NON-BANK FINANCE

MEASURE PLUS: INDONESIA

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Authored by:
Dr. John Thompson

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Executive Summary

Development of the non-bank financial institution (NBFI) sector, which is rather backward in comparison to other East Asian countries, has been identified as a high priority by BAPEPAM-LK. Expansion of NBFIs would expand the possibilities for financing through the capital market while providing enhanced social protection through greater access to pensions and insurance. Efforts should focus on developing the main categories of institutional investors, i.e. pension funds, insurance and mutual funds. There are considerable complementarities among the various forms of institutional investment. Thus, various annuities (insurance products) are used to provide retirees payments. The mutual fund mechanism is often used in conjunction with insurance and pension funds.

Pension coverage is very low at around 10% of all workers. Civil servants and the military have relatively generous defined benefit schemes, but most private sector employers do not contribute to the "mandatory" publicly managed JAMSOSTEK scheme. In addition, around 70% of the workforce is in the informal sector. The level of pension for those private sector workers who are covered is limited (around a 10% replacement rate has been estimated). Most Indonesians therefore still rely on family support in their old age.

The government is working on pension reform with the intention of providing universal coverage, including old age provision. If a successful reform of pensions is actually undertaken, substantial sums will be available for investment, which should provide a great spur to the development of capital markets. The government has also pledged to improve investment performance of JAMSOSTEK (overseen by the Ministry of Finance) and to expand the use of private pension funds. Only the latter is currently supervised by BAPEPAM-LK.

Private pension funds, which now cover less than 2% of the workforce, can be either 1) employer pension funds (EPFs) managed by (single or multiple) employers, or 2) financial institution pension funds (FIPFs) managed by banks and insurance companies. Most FIPFs are provided by employers, but individuals may also invest directly in FIPFs. Private pension funds will clearly be impacted by the overall reform of the social security system. However, work on private pinions does not have to await a complete reform, and BAPEPAM-LK has a clear mandate to supervise this sector. In this context, partners can work with BAPEPAM-LK to analyze what legislative, regulatory and other changes are needed in order for private pensions to meet the needs of the population more effectively as the reform proceeds.

There are several possibilities to collaborate with BAPEPAM-LK on the design of private pensions as part of the pension reform. It should be possible to provide analysis that would enable private sector workers to substitute private pensions, in which the worker has a guaranteed income, or at least has some control over the investment, for contributions to JAMSOSTEK. BAPEPAM-LK, which has been arguing in favor of easing tight controls on the investment portfolios of pension funds, could strengthen its case with analytic work to support the case for greater regulatory flexibility. Instead of the present system under which those in defined contribution schemes must buy an annuity upon retirement, it should be possible to allow retirees to make phased withdrawals while keep funds invested, possibly using mutual funds for funds that are held in individual retirement accounts after retirement. The tax treatment of pension funds could be examined in order to provide incentives to save through pension funds while treating pension income fairly. In order to be able to manage the reformed private pension market more effectively, BAPEPAM-LK will have to upgrade its supervisory capability.

The biggest challenge facing the mutual fund sector is to expand its very narrow economic base. Considerably less than 1% of households now invest in mutual funds, and these investors are heavily concentrated in high income groups in urban areas on Java. While Indonesia is probably not likely to have mutual fund ownership as widely dispersed as in the United States or most European countries, it is reasonable to expand into relatively affluent business and professional classes. Most funds are now sold through banks' private client units, but many in the industry and in BAPEPAM-LK believe that the development of alternative distribution channels could assist in bringing mutual funds to broader social categories. This would require changes in current laws and regulations. Independent financial advisors have been successful in marketing these products in other emerging markets. If this distribution channel is opened, it would require significant capacity building among regulators and in the industry. The tax treatment of mutual funds should be analyzed. The effort to broaden the appeal of these products will require cooperation between the regulator, the industry and the government to agree on ways of educating the public to the potential of mutual funds while making sure that regulators and the industry have the capacity to take measures to assure that investors are adequately protected. At the same time, recent surveys of financial supervision have identified some areas of mutual fund oversight where improvements are needed. If the mutual fund industry grows beyond its current proportions it will be essential to correct these shortcomings.

Insurance, still only used by a very limited part of the population, has been making steady progress in recent years. However, much of the progress has been made in offering unit-linked products rather than traditional protection. At the same time, there are probably too many companies seeking to offer insurance and there are a number of large insolvent companies that distort competition in the market. BAPEPAM –LK has tried to deal with the problems by raising minimum capital for insurance companies, but progress has been slow. Legal authority to sanction insolvent companies is unclear. In order to address this problem, analyses can be undertaken of the competitive situation in the insurance market including the size of companies and the range of products offered. The analysis can recommend how the authorities can act so as to achieve a dynamic and prudentially sound industry. One related priorities, as pointed out in several analyses, is to draft and enact a new insurance law that will place supervision on a firm footing.

Background

If Indonesia is to achieve increased investment in capital equipment and infrastructure, the capability of the system to provide finance in appropriate forms will have to be increased. As the USAID Economic Growth Strategy[1] observes, economic progress occurs as firms find more efficient ways to organize production and distribution or to improve the quality of their output by hiring more skilled workers, using better machinery, or improving management techniques. In an economic environment conducive to growth, financial intermediaries seek out firms with good financial records and/or credible growth prospects, and provide those firms with the financial resources to conduct and expand their business. However, the underdeveloped state of the financial system often prevents firms with good prospects from investing. Particularly in Indonesia, aggregate savings and investment ratios have been sufficient to support growth, but there is a scarcity of savings in the forms most conducive to productive investment, since the public's holdings of financial assets have often been concentrated in short-term bank deposits. The development of longer term institutional savings through non-bank financial institutions has the capacity to provide assets in a form more appropriate for financing investment in capital equipment and infrastructure.

Development of the non-bank financial sector can help individuals to provide for their own retirement, to obtain attractive returns on their savings and to mitigate risks such as illness, accident, natural catastrophes or the death or disability of a wage earner. As noted in several reports from the World Bank, most Indonesians lack access to basic financial services such as bank accounts and bank credit.[2] An even smaller share of the Indonesian population has a pension to provide retirement income. At present less than 10% of the Indonesian population is covered by any form of pension or insurance.

Strengthening of the framework for regulation and supervision of the financial system is also an important objective. Indonesia clearly suffered more than any other country from the 1997 Asian crisis. During the ensuing decade huge amounts of money and much of the energy of key officials had to be expended on dealing with the repercussions of the crisis. As funds invested in the capital markets increase in coming years and as more Indonesians depend upon capital market performance to obtain adequate income, the possibilities for market abuse may increase and the consequences of inadequate market supervision will become more serious. Accordingly, as progress is made in modernizing the financial system, it will be essential to assure that the authorities enlarge their capacity to provide effective supervision.

In 2008, a preliminary report for USAID identified the non-bank financial intermediary (NBFI) sector as one as one where future assistance efforts could usefully be focused. The following sections analyze why the NBFI sector is critical to Indonesian economic development and how they can effectively support the development of this sector. The top priorities of the government for the financial sector are: 1) to continue strengthening the banking system following its collapse in the 1997 Asian financial crisis in order to make it more prudentially sound and better able to support economic growth; and 2) to accelerate the development of non-bank financial

[1] USAID Economic Growth Strategy: Securing the Future. April, 2008.
[2] World Bank, Access to Financial Services in Indonesia, April 2010. Also see: World Bank, Finance for All (November 2007.)
http://siteresources.worldbank.org/INTFINFORALL/Resources/4099583-1194373512632/FFA_book.pdf

institutions (NBFIs) which are considerably less advanced than the banks, and 3) to implement a reform of pensions and social security which will, if accomplished effectively, make increased funds available for investment in capital markets,

The development of the NBFI sector is part of the strategy of Indonesian economic development, which calls for an enlarged share of financial intermediation to take place through the capital market, rather than the banking system. In addition to the direct expansion of capital market institutions and instruments, greater reliance on the capital market will mean that a rising share of wealth will be held in the form of institutional savings, such as pension funds, insurance and mutual funds. In addition, a major reform of the system of pensions and social protection has been launched and the implementation of that reform is under discussion. Taken together, these changes should result in a significant shift in patterns of financial intermediation as well as sizable expansion of the funds available for investment in the capital market. This basic transformation in the pattern of asset holding and intermediation will require a significant strengthening of the legal and regulatory framework for institutional investment and development of capacity among market participants.

Table 1: Indicators of Financial Development in Asia

Financial Assets as a Share (%) Percent of GDP in 2005

	Bank	Insurance	Pension Funds	Mutual Funds	Bonds	Equity
INDONESIA	54	3	4	1	6	29
China						
India						
Philippines						
Thailand	115	3	5	12	12	79
Malaysia	160	20	56	20	38	162
Singapore	233	50	66	20	32	162

Source: World Bank, 2006

Comparatively Underdeveloped and Bank-Dominated Financial System

As Table 1: Indicators of Financial Development in Asia demonstrates, the Indonesian financial system has a low level of overall development in comparison to other countries in the region. Holdings of all categories of financial assets account for lower shares of national income than in comparable Asian countries. Although the banking sector is small by international comparison, it is by far the dominant component of the financial system, with bank deposits accounting for some 80% of all financial assets.

Following the 1997 Asian crisis, the rehabilitation of the banks required expenditures of $45 billion (about 50% of 1997 GDP) and incapacitated the financial system for much of the ensuing decade. Working closely with international financial institutions,[3] the authorities, led by Bank Indonesia, engineered a recovery in the banking system. Bank balance sheets were strengthened. Many banks were sold to foreign strategic investors, mostly from other Asian

[3] IMF, the international development banks (the World Bank and the Asian Development Bank (ADB) and the Bank for International Settlements (BIS).

countries, including Malaysia, Singapore, India and Korea. The government also sold minority stakes in the major state-owned banks. Most banks are now comparatively well rated by agencies such as Moody's and Standard and Poor's.[4]

In 2004 Bank Indonesia unveiled its sweeping Banking Architecture Plan, which aimed to develop a core of prudentially sound, market-oriented, banks capable of providing a broader range of financial services with more competition and reduced systemic risk.

The Non-Bank Financial Sector

In order to facilitate analysis discussion of NBFIs, it is important to define some basic terms, and particularly to explain the difference between finance through banks and finance through capital markets. In bank financing, savers (i.e. individuals or other entities with excess funds) place their savings on deposit in a bank which in turn lends those funds to borrowers (governments, consumers or firms). The depositor generally does not know, and cannot control, how the bank deploys funds on deposit. The bank assesses the risk of each borrower and keeps the claims reflecting that risk on its own balance sheet. The depositor is basically indifferent to the way banks utilize funds and is at most concerned with the overall credit standing of the bank. (In cases where bank's deposits are insured, even the concern with bank creditworthiness is further diminished.)

In a capital market, by contrast, investors provide funds directly to the final users of funds (companies, governments etc.) by purchasing securities issued by those users. The investors assume all risks inherent in the securities they purchase and hence investors require information about borrowers as well as a regime to protect investors from fraud, misrepresentation or market manipulation, but <u>not</u> from investment risk. Therefore a capital market requires: 1) an infrastructure to provide regular flows of information to investors; 2) rules governing the introduction of new securities in a <u>primary</u> market as well as for trading existing securities in a <u>secondary</u> market; and 3) enforcement mechanisms in cases where infractions of investor protection rules occur.

Development of the NBFI sector has several important categories of participant such as 1) <u>investment banks</u> that structure and introduce new securities to the market 2) the <u>markets</u> (exchanges, alternative trading platforms or over-the-counter, or OTC, markets) in which securities are traded 3) <u>brokers</u> and/or <u>dealers</u> who trade in the secondary market and 4) <u>investors</u> who are the final holders of securities. Investors may be a) individuals, often called retail investors, or b) institutions.

The main categories of institutional investors are pension funds, insurance companies and mutual funds. In most advanced countries institutional investors, rather than retail investors, are the main holders of securities. Similarly, as financial systems become more advanced, a rising share of financial intermediation takes place through the capital markets rather than through the banking system.

In addition to their role in promoting capital markets, the emergence of institutional savings is a defining characteristic of the movement out of poverty. Pensions and insurance in particular form part of a broader "social safety net." The social safety net consists of a network public and private systems which enable the population to mitigate the financial shock of events such as

[4] Indonesian banks are rated below investment grade, but this is due mainly to the sub-investment grade sovereign rating of Indonesia.

such as untimely death, disability and unemployment and also provides retirement income for a population in which life expectancy is rising.

At this time a major overhaul of the social security system is under discussion which, if implemented successfully, would expand the social safety net significantly. It is expected that as a result of the reform of social security, the volume of assets available for investment in the capital market will rise by a large amount while demand for pensions and insurance and other forms of institutional savings will rise.

The challenge is much more fundamental in the NBFI sector than in banking. In some sub-sectors, basic laws and regulations will have to be enacted or revamped. The capability of the supervisors to provide effective oversight to the market will have to be strengthened, in some cases starting from very low levels. The officials responsible for the legislative and regulatory framework will have to work closely with self-regulatory organizations (SROs), private industry associations and individual firms, all of which will need to acquire new capabilities. Finally, there is a task of educating legislators and the general public about how NBFIs can help the country and its citizens to attain their basic objectives, a task that is made more difficult by some negative past experiences with insurance, pensions and mutual funds.

The priority of developing the NBFI sector has been recognized at high policy levels for several years. In a speech in 2006, Finance Minister Sri Mulyani Indrawati outlined the urgency of moving away from excessive reliance on bank finance and committed her ministry to accelerate support for the NBFI sector. The Finance Minister noted that development of a vibrant non-bank sector is particularly important for the development of longer-term finance in order to increase expenditure on plant and equipment, while expenditure on public infrastructure will have to grow significantly in order to raise growth and increase living standards. Housing finance, another important priority, also requires long-term funding. The Finance Minister also alluded to the challenge facing NBFIs because the vast majority of the population does not have pensions or insurance coverage, instruments that are basic characteristics of every advanced economy.

This commitment to accelerated development of NBFIs has been reaffirmed on many occasions. Thus, the Capital Market & NBFI Master Plan for 2010-2014 highlights the importance of this sector in enabling the country to undertake more advanced forms of financial intermediation.

Future Prospects in the NBFI Sector

While the situation varies among sub-sectors, overall there are very good prospects in several components of the NBFI sector. Furthermore, fundamental improvements in the enabling environment are needed on several levels. In some cases it is necessary to undertake basic conceptual analysis to help BAPEPAM to propose solutions so as to construct the broad outlines of the in the most effective way. The objective will be to design a system that is based on good international practices and that serves the needs of final beneficiaries (i.e. pensioners, insurance policy holders and investors in mutual funds) while promoting financial stability. This may entail the drafting and enactment of basic laws governing the sector. In other cases BAPEPAM-LK will have to promote basic institutional changes within the sector. As changes proceed in the legal and regulatory environment and in the market it will be necessary to strengthen regulatory capacity and capacity within the private financial sector.

The demand is for high quality technical assistance with only a small element of financial assistance and little conditionality. The willingness of the responsible officials to work with foreign advisers in key agencies is strong, and in many cases there is a history of positive collaboration.

Regulation of NBFIs: BAPEPAM-LK

The agency responsible for regulation of NBFIs is BAPEPAM-LK (Capital Market and Financial Institution Supervisory Agency). This agency was created by merging BAPEPAM, the existing regulatory authority for capital markets with bodies responsible for other NBFIs (particularly private pensions and insurance). BAPEPAM-LK is currently organized as a directorate general inside the finance ministry. (However, it is generally considered good practice to organize the financial regulator as an independent body rather than as an entity directly subordinate to the minister.)

Shortly after 2000, a law was enacted under which by 2010 all financial supervision (i.e. bank supervision by Bank Indonesia and supervision of NBFIs by BAPEPAM-LK) would be merged into Otoritas Jasa Keuangan (OJK,) a unified financial supervisor along the lines of the FSA of the United Kingdom. However, senior officials in many of the agencies involved had basic reservations concerning the concept of the single regulator. Following the 2007 global crisis many countries have been reconsidering their arrangements for financial market supervision, and momentum toward implementation of the merger has been slowed considerably.

BAPEPAM-LK has a history of collaboration with partners, particularly with respect to the capital market. On recent occasions, the Chair of BAPEPAM-LK has expressed a desire to resume collaboration in developing the NBFI sector, with somewhat greater emphasis on institutional investors.

Key Components of the NBFI Sector: Institutional Investors

For expositional purposes, this note will divide the NBFI sector into three components:

- institutional investors,
- capital markets, and
- other NBFIs

However, as mentioned above there are very close linkages between the first two components of the sector, since institutional investors are the main owners of financial assets in advanced economies. The capital market tends to grow as institutional the volume of asset managed by institutional investors rises.

Each category of institutional investor has distinctive characteristics that will be considered in detail below. At the same time, institutional investors share certain attributes and hence this note will first consider some common characteristics that are present in all institutional investors.

All institutional investors bring together identifiable pools of assets that are segregated from the assets of the beneficiaries, of the institution and of the fund manager. Those funds are managed on behalf of beneficiaries.[5]

[5] The term "beneficiary" is used in this text to designate the individual on whose behalf the institutional funds are to be managed, such as the workers or retirees of a company in the case of a pension fund, policy holders in the case of insurance and investors in mutual funds.

Institutional investors serve two functions in a modern economy. First, as capital markets mature, institutional investors tend to become the dominant investors. A market without institutional investors faces inherent limits on its development. Second, institutional investors fulfill socially necessary functions. Institutional investors are necessary to the development of a "social safety net" in which citizens acquire the means to alleviate risk (such as those mitigated in an insurance market) or to provide income security for retirement or disability. At this time less than 10% of the Indonesian population has access to a pension of any kind and most Indonesians do not have access to insurance. Mutual funds are not very widely used in Indonesia.

Even if the aggregate rate of savings in a given country remains constant, if the population shifts from bank deposits to institutional savings products, patterns of financial intermediation will change. Demand will rise for various categories of financial assets. Because pension funds and insurance companies have long-term liabilities, they are the "natural" buyers of long-term fixed income securities and will thus stimulate development of markets in long term assets.

Institutional investors invest on behalf of their ultimate beneficiaries. If the market is functioning well, they compete on the basis of investment performance and quality of service. The presence of institutional investors raises the level of professionalism of the market. Other things being equal, spreads on bid and offer rates on financial assets will narrow and other fees for financial services will diminish. Thus, institutional investors demand that investment banks and dealers provide a full range of services to investors and that exchanges offer transparent trading systems. Institutional investors also hold issuers of securities to high standards of transparency and disclosure and encourage the production of unbiased research. As institutional investors become the predominant holders of corporate equity they tend to press for investor-oriented practices of corporate governance.

The development of institutional investors spurs the growth of the asset management industry. As institutional investors accumulate funds, those funds must be managed efficiently in order to produce acceptable results for final beneficiaries. In a competitive environment financial intermediaries will develop their skills so as to be able to earn high returns for final beneficiaries and will compete for mandates to manage assets on the basis of their performance, which will be measured against a benchmark.

A company pension fund may award a mandate for managing some or all of its assets to an outside manager rather than managing the funds in-house. For example a pension fund might decide to manage its equity portfolio in-house but award a mandate for managing fixed income assets to an outsider. Financial institutions, such as banks, investment houses or insurance companies, will often seek to develop their skills in asset management. Institutions that have acquired asset management capability will often solicit fund management mandates from institutions such as pension funds while simultaneously seeking to manage funds for retail investors through mutual funds.

Because institutional investors control large pools of assets that are in principle managed on behalf of beneficiaries who are dispersed and who often have limited capability to monitor the institution directly, they pose serious challenges for governance and regulation. Experience in a broad range of countries clearly demonstrates that the existence of large pools of assets without an adequate governance framework can lead to unfavorable consequences ranging from sub-standard investment results and excessive charges to major losses to beneficiaries in the worst cases.

There are numerous examples in many countries where those managing institutional assets have been "captured" by governments at various levels and/or private interests rather than being invested to advance the interests of beneficiaries. For example, company's pension funds have been used to meet the financial needs of the company rather than to provide maximum retirement income for the company's pensioners. Insurance companies have often been captured by the real estate industry. Mutual funds have been managed to finance to companies affiliated with the fund sponsor or to generate revenue for affiliated brokers Major improprieties have occurred in the valuation, marketing and disclosure practices of mutual funds. Even without fraud or outright malfeasance, the managers of institutional investment might simply not achieve a competitive return for beneficiaries. The governance/ regulatory system should make it possible for beneficiaries to obtain needed information and monitor their activities. The task of building a sound regulatory and governance framework is particularly urgent since the ultimate beneficiaries are often of limited sophistication and without adequate oversight, so it is possible for problems to remain undetected for long periods.

There are considerable complementarities among the various forms of institutional investment. Thus, various insurance products are used to guarantee retirees payments for funds that are accumulated in pension funds. The mutual fund mechanism is also important throughout the institutional sector since many pension funds (such as individual investment accounts) and insurance products (such as variable annuities) share many characteristics of mutual funds.

The preceding discussion has treated institutional investors as a single homogenous category. In the following sections, each category of institutional investment is considered separately.

Pension Funds

Pension funds play a crucial role in assuring an adequate retirement income for the population in advanced economies. In most countries the pension regime consists of at least three pillars "pillars," 1) a universal pay- as-you-go (PAYGO) public pension 2) employer supplied funded pensions and 3) personal pensions. The first pillar is typically unfunded in the sense that pensions are in effect payments from those currently working and contributing to pension schemes to those who have retired and are collecting pensions. The second and third pillars are funded, as they represent pools of assets that are invested on behalf of retirees who are receiving pensions or workers who will eventually receive pensions in retirement.

The breadth and adequacy of coverage of the population in Indonesia are among the lowest in Asia.[6] More than 80% of the labor force is not covered by any public or private pension scheme and thus depend upon their personal savings or upon their families for income in retirement.

The Indonesian labor force exceeds 100 million. Depending on one's definition, as many as 30 million workers can be included in the formal sector. There are defined benefit pension (DB) plans for civilian government employees and for the police and armed forces. With regard to private sector workers, those in the informal sector (about 70% of all workers) may contribute on a voluntary basis, but very few actually do.

There are defined benefit pension (DB) plans for civilian government employees and for the police and armed forces, which are invested by specialized entities that are not supervised by BAPEPAM-LK.[7] While the government has a commitment to pay pensions for its workers, the

[6] Muliati pp.8-9
[7] TAPSEN the pension funds for civil servants and ASARI for police/military personnel are budget financed and overseen by the Ministries of Finance and Ministry of Defense, respectively.

assets in the fund have not been earning sufficient revenues to make payments. As a result these schemes have seriously underfunded pensions that may well represent a growing drain on the public finances in coming years.

All private companies with ten or more employees in the formal sector are required by law to provide coverage to their employees through JAMSOSTEK, a scheme that provides pensions as well as health, accident and life insurance. However, many employers do not contribute to JAMSOSTEK. It is estimated that only slightly more 40% of eligible employees for actually are covered. The assets of all pension funds for private sector workers are shown in Table 2.

Table 2: Pension Fund Assets in Indonesia at end 2009

FUND	Assets end 2009[8]	Number of Active Participants (thousands)	Assets per Active Participant[9]
Jamsostek	92.2	8000	10.98
Employer Pension Funds	97.4	923	105.53
(Defined Benefit)	(89)		
(Defined Contribution)	(8.4)		
FIPF	14	1197	11.7
Total	204.5	9.3	

Memo: total labor force = 100 million, total formal labor force= 32 million
Sources: Annual Reports of JAMSOSTEK and BAPEPAM-LK

JAMSOSTEK is similar to the provident funds that are found in many Asian countries. The employer contributes to funds for all purposes but the worker contributes only to the retirement portion of JAMSOSTEK. JAMSOSTEK is a funded defined contribution (DC) scheme managed by a government entity. It is not subject to supervision by BAPEPAM-LK. JAMSOSTEK makes lump sum payments at retirement or upon earlier termination of employment. Contributions (5.7%) for the pension portion of coverage are split between employers (3.7%) and employees (2.0%). Employers pay 6 to 9% of the workers' monthly salaries to healthcare, death, occupational accident and old age risk plans while workers contribute only 2% to the old-age risk scheme. These rates of contribution can be compared to those in Singapore, where employers and workers each contribute 20% to the Central Provident Funds, or Malaysia, where employers contribute 13% and workers' pay 10% in the Employee Provident Fund (EPF).

It should also be added that employers are required to set aside funds for severance pay that is an obligation that appears on the firm's balance sheet. This obligation adds to costs of hiring workers in the formal sector and discourages compliance with rules regarding pensions.

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[8] Trillions of Rupiah
[9] Millions of Rupiah

Although all formal sector workers should be covered by this program, the total amount of workers contributing to JAMSOSTEK is about 9 million, only 30-40% of eligible workers. Some employers remain within the letter of the law by recruiting workers on short-term contracts. In other cases, employers simply do not comply with the law.

Payments to workers upon retirement result from investments made by JAMSOSTEK. In effect the worker's contribution is obligatory, but the worker has no control over the investments made or any possibility to shift retirement assets to other managers in order to obtain better returns. This situation is not unique to Indonesia. Provident funds in several other Asian countries operate in similar ways.

Actual benefits received are rather low. Outside the relatively generous civil service and military schemes, the level of pension benefits for those private sector workers who are covered is low (around a 10% replacement rate has been estimated). Most observers have concluded he funds that are under management through these schemes have not produced competitive investment returns. The low returns under existing pension plans has undermined confidence in pension funds and led to high rates of non-compliance, inasmuch as the employers and the workers both believe that they will not receive good value for their money.

Funds are constrained by government rules on asset allocation with a large share of funds invested in bank time deposits. JAMSOSTEK and other entities responsible for management of official pension assets are organized as state–owned enterprises (SOEs) and pay dividends to the government. In the past, these entities have been used as easy sources of cash by government officials and political parties.

Pension benefits are provided when a member reaches age 55 or, in case of death prior to age 55, or in case of total and partial disability. Benefits are paid at retirement in form of a lump sum. (Again, the lump-sum payment is fairly common in Asia.) The pensioner is required to use the lump sum to purchase an annuity from an insurance company. It is difficult for insurance companies to provide attractive returns on annuities given the paucity of long term fixed income securities. Additionally, the lack of strong competition in the insurance market and the comparatively high rate of inflation further reduce net real benefits. The replacement rate for private sector workers covered by JAMSOSTEK is estimated to be around 10 per cent, i.e. (the retiree receives about 10% of his/her previous wage) resulting from low contribution rates but also from quite high administrative expenses, compounded with modest investment returns.

JAMSOSTEK has been criticized for its high administrative costs and substandard investment results. It is estimated that between 40-50% of JAMSOSTEK's assets are currently in bank time deposits and around 40% of its funds are in fixed income instruments, mostly government bonds. Around 10% of assets are invested in equities with the remainder in mutual funds and real estate. The fund is currently not permitted to invest overseas. The government is currently considering easing restrictions in order to raise the long-term returns of the fund. One option is to raise the ceiling on investment in domestic equities.

Recognizing the need to improve the performance of JAMSOSTEK, the Government has recently exerted efforts to strengthen the corporate governance and improve risk management practices at JAMSOSTEK. A new team of directors was appointed to manage the fund, which included the creation of a new director position at JAMSOSTEK, responsible for compliance and risk management. Further efforts are expected be made to improve the disclosure practices of the fund. The World Bank concluded that owing to its poor results JAMSOSTEK has tarnished the image of pension funds in the eyes of the public and led to widespread evasion.

As noted elsewhere in this report the assets of pension funds account for about 3% of GDP, among the lowest ratios in Asia. The various funds that are under government mandates (JAMSOSTEK and the funds for public employees) are spread among several funds. If these funds were consolidated and managed according to competitive principles the results would be more satisfactory in terms of coverage of the population and of development of the capital market. However, none of these entities is directly regulated by BAPEPAM-LK.

In addition to mandatory contributions to JAMSOSTEK, private companies (as well as SOEs) can contribute to pension plans for their workers. Table 2 shows the assets of JAMSOSTEK as well as the assets of pension funds that are regulated by BAPEPAM-LK. At the end of 2009, the total amount of assets under management in private pension plans totaled 106 trillion Rupiah compared to 92 trillion Rupiah in JAMSOSTEK. The amount of workers covered was 1.6 million in private plans versus 9.2 million in JAMSOSTEK. Thus, the average size of assets per worker in private plans was about 5.75 times that of JAMSOSTEK.

The main pension schemes for formal private sector workers are:

Employer Pension Plans (EPFs.) In addition to the mandatory plans offered by employers through JAMSOSTEK, some employers voluntarily offer funded pension plans to their employees through special plans, which can be defined benefit (DB) or defined contribution (DC). In fact about 75% of all company plans are DB. There are some 247 EPFs. These are mainly state-owned enterprises (SOEs) or large private companies. Each pension plan hires its own asset managers and makes it decisions about asset allocation, subject to guidelines set by BAPEPAM-LK.

Financial Institution Pension Funds (FIPFs), which are also supervised by BAPEPAM-LK, may only be offered by authorized banks and insurance companies. All FIPFs are DC plans. Plan participants have some discretion in selecting investment options. These plans can be purchased by employers in lieu of company pensions. Smaller companies tend to offer FIPFs. At the same time individuals can provide for their own retirement through voluntary subscription to FIPFs. Over half of all pension fund assets are in these two categories of private plans, although the number of individuals covered is much smaller than in JAMSOSTEK. Private plans also have a better investment record. Investments were distributed among time deposits, corporate and government bonds.

BAPEPAM has been advocating an increase in the permissible share of equities in total portfolios of pension funds and a progressive reduction of the allocation of funds to bank deposits.

Pension Reform

In 2004, a basic National Social Security System Law (SJSN) was enacted which aimed to rationalize existing programs and to produce a mix of public and private pensions that would ensure reasonable coverage for the population. The reform was launched partly to extend coverage to those in the informal sector. Moreover, rising real income is expected to generate demand for more diversified financial assets and the share of persons over 60 in the population was projected to grow significantly in coming decades adding urgency to implement pension reform. The reformed system was expected to cover 1) accident insurance, 2) pensions, 3) health insurance 4) old age savings and 5) death benefits. The Law mainly established broad objectives and required additional legislation as well as administrative rulings. The concept of the reform is that workers in the formal sector and their employers will contribute to pension funds (JAMSOSTEK + private pensions), while those in the informal sector will be funded from general revenues.

Recognizing the need to prepare the groundwork for the transition to the new system, the government introduced the Road Map of the Pension Fund Industry in 2007[10]. The Road Map is designed to guide discussion with stakeholders during the period when the reform is under consideration, which is projected end at the end of 2011. The objectives of the Road Map are a) to widen public understanding of the role of private pension funds. Much of the population lacks of knowledge about purposes and operation of private pension funds. The Road Map will focus on changing the mindset of the people through education and promotion of the private pension funds. The efforts should involve all stakeholders, b) to strengthen the governance of pension funds. The regulator has issued a requiring pension funds to design and implement good fund governance. The Bureau of Pension Fund of BAPEPAM L&K, as the supervision body for the private pension funds will adopt risk based supervision approach in its supervisory function, c) to review current regulation of private pensions in order to propose Amendments so as to make the pension program become more flexible in order to attract more participants/employers, and d) to harmonize the Law of Pension Funds with the labor law and social security law. This harmonization requires coordination among government agencies such as the Ministry of Finance the Ministry of Manpower, The Ministry of Welfare will be enhanced to harmonize the Labor Law, national social security law and the Pension Fund Law.

The reforms are designed to assure a basic level of social protection for all workers in both the formal and informal sectors. The government will make payments to fund the pensions of low income workers but this will only provide a minimal pension. It is expected that for workers with higher incomes will utilize additional forms of pension and insurance. The Ministry of Finance with substantial cooperation with the World Bank has been working to develop a reformed scheme. Results to date have been summarized in a White Paper on the National Social Security System. The White Paper calls for the launch of a new social security regime as early as 2012. Given continued slowness in the legislature and among ministries, it seems increasingly unlikely that the new system will be ready at that time.

Some parts of the reformed pension scheme will be funded from the government's budget and have limited relevance to the development of the NBFI sector. However, other reforms will entail the creation of huge pools of assets under management and thus will require development of an appropriate institutional and regulatory infrastructure.

The White Paper proposes that the administrators of all current plans (civil service, armed forces, and private companies, i.e. JAMSOSTEK) should be merged into a unified plan with a single administrative structure. Administration will be organized by type of program (pensions, disability, medical care etc.) rather than by sector of employment. The funds will be re-organized into trust fund structures with transparent reporting of their assets and performance administrators (BPJS) will have a legal obligation to invest in the interest of beneficiaries.

The White Paper recommends that on a very broad level a Social Security Council should assume responsibility for oversight. On the level of operational regulation, it recommends that responsibility be assigned to a newly created bureau within BAPEPAM-LK or to new a fully independent regulatory body. Given lack of skill, it is expected that BAPEPAM-LK may, at least temporarily, be assigned this responsibility. In any event to the extent that the reform results in

[10] Sistem Jaminan Sosial Nasional

investment mandates being awarded to external fund managers, BAPEPAM-LK will probably have incased responsibility for the regulation of pension investments.

Discussions over the future shape of the pension system are continuing. Partly due to uncertainties over the coverage of the new schemes many employers may be hesitating about increasing efforts to expand employer sponsored plans. Individuals may also be deterred from contributing to personal plans due to uncertainties about prospective coverage under the reformed system.

Regulation of Pension Funds

The legal, regulatory and tax framework inside which pension funds now operate is complex and leads to an uneven playing field for various forms of institutional savings. JAMSOSTEK operates outside the pension law and the insurance law under a set of ad hoc regulations. In 2004 measures were taken to bring JAMSOSTEK under the supervision of the Ministry of Finance, where it is regulated in the insurance section. Employer pension plans and FIPFs are supervised by a special unit of BAPEPAM-LK. Present rules narrowly limit investment in equities and long-term bonds. A large share of assets is invested in bank deposits and hence the contribution of the pension fund sector to long-term capital market development is negligible.

While the reform will enlarge possibilities for social protection, it will also create new risks. With the reform of the pension regime, basic capacity building inside the industry and its regulators as well as education of the public and legislators are serious challenges. Laws and regulations have to be modified. Capacity has to be upgraded among fund administrators, trustees, asset managers and regulators. More accountable governance systems and codes of conduct as well as related sanctions will have to be developed to reflect the enhanced autonomy of pension funds. A more robust infrastructure has to be developed to inform the public about the opportunities and risks in new products. Tax policy has to be reconsidered to remove present distortions.

Future Prospects in Pension Funds

BAPEPAM-LK is keen to enhance its capability to regulate the pension market and to assist in its development as the country enters a phase when a larger shares of the population will be covered by pension programs and when pension fund managers will be able to manage assets so as to produced high long term returns. On the simplest level, this will require a campaign of public education to explain the functioning of pension plans and the distribution of risks between the individual and the fund manager. Increased reliance on market forces will also require capacity building on the part of BAPEPAM-LK to engage in supervision supervisory skills. In addition, pension plans will have to introduce safeguards in order to enable the supervisors and stakeholders to monitor the actions of fund administrators.

In addition to simply building capacity to supervise the pension system however it develops, BAPEPAM-LK will have to enlarge its capability to recommend reforms of the pension system to accompany the implementation of the SJSN reform. In order to accomplish this, BAPEPAM-LK will have to undertake studies of issues relevant to those parts of the pension system which will be under its supervision, especially EPFS and FIPFs.

It should be noted that several studies of the SJSN reform with recommendations for policy changes have already been completed, so it is important not to duplicate work already done. At the same time most studies to date have focused on the overall system of social protection health insurance and workmen's compensation. Analytic work by BAPEPAM-LK should focus on funded pensions that are managed by professional fund managers and clearly under its supervision rather than those which will be funded through the budget.

Analytic work can focus on design of the new system. One issue that can be addressed is whether some or all workers should have the option of placing funds that are now invested through JAMSOSTEK in other pension plans such as EPFs or FIPFs. Rigidity in the pension system is that upon retirement workers receive a lump sum, which must be converted into an annuity. This requirement clearly locks retirees into a pattern of payout that is often not in the interest of the retiree and the lack of depth in the annuity market in Indonesia further diminishes the attractiveness of pensions as an investment. In many countries, retirees have the option of phased withdrawal for all or part of funds in DC plans. Given the relatively early retirement age and the weakness of the annuity market, alliterative systems should be seriously explored. The study can also investigate how pension plans can be combined with other forms of institutional savings, such as insurance and mutual funds. Finally, the tax treatment of pension contributions, earnings and withdrawals should be analyzed. In many countries one of the main attractions of pensions is that pension assets is that income from pension assets are not taxed as long as the funds remain in the accumulation phase. Indonesia could align its pension system with international practices.

Mutual Funds

One form of institutional investment that is of critical importance in many countries is the mutual fund[11] (reksadana). Owing to its great flexibility, the mutual fund industry has attained huge proportions in North America and Europe. Some commentators describe the mutual fund sector as the "democratization of finance," putting relatively sophisticated investment strategies and professional portfolio management within the reach of ordinary citizens.

The concept underlying a mutual fund is fairly simple. A mutual fund sponsor solicits the savings of the public and agrees to invest the assets of the CIS in keeping with a specific investment mandate. By pooling the savings of a large number of investors, individuals with modest wealth can obtain access to professional portfolio management. Laws and regulations specify conditions under which the fund should be operated and require operators to respect other measures other provisions to protect investors. Mutual funds are usually required by regulation to observe operating standards observe anti-fraud rules and to disclose specific information to present and prospective investors.

The mutual fund contains a legal structure that provides safeguards to the investor as well as offering professional portfolio management. Although the terminology and legal characteristics of these instruments vary, the underlying principles are the same, namely a) pooling of assets, b) a legal framework for investor protection and c) professional asset management.

Mutual funds typically have explicit rules governing valuation and calling for a clear statement of investment policy as well as regular reporting requirements. Mutual funds are frequently used in conjunction with other forms of institutional investment such as pension funds, where mutual funds are one of the vehicles typically used in a defined contribution pension plans. Many pension funds, such as IRAs in the United States or individual accounts in Chile rely heavily on

[11] "Mutual fund "is the term most commonly used in the United States to designate various instruments that in the IOSCO parlance are known as Collective Investment schemes (CIS.) Other commonly used terms include unit trusts and investment trusts.

the mutual fund structure. Some insurance products (such as variable annuities) share many characteristics of mutual funds. A mutual fund can be packaged as an insurance product with tax advantages and marketed as a “unit linked” product. The mutual fund industry is closely linked to the investment management industry. A firm that engages in investment management through mutual funds is likely to manage assets of other institutions, such as pension funds and insurance companies.

There are two kinds of mutual funds in Indonesia, "investment company" style mutual funds[12] and contractual funds[13]. In Indonesia funds are directly managed by an Investment Management Company (IMC) an entity created specifically for the purpose of managing assets and usually owned by a major financial institution such as a bank or insurance company. In early 2011, there were 83 licensed IMCs in the country. There were 740 funds in the country. Each fund must be approved by Bank Indonesia as well as by BAPEPAM-LK.

Assets of the funds are held in custodian banks, which must be independent of the IMC. The functions of the custodian banks include administration safekeeping and transfer as well as some role in monitoring the activities of the IMC. There are 19 licensed custodian banks, but not all of these provide services for mutual funds.

Like other sections of the NBFI sector the mutual fund industry is very small in Indonesia, although it has expanded since its inception in 1995. Even in its current embryonic form, however, the industry has a checkered history. With the resolution of the banking crisis after 2000, the government began to issue special bonds to recapitalize banks. Fund managers bought heavily for their portfolios. As a result, the assets of fixed income funds surged from 4.6 trillion RPH in 2001 to 37 trillion one year later. The domestic mutual fund industry was ill-equipped to absorb this sharp rise in inflows. Inappropriate valuation procedures were used in calculating net asset value (NAV) which is a particularly serious problem at times of market instability. Many of the funds were marketed as if they were bank deposits, without adequate explanation of the risks in fixed income investments. Disclosure practices were inadequate.

The highly publicized surge in investment in 2000-2005 was followed by a collapse which led to a major loss in confidence in the industry. In 2003 and again in 2005, price corrections in the bond market induced a panic among investors which led to a wave of redemptions and widespread allegations that improper methods of valuations were used. Due to the thinness of markets in Indonesia, the sharp movements in asset prices and lack of experience of regulators with new products, a serious disturbance in the mutual fund sector was probably inevitable. However, deficiencies in the regulatory environment doubtless aggravated the downturn. Net liquidations were especially high during 2005, when assets in fixed income funds fell from 88 trillion RPH at the end of 2004 to only 14 trillion a year later.

Following the collapse in 2005-6, there was a second drop in activity due to the global crisis of 2007-08. However there has been some recovery in the past two years due to improved conditions in the underlying market as well as efforts by BAPEPAM-LK to strengthen the regulatory framework and successful efforts to educate the public.

In the wake of the crisis, the Indonesian mutual fund sector was analyzed by international experts from the IMF, the World Bank and the ADB. The reports issued at that time highlighted a number of shortcomings in valuation and disclosure policies, gaps in supervisory practices at

[12] Perseroan
[13] Kontrak Investasi Kolektif –KIK.

BAEPAM and more general gaps in the Securities Law. The FSAP that was completed in September 2010 noted that BAPEPAM-LK had made substantial strides in bringing regulatory practice into line with global standards, but nevertheless called for further upgrading of regulatory practices including a new securities law.

It is widely agreed that if the industry is to realize its potential mutual funds are characterized need basic improvement in the legal, regulatory and tax framework. Private industry, SROs and the regulators need to make major advances in order to remove the distortions that are found in the sector and to forestall recurrences of the shocks in various segments of the institutional investor market. Since 2007, BAPEPAM-LK has been enhancing efforts to deepen technical capacity, both among its own officials and with industry participants. A working relationship has been established with the Australian Prudential Regulatory Agency (APRA), which supervises capital markets. The APRA has been especially active particularly in the fields of risk management and compliance in mutual funds as well as in in enforcement and investor education.

In 2009-2010, the mutual fund industry has enjoyed a strong rebound as the Indonesian equity market boomed and demand for Indonesian fixed income products was strong, leading to substantial gains for investors. Indonesia has also developed a wider range of products including capital protected products and Exchange Traded Funds (ETFs) and private investment funds. Despite the comeback after 2008, the industry remains small with the assets of mutual funds accounting for 2% of GDP against 12% in Thailand and 20% in Malaysia.

The investment management industry is highly concentrated with the five largest asset management groups accounting for some 90% of assets under management (AUM).

Outlook for Expansion in the Mutual Fund Sector

BAPEPAM-LK and the asset management industry see considerable potential for growth. At this point, ownership of mutual funds is confined to a very small part of the population, consisting of high net worth individuals. Ownership is also concentrated geographically with more than 90% on Java and 78% in the Jakarta area. Thus, unlike OECD countries where mutual funds have achieved wide acceptance in the general population, it remains a “luxury product” in Indonesia. By way of comparison it is estimated that almost half of all households in the United States own Mutual funds only 15/100 of 1 per cent of Indonesian households own funds. Both the industry and the BAPEPAM-LK would like to expand mutual fund ownership to persons of more moderate circumstances. In any event, the target market will still have to be relatively affluent social groups, since about half of Indonesians do not have a bank account.

Many analysts believe that in addition to generally educating the public about the potential of mutual funds one of the keys to broadening the usage of mutual funds is to develop new distribution channels. At this time distribution is closely linked to the banks. There are 21 authorized selling agents, all of which are banks. These products are typically distributed through banks’ private client department on bank premises. Anti-money laundering requirements specify that a face to face meeting must take place between new investors and the selling agent.

Some analysts and industry representatives believe that alternative distribution channels, including use of mail and internet would be helpful in expanding the market. Industry representatives also note that that in some countries such as India, Australia and the United Kingdom, mutual funds are mainly distributed by Independent Financial Advisers, who market the funds of several companies directly to investors and receive fees from sales of funds. In India IFAs have been credited with enabling mutual funds to reach a wider audience. In many cases, IFAs offer mutual funds along with other products such as insurance.

Future Prospects in Mutual Funds

Given the narrow base of investment in mutual funds in Indonesia and the potential for the wider use of mutual funds in connection with pension reform, it is clearly appropriate to explore ways in which greater use can be made of this technique. It is important that progress be made simultaneously on two fronts 1) efforts to expand utilization of this instrument and 2) enhanced capacity of BAPEPAM-LK to oversee the market. The effort to encourage sectors of the population that have not hitherto invested through mutual funds to consider investments in this category of asset will entail an effort at public education in which BAPEPAM-LK and the industry will develop educational materials while individual firms advertise their skills. In this connection it can be noted that the mutual fund industry does not have a permanent institution to represent the industry in public education programs and in discussions with the authorities. Similar institutions in other countries also provide statistical data and engage in contacts with associations from other countries.

As noted above the industry has been pressing to broaden distribution channel to include independent financial advisers, and BAPEPAL-LK has been listening sympathetically to their arguments. If it is decided to utilize this distribution channel more intensively, the regulatory framework will have to be strengthened with strict licensing and training requirements, and adequate official oversight. This will require training and certification of IFAs. As noted above, there have been numerous instances of mis-selling mutual funds in the past. Furthermore, usage of mail and internet communications for the distribution of mutual fund can be encouraged.

The effort to broaden the appeal of mutual funds will have to be accompanied by an effort to upgrade the supervisory capacity of BAPEPAM-LK. With a higher volume of operations, enhanced capability will be required on the part of IMCs to value funds properly the capacity of custodians to monitor IMCs and of BAPEPAM-LK to monitor the functioning system. As new products are offered to increasingly less affluent elements of society the need to enforce investor protection rules will gain even more significance, the more so if these instruments are used in conjunction with pensions. In this connection it can be noted that past reviews of BAPEPAM-LK's capacity to supervise the mutual fund industry has been found wanting in some respects. Recent evaluations have noted improvement, but clearly BAPEPAM-LK must continue to strengthen its capacity to supervise the mutual funds sector as the sector grows. In addition, several FSAPs have identified serious gaps in the Securities Law pertaining to mutual funds that should be addressed as part of a program to modernize financial supervision.

Insurance Sector

As in other forms of institutional investment, the insurance coverage of the Indonesian population is low by international comparison. One of the common measures of coverage is the penetration ratio (the ratio of insurance premiums to GDP.) The figure was 1.9% in Indonesia against an average of 2.2% among ASEAN countries and 9% in OECD countries. Among Asian countries only Sri Lanka, Bangladesh and Pakistan had less favorable ratios than Indonesia. In addition to the low level of participation, the past low net earnings on investment by insurance companies have meant that the insurance industry has not generated a growing pool of long-term savings suitable for investment in the capital market.

There have been some improvements registered in the last few years with activity as measured by premium income and investment results rising by more than 20% annually. However, instead of expanding coverage through traditional protection products, much of the growth has come in the form of sales unit-linked products (variable annuities) which are similar to mutual funds, but also have an aspect of life insurance. The earnings on investments by insurance companies have also been rising in recent years.

The insurance industry has also been experimenting with new products and distribution techniques. New products have been launched with that contain some characteristics of bank and insurance products. Banks have signed distribution agreements with insurance companies under which bank branches will be used to market insurance products. A public education campaign has been under way for several years and a national insurance day has been celebrated each year since 2006.

Despite the small market, there are 140 companies offering insurance, many too small to be economically viable. Partly in anticipation of an opening of the market to competition from other ASEAN countries after 2015 the authorities have been trying to encourage consolidation by imposing progressively higher minimum capital requirements. However, these requirements are only imposed on new companies, leaving the field overcrowded.

Some 20 companies have had their licenses withdrawn or have been or acquired by other companies since 2005. In addition a number of large companies are insolvent and to date no decisive action has been taken to close or consolidate marginal companies. There have also been many instances in which insurance agents have engaged in deceptive marketing practices.

Supervision of Insurance

BAPEPAM-LK is responsible for the supervision of the insurance sector. In 2000, Indonesia was the first country in Asia to implement a system of risk-based capital in insurance supervision. By 2005, companies were expected to have a minimum risk-based capital ratio of 120%. Some major companies, including some large publicly owned companies still have not reached that ratio. Both political considerations and a lack of clear legal authorization have inhibited the authorities from intervening more proactively against insolvent companies.

BAPEPAM-LK would like to launch several initiatives to modernize the industry and to deal more decisively with insolvent companies. One of the first steps would be to begin a major revision of the Insurance Law which has been identified as a major hindrance to effective supervision on several occasions. Some assistance has been received from the World Bank and the ADB, but BAPEPAM-LK would like to complete this task as quickly as possible. With increased legal authority BAPEPAM-LK would have surer legal grounds to require insolvent firms to take corrective action and/or to encourage companies to merge so as to attain viable size.

For the past few years BAPEPAM-LK has been studying the possibility of establishing of a policyholder protection fund (PPF) to provide policyholders with some compensation in cases where companies become incapable of meeting obligations. Until now the position of policyholders in the case of insolvency of an institution has been unclear. BAPEPAM-LK has undertaken studies of this issue and also conducted public opinion surveys regarding the desirability of such a program.

Future Prospects in the Insurance Sector

BAPEPAM-LK would like to formulate and execute a plan for significantly expanded use of insurance by the population broadening of the range of services offered, a strengthening of the framework for supervision. One of the objectives of the reform should be to restore the industry by consolidating insurance companies that are too small to be economically viable and to deal more effectively with large insolvent companies. This program would entail development of a strategic plan for the insurance sector, the drafting an improved insurance law, and the introduction of restructuring plans for insolvent companies. The execution of the plan would involve collaboration between BAPEPAM-LK and the industry to educate the public about the potential of insurance for risk mitigation. BPEPAM could work to determine whether such a program should go forward and to if the decision is positive to begin preparations for establishing the fund.

Future Prospects in the Institutional Investor Sector

In all likelihood, there should be substantial room for expansion of activity in the institutional investor sector. A large rise in assets under management is likely to follow the pension reform. This will require an improvement in the legislative and regulatory framework as well as a general rise in skills among regulators and market participants. This will have to be accompanied by an effort to educate the public about modern financial instruments and techniques.

As in the remainder of the NBFI sector, the staff of BAPEPAM-LK, charged with regulation of the insurance, pension and CIS industries, would be eager to expand cooperation in various forms. It is realized that building the institutional investor sector will last a long time and that the process can be sped up through adapting foreign experiences. Fortunately, there is a wealth of experience upon which the country can draw. Cooperation can take many forms, such as resident advisers, assistance in drafting basic laws and regulations and capacity building.

Capital Markets

The preceding section discussed the institutional investor sector which constitutes the main owners of securities as well as important mechanisms to enable the population to mitigate risk and provide for retirement. This section will discuss the capital markets, which are also under the supervision of BAPEPAM-LK and in which investors deal in securities and similar financial instruments.

It is understood that the focus of efforts will be upon institutional investors. However If the authorities are successful in developing institutional investors, it will be important to broaden the range of instruments in which they can invest and enhance the capability of the regulators to provide oversight.

Equity Markets

The Indonesian equity market has relatively advanced physical and technological infrastructures with an automated stock trading platform as well as custody and clearing and settlement systems that are in line with international norms. The country recently formed the Indonesian Stock Exchange by merging the two existing exchanges in Jakarta and Surabaya. Several equity derivative products are traded. The staffs of the major investment houses that are active in the market have a level of skill commensurate with the level of development of the market.

The equity market makes a relatively small contribution to raising capital for business. Total market capitalization as a share of GDP (36%) is the lowest among middle income Asian countries. The comparable figures were 40% in the Philippines, 65% in Thailand 100% in India and 150% in Malaysia. The exchange has attracted a relatively small number of new listings in recent years. There were 426 companies listed in 2011 compared to 288 fifteen years earlier, a rate of growth that lags well behind those of regional peers. New listings have not been especially dynamic in the past few years.

The market has one of the highest rates of concentration in Asia, with the ten largest firms accounting for more than half of market capitalization. Most listed companies are family-owned conglomerates in which the inside group maintains control. The “free float” (i.e. the tradable share of equity) is generally about 35-40% of the total. The exchange has attracted a relatively small number of new listings in recent years.

Domestic institutions do not invest heavily in equity and retail investors have also been largely absent. This can be contrasted with some other Asian countries with strong equity cultures (India, China etc.) where the general population invests heavily in stock markets. As a result, trading has been dominated by foreign institutions.

At the end of 2004, foreign investors held about 75% of tradable equity, domestic institutions held 20% and domestic retail investors only 5%. While the presence of foreign investors is basically positive, excessive reliance on foreign investors plainly exacerbates the risk of volatility. When foreign investors change their exposure to the market the impact is more severe than when there is a steady core of domestic investors with asset allocations weighted to the home market. In this context, it is a positive sign that domestic investors have increased their activity somewhat in recent years.

The equity market plunged during the early days of the global financial crisis in 2008, but has been recovering strong in 2009-10. The rise of the Indonesian market in these two years was one of the strongest in the world.

Bond market

It is generally recognized that the government bond market is the foundation of the fixed income market. By providing a base of risk free and liquid assets, the government bond market usually serves as a basis for pricing and trading other bonds with higher risk and less liquidity. Prior to the crisis, the government had been legally prohibited from issuing domestic debt, but with the banking crisis a large volume of bank recapitalization bonds were issued. The sharp rise in the outstanding stock of debt enabled the authorities to engage in large scale operations to restructure the debt.

Although the bond market is one of the least developed in Asia, substantial strides have been made in modernizing the government bond sector by issuing paper with longer maturities and by introducing regular issuance calendars. Foreign advisers have helped in the development of the government bond market, which now has a level of technical capability that is adequate. A system of primary dealers with access to special central bank facilities has helped add liquidity. Some progress has been registered in diversifying the investor base for government bonds. In 2002 domestic banks owned some 80% of all government debt, but this share had declined to less than 40% in mid-2010. In that same period, foreign investors increased their share from 1% to 26%. Domestic institutions (insurance companies and mutual funds) own about 20%. Still, trading remains very thin. The expansion market is hampered by the scarcity of institutional investors who are normally the natural buyers of longer-term fixed income assets (see below).

Outside of the government debt sector, the fixed income market is very shallow. Outstanding corporate bonds amount to only 2% of GDP, as against some 20% in the rest of the region. Domestic institutional investors are the main holders of corporate bonds. At the same time, this market has expanded rather rapidly in the past few years, albeit from a very low base.

An attempt was made to launch a market in local government debt in 2001, but few issues of local government debt have actually taken place.

There is a very limited market in housing related debt. Housing related bonds are a major feature of more advanced markets, such as the United States and many European countries. In addition neighboring Malaysia has a well-developed market in housing related bonds. Outstanding housing loans amount to 2% of GDP (28% in Malaysia). One institution, Bank Tabungan Negara (BTN), is mandated to extend credit to middle and low income families. BTN depends upon deposits and government funds for its operation and its business remains limited. In 2009, a few securitized issued mortgage-backed securities for $48 million equivalent supported by residential mortgages from BTN were issued. BEPEPAM interpreted these issues as signaling the possible opening of a new source for longer term finance in Indonesia.

The government created a specialized institution (Sarana Multigriya Finansial) to purchase mortgages from banks in order to build a secondary market in housing related assets. This project has received some support from the ADB and the Japanese AID agency. Under the scheme, SMF will purchase qualified mortgages from financial institutions with proceeds of bond sales backed by these assets. The target market for its securities product would be long-term investors, such as insurance companies and pension funds. Since the inception of secondary mortgage facility by the government, Sarana Multigriya Finansial has not launched any products yet because of legal and tax impediment. In sum, the market in housing finance is one where technical assistance may be useful.

Supervision and Regulation of the Capital Market

BAPEPAM-LK, which has a long history as the capital markets regulator, is clearly the strongest official institution in the NBFI sector. BAPEPAM-LK has the basic organizational structure that is common to all capital market supervisors with departments responsible for intermediary's market conduct and investment management. Unlike other parts of the NBFI market which are still creating their basic legislative frameworks, BAPEPAM-LK already has enacted the basic laws defining the capital market, the status of the regulator, insider trading and market manipulation and the status of the stock exchange. Institutional capability is adequate for a market at Indonesia's relatively incipient stage, but if as is hoped the capital market begins to assume an increasing share of financing, ongoing strengthening of capability will be necessary. In summary BAPEPAM-LK is an agency that has made substantial progress in developing as a competent capital markets regulator, and is now preparing to advance to more sophisticated levels of supervision.

In recent years, capital market regulators have continued to make progress in introducing new products, tightening standards of disclosure and transparency and generally aligning investor protection activities in line with international practices. Thus, it has been observed that the authorities have recently begun taking disciplinary action in cases of insider trading and market manipulation. Although Indonesian standards of corporate governance are still poor, international observers have recently upgraded their assessments of the entire regime of corporate governance.

Since the 1990s, BAPEPAM-LK has published five-year Master Plans for the Capital Markets and NBFIs in which the objectives for the coming five years are specified. BAPEPAM-LK is currently operating under a Capital Market Master Plan covering the period 2010-2014. The Plan has been completed in the Indonesian language, and most commentators have said that the plan is very well conceived. However, an acceptable English translation is not yet available.

The details of the Action Plan are less important than the fact that BAPEPAM-LK continues to take concrete measures to introduce practices based upon best international experience in pursuit of the goals of capital markets supervision, which are the development of transparent, fair and efficient capital markets. In the 2010 FSAP, several areas for improvements in arrangements to supervise the capital markets were identified. Moreover, it was recommended that Indonesia undertake a complete revision of its capital market law.

The country is working under an ADB technical assistance (TA) loan to support various projects related to modernization of the capital market in keeping with the Master Plan. The TA loan covers the period from end 2009-mid 2011. Among the main objectives of the TA loan are: i) continued implementation of the capital market master plan (2010-2014); (ii) establishment of a regulatory framework for harmonizing standards and regional cooperation; (iii) enhancing BAPEPAM-LK's investigative and enforcement capacity; (iv) implementation of any regulatory reforms that are required following reviews under the Financial Sector Assessment Program; (v) establishment of an investor protection fund for the securities market; (vi) development of a comprehensive human resource program for BAPEPAM-LK; (vii) development of a comprehensive capital markets database and website for public information services; (viii) establishment of a capital markets institute; (ix) development of a comprehensive compliance framework for capital markets to enhance investor protection; (x) introduction of new products, such as mortgage credit insurance; and (xi) strengthening and consolidation of the insurance industry.

Future Prospects in Capital Markets

While efforts are expected to be focused on institutional investors, there may also be some opportunities for collaboration in capital markets. BAPEPAM-LK is planning a major expansion of institutional capability to supervise markets and the demand for foreign expertise is expected to be high. BAPEPAM-LK would like to have access to assistance in several forms, including resident advisors who operate inside BAPEPAM-LK as well as training seminars and the possibility to send BAPEPAM-LK personnel for several months to obtain on the job training with capital market supervisors in major jurisdictions. A program of regular exchanges already exists with the Australian Prudential Regulatory Agency (APRA). It might be possible to establish a similar relationship with a counterpart in the United States, especially the SEC.

In capital markets, it is a common practice for industry associations and self-regulatory organizations (SROs) to play a role in setting standards, establishing codes of conduct and disciplining market participants. Therefore, the capacity building exercise could encompass not only BAPEPAM-LK but also the self-regulatory organizations (SROs) that will assist in market oversight. Other programs can be undertaken to raise capacity among key market participants or to educate the investing public about the potential uses and risks of various investment instruments and techniques.

Concerning resident advisors, BAPEPAM-LK would prefer advisors to remain for relatively long periods. It was observed that advisors who spend short periods observing the capital markets tend to make recommendations on a rather general level and then leave. What is needed is to carry recommendations through to the stage of implementation and adapt initial recommendations to the concrete conditions in Indonesia.

Technical assistance should be coordinated with other donors as well as with the IOSCO (International Organization of Securities Commissions), the body which is charged with international coordination of capital markets supervision and the establishment of international norms in capital market oversight. Indonesia is an active member of the IOSCO.

Other NBFIs

SME Access to Finance: Collateral Law Reform and NBFIs

In many countries, especially emerging markets, SME frequently have access obtaining credit inasmuch as prospective lenders banks, non-bank financial institutions, and private parties) have difficulties in assessing the risk of lending to each SME and of obtaining adequate legal protection when lending. One way in which lenders have found in mitigating this risk is through the use of collateral, real or moveable property pledged by a borrower as security for the loan. A transaction secured with collateral is called a secured transaction.

Most well-developed economies have collateral and secured transactions laws that make securing interests in collateral easy, thereby avoiding excessive legal costs, delays and attendant formalities in creating security rights. These laws, in general, define what kinds of property may be used as collateral, and allow the creditor, on the granting of a loan based on collateral, to file a notice of claim on the collateral in a publicly accessible and readily searchable secured transactions registry. One major reform that has been instrumental in determining whether any prior claims on collateral exist is to develop a central registry for secured transactions. The registry provides notice to subsequent potential creditors that particular asset already has been pledged as collateral. The registry also solves the problem that exists in some collateral financing systems of delivery of possession of moveable collateral to the creditor to hold until the loan is repaid. Finally, the registry serves to establish creditor priority in cases where there are multiple creditor claims on the same collateral, usually a matter of the first to file.

Secured transactions laws that broadly define what kinds of property can be collateral - e.g., moveable property of all kinds, accounts receivable, warehouse receipts, after acquired property fungible with the property that was offered as collateral, and so on, greatly expand access to credit.[14]

Reform in this area should focus on legislation to create a modern secured transactions law, which would include a broad, encompassing definition of collateral, in Indonesia. To do this, it is essential to bring together all relevant potential stakeholders to discuss how such a law would improve and facilitate financing for businesses. The stakeholders would include: business entrepreneurs; banks and other potential suppliers of credit; commercial lawyers; notaries; commercial law academics; NGOs working on the BEE; and, later on, once there were legislative or policy proposals, legislative and executive policy makers.

[14] "…In the United States, 70 percent of small business loans are secured by movable property…A reported 31 percent of Indonesian small businesses do not apply for credit because they experience difficulties when asked to provide collateral..." USAID, Southeast Asia Commercial Law and Institutional Reform and Trade Diagnostics - Indonesia, Final Report, p. 48 (November, 2007)

All groups should have the same foci. The following list, while not exhaustive, provides ideas regarding the issues that should be discussed: a review of Indonesia's existing forms of securing credit and their advantages and disadvantages; what kinds of collateral; what forms of secured transactions are the most practical and efficient in promoting commerce; what creditor priority rules will promote commerce; what kind of notice secures a creditor interest; what is the legal meaning of filing such a notice; what kind of public, open, accessible, and searchable secured transactions registry should there be; how to enforce secured creditor rights in the simplest, least expensive ways.

This short study is not the place to discuss all the details of what the substance of guided secured transactions discussions should involve, nor how to enlist stakeholders, manage meetings, nor devise a strategy for secured credit law reform. There are easily accessible reference texts that provide the relevant detail, e.g., World Bank, Reforming Collateral Laws[15], and, for Indonesia, Southeast Asia Commercial Law & Institutional Reform and Trade Diagnostics - Indonesia.[16] There are also American and European Model Draft Secured Transactions laws that could serve as foundations for discussion and development of a comprehensive Indonesian law.

SME Access to Credit: Asset-Based Finance[17]

In addition to the expanded used of collateral in SME lending there exists a range of financing vehicles that enable SMEs to improve access to finance by using assets that provide the supplier of financing with level of comfort comparable or to that provided by collateral. For example, an SME that has sold goods to a larger company with a good credit standing, has a claim on that company that can be sold to a financier at a discount. Operations of this kind (sale of trade receivables) are known as factoring, which is a close substitute for bank credit. Likewise, SMEs that do not have an established credit rating can use leasing to obtain financing for long term capital equipment. Under leasing the provider of finance (the lessor) extends funds for the purchase of a piece of capital equipment that is used by the SME. However, rather than obtaining a loan for the purchase of the equipment as in a conventional bank loan the lessor retains ownership of the asset and can repossess the asset in case of non-payment.

These techniques are especially useful in cases where the legal system is not robust enough to protect the creditor. In some cases, leasing or factoring companies are subsidiaries of banks. In others they are independent companies. Banks prefer to undertake these operations through specialized subsidiaries, because the characteristics of these operations differ significantly from bank lending. In many cases, banks initiate operations with SMEs through these "near banking" techniques and when sufficient familiarity with the borrowers is acquired it may be possible to offer bank loans.

In Indonesia an important category of NBFIs is "multi-finance" companies that engage in a range of "near banking activities," such as credit cards, leasing, consumer finance and factoring. There are about 130 multi-finance companies, whose main regulator is BAPEPAM-LK. Originally multi-finance companies were engaged in leasing but in 2005 nearly 70% of their activity was in consumer finance, with leasing accounting for most of the remainder. Automobile

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[15] Fleisig, Heywood; Safavian, Mehnaz; de la Pena, Nuria, Reforming Collateral Laws to Expand Access to Finance, (The World Bank, 2006)

[16] Booz, Allen, Hamilton, Southeast Asia Commercial Law & Institutional Reform and Trade Diagnostics - Indonesia Final Report, pp. 48-62 (USAID, 2007).

[17] This section is based on an analysis by Gary Goodpaster, who also contributed a separate Annex on the Business Enabling Environment in Indonesia.

and motorcycle credits and leases, often to low income segments of the population, are the most common operation. Multi-finance companies often engage in consumer finance operations.

These companies can also become active in operations that help SMEs to obtain finance such as factoring, leasing and other forms of asset-based finance. Multi-finance companies receive a considerable amount of their funds from commercial banks; the largest multi-finance companies are bank affiliated.

The possibility to support development of “near banking” activity may want to be explored, which could be part of the effort to strengthen the Business Enabling Environment as well as the effort to promote the NBFI sector.

Equity Finance for SME: Business Angels and Venture Capital

Economic Growth Stakeholder Workshop expressed the need for venture capital as a means of providing finance to newer companies with high growth potential, and notes that this market sector is seriously underdeveloped in Indonesia. Interview with University business school programs and private sector leaders including KADIN, the Indonesia Chamber of Commerce also indicate a growing demand for and interest in the development of VC networks.

Venture capital is a technique to provide unlisted equity finance to smaller companies with high potential growth and high risk. Such firms are not typically suitable for bank finance or for stock exchange listing. Venture capital finance usually occurs in several rounds (start-up, expansion and late stage). At the end of the venture capital cycle, investors exit through an IPO (public offering) or a “trade sale” to strategic investors. Many VC-suitable companies are found in innovative or high technology sectors. In the Business Development section of this report, it is noted that one subsector of the SME in which the absence of finance is perceived as a constraint on growth is in technology oriented SME.

In 1995 the Ministry of Finance issued a regulation recognizing venture capital as a special field of activity in the financial sector. Subsequently a number of venture capital companies with both domestic and foreign participation. Nevertheless the industry remains, although it has not progressed beyond a nascent stage with less than 0.1 per of total assets of the financial system.

Venture capital tends to be highly concentrated geographically. This industry is very significant in the United States and Israel, but most European countries and Japan have not succeeded in creating dynamic venture capital industries despite the fact that they have mature capital markets. On the other hand, several Asian countries (i.e. Korea, Taiwan, China and India) have developed vibrant VC markets although in many cases they do not appear to have as a regulatory and investment climate that would favor the growth of such a sector. The main advantage that such markets enjoy is an environment in which there are strong linkages among research, innovation, entrepreneurship and production, especially in technology-related industries. Venture capital tends to migrate to narrow geographic areas (e.g. Silicon Valley or Bangalore) where there are environments supportive of venture capital investment. Such an environment includes critical masses of universities, other research centers, high tech companies and entrepreneurs with talent for combing technical skill, practical application and willingness to take risk. The access to “seed money” in the form of grants from universities, companies or governments is also helpful. Venture capitalists seek out promising deals in such environments.

There is a considerable body of experience in the United States and in other Asian countries about how governments can work with universities and other research centers to build science parks and technology corridors in which venture capitalists can remain in touch with entrepreneurs and providers of business services in order to be able to be exposed to a constant deal flow from potentially innovative companies.

Clearly, the starting point for a country seeking to replicate other success stories in Asia is to introduce policies to attract high technology industry and to promote domestic research that is closely related to production so as to create an environment conducive to entrepreneurship in innovative companies. ITB University and the Ciputra University programs on Entrepreneurship are seeking to develop VC capacity as part of their degree program, capitalizing on local talent from universities and the growing ICT sector.

The Business Development section discusses that the Ministry of Research and Technology has initiated the Business Innovation Center as a public lead initiative to improve linkages between research centers and universities and the private sector. This section also discusses the work of local ICT firms and partnerships with CISCO and Microsoft.

A concept that is close to that of venture capital is that of “business angels” (BAs), informal equity investment, by “cashed out” entrepreneurs who have retired as active owners, but who would like to invest in newer companies. BAs contribute not only money but their own expertise in launching and nurturing a business. In the United States, more innovative firms are financed though BAs than through formal venture capital while VC firms are increasingly specializing in later stage deals and buyouts. BAs operate in high growth and innovative companies as well as in traditional SME. BAs typically form “networks” that provide information about potential investors and projects and allow BAs to form syndicates to finance promising projects. BAs also use their experience in helping entrepreneurs gain access to finance, while “coaching” prospective entrepreneurs for example in the preparation of business plans. BAs are often the first stage in a “financing ladder” in which high growth technology companies eventually gain access to formal venture capital.

The BA approach can be integrated into existing programs to strengthen the business environment. There are examples of support extended by regional governments to BA networks. Support usually consists of meeting facilities data bases about prospective seekers of capital, as well as access for business services such as accountants and lawyers.

It could be considered to launch small scale venture capital and business angel’s projects that could have significant impact through their demonstration effect. These activities should be linked with projects described in the Business Development section that relate to the expansion and support of University entrepreneurship networks and local research institutions.

Activities of Other Donors in the NBFI Sector

Although there are a number of active donors in various parts of the NBFI sector, there is a better opportunity to develop a distinctive role in NBFIs than in banking. There is little risk of any donor monopolizing assistance, given the low level of development in NBFIs and the wide variety of activity undertaken.

The largest single bilateral donor is AUSAID, which has several advisors in the Ministry of Finance, including an advisor to the head of BAPEPAM-LK. AUSAID regularly sends Indonesian capital market regulators from BAPEPAM-LK for extended stays inside the Australian Prudential

Regulatory Agency (APRA), which supervises capital markets. AUSAID also sends Indonesian supervisory officials for training at Australian technical schools and universities.

The World Bank Study of 2006 provided a basic store of information about the NBFI sector. The World Bank also has an ongoing policy dialogue with the officials of BAPEPAM-LK and frequently provides ongoing technical advice. The World Bank is cooperating closely with Indonesia in pursuing pension reform. However, the World Bank is mostly focusing on the overall design of the new social security system. There should be ample grounds for other donors to become actively involved in the implementation of the reform, especially those aspects of the reform that involve investments in the capital market.

The Asian Development Bank recently produced a basic study of the Social Security System of Indonesia that is a basic reference about insurance pensions and the social safety net. The ADB also has sponsored a feasibility studies to consider the possibility of developing housing finance, asset-backed securities and corporate bonds. Neither the World Bank nor the ADB has advisers inside government agencies, or a program for comprehensive reform for the sector. As mentioned above, the ADB has two technical assistance loans that are designed to support the implementation of the Capital Market Master Plan.

In addition to technical assistance narrowly defined, BAPEPAM-LK participates with other securities supervisors through IOSCO (International Organization of Securities Commissions), the body which is charged with international coordination of capital markets supervision and the establishment of international norms in capital market oversight. It was also be desirable for BAPEPAM-LK to take part in the work of the International Association of Insurance Supervisors (IAIS) which does comparable work for insurance. Indonesia gas recently expressed interest in becoming involved in the work of the international organization of private pension supervisors.

Islamic Finance

The past decade has witnessed a sizeable expansion of Islamic financial products; i.e. instruments that are similar to conventional financial instruments but structured so as to conform to restrictions in the Koran, especially those concerning the payment of interest. While still a rather small part of the financial system, these instruments have become well established in several sectors. Many banks are targeting Islamic banking. As of August 2007, only 1.3% of bank assets were in Shariah-compliant products but Bank Indonesia (perhaps over-optimistically) projects the proportion to grow to 5% by end-2008. There are three pure Shariah banks, while 24 conventional banks have opened Shariah units. The government recently issued its first Shariah–compliant bond-like product (sukok) in the domestic market and further issues are planned. Sukok have also been issued in foreign currency for placement with foreign investors. Islamic financial products are also found in the mutual fund and insurance sectors

Recommendations

Indonesia's financial system is less advanced those of its regional peers. In order to support its advance into the ranks of middle income countries during the next few years the country will need a more developed system financial system that operates in a robust legal and regulatory environment. Consistent with other sectors and finding of this assessment, capacity building is a critical issue. Private sector bodies such as industry associations, self-regulatory organizations (SROs) and private institutions will have to build their capacity to operate in a more sophisticated and competitive environment as well.

1. The biggest opportunity will be in the NBFI sector which is 1) more backward than the banking sector 2) crucial for the next stage of development, and 3) likely to expand rapidly with the pension reform. This sector is critical because capital markets are necessary to provide long term finance in critical sectors. Additionally the expansion of institutional investors will permit the country to attenuate risk, enhance income security and generally build a social safety net. BAPEPAM-LK, which is the natural counterpart, would welcome the chance to resume cooperation. Assistance is requested in capital markets and institutional investors (pension funds, insurance and CIS). Assistance can take several forms, including the form of long term-advisors, training and other forms of capacity building.

2. Support can be extended to programs designed to enlarge the access of SME to finance. The authorities have targeted the SME sector as an important priority, not only because of their importance in maintaining a high aggregate rate of growth, but also because of their social importance in achieving balanced and equitable growth. Many banks have also targeted the SME sector as one with promising growth prospects, but they are also concerned due to the special risks of SME lending and banks are seeking to sharpen their relevant skills. One possibility for expanded activity is through the use of asset-based finance, such as factoring and leasing. This form of financing can be offered by independent finance companies or by specialized finance companies affiliated with commercial banks. Also, the current DCA mechanism should be reviewed and revised. Unlike the work with BAPEPAM-LK, which would provide direct support to systemic transformation, these activities would seek to have a catalytic effect. By working on smaller projects in unfamiliar territory, they would help to uncover some practical techniques and methods that might eventually have wider applicability in helping underserved market segments gain access to formal finance. Since other donors, such as IFC, are also active in this field, there is a possibility that different experiments using somewhat different approaches might increase the chances of finding techniques that work.

3. Support of venture capital as well as informal equity finance (business angels) is also a worthwhile concept. High technology SMEs, which can make a strong contribution to economic progress, have a recognized need for finance and there are reasons to believe that Indonesia has some of the elements of a successful technology-based industry. At the same time, there are reasons to be cautious. It is not obvious whether any official agency is able to make a decisive contribution to the development of this sector and hence there is an argument for leaving this task to the private sector. Silicon Valley developed without very much positive help from the US government while many European countries have been trying for years to develop their domestic markets without success. That being said, there are cases of successful venture capital sectors in Asia and many Asian governments have developed venture capital with approaches that involve higher doses of government intervention that is found in the United States.

Time Frame

During the first year of operation the program would concentrate on 1) to communicate intensively with Indonesian counterparts in order identify areas where technical assistance should be focused and 2) to reach agreement on the form is which assistance should be provided, the amount of assistance that can be absorbed and the time frame for implementation of programs. Discussions can he held with other donors about the destruction of tasks Agreements with the Indonesian government should be finalized by the end of the year.

By 2012, programs should begin. For example, advisors should be in place and training materials should be produced and training activities should begin.

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This World Bank report begins with an analysis of the role access to finance plays in development, examines the ability of firms to access financial services, enquires if enhancing

access to finance is consistent with a pro-poor growth strategy, and finally looks at the government's role in facilitating access to financial services.

U.S. Agency for International Development
1300 Pennsylvania Avenue, NW
Washington, DC 20523
Tel: (202) 712-0000
Fax: (202) 216-3524
www.usaid.gov