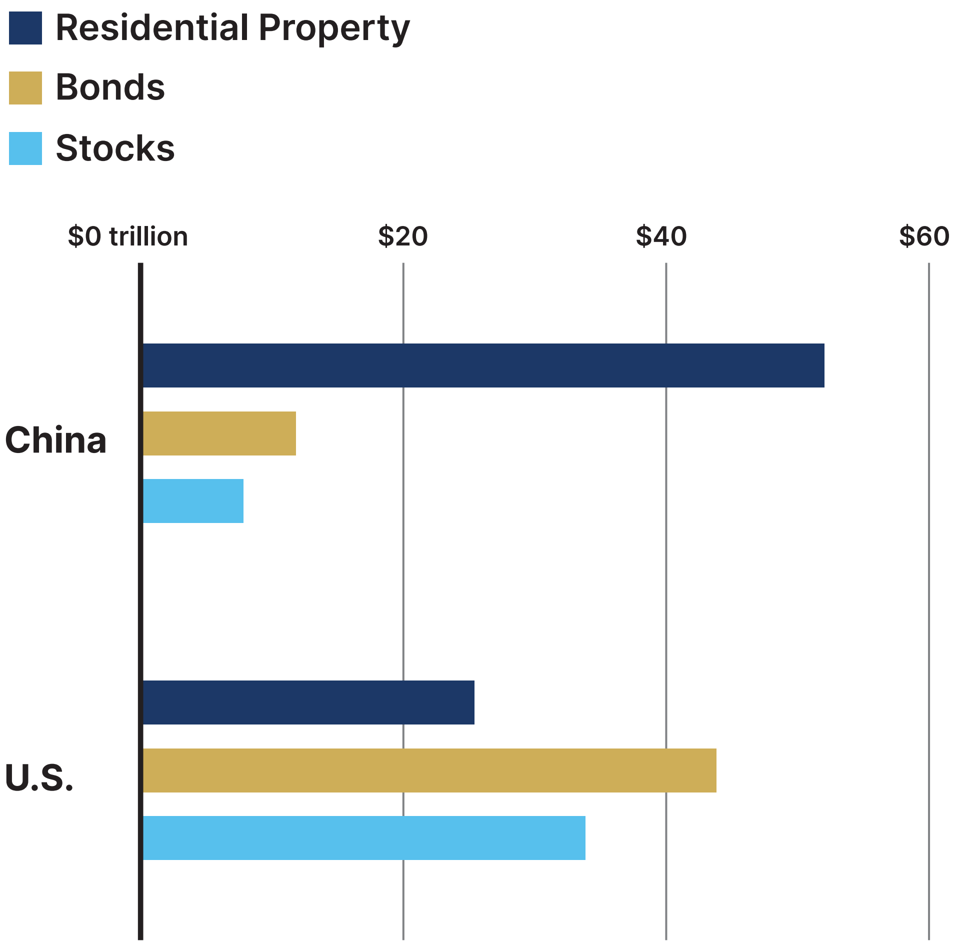
FIGURE 31 Land Index for Different Types of Land Sales in China



Source: Chen et al. (2018)

Another evidence that should concern us is that the fact that the capital accumulation in the real estate, especially residential and commercial, has crowd out overall financial development of the country. From figure below, the residential property bubble has "eaten up" financial depth in China and even the world with a huge accumulation of asset amounting to USD 49 trillion which is around two times the size of Chinese stock and bond market combined. Compared to the world class asset size like US bond and stock market, the amount is also bigger. Chinese residential property was twice the size of US residential property.

FIGURE 32 Market Value of Each Asset Class, 2019



Source: Goldman Sachs (2020)

In the past years, the Chinese property bubble have turned to a burst. China residential property total return index has fallen more than 80% from May 2021 until now or in less than 5 years. This surely affects many sectors in the economy, including financial sectors.

Banking sectors is among the most affected ones in the financial sector due to its high exposure to this type of assets. The burst of property sector in China is also indicated by the bankruptcy claim of Evergrande, one of Chinese biggest real estate company.

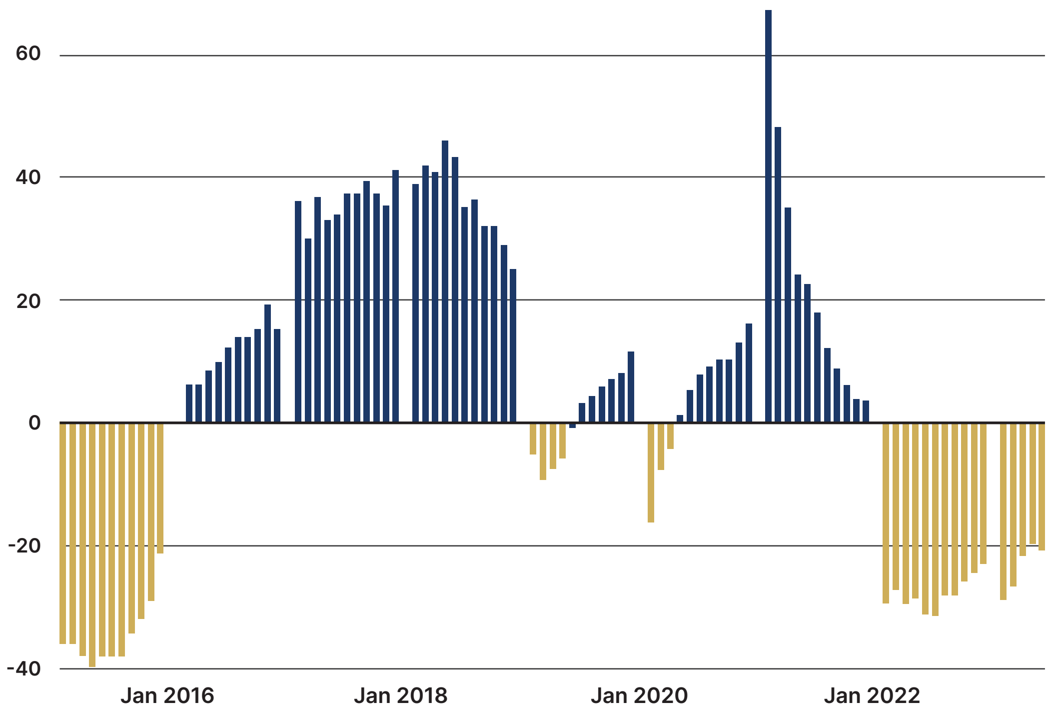
FIGURE 33 China Real Estate Total Return Index

Source: BofA Global Investment Strategy, Bloomberg (2021)

Lastly, there is also exposure of the real estate sector to the public sector. Right now, development of infrastructure in China is financed with public debt. The public debt health indicators of some provinces are very low indicating the credit risk when a burst happened. Besides, local government has also enjoyed income from land sales.

Add the fact that local governments are very reluctant to sell its assets, the central government is currently implementing a bailout plan by issuing central government bond to restructure and restore Chinese public debt condition to pre-bubble level.

FIGURE 34 Local government income trend in China (cumulative, yoy change)



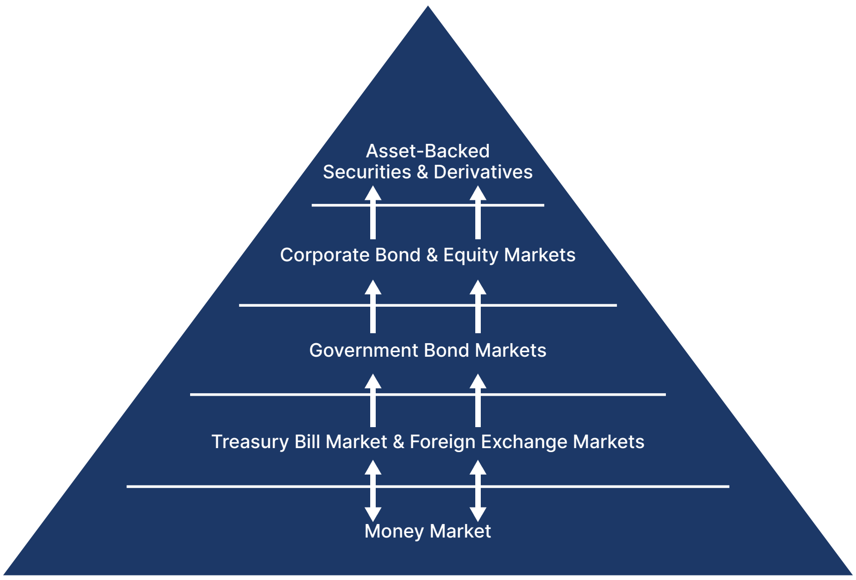
Source: Wind (2022)

From China's case, we learned that unregulated emerging economies whose growth is spurred by real estate development needs to equip itself with policy intervention tools to mitigate the potential of bubble existence. Reducing building up exposure of a particular sector to financial sector is an area that policy intervention should be directed at. Macroeconomic policy, fiscal policy, microprudential and macroprudential policies all can have roles.

(ii) Promoting Financial Instruments

Based on IMF, money market serves as basis for a country's financial development due to its role as risk absorber. Money market development therefore needs to be put as priority to ensure that the financial sector is optimally functioning. Same as overall financial development indicators, money market should be deep, accessible, and efficient so the overall financial sector that comes after it is also optimally developed.

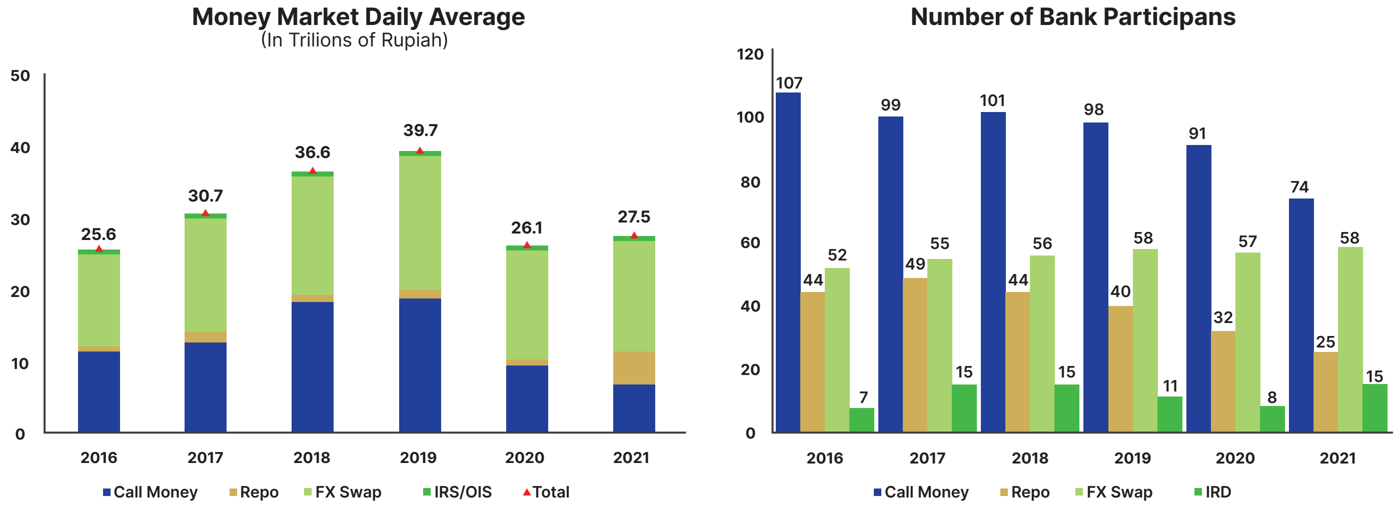
FIGURE 35 Stages of Financial Market Development



Source: IMF (2015)

Currently, Money market development in Indonesia, that consist of Rupiah, foreign currency, and derivative, is still not optimal. The size is only IDR 27,5 trillion (lagged government bond market -depth problem), with only 74 bank participants (lagged number of banks -access problem), and with high rate of 4,3% (lagged other countries -efficiency problem). The type of transaction is only active in term of call money and very lack on repo, foreign swap, and Interest Rate Derivatives (IRD) indicating the inability of the market to provide risk absorber.

FIGURE 36 Money Market in Indonesia



Source: IMF (2021)

There is currently no incentive in the money market. First, there is no legal certainty regarding money market instruments. The tax regime only acknowledges money market instruments such as treasury bills (surat perbendaharaan negara/SPN), central bank certificates (surat berharga Bank Indonesia/SBI), that is applied with 20% of final tax. Second, there is issue of unsuitable tax treatment, as it taxes repo and IRD as if the transaction is like a stock market (while it is only traded for short term liquidity and not for investments) hence creating a double taxation.

Lastly, there is level playing field issue as the tax of income from interest of SPN and SBI tax with final system with a higher rate than SBK that is now also taxed with capital gain system. To promote the development of money market, the paper suggested that money market-related income can be taxed with capital gain instead of final and with rate same or lower than income from other market like Government Bond market.

FIGURE 37 Money Market Tax Treatment

Tantangan distorsi pajak dalam pasar keuangan

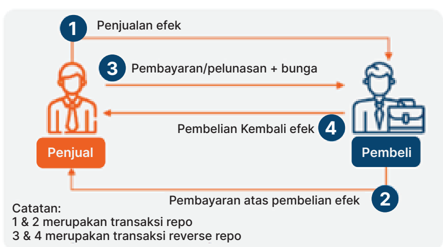
- Kurangnya kepastian hukum pajak
- Belum tepatnya perlakuan pajak
- Perbedaan perlakuan (level playing field issue)

Ilustrasi 1

Perbandingan PPH atas bunga SPN, SBI, NCD, dan SBK

Jenis Penghasilan	Jenis Pemotongan PPH	Tarif
Diskonto SPN	PPH Pasal 4 ayat (2) dan bersifat final	20%
Bunga SBI	PPH Pasal 4 ayat (2) dan bersifat final	
Bunga sertifikat deposito atau NCD	PPH Pasal 4 ayat (2) dan bersifat final	
Bunga SBK atau promes	PPH Pasal 23 dan tidak final	15%

Ilustrasi 2 **Transaksi Repo dan Reverse Repo**



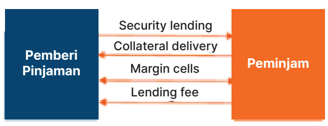
- **Isu Pajak berganda**
- **Dualisme perlakuan bunga repo**

Ilustrasi 3 **Transaksi Derivatif**

- Interest rate swap (IRS)
- Overnight Index swap (OIS)

Keuntungan dari kedua skema kerap dianggap sebagai pendapatan biaya

Ilustrasi 4



Securities lending belum memiliki ketentuan pajak yang jelas

Source: DDTC (2023)

(iii) Promoting Fairness

To ensure fairness and a level playing field among savings products, the tax treatment of all forms of capital accumulation needs to be equalized to avoid distortions. The case that is used for this paper purpose is Income tax in Indonesia, because income tax is proven by literatures to have significant impact on taxpayer behavior.

As evidence, DDTC (2023) highlights the distortions in income tax for capital-related income, revealing an unequal playing field among different types of capital. Figure 38 illustrates the significant disparities between income tax treatment for land sales and formal financial instruments like bank term deposits. Land sale income faces a final tax rate of 2.5%, while bank term deposit income is subject to a final tax rate of 20%, both calculated based on gross income.

The income tax treatment therefore is quite distortive as the rate is lower for land savings-related income compared to formal financial savings-related one. The different treatments also existed between formal financial savings products such as income from banks term deposit (20% final tax based on gross income), bonds (10%), and stock (0,1%) instrument. Therefore, the paper suggested to equalize the treatment between all income related to capital.

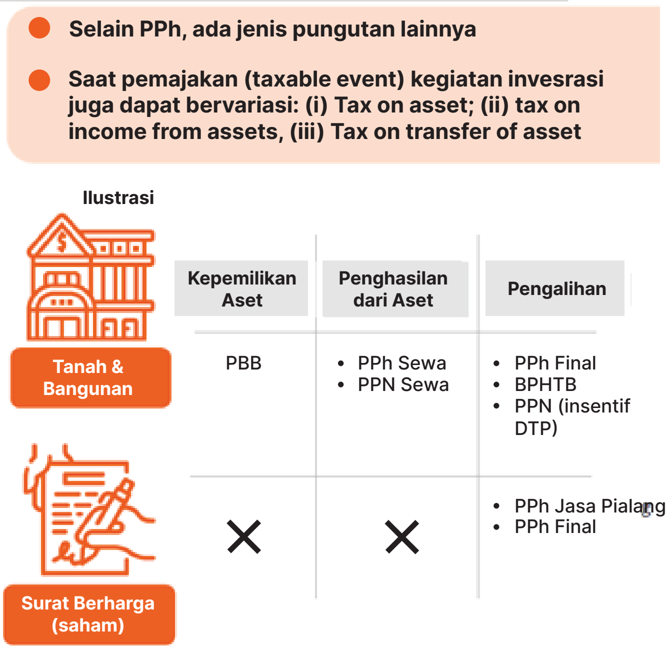
However, when deciding the income tax rate and basis, Government should also consider holistic approach, e.g. "total fiscal burden". On land and buildings, for instance, there are many types of taxes outside the income taxes. They are (i) tax on asset like Land and Building Tax (Pajak Bumi dan Bangunan/PBB), (ii) tax on income from assets such as income tax and Value Added Tax (Pajak Pertambahan Nilai/PPN) for rent income, and (iii) tax on transfer of asset such as Fees for Acquisition of Land and Building Rights (Bea Perolehan Hak atas Tanah dan Bangunan/BPHTB) and VAT.

FIGURE 38 Tax Rate Summary on Capital / Passive Income

Perlakuan Pajak atas Penghasilan dari Modal di Indonesia

Jenis Penghasilan	Sifat	Tarif	DPP
Pengalihan tanah	Final	2.50%	Bruto
Sewa	Final	10%	Bruto
Bunga deposito	Final	20%	Bruto
Asuransi dwiguna	Dikecualikan(?)		
Reksadana	Dikecualikan		
Kupon Saving Bond Ritel	Final	10%	Bruto
Pengalihan saham	Final	0.50%	Bruto
Penjualan emas oleh pengusaha	Tidak Final	0.50%	Bruto
Valuta asing	Tidak Final	Tarif Umum	Neto
Dividen	Dikecualikan selama diinvestasikan kembali		
Royalti	Tidak Final	10%	Bruto
Kupon Sukuk	Final	10%	Bruto
Kupon Ori	Final	10%	Bruto
Bunga obligasi	Final	10%	Bruto
Manfaat DPLK	Final	5%	Bruto

Apakah akan mengubah perilaku untuk saving/investment?



Source: DDTC (2023)

C. Mandatory Savings Innovation through Targeted Financial Incentives

Financial institution's depth will be key to overall financial development. Not only that it is adding more money to allocate resource and distribute wealth, but it is also good for creating more balanced competition as these institutional investors will promote financial market development. Right now, as mentioned in the chapter II, Indonesia's financial development is still bank-dominated. With the current structure of banks, it is hard to create competitive market for financing.

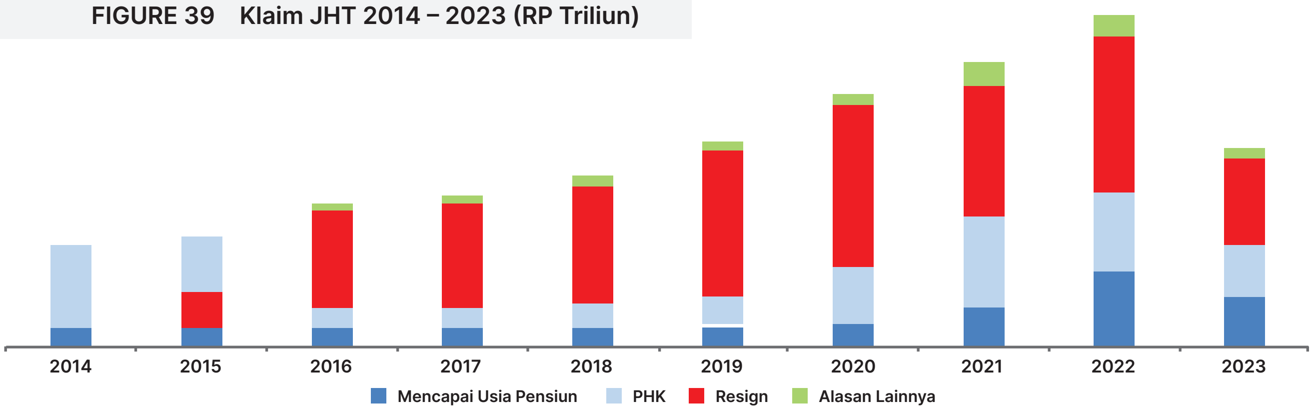
Hence, we need to increase pension fund and insurance assets to GDP. In addressing this issue, considerations of equity are above other things. Hence, in this paper, we focus on how to (i) strengthen the program hence can boost funds accumulations of funds in fair and equitable way, and (ii) increase coverage by applying financial incentives.

(i) Strengthening the Current Retirement Program

One of the problems of Indonesia's low pension fund accumulation is due to the design of the program itself. As can be seen from Figure 39 below, the old age security accumulation has been negatively affected by the enabling of early withdrawal, among others. The early withdrawal amount became skyrocketing after the policy was first commenced. This resulted in two bad things, first is suboptimal accumulation of funds, and secondly is the low benefit for old age protection.

Based on Ministry of Finance (2023), the prediction of amount for average Indonesians if this withdrawal policy is not changed is only around 10%, lower than International Labor Organizations (ILO)'s standard at 40% replacement ratio. To strengthen the program, P2SK Law has tried to address it as explained in Chapter IV. IBC believes that there needs to be enhancement of the current retirement program such as by mitigating early withdrawal and applying penalties for non-compliance policy.

FIGURE 39 Klaim JHT 2014 – 2023 (RP Triliun)



Source: BPJS TK (2023)

Malaysia's Employees Provident Fund (EPF) model, with pension fund assets close to 100% of GDP, showcases its impact on household consumption through a mandatory savings rate, covering 11.36 million members in 2006 with a high contribution rate of 23% of wages (Gloria & Prayoga , 2009). This integration into the financial system presents a robust framework for Indonesia to enhance its pension program.

I. Legal Working Age and Retirement Age

First, withdrawal is strictly linked to legal working and retirement age as it defines ratio of years of contributions to years of receiving benefit. It is therefore important that retirement system is designed based on maximum contribution and equity. In Malaysia, the regulation states that legal age for employment in Malaysia is 14 years while minimum retirement age is set at 60 years. This means that there are 46 years contribution. More options are also given for the late retirees by enabling the last EPF contribution at 75 years.

in Indonesia, the pension age is currently quite young at 58 while legal working age is 18 years which makes 40 years of contribution. The difference between the 2 countries is the ratio of contribution vs benefit. Malaysia reaches 46/20 while Indonesia is lower at 40/20. The bigger the ratio is the better for sustainability for the program, but we should understand that the legal working and retirement age are most dominated by non-program considerations such as type of work. Therefore, many literatures for instance never suggested a regulation of minimum retirement age.

II. Employee Pension Contributions

Members of the Employees Provident Fund (EPF) can withdraw minimum at Malaysia's legal retirement age which is minimum 60. The contribution rates also vary based on age. As shown in Figure 40 below, the contribution is high during productive age and even higher for higher salary group. Two things about the design of the contribution rate: (1) it is 36:64 ratio of employee and employer contribution is at 40:60 while in Indonesia is about the same at 35:65, (2) total contribution is around 22% in total than in Indonesia of 8,7% in total for old age and pension programs.

Next, there is a possibility of late entrance to the program can still be part of program by enabling above retirement age to still contribute at lower rate. Additionally, Malaysia applied dual accounts model where monthly contribution goes to two separate accounts: (1) 30% is account that can be withdrawn, while (2) 70% is called retirement account which is not withdrawable.

FIGURE 40 Contribution Rates in Malaysia

CONTRIBUTION RATES

Age 14-60			Age 60-75		
SALARY	<RM5,000	>RM5,000	SALARY	<RM5,000	>RM5,000
Employee	9%		Employee	9%	
Employer	13%	12%	Employer	13%	12%

Employer must make monthly payment on or before 15th of the month.

Example:
Contributions for February 2022 salary has to be paid either before or on 15th March 2022

Monthly Contributions:

- **70%** — **Account 1** Retirement Account
- **30%** — **Account 2** Pre-retirement Withdrawals

Source: NOR (2023)

III. Penalties for Non-Compliance

Next, EPF Malaysia also apply strict penalties and legal action for non-compliance to employers as can be show in Table 11 below. As a result, coverage of retirement program in Malaysia is relatively high.

TABLE 11 EPF Malaysia Penalties and Legal Action

<table>
<tr><th>Section in the APF Act</th><th>Offences</th><th>Penalties/Legal Action</th></tr>
<tr><td>41(1)</td><td>An employer who fails to register with EPF within 7 days from the date he employs an employee</td><td rowspan="3">Imprisonment term not exceeding 3 years or to fine not exceeding RM10,000 or both</td></tr>
<tr><td>43(2)</td><td>Failure to make contribution on or before thr 15th day of the month.</td></tr>
<tr><td>59(A)</td><td>Make false satatment orally or in writing.</td></tr>
<tr><td>48(3)</td><td>Deducts the employee's share of contributions from the wages and fails to pay EPF.</td><td rowspan="2">Imprisonment term not exceeding 6 years or to fine not exceeding RM20,000 or both</td></tr>
<tr><td>47(1) & 47(2)</td><td>Deducts from the wages of any employee as part of the employer's share of contribution.</td></tr>
<tr><td>41(3)</td><td>Fails to notify the EPF within 30 days from the fate he ceased to have any employee</td><td rowspan="2">Imprisonment term not exceeding 6 months or to fine not exceeding RM20,000 or both</td></tr>
<tr><td>42(1)</td><td>Fails to furnish the statement of wages to his employee.</td></tr>
<tr><td>46(1)</td><td>Failure od the Company's Director. Partner of the Firm or an Association of Persons to pay the outstanding EPF contribution.</td><td>Claims may be filed in a court and actionss that can be taken againts you:
• Bankruptcy action
• Seizure & sale of assets
• Retention of Passport
• Section 39 – The EPF Board may apply to the immigration Department to prevent any company directors/partnership of firms/business owners from leaving the country if the company/firm fails to pay the contribution asset.</td></tr>
</table>

Source: Nor (2023)

IV. Withdrawal Types and History

In Malaysia there were also changes in the early withdrawal regulations over time. As shown in Table 12 below, earlier in 1951-1994, there was only one account of the retirement program, just like Indonesia has now. Later, 1994-2007, there were 3 accounts, where the un-withdrawable one only accounted for 60%. And from 2007 until presently, the dual accounts were implemented with retirement account accounting for 70%. There were also other details on the regulation that became a change factor such as the reason which the non-retirement account can be withdrawn. Presently, there were many reasons that could be accommodated compared to before, such as housing-related, education, health, Islamic pilgrimage, and even infertility treatment. Indonesia could adapt gradual change as well; this is to balance between the urgency for accommodating people’s immediate needs as well as the need to accumulate funds for the sustainability of the program.

TABLE 12 Malaysia Retirement Account Withdrawal Regulation

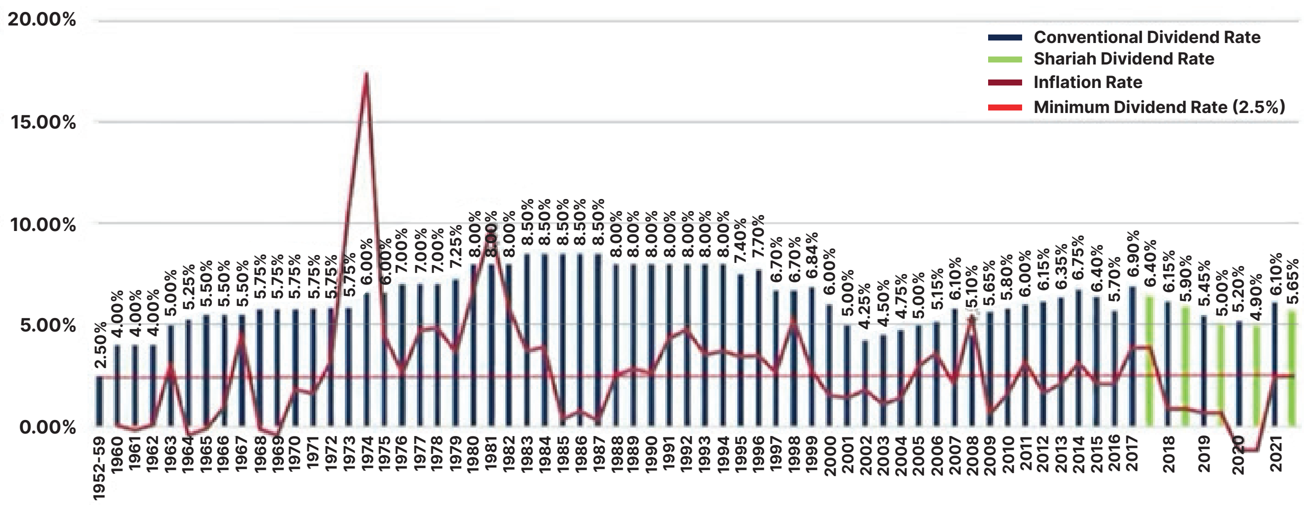
	1951-1994	1994-2007	2007-Present
Number of Account	Single Account	Triple Accounts	Dual Accounts
Name of Account (%)	EPF Account (100%)	Account 1 @ Retirement Account (60%) Account 2 (30%) Account 3 (10%)	Account 1 @ Retirement Account (60%) Account 2 (30%)
Withdrawals (Year of Introductions)	• Age 55 (1951) • Death (1951) • Incapacitation (1951) • Leaving country (1951) • Age 50 (1967) • Purchase of House (1977) • Building a House (1962) • Reducing/Redeeming Mortgage Loan (1984)	**All Accounts** • Age 55 • Death • Incapacitation • Leaving country • Balance of RM1 Million (2007) **Account 1** • Member Investment Options (1996) **Account 2** • Age 50 • Purchase of House • Building a House • Reducing/Redeeming Mortgage Loan • Education (2000) **Account 3** • Health (Critical Illnesses) (1994) (Self, spouse, children, siblings, parents, parents in law, & adopted children)	**All Accounts** • Age 55 • Death • Incapacitation • Leaving country • Balance of RM1 Million **Account 1** • Member Investment Options **Account 2** • Age 50 • Purchase of House • Building a House • Reducing/Redeeming Mortgage Loan • Education • Health (Critical Illnesses) • Housing Loan Monthly Instalment (2008) • Islamic Pilgrimage (Max RM3.000) (2012) • Infertility Treatment (Under Health Withdrawal) (2020) • J-Lindung (2022)

Source: Nor (2023)

V. Sharia Compliance Savings

Introduction of Sharia-compliant savings in 2000. These savings comprise a significant portion of total savings, with distinct features compared to conventional savings. Over 3 billion members have opted for Sharia savings, making up about 9.2% of total members.

FIGURE 41 Malaysia's Comparison of Conventional and Shariah Dividend Rates with Inflation and Minimum Dividend Threshold (1950-2021)



Source: Nor (2023)

To summarize, from the analysis above, Indonesia could adopt Malaysia's employee contribution system by (1) modifying retirement account from single to dual account with distribution from retirement plus withdrawable account at 70:30 as a start, (2) making sure that trigger for early withdrawal is something of participant's needs, (3) applying regulations for penalties, as well as (4) considering adding sharia-compliance to accommodate Indonesian muslim's needs. This will complement the improvement of overall Government effort to increase pension and insurance institutions' governance. This will increase the fund accumulation as the program becomes stronger while still maintaining equity for the people.

(ii) Financial Incentives for Mandatory Savings[4]

Next, to further enhance the coverage of the mandatory savings schemes in Indonesia that as seen in Chapter III is currently very low on coverage despite the mandatory regulation. In order to increase coverage, we need to consider financial incentives. These financial incentives in principle should balance between encouraging savings for retirement while considering the fiscal sustainability of such incentives in an era of budgetary constraints.

First there is Exempt-Exempt-Taxed (EET) regime in OECD. This is because OECD advocates for complementary retirement savings arrangements to bolster overall retirement income. Given the voluntary nature of these savings, aside from all the efforts to strengthen the program itself as established in earlier section, financial incentives are crucial for encouraging participation.

EET regime is a prevalent tax treatment for retirement savings, blending tax and non-tax incentives to bolster individual and employer pension contributions. This system exempts contributions and their returns from taxes until withdrawal, aiming to make retirement saving more appealing and increase assets for institutional investors. Despite the widespread adoption of the EET model, its efficacy and fiscal implications vary due to the unique pension frameworks, demographic challenges, and budgetary limitations of each country, revealing a disparate landscape with no uniform solution for promoting retirement savings. Therefore, below guidelines are needed to ensure before applying EET.

1. **Harmonization of Incentive Structures:** Streamline the approach to financial incentives across OECD countries to reduce complexity. For instance, adopting a uniform tax treatment similar to the EET regime could simplify international workers' retirement savings portability.
2. **Targeted Incentives for Underrepresented Groups:** Implement specific incentives for low-income earners and young workers, akin to the UK's tax relief at source system, which effectively targets lower-income groups by providing tax relief on pension contributions at the basic rate of income tax.
3. **Evaluation and Adjustment:** Follow the example of countries like Australia, which periodically reviews the effectiveness of its superannuation incentives, adjusting contribution caps and tax benefits to ensure alignment with economic conditions and policy objectives.
4. **Fiscal Sustainability:** Model policies on the Swedish approach, where fiscal sustainability of pension incentives is ensured through a pension system that adjusts benefits based on demographic changes and economic performance.

To support the above policies, we need to also promote policies like (1) international cooperation on tax treatment and (2) promote transparency and simplicity for example by Simplifying the tax code regarding pensions and contributions can enhance taxpayer understanding and compliance. While the study does not cite specific country examples for these recommendations, the general principle would involve (1) establishing agreements that prevent double taxation and ensure equitable treatment for pensioners receiving benefits from abroad and (2) adopting clear rules for the taxation of pensions and the deductibility of contributions, similar to the systems in Austria and Belgium, which provide straightforward guidelines for taxpayers.

[4] OECD (2021). Financial Incentives for Funded Pension Plans in OECD Countries. Organisation for Economic Co-operation and Development.

Financial incentives play a pivotal role in promoting retirement savings and enhancing the capacity of institutional investors through mandatory savings schemes. By refining these incentives and ensuring their alignment with broader economic and social objectives like those in OECD countries, Indonesia countries can improve retirement income security and the efficiency of capital markets.

D. Enhancing Credit Information and Collateral[5] to Open Access to Finance

Indonesia's financial sector, particularly in credit information and regulations, faces significant challenges related to the fragmented credit information systems and regulatory frameworks. Key issues include limited coverage and connectivity in credit systems like SLIK and LPIP, an inadequate legal framework for recognizing movable assets as collateral, and inefficient insolvency processes. These obstacles hinder credit access, especially for SMEs and entrepreneurs, and deter potential creditors due to the risks in asset recovery. Addressing these challenges through reforms—enhancing data interconnectivity, expanding collateral frameworks, streamlining insolvency procedures, and improving institutional coordination and capacity—will boost the sector's efficiency, inclusivity, and competitiveness, fostering overall economic stability and growth.

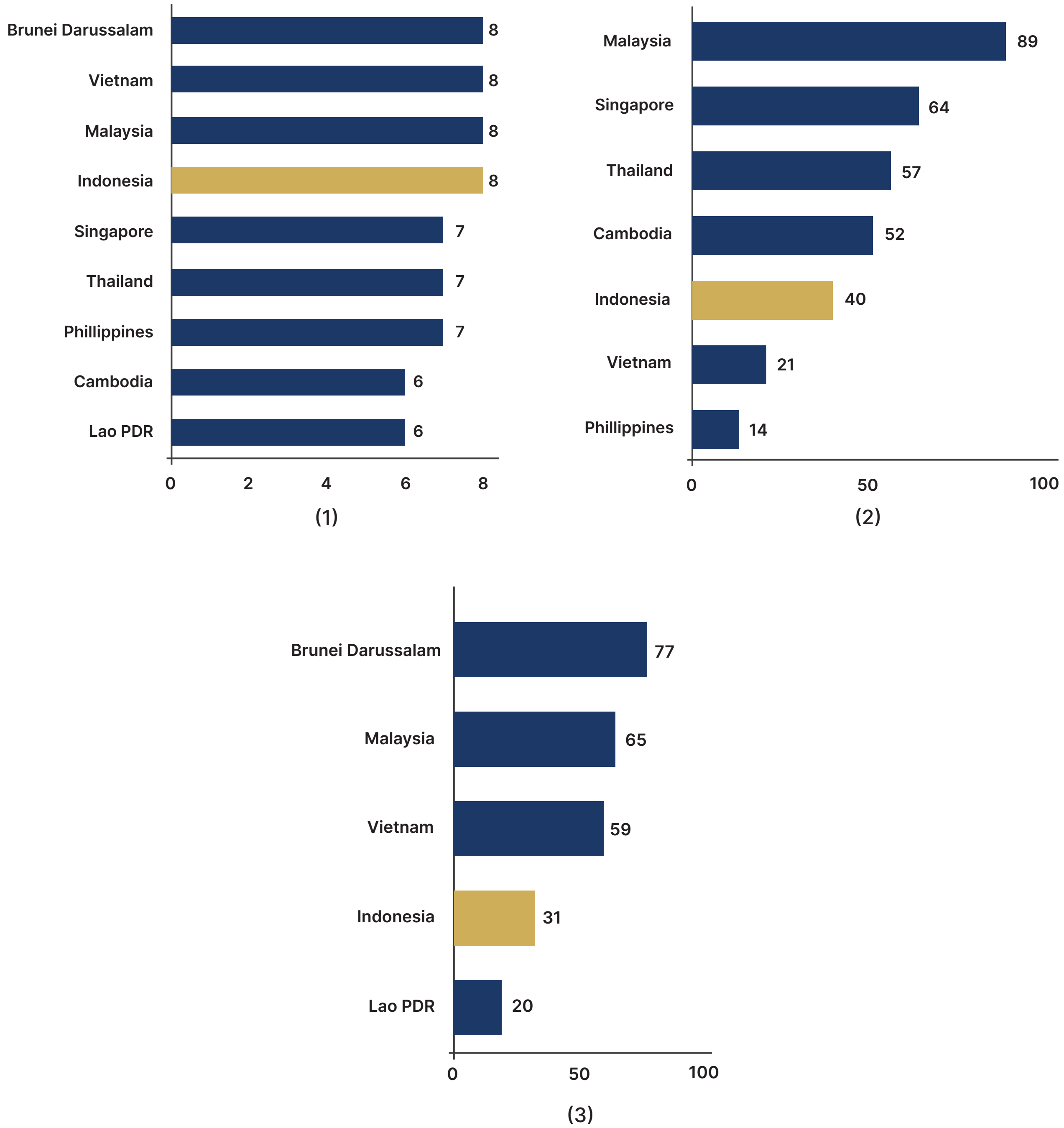
Indonesia's financial sector is crucial for its economic growth, yet it faces significant challenges that impede its efficiency and inclusiveness, especially for SMEs and individuals with limited access to credit. The key challenges identified include fragmented credit information systems, inadequate coverage of credit histories, regulatory gaps in secure transaction frameworks, and an inefficient insolvency regime. The brief aims to provide insights into these issues and propose strategic recommendations for improving financial access, thereby boosting the potential of the financial sector for the unbanked populations and small and medium-sized enterprises.

1. Comparison of Credit Access among ASEAN Countries

Indonesia's access to credit is behind several ASEAN countries, such as Singapore and Malaysia, which have robust credit systems and efficient credit information sharing. Despite a high depth information index, Indonesia faces challenges in the comprehensiveness of credit databases, the efficiency of credit distribution, and inclusiveness in credit systems. This impacts the ease of accessing credit, especially when compared to countries with more developed systems.

[5] World Bank and Indonesian Business Council Discussion, 25 January 2024

FIGURE 42 (1) Depth of Information Index (0-8), ASEAN 2020. (2) Credit Registry Coverage (% of adults), ASEAN 2020. (3) Credit Bureau Coverage (% of adults), ASEAN 2020.



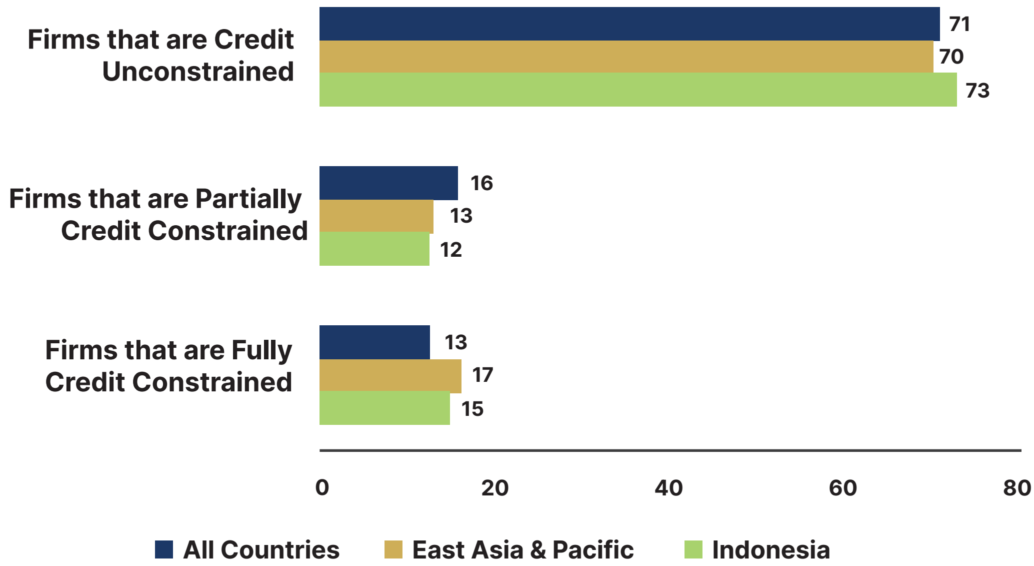
Source: World Bank (2023)

2. Challenges in Credit Registry Coverage

SLIK and similar credit registries in Indonesia cover only a fraction of potential borrowers, particularly affecting SMEs and the unbanked population. This limited coverage restricts access to credit for significant portions of the economy.

Existing credit registries like SLIK (Sistem Layanan Informasi Keuangan) managed by OJK (Financial Services Authority) cover only a fraction of potential borrowers, particularly in the SME sector and among unbanked populations (about 30%).

FIGURE 43 Access Credit as Constraint for Firms in Indonesia, 2023.



Source: World Bank (2024)

3. Fragmented Credit Information Systems

The primary sources for banking credit scoring in Indonesia are SLIK (managed by OJK) and private credit bureaus like LPIP. SLIK serves as a central repository of formal sector borrowers' credit histories, while private bureaus supplement this with data from non-traditional sources, including peer-to-peer lending platforms. However, Indonesia's credit information ecosystem is fragmented, with data dispersed across different databases and authorities, leading to inefficiencies and limited coverage.

TABLE 13 Indonesia Credit Reporting System (CRS)

Credit Reporting System / Credit Information Providers	Banks	MFIs	P2PL		
Credit Registry - SLIK	Yes	Yes	No		
Credit Bureau - LPIP	Yes	Yes	Yes		
Innovative Credit Scoring - ICS	Yes	Yes	Yes		
Other data Providers/sharing platform:				**LPIP**	**ICS**
Fintech Data Center	No	No	Yes	No	No
RAPINDO	No	Yes	No	No	No
TELCO	No	No	No	No	Yes
E-Commerce	No	No	No	No	Yes
BPJS and Utility Bills	Unclear	Unclear	Unclear	Unclear	Unclear

Source: World Bank (2024)

4. Reliance on Traditional Collateral

Indonesian banks heavily rely on traditional collateral (real estate, fixed assets), which is often inaccessible to SMEs and individual entrepreneurs. That happens because the legal framework for recognizing movable goods as collateral is limited. This reliance limits the potential for diverse and innovative lending practices.

5. Inefficient Insolvency and Bankruptcy Processes

Inefficiencies in the judicial process and outdated insolvency laws lead to lengthy and uncertain recovery processes, deterring creditors and investors.

Therefore, Indonesia could implement policies below to address credit information and collateral issues:

1. **Unified Credit Information System**
   Develop a centralized, online, and integrated credit information system. This system will consolidate data from various sources like SLIK, private credit bureaus, and alternative data sources, including fintech platforms. It should encompass all movables security interests, aiming for broader coverage, easier access for lenders, and a supportive environment for Non-Deposit-Taking Lenders (NDTLs). This approach streamlines secured lending and enhances transparency in the lending industry, particularly in movables finance.

2. **Implement Changes to the Personal Data Protection Law to Expand Credit Registry Coverage**
   Expand the coverage of credit registries to encompass Small and Medium Enterprises (SMEs) and participants in the informal sector. Additionally, the inclusion of alternative data sources like telecommunications, utility payments, and e-commerce transactions should be considered by ICS companies to develop more comprehensive borrower profiles.

3. **Legal and Regulatory Reforms for Movable Collateral**
   Revise legal frameworks to recognize a wider variety of movable assets as collateral, such as inventory, accounts receivable, and intellectual property. This reform requires amending existing laws, creating a clear, effective, efficient, and unified legal framework for secured transactions. It also supports the creation of a central, single, online, notice-based Registry covering all movables security interests and fosters an effective judiciary that comprehends the nature of movables business.

4. **Streamlining Insolvency and Bankruptcy Processes**
   Overhaul the current insolvency and bankruptcy framework to be more efficient and less time-consuming. Establish clear guidelines and timelines for asset liquidation and debt recovery. This step will support a robust and active lending industry and create a more secure and predictable environment for secured transactions.

5. **Capacity Building and Awareness**
   Implement extensive training and awareness programs for financial institutions, relevant government bodies, industry associations, and borrowers. These programs should emphasize the importance of alternative data and movable collateral in credit decisions, understanding the movables financing mechanisms, and the changes in legal frameworks and secured transactions practices.

6. Fostering Public-Private Partnerships

   Promote collaboration among government, financial institutions, and fintech companies to develop innovative credit scoring models and lending practices. This partnership aims to create an ecosystem that is inclusive, efficient, and supportive of electronic finance platforms linking up value chain actors.

7. Regular Monitoring and Evaluation

   Establish a system for ongoing monitoring and evaluation of both the credit information system and regulatory reforms. This will ensure that the systems adapt to changing market needs and remain effective in enhancing access to finance, particularly in the context of secured transactions involving movable assets.

In conclusion, addressing the challenges in Indonesia's financial sector, particularly regarding fragmented credit information systems, restrictive collateral frameworks, and inefficient insolvency processes, is imperative for economic development. Implementing reforms to enhance data interconnectivity, broaden the legal recognition of movable assets as collateral, and streamline insolvency procedures will significantly improve access to credit, especially for SMEs and entrepreneurs. This transformation requires collaborative efforts from government, financial institutions, and regulatory bodies. Such comprehensive changes are vital to fostering a more robust, inclusive, and competitive financial environment, ultimately driving Indonesia's economic growth and stability.

BOX II. International Experiences with Innovative Credit Scoring

Indonesia's Innovative Credit Scoring (ICS) landscape is at a pivotal stage, with rapid growth driven by the surge in digital banking and peer-to-peer (P2P) lending platforms since 2015. This growth is in response to addressing the financial needs of the significant unbanked (51%) and underbanked (26%) populations, particularly in rural areas. The adoption of ICS has notably advanced financial inclusion, enabling credit access for micro, small, and medium-sized enterprises (MSMEs), which constitute more than 64 million businesses and contribute to 97% of domestic employment.

The Indonesian Financial Services Authority (Otoritas Jasa Keuangan, OJK) has taken steps to regulate this emerging sector through Regulation No. 77/POJK.01/2016 and Regulation No. 13/POJK.02/2018, aimed at outlining operations requirements for P2P lending and digital finance innovation. The establishment of the OJK Innovation Centre for Digital Financial Technology (OJK INFINITY) further underscores the government's commitment to nurturing the fintech ecosystem, including ICS.

However, the ICS sector's growth is hampered by significant challenges:

- Data Privacy and Protection:

  The extensive use of alternative data raises concerns over privacy breaches and data security. Notably, Indonesia has experienced critical data breaches, underscoring the vulnerability of consumer data to cyber threats.

- Regulatory Clarity:
  Despite OJK's efforts, the ICS industry faces regulatory uncertainties, particularly around the use and governance of alternative data, cybersecurity measures, and the protection of consumer rights.

- Risk of Discrimination:
  The reliance on AI and machine learning for credit scoring introduces risks of reinforcing existing socioeconomic biases, potentially marginalizing vulnerable groups.

- Cybersecurity Threats:
  With the digital nature of ICS, there's an increased risk of cyberattacks, necessitating robust cybersecurity measures to protect consumer data.

Other Country Case Studies

I. China (Government Administered, Centralized Mode)

- Dual Concept of Credit Scoring:
  In China, credit scoring encompasses both financial creditworthiness and "social" creditworthiness, with the latter integrating a broader assessment of individual behavior and trustworthiness.

- Social Credit System (SCS):
  China has implemented a Social Credit System alongside traditional financial credit scoring, involving extensive data collection (financial transactions, social behavior, legal compliance, and government interactions) and sharing among various stakeholders, including government agencies and private companies.

- Excessive Data Use and Transparency Issues
  The Chinese approach to credit scoring has raised concerns over excessive use of data, lack of transparency, and potential for privacy violations due to the intertwined relationship between data collectors and the state.

- Government Involvement:
  The Chinese government plays a significant role in data collection and usage, leading to conflicts of interest between its role as a regulator and a participant in the credit scoring system.

- Impact on Consumers:
  Consumers face potential restrictions based on their social credit scores, affecting their ability to access services and participate in certain activities.

- Regulatory Challenges:
  The system's complexity and lack of clarity around data protection and privacy have posed significant challenges, with few mechanisms in place to hold data controllers accountable for violations.

II. US (Private Sector-Led Model)

- Private Sector Dominance
  Unlike China, the U.S. credit scoring system is primarily dominated by private interests, with three major credit bureaus (Equifax, Experian, and TransUnion) providing most credit reporting services.

- Use of Alternative Data:
  U.S. credit scoring increasingly incorporates alternative data, including phone bills, tax data, and rent payments, to provide a more comprehensive view of creditworthiness.

- Regulatory Framework:
  The U.S. has established legal mechanisms to ensure fair credit reporting and protect consumer privacy, such as the Fair Credit Reporting Act (FCRA) and the Equal Credit Opportunity Act.

- Challenges with Discrimination:
  Despite regulatory efforts, concerns persist about discriminatory lending practices, particularly impacting minority and low-income populations due to systemic biases in data and algorithms.

- Innovative Credit Scoring Models:
  New players in the ICS market offer alternative credit scoring using AI and machine learning, challenging traditional credit bureaus and introducing more inclusive financial services.

- Legislative and Ethical Considerations:
  Ongoing debates and legislative efforts, such as the Algorithmic Accountability Act, aim to address the complexities of automated decision-making systems and ensure transparency and fairness in credit scoring.

Indonesia has the opportunity to foster the growth of Innovative Credit Scoring (ICS) by implementing recommendations that strike a balance between innovation, consumer protection, data privacy, and financial inclusion. Among these recommendations are:

I. Robust Data Protection Framework

- Legislation Specificity:
  IEstablish and enforce a comprehensive data protection law in Indonesia, specifying rules for data collection, processing, and sharing, with stringent regulations on data consent, sensitive information anonymization, and cross-border data transfer to protect consumer privacy. Adopt regulatory guidelines for alternative data operations, following the U.S. model, to ensure fair, non-discriminatory, and empirically validated credit scoring models in accordance with the U.S. Equal Credit Opportunity Act.

- Consumer Rights Enhancement:
  Ensure consumer-friendly access to data, correction of inaccuracies, and consent revocation, with reporting mechanisms for data misuse and remedies. Learn from challenges in China's Social Credit System and enhance Indonesia's data protection laws, requiring explicit consent for data collection, limiting data sharing without consent, and imposing severe penalties for data breaches to safeguard consumer privacy.

II. Transparent and Fair Credit Scoring

- Algorithm Disclosure:
  Require ICS providers to transparently disclose credit scoring determinations, including algorithm summaries while safeguarding proprietary information. Adopt a framework akin to the U.S. Fair Credit Reporting Act in Indonesia to give consumers access to their data, understanding of credit score calculation, and the ability to dispute inaccuracies, fostering trust in the credit scoring system.

- Bias Mitigation:
  Create a framework to audit AI models for bias and discrimination, including third-party audits if needed. Implement measures, similar to the U.S., to prevent algorithmic biases in lending practices by mandating regular audits and corrective actions by ICS providers to ensure fairness, especially for underserved populations and minorities.

- Consumer Education:
  Launch educational campaigns to inform consumers about how credit scores are determined and their implications on access to financial products. This should include guidance on improving creditworthiness under the ICS model.

III. Regulatory Sandbox Enhancement

- Dynamic Testing Environment: Create an adaptable regulatory sandbox that evolves with new technologies and market requirements, with periodic reviews and lessons incorporated. Follow models from established economies like the US to foster innovation in credit scoring while maintaining strong consumer protection, helping to identify and mitigate risks in new scoring models before widespread use.
- Collaborative Innovation: Encourage collaboration within the sandbox among fintech companies, traditional financial institutions, and technology providers to explore synergies and develop holistic solutions that address broader financial inclusion challenges.

IV. Cybersecurity and Data Integrity

- Standards and Certification: Introduce cybersecurity standards specific to the fintech sector, requiring ICS providers to adhere to these standards. Implement a certification process for fintech products and services that meet these standards, promoting trust among consumers.
- Incident Response Protocols: Mandate the development of robust incident response plans for data breaches, including immediate notification to affected individuals and regulatory bodies. Establish clear penalties for non-compliance to incentivize stringent cybersecurity practices.

V. Financial Literacy and Consumer Empowerment

- Targeted Programs Create financial literacy programs for .diverse population segments, emphasizing digital financial services and ICS risks and benefits, using local languages and cultural relevance. Launch consumer education initiatives explaining credit scoring rights and data usage, including public awareness campaigns and educational resources, enhancing financial literacy and data privacy understanding.
- Digital Literacy Integration: Integrate digital literacy into financial education programs to equip consumers with the skills needed to navigate the digital financial landscape safely and effectively.

VI. Multi-Stakeholder Engagement

- Regular Dialogue: Create a lasting platform for dialogue among ICS stakeholders (fintech, advocacy groups, academia, government) to exchange ideas and propose regulatory changes. To prevent issues like China's Social Credit System, establish an independent body to oversee the ICS industry, ensuring data protection, algorithm fairness, and addressing consumer concerns.
- Best Practices and Learning: Promote the sharing of best practices, lessons learned, and research findings among stakeholders to continuously improve the ICS framework. This could involve partnerships with international organizations and other countries to learn from their experiences.

VII. Addressing Socioeconomic Biases

- Inclusive Credit Models:
  Encourage the development of credit scoring models that consider the socioeconomic diversity of Indonesia. This includes exploring non-traditional data sources that can provide a more comprehensive view of a consumer's creditworthiness without introducing bias.

- Monitoring and Enforcement:
  Implement a system for ongoing monitoring of credit scoring practices for bias and discrimination. This should include the ability for regulators to enforce corrective actions and, if necessary, sanctions against ICS providers that fail to address biases in their models.

E. Enabling Sales of NPL to AMC to Mitigate the NPL Risk and Improve Formal Financial Institutions' Appetite to Lend to MSMEs

Throughout the covid period, the NPL has been managed below 3% with the implementation of OJK's loan restructuring relaxation and formation of additional loan loss provision. The Loan at Risk, however, shows the true color of the portfolio quality that increased during the covid to 23.4% and gradually reduced post pandemic to 12.6%. The LLP (Loan Loss Provision)/NPL ratio increased from 181,4% in December 2020 to 206.2% in July 2023.

This value is higher than pre-pandemic levels, driven by the implementation of IFRS9 and OJK Regulation No.17/2021. The LLP/LaR ratio in the banking sector has exhibited a consistent upward trend, going from 23.7% in December 2020 to 41.1% in June 2023. This increase slightly exceeds the pre-pandemic ratio of 39.5%, primarily attributed to credit restructuring related to COVID-19.

The common structure being used in Indonesia is where the ultimate shareholder takes the responsibility of taking out and manage the NPL formed by the Bank. However, there should be an enhancement to this process by opening up options such as using AMC to manage NPL. Because there are more advantages from centralized management for NPL in AMC such as, formation of secondary market, business efficiency, etc.

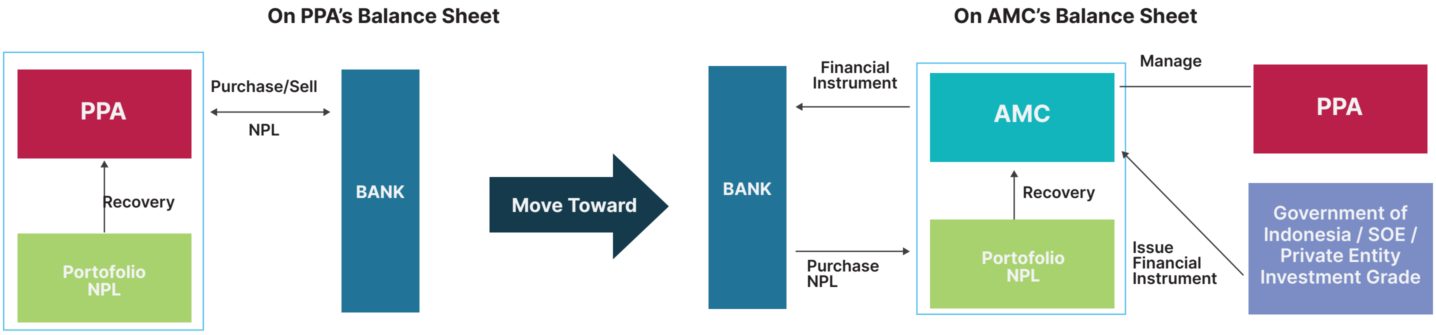
In 2004, the Indonesian Bank Restructuring Agency (IBRA) has transformed into PT Perusahaan Pengelola Aset (PPA). PPA has three business pilar and mandated as the National Asset Management Company (NAMCO): Indonesian SOEs Restructuring, Non-Performing Loan (NPL) Management, and Special Situations Fund (SSF) for SOE ecosystem. PPA works together with both state-owned and private banks in handling NPL and improving the financial capacity of the Bank's debtor. NPL portfolio management is carried out through a proper due diligence and measured risk management.

PPA has successfully done two securitization NPL assets of private Indonesian Banks in 2021 and 2022, which are Bank Muamalat and Bank Bukopin. Bank Muamalat, transformed into a healthy bank. PPA manages NPL assets through an off-balance sheet scheme. PPA has received national and international awards for this new innovation because it can be implemented in other developing countries.

Next, KB Bukopin resolved NPLs worth IDR1.3 trillion with an asset swap scheme, which could improve the company's financial position (Figure 44). The KB Bukopin was able to decrease its NPL ratio and the LAR ratio through this transaction.

The issuance of this Financial Instrument is expected to help KB Bukopin remain consistent in managing low-quality assets.

FIGURE 44 Indonesia's NPL Asset Swap Innovation by PT PPA that Got International Recognition



PPA acquires a portfolio of Non-Performing Loans (NPLs) from a Bank, funded through a bank loan

PPA acquires a Bank's of Non-Performing Loan (NPL) portfolio through an Asset Management Company (AMC) in exchange for a long-term financial instrument (Asset Swap)

Source: PT PPA (2023)

The challenge for NPL management through AMC model in Indonesia especially lies in the absence of strong and unitary NPL resolution framework. For SOEs, there are specific challenges that prevents State-Owned Banks to transfer assets: (1) SOE banks are not allowed to sell NPL below book value (at par), (ii) Time required to find an issuer, negotiate and process a structured financial instrument is unclear, while Size of issuance will be capped at legal lending limit (LLL) of the bank, (iii) Requirement for approval or opinion from relevant stakeholders at least 5 external stakeholders involved in this transaction (OJK, BPK, BPKP, Jamdatun, KBUMN, etc), and (iv) Bank must prepare a comprehensive study, which consequently demands time for the preparation of internal documents, and (v) Limited investor in NPL secondary market given inadequate NPL size.

Based on country experiences, to build effective market of NPL management, there needs to be a strong NPL resolution framework and political buy in. A mixture between the commencement of specific regulation on (i) collateral legal acknowledgement, clarity of procedures (from types of allowed procedures and standardized length of procedures) of debtor's insolvency and enforcement of collaterals to ensure risk mitigation for NPL investors, asset owners, an incentive for transfer taxes, (ii) increased capacity of banks, and (iii) establishment of national AMCs are strongly encouraged.

BOX III. Strategies For Developing Asia's Nonperforming Loan Markets and Resolution Mechanisms[6]

A healthy financial system is crucial for economic growth and stability. However, the accumulation of nonperforming loans (NPLs) poses a significant risk to the financial health of banks and the broader economy. Addressing NPLs requires a multifaceted approach that includes enhancing the capacity of institutional investors to participate in NPL resolution. A mandatory savings scheme, by directing savings into institutional investment, can play a pivotal role in this context.

The buildup of nonperforming loans (NPLs) remains a significant challenge across various economies in Asia, with diverse impacts on the financial health of banks and the broader economic landscape. NPL ratios exhibit considerable variance across countries, with some showing persistently high levels, particularly in Central, West, and South Asia. These high NPL ratios compromise bank profitability, limit credit growth, and stifle economic activity by constraining banks' ability to lend. Despite the presence of NPL resolution mechanisms and markets in some Asian economies, these markets are often illiquid and underdeveloped.

The lack of development in these markets is attributed to several factors, including information asymmetry between sellers (banks) and buyers (investors), regulatory and tax impediments, and inefficiencies in debt and collateral enforcement. These challenges are compounded by the relatively limited capacity of institutional investors to actively participate in the NPL market, due in part to a lack of robust funding bases and the necessary market infrastructure to facilitate efficient transactions.

Enhancing Legal and Regulatory Frameworks

Reform Efforts in the Republic of Korea and China: Drawing from the experiences of the Republic of Korea and China, legal and regulatory reforms are crucial. The Republic of Korea, following the Asian financial crisis, undertook comprehensive legal and judicial reforms to facilitate the operation of its asset management company (KAMCO), leading to the development of a vibrant NPL market. Similarly, China's efforts to revamp its legal system for insolvency resolution and debt enforcement have made significant strides in resolving NPLs by enhancing the efficiency of its public asset management companies (AMCs) and fostering secondary NPL markets.

Developing Market Infrastructure

NPL Trading Platforms in Europe: Inspired by the European Data Warehouse, establishing NPL trading platforms can. significantly reduce information asymmetry, a major impediment to NPL market development. These platforms, by providing validated and transparent data on NPLs, can enhance market liquidity and facilitate transactions.

Fostering Regional Collaboration

Regional Frameworks and Supervisory Colleges: The Asian experience underscores the importance of regional cooperation in addressing cross-border NPL issues. Drawing lessons from European initiatives like the Vienna Initiative, which coordinated decision-making among stakeholders to safeguard financial stability, Asia could benefit from establishing regional frameworks and supervisory colleges for enhanced cross-border supervision of systemically important financial institutions.

[6] Lee, J., Park, C.-Y., Park, D., & Rosenkranz, P. (2023). Strategies for Developing Asia's Nonperforming Loan Markets and Resolution Mechanisms. Development Asia

Directing Savings into Institutional Investment

Mandatory Savings Schemes: Implementing mandatory savings schemes, similar to those in Malaysia and Singapore, where a portion of savings is directed into long-term investment vehicles, can provide a stable funding base for institutional investors. These funds can then be channeled into investments in distressed assets, including NPLs, thereby enhancing the capacity of institutional investors to participate in NPL resolution efforts.

By addressing these key areas, based on the experiences and strategies outlined in the paper, Asia can develop a more robust infrastructure for NPL resolution, increase the capacity of institutional investors, and ultimately contribute to financial stability and economic growth.

F. Continuously Improve Sovereign Rating[7]

The global economy, characterized by interconnected financial markets and cross-border investments, places immense significance on sovereign credit ratings. These ratings are an assessment of a country's creditworthiness. This is in line with Pratiwi (2015) which found that there are two significant determinants for sovereign bond yield, which are default (sovereign ratings) and non-default determinant (global liquidity). These ratings are not mere indicators of national financial health but are pivotal in shaping a country's access to international capital markets and the terms of that access. The study titled "The Determinants of Sovereign Credit Ratings: Indonesia and Its Neighborhood Countries 1998-2016" delves into this crucial aspect of international finance by examining the factors influencing the sovereign credit ratings of Indonesia and its neighboring countries - Malaysia, Thailand, and the Philippines - over 18 years.

The Importance of Sovereign Credit Ratings

Global Market Influence: Sovereign credit ratings significantly impact a country's position in the global market. Higher ratings usually translate to lower borrowing costs and increased attractiveness to foreign investors.

- Economic Implications:

  These ratings directly correlate with a country's economic trajectory, influencing foreign direct investment (FDI) inflows, the cost of debt, and the overall economic stability.

- Political and Economic Risks:

  Ratings offer insights into the political and economic risks associated with investing in a particular country, thereby influencing investor decisions.

The period from 1998 to 2016 saw significant changes in the sovereign credit ratings of Indonesia and its neighboring countries (Malaysia, Thailand, and the Philippines). This period was marked by economic upheavals, such as the 1998 Asian financial crisis and the global financial crisis of 2008, impacting these countries' economic indicators and, consequently, their credit ratings.

[7] Solikin, A., & Michel, G. (2019). The Determinants of Sovereign Credit Ratings: Indonesia and Its Neighborhood Countries 1998-2016. Agregat: Jurnal Ekonomi Dan Bisnis

I. Indonesia's Credit Rating

Indonesia has experienced volatile credit ratings, generally lower than its neighbors. Despite some improvements, it has struggled to achieve investment-grade status from major rating agencies like Standard & Poor's (S&P) during this period. Other rating agencies, such as Fitch, have awarded investment grade ratings for Indonesia since 2012, while Moody's has awarded it since 2011.

II. Comparative Stability in Neighboring Countries

Malaysia, Thailand, and the Philippines generally have more stable and favorable credit ratings than Indonesia. Mean sovereign credit ratings lie between 2.42 and 2.76, out of a maximum of 4. It means that mostly Indonesia and the neighborhood countries have sovereign credit ratings of 2 or 3. Since rating 3 means the minimum base for investment grade, it implies that these countries are under investment grade.

III. Influence of Macroeconomic Indicators

The study reveals that sovereign credit ratings are intricately linked with macroeconomic factors. Positive fiscal balance, current account surplus, and a strong financial freedom index correlate with higher ratings. Conversely, high external debt and unfavorable real exchange rates are associated with lower ratings.

IV. Agency-Specific Criteria

Different rating agencies prioritize various factors, leading to variations in ratings across S&P, Moody's, and Fitch. Table 14 shows the significance and sign of variables in all three models. A positive sign indicates a direct correlation with the credit rating, while a negative sign suggests an inverse relationship. owever, there is a unique situation with the SAVGDP variable, where it has opposite signs in the S&P and Fitch models due to differences in economic development levels. Chodnicka (2015) discovered that middle-income countries in Europe have positive signs for this variable, while low-income countries have negative signs.

TABLE 14 Rating Agencies Criteria Variables Significances

Variables	Definition	S&P	Moody's	Fitch
CATGDP	Coefficient for fiscal balance and current account deficit to GDP	**		**
DEF	Inflation as calculated from GDP deflator			
EXDGNI	External debt to gross national income		**	**
FHI	Freedom Index	**	**	**
GDPPC	Gross domestic product per capita	**	**	**
REXR	Real exchange rate	*	**	
SAVGDP	Gross domestic saving to GDP	**		**

**=sig. 1%
* =sig. 5%

Source: Solikin, A., & Michel, G. (2019)

V. Regional Economic Integration and Globalization

The increasing integration of Southeast Asian economies and their participation in global markets has made sovereign credit ratings even more critical. These ratings significantly impact foreign direct investments and the cost of debt, influencing the region's overall economic growth and stability.

Indonesia is presented with a multifaceted policy challenge that encompasses several critical objectives. To achieve a balanced fiscal position, the country must prioritize an increase in its current account while concurrently reducing external debt. It is imperative to uphold the freedom index, foster growth in GDP per capita, and foster an appreciation in real exchange rates. However, it is important to exercise caution when evaluating the impact of gross domestic savings to GDP, as its influence on sovereign credit ratings remains ambiguous.

Furthermore, Indonesia needs to explore additional independent variables, such as political stability and corruption control as studied by Kalloub et al. (2018). It is important to emphasize the significant impact of political stability and corruption control on sovereign credit ratings.
The research highlights that countries with higher political stability tend to have better credit ratings, illustrating the positive correlation between a stable political environment and financial credibility. Furthermore, the study underscores the role of corruption control in this dynamic. Effective corruption control, signifying reduced corruption and increased transparency, is also positively associated with higher credit ratings. These findings are crucial in understanding how macroeconomic and political factors influence a country's creditworthiness, especially in Basel III adoption.

By focusing on these areas, Indonesia can work towards enhancing its sovereign credit ratings, thereby reducing borrowing costs, attracting more foreign investments, and promoting sustainable economic growth.

At the end, IBC underscores the importance of macroeconomic stability and financial freedom in enhancing sovereign credit ratings. By addressing these key determinants, Indonesia and its neighboring countries can improve their global credit standing, attract more FDI, and foster economic growth.

Irfan Hakim, Unsplash

G. Promoting Banks Consolidations[8]

Banks consolidation is an area that can be explored to improve banks competitiveness. There is an interesting way to go about banking consolidations, as it may help banks navigate their business in the middle of Volatility, Uncertainty, Complexity, and Ambiguity (VUCA) era. Banks needs to adapt to these challenges through consolidation and the active role of banking owners. Strong ownership and commitment are crucial for banks to remain competitive and resilient.

VUCA, representing Volatility, Uncertainty, Complexity, and Ambiguity, highlights the challenging landscape of the banking sector, especially post-COVID. Since 2016, banks have witnessed a downward trend in profitability, exacerbated by the pandemic's effect on loan defaults and the surge in restructured loans.

Volatility in the sector is evident through the highly fluctuating financial markets, influenced by various economic conditions and issues, such as the movements in the Composite Stock Price Index (IHSG) and the USD/IDR exchange rate. **Uncertainty** arises not only from competition among domestic banks but also from international players, with a stark disparity in market capitalization, as exemplified by Singapore's MIM reaching 150 trillion compared to Indonesia's 10.493 trillion, highlighting the vast differences between large and small banks.

The **complexity** of the Indonesian banking sector is underscored by the country's diverse population, varying in age, education, culture, technological proficiency, and geographical spread, necessitating banking products and services that cater to everyone. **Ambiguity** has been further fueled by the COVID-19 pandemic since early 2020, leading to drastic reductions in customer visits to bank branches and raising questions about the future of banking strategies in the new normal, such as maintaining physical branches versus fully transitioning to digital platforms and the timing for issuing loans to pandemic-impacted sectors.

To anticipate and adapt to these VUCA elements in the banking industry, continuous change on both global and national levels underscores the importance of industry consolidation and committed ownership. The era of VUCA pushes for consolidation, emphasizing the strengthening of structure, IT, resilience, and competitiveness in the banking industry, adequate business processes and infrastructure, and financing needs to support sustainable development. This also includes the role of owners in development commitment and capital capability, as well as commitment to rescuing operations.

The Roadmap for Indonesian Banking Development (RP21) for 2020-2025 reflects these challenges, where consolidation efforts are integral to achieving a resilient, competitive, and contributory banking sector, as outlined in RP21.

[8] Webinar Discussion: "Consolidation and the Role of Banking Owners in Facing the VUCA Era."

First there is Technological Disruption. The rise of fintech, neobanks, and digital banking platforms has intensified competition. Traditional banks urgently need to innovate and embrace digital transformation to remain relevant. Second, there is **Changing Consumer Behaviors.** The pandemic has accelerated the shift from offline to online banking, with customers, especially millennials, preferring digital banking services. Next, there is **Regulatory Pressures.** Regulators like OJK have proactively enforced policies to strengthen the banking sector, including setting higher capital requirements and encouraging consolidation. Last is global trends. The banking sector is not isolated from global economic trends. The shift towards technology and sustainability in global markets influences local banking practices and strategies.

With that above, banks need to adapt, for example with consolidations strategy. However, such condition needs to be equipped with other strategies to result in financial efficiency, such as digital transformation, strategic partnership and global alignment, **Enhanced Regulatory Framework and Support, Focus on Sustainable and Inclusive Banking, Focus on Sustainable and Inclusive Banking, Risk Management and Resilience Building.**

I. Capital Adequacy and Consolidation

In the current banking landscape, characterized by increasing risks and diminishing profitability, it is crucial for banks, especially smaller and family-owned institutions, to actively engage in mergers and acquisitions as a survival strategy. This approach is not only about staying afloat but also about scaling up to strengthen their capital base and improve their competitive stance.

The regulatory requirement to reach a minimum capital of 3 trillion IDR by 2022 should be met in a phased approach, allowing banks adequate time to comply without jeopardizing their operational stability. Such a strategy is anticipated to create a more robust banking sector, better equipped to handle economic variances.

To adapt to these changes, banks need to reinforce their capitalization and implement sound management practices, which are vital for their growth, innovation, and optimal performance in business operations, ultimately benefiting the national economy. The support from controlling shareholders (PSP) is particularly critical in enhancing bank capitalization.

The recommended action plan for banks comprises several essential strategies. First, banks must satisfy their paid-up capital requirements, achievable through deposits from PSP or rights issues. The Financial Services Authority (OJK) advises that capital raised via rights issues should be strategically utilized to enhance bank performance, thereby offering additional value to public shareholders. Second, banks should look for strategic investors through acquisition schemes or by joining larger banking groups as part of Consolidated Banking Groups (KUB). Prospective investors are expected to be committed to the bank's future growth. Additionally, bank owners should perform comprehensive and unbiased evaluations of their banks. Lastly, Regional Development Banks (BPDs) are required to meet the Minimum Core Capital (MIM) requirements.

Although the Banking Payment System (BPS) has set the deadline as 2024, BPDs are urged to create early action plans to achieve the Rp 3 trillion MIM or consider consolidation options like merging with other BPDs. In this process, support from the Ministry of Home Affairs and regional governments is crucial.

II. Embrace and Invest in Digital Transformation

Digital transformation is no longer a choice but a necessity for banks in this era. The shift in consumer behavior towards online banking, especially among the younger generation, necessitates a robust digital infrastructure. Banks should not only digitize their existing services but also innovate digital-only products to compete effectively with FinTech and Neobanks. This transformation should focus on user experience, harnessing the power of data analytics, AI, and mobile technology to provide seamless and personalized banking services.

III. Strategic Partnerships and Global Alignment

Traditional banks should seek strategic partnerships to keep pace with the rapidly evolving global banking landscape. These collaborations, particularly with technologically advanced entities, can provide the necessary impetus for innovation and global alignment. Additionally, fostering a collaborative ecosystem where traditional banks and fintech companies work together can create synergies, blending the strengths of established banking practices with innovative fintech solutions.

IV. Enhanced Regulatory Framework and Support

Regulatory bodies, like OJK, play a pivotal role in shaping the banking sector's response to the VUCA environment. Regulatory frameworks must be continually adapted to reflect the dynamic nature of the banking sector. These adaptations should not only address the challenges but also facilitate and support banks in their digital transformation and consolidation efforts. Clear guidelines, supportive policies, and regulatory foresight that refer to principle-based can significantly ease this transition for banks.

V. Focus on Sustainable and Inclusive Banking

Aligning with global trends, banks should adopt sustainable banking practices, focusing on environmental and social responsibility. This approach will not only enhance their global competitiveness but also fulfill their corporate social responsibility. Simultaneously, banks should strive for inclusive banking, extending their services to the underbanked and unbanked populations. Digital platforms can play a crucial role in this inclusivity, reaching broader demographics and promoting financial literacy and inclusion.

VI. Risk Management and Resilience Building

The VUCA environment demands robust risk management frameworks, particularly in credit and operational areas. Banks must strengthen their risk assessment and mitigation strategies to manage the heightened risks effectively. Developing resilience strategies is also crucial, ensuring banks can withstand economic shocks and recover swiftly. This resilience is key not only for individual banks but for the stability of the entire banking sector and, by extension, the broader economy.

To summarize, in an era of volatility, uncertainty, complexity, and ambiguity, the banking sector's adaptability and proactive strategies are crucial. Banks can navigate these challenges effectively through consolidation, embracing digital transformation, strategic partnerships, and robust regulatory support, ensuring growth and stability in the VUCA era.

BOX IV. Banks Consolidations in Emerging Market Economies[9]

The consolidation of banks in emerging market economies presents a strategic opportunity to enhance competition, efficiency, and systemic stability in the banking sector. Driven by technological innovation, deregulation, and shifts in corporate behavior, bank consolidations are emerging as vital responses to global pressures and banking crises. This brief examines the current landscape of banking industry transformations, recommends policies for encouraging bank consolidations, and discusses the implications for regulatory frameworks and systemic stability.

The banking industry worldwide is undergoing significant transformations due to technological advances, deregulation, and changes in corporate behavior. This evolution is particularly pronounced in emerging market economies, where the potential for further consolidation is substantial. Consolidation efforts, including privatizations, domestic mergers, and the entry of foreign banks, are reshaping the banking landscape, raising important microeconomic and macroprudential questions.

The current landscape of the banking industry in emerging market economies is multifaceted, with several key trends and challenges shaping its evolution. These include:

I. Technological Innovation

The adoption of new information technologies (IT) has been a driving force behind the transformation in the banking sector. Emerging market economies, despite being technologically behind their developed counterparts, are rapidly embracing digital banking, mobile financial services, and fintech innovations. This technological leapfrogging presents both opportunities for efficiency gains and challenges in terms of cybersecurity and the digital divide between different segments of the population.

[9] Hawkins, J., & Mihaljek, D. (2001). The banking industry in the emerging market economies: Competition, Consolidation and Systemic Stability - an Overview. Bank for International Settlements.

TABLE 15 Authorities-Related Provisions in FSOL 2022

	USDC	BAH	GSBCG
Physical Branch	1.07	1.07	1.06
Phone	0.52	0.54	0.55
ATM	0.27	0.27	0.32
PC-Based Dial-Up	0.11	0.02	0.14
Internet	0.01	0.01	0.02

Hawkins & Mihaljek (2001)

II. Regulatory Deregulation and Opening-up

Many emerging economies have initiated financial deregulation and liberalization, dismantled former protective barriers and opening up their banking sectors to foreign competition. This shift has led to increased competitive pressures on domestic banks, forcing them to innovate, improve efficiency, and reassess their business models. The presence of foreign banks has had both positive and negative effects, bringing in capital, expertise, and competition, while also provoking concerns about domestic banks' competitive capabilities and potential repercussions on financial stability.

III. Changes in Corporate Behavior

The adoption of information technology has transformed the banking industry influencing risk management, marketing of financial products, and corporate behavior. It has led to disintermediation, with technology firms and large corporations increasingly turning to capital markets for funding. Small and medium-sized companies face challenges accessing non-bank funding sources. Banks, under pressure to compete, are refining credit risk management, leading to consolidation and the entry of foreign banks. Traditional bank-customer relationships are evolving into more profit-driven models, raising concerns about stability and riskier investments. This shift may lead banks towards fee-based services and greater involvement in capital markets.

IV. Banking Crisis Responses and Industry Consolidation

Emerging markets have faced banking crises due to poor lending and risk management, prompting government interventions to prevent bank runs and credit contractions by temporarily nationalizing distressed banks and later returning them to private ownership or facilitating mergers and foreign takeovers. This has led to consolidation, with larger banks becoming more dominant to enhance efficiency, competition, and reduce fragmentation. Despite this, many small banks persist, struggling with scaling, technology adoption, and regulatory compliance, indicating ongoing consolidation potential.

VIII. Impact of Global Economic Forces

Global economic trends, including fluctuations in commodity prices and interest rates, significantly impact the banking sectors of emerging economies. These external forces can influence credit quality, profitability, and the overall stability of banks. For example, higher global interest rates raise borrowing costs, leading to tighter credit and increased borrower default risks. Commodity price volatility affects repayment abilities of businesses in commodity-dependent sectors.

Therefore, needs to accommodate policies such as:

I. Facilitate Mergers and Acquisitions

- Implement regulatory frameworks and incentives that encourage consolidation, particularly among smaller and less efficient banks.
- Indonesia and Thailand offered financial assistance, regulatory forbearance, and streamlined approvals post-crisis to encourage consolidation.
- Poland and Brazil opened their markets to foreign banks through privatization and liberalization, using these measures as tools for economic stabilization and sectoral efficiency.
- Mexico relaxed restrictions on foreign ownership, inviting significant foreign investment.
- India embarked on a consolidation path for public sector banks, supported by regulatory aid and capital infusion, while Malaysia led a consolidation program with financial incentives for merger-related expenses.
- South Africa adjusted its regulatory framework and liberalized foreign exchange controls to foster a stable and competitive banking environment.

II. Enhance Technological Integration and Innovation

- Implement tax incentives, subsidies, or grants to facilitate banks' investment in digital infrastructure and cybersecurity enhancements. This approach aims to reduce financial barriers for technology upgrades, enabling banks to innovate and improve competitiveness.
- Encourage strategic collaborations between banks and fintech companies to develop innovative financial products and services. Regulatory environments that support such partnerships can accelerate the adoption of new technologies and business models, benefiting the broader financial ecosystem.
- Prioritize training and capacity building in digital banking and cybersecurity. Initiatives could include targeted training programs, partnerships with educational institutions for fintech courses, and investments in continuous professional development, ensuring the banking workforce is equipped for the digital era.

III. Regulate Foreign Bank Entry and Participation

- Liberalize the banking sector to foreign investment with strategic controls. This could involve setting clear guidelines for foreign bank entry, ensuring that foreign banks bring added value in terms of capital, technology, and management practices.
- Encourage joint ventures or strategic partnerships between foreign and domestic banks to facilitate knowledge and technology transfer.
- Example: Foreign banks transformed Poland's banking sector through acquisitions and greenfield investments, introducing capital, innovative practices, and technology, modernizing and intensifying competition.

IV. Strengthen Regulatory and Supervisory Frameworks

- Enhance the capacity of regulatory and supervisory bodies to oversee a more consolidated banking sector.
- Update regulatory standards to align with international best practices, particularly in areas of risk management and capital adequacy.
- Implement robust monitoring systems to identify and address systemic risks promptly.

V. Ensure Competitive Neutrality

- Monitor market concentration and competitive dynamics post-consolidation to prevent excessive market dominance and ensure a level playing field for all market participants, including smaller banks and new entrants.
- In Mexico, the regulatory authorities, after the wave of consolidations that saw significant foreign bank entries, implemented measures to bolster competition by easing entry for new, smaller banks and fintech companies. This strategy aimed to balance the benefits of consolidation with the need to maintain a vibrant, competitive banking ecosystem.

These recommendations aim to provide a data-driven and comprehensive approach to guiding the evolution of the banking sector in emerging markets. They reflect the need for a balanced strategy that promotes efficiency and competitiveness while ensuring financial stability and inclusion.

In conclusion, the consolidation of banks in emerging market economies is a critical step toward creating a more efficient, stable, and competitive banking sector. This process, supported by appropriate policies and regulations, can help these economies navigate the global changes in the banking industry and leverage new technologies and practices for sustainable growth.

BOX V. Mitigating Risks Arising from Banks Consolidation: Case of Chile[10]

The Chilean banking industry has experienced substantial changes since the early 1990s. These changes, including increased penetration, consolidation, and international integration, have significantly altered the structure of the banking sector. This paper reviews the evolution of the Chilean banking industry, focusing on growth, consolidation, and internationalization since 1992, post the 1982-83 banking crisis.

The current landscape of the Chilean banking sector is characterized by three primary trends: increased penetration and efficiency, consolidation, and international integration. These trends have been influenced by a mix of economic stability, regulatory changes, and global market dynamics.

[10] Ahumada, A., & Marshall, J. (2001). The banking industry in Chile: competition, Consolidation and Systemic stability. Bank for International Settlements.

I. Penetration and Efficiency

- **Growth in Penetration:**
  As of 2000, banking loans in Chile amounted to 70% of GDP, while total deposits stood at 61% of GDP. This marks a notable increase from 1990, which was 54% and 47%, respectively. Despite these impressive figures, Chile's financial intermediation levels, compared to global standards, indicate potential for further growth.

- **Improvements in Efficiency:**
  Operating efficiency, measured as the ratio of expenses to the gross interest margin, improved from 61% in 1992 to 58% in 2000. Concurrently, the gross interest margin decreased from 5.4% to 3.6%, suggesting an increasingly competitive environment. These efficiency gains are partly attributed to technological investments and a stable period of economic growth that enforced fiscal discipline among banks.

TABLE 16 Banking Penetration and Efficiency, 1992 - 2000

	Loans (% of GDP)	Expenses (% of operating margin)	Operating matgin (% of total asstes)	Return on Equity (%)
1992	54.0	61.2	5.4	17.0
1993	59.2	58.6	5.5	20.6
1994	56.7	63.8	4.9	19.1
1995	59.9	64.2	4.4	13.9
1996	65.1	63.5	4.5	16.6
1997	70.1	63.2	4.1	14.8
1998	71.5	59.4	4.6	12.4
1999	73.4	58.9	4.0	9.8
2000	70.0	58.3	3.6	12.7

Source: (Hawkins & Mihaljek, 2001)

II. Consolidation

- **Market Concentration:**
  The Herfindahl Hirschman Index (HHI) in the Chilean banking sector rose by 200 points between 1992 and 2000, indicating increased market concentration. Despite this rise, Chile's concentration level remains moderate compared to other small economies. For instance, the market share of the five largest banks (C5) increased from 52% in 1992 to 61% in 2000, whereas in small OECD countries, the C5 market share often exceeds 80%.

- **Trends in Mergers and Acquisitions:**
  The rise in the HHI and C5 in Chile is partly the result of mergers and acquisitions. Notable examples include the mergers of Banco Santander Chile with Banco Osorno and Banco O'Higgins with Banco Santiago in the mid-1990s. These mergers led to significant shifts in market structure, highlighting the role of external growth strategies in the consolidation process.

TABLE 17 Banking Consolidation, 1992 - 2000

	HH Index (total loans)	C5 (loans plus investment)	Private Banking Institutions	Non-banking institutions
1992	704	51.7	35	4
1993	722	51.2	33	4
1994	673	50.9	32	4
1995	731	50.8	30	3
1996	799	55.5	29	3
1997	913	61.0	28	3
1998	922	61.7	28	3
1999	926	62.5	28	1
2000	904	60.8	27	1

Source: (Hawkins & Mihaljek, 2001)

III. International Integration

- **Growth in External Financing:**
  The volume and composition of private sector external financing have expanded significantly. In 2000, external financing accounted for nearly 40% of Chile's GDP, up from around 20% in 1990. This increase reflects a greater reliance on bonds and American Depository Receipts (ADRs) issued by domestic companies.

- **Foreign Bank Participation:**
  As of June 2000, foreign entities controlled 18 out of 28 private banks in Chile, with foreign private banks representing 53% of the financial system's assets. American banks accounted for approximately 30% of this foreign ownership. The presence of foreign banks has been a crucial factor in promoting competition and efficiency within the Chilean banking sector.

TABLE 18 International Integration, 1992 - 2000

	External financing to private sector (% to GDP)	Private investment abroad (% to GDP)	Asset share of foreign banks (% to GDP)	Foreign banking institution
1992	7.1	1.5	20	22
1993	9.9	2.5	19	20
1994	12.9	4.5	20	19
1995	13.2	4.5	22	17
1996	18.0	5.7	27	17
1997	25.6	8.8	29	17
1998	29.9	15.8	32	17
1999	34.9	29.4	53	19
2000	36.2	35.6	56	19

Source: (Hawkins & Mihaljek, 2001)

In summary, the current landscape of the Chilean banking industry is marked by significant advances in market penetration and operational efficiency, a trend towards greater consolidation, and an increasing level of integration with international financial markets. These developments have reshaped the sector, presenting both opportunities and challenges for regulatory authorities and market participants. In response, the Central Bank of Chile has had to adapt its strategies to ensure the stability and efficiency of this dynamic financial system.

Several policy recommendations can be proposed in response to the trends and challenges identified in the Chilean banking sector. These suggestions are aimed at enhancing the banking industry's stability, efficiency, and competitiveness in the face of increased consolidation and international integration.

I. Strengthening Regulatory Frameworks

- Enhanced Supervision of Consolidation:

  Given the rise in market concentration, with the HHI increasing by 200 points between 1992 and 2000, there is a need for more stringent supervision of mergers and acquisitions. The Central Bank and the Superintendency of Banks should work together to monitor these activities closely, ensuring they do not compromise market competitiveness or financial stability.

- Adapting to International Standards:

  Align Chilean banking regulations with international best practices, such as the Basel III standards, to improve risk management and capital adequacy. This alignment is crucial in a sector where foreign banks control 53% of the financial system's assets.

II. Promoting Competitive Equity

- Ensuring Fair Competition:

  Chile is promoting competitive equity between domestic and foreign banks by enhancing its regulatory framework, implementing stringent supervisory practices, and enabling both sets of banks to engage equally in sophisticated financial activities, including futures, forwards, and swaps transactions, as well as international operations. This approach ensures that domestic banks can compete on equal footing with their foreign counterparts, aiming to prevent market dominance concerns and foster a balanced competitive environment.

- Incentivizing Technological Advancements:

  Encourage investments in technology to increase efficiency and competitiveness. With operating efficiency improving from 61% to 58% between 1992 and 2000, further technological investments could enhance this trend, benefiting both large and small institutions

III. Fostering International Financial Integration

- Capital Market Development:

  Chile is facilitating the development of deeper and more diverse capital markets by integrating its financial market internationally, which includes removing capital account transaction restraints, eliminating reserve requirements, allowing the repatriation of foreign investments without a mandatory waiting period, introducing peso-denominated foreign debt instruments, expanding the use of interest rate and credit derivatives for hedging purposes, and increasing the percentage of international investment permitted for pension funds and insurance companies.

- Cross-Border Collaboration:
  Strengthen cross-border regulatory cooperation to manage the risks associated with the international activities of Chilean banks. This is crucial in a context where Chilean banks increasingly engage in commercial activities in the region.

IV. Enhancing Financial Inclusion and Innovation

- Support for Small and Medium Enterprises (SMEs):
  Develop targeted programs to improve SMEs' access to credit, particularly those in regions or sectors less served by the major banks. As consolidation increases, there is a risk that smaller businesses may find it harder to secure financing.
- Innovation in Financial Services:
  Encourage innovation in financial products and services to cater to underserved market segments. This includes fostering fintech development, which can offer more tailored and accessible financial solutions.

V. Improving Monetary Policy Framework

- Responsive Monetary Policies:
  The Central Bank should continue to refine its monetary policy tools to respond effectively to the challenges posed by a more consolidated banking sector. This includes maintaining an effective floating exchange rate regime and using open market operations strategically.

In Conclusion, The Chilean banking sector, while experiencing less significant consolidation compared to other markets, is pivotal for the nation's financial stability. This sector is marked by heightened efficiency, consolidation, and global integration, necessitating a dynamic regulatory strategy. The Central Bank of Chile plays a vital role in adapting its policies to address the risks tied to these transformations. It is imperative that future policies not only accommodate market dynamics and technological progress but also maintain equilibrium between domestic and global financial activities. These policies aim to foster a stable, competitive, and inclusive financial landscape in line with Chile's overarching economic objectives. This approach is essential for safeguarding systemic stability while promoting a healthy competitive banking environment.

Chapter VI Conclusion and Suggestions

Based on literature, in-depth interview that went from 1 November 2023 to 13 February 2024, report 1 has concluded that there are 7 policy areas to consider, in order to address structural challenges in financial development in Indonesia. Those policy ideas are (1) product innovations such as infrastructure project finance development, (2) tax innovations to create optimum playing field between financial and non-financial savings instruments, (3) promoting non-bank financial institutions by reforming the current program and providing financial incentives to increase coverage, (4) enhancing credit information and collateral regulation to open access for the unbanked MSME, (5) promoting banks consolidations, (6) increasing sovereign rating by maintaining fiscal and macroeconomic management, and lastly by (7) enabling sales of NPL to AMC to improve NPL management.

These 7 policy ideas have their own caveats as explained in chapter V. The caveats are especially due to the relatively new issues which leaves policy makers with limited room for evidence-based policy. Given these circumstances, report suggests that there should be in-depth executive discussions with stakeholders such as Government, authorities, and practitioners, particularly IBC members to seek for qualitative findings that could better adjust the recommendations to be more effective and implementable.

Besides, further empirical studies to refine and develop these ideas are also needed. The final report should complete the recommendations including how the current regulation should change to accommodate the policy ideas. Models like new omnibus law on improving competitiveness also could be considered as umbrella reform to implement these 7 policies to improve finance competitiveness.

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