FINANCIAL DEEPENING IN INDONESIA

FUNDING INFRASTRUCTURE DEVELOPMENT – CATALYZING ECONOMIC GROWTH

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FOREWORD

Financial deepening has been a very important topic in Indonesia in recent years, with many studies published. Despite this attention, the Indonesia markets have made limited progress, with the ratio of equity market capitalization to GDP the same as in 2007.

This joint Oliver Wyman - Mandiri Institute report marks a departure in several ways. First, it comprehensively examines all six components of the financial market ecosystem - issuers, investors, intermediaries, products, infrastructure, and tax and regulatory. Further, the report quantifies the benefits of successful financial deepening, estimated at a GDP increase of US$600 BN by 2030, and a 15% increase in per capita incomes. Finally, the report is focused on execution, and has identified a set of initiatives both for the short and for the long term.

We also include a specific recommendation on governance structure. The central bank, the regulator and the Ministry of Finance have already initiated moves in this direction. However, a more integrated approach is called for. We recommend establishing a dedicated Indonesia Financial Deepening taskforce comprising senior people from relevant government ministries, the regulator, the central bank, and industry players. This taskforce should be headed by a senior functionary, able to lead decision-making and push for necessary legal reforms. While the taskforce will be accountable for overall execution, individual initiatives should be led by working groups comprised of industry representatives, and other experts.

We hope that the report provides some useful guidance for the relevant authorities as they embark on a critical reform journey that has the potential to catapult Indonesia to the position of a G7 economy by 2030.

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EXECUTIVE SUMMARY

Indonesia has shown strong and sustainable growth over the last ten to fifteen years, with the real GDP growth rate ranging from 4% to 6% during this period. At the same time, the development of financial markets has been slow. The relative depth of most of the markets has not increased over the last ten years, while most peer markets have on the other hand made significant progress. With the right economic reforms, Indonesia is expected to continue on a strong growth trajectory. By 2030, the country could reach around US$4 TN in annual GDP and become a G7 economy.

Extensive research has established that economic growth and financial deepening go hand in hand. It is therefore imperative that Indonesia deepens its financial markets if it is to achieve its growth potential. We estimate that capital markets in Indonesia will need to grow six to eight times over, and reach US$4 TN by 2030 in total outstanding equity and bonds. This implies a 13% to 16% growth in total capital over sixteen years, which is well above the growth rates achieved in the last five years.

To sustain this growth in capital markets, Indonesia needs urgently to embark on a series of reform measures aimed at financial deepening. We estimate that in the absence of adequate reform, Indonesia will not have sufficient capital to fund GDP growth. Indeed, without such reform, assuming capital markets grow at recent historical levels, we estimate that Indonesian GDP in 2030 might be lower by as much as US$600 BN, with per capita incomes about 15% lower. In this case, Indonesia will not be a G7 economy, and may not even be a top ten country measured by GDP.

In order to understand the root cause of the status quo in Indonesia, we conducted primary research in the form of interviews with stakeholders within the Indonesia financial market ecosystem. We also closely analyzed the development experience of ten other peer markets across bond markets, equity markets, foreign exchange markets and money markets. The ten peer markets we reviewed comprise Malaysia, Thailand, Singapore, Philippines, China, India, Hong Kong, South Korea, Chile and South Africa. On this basis, we shortlisted 40 initiatives that would need to be executed in Indonesia, which cover not just bond markets, equity markets, Foreign Exchange (FX) markets and money markets, but also overarching initiatives across the legal and tax fields. Execution will require coordinated efforts by the regulator, central bank, government ministries and market participants.

We used a set of guiding principles to develop a roadmap for the execution of these 40 initiatives over the next decade. The primary choices made include a more gradual approach to execution, as opposed to sudden "big bang" reforms, an emphasis on domestic market development, and the fostering of increased participation from existing players, rather than aggressively encouraging new players. On this basis, we have identified 22 initiatives that will need to be executed by 2020. These initiatives cut across markets and also address some fundamental legal and tax issues.

Finally, we examined the question of how to execute these 22 initiatives effectively. Financial deepening has been a hot topic in Indonesia, with multiple publications, reports and recommendations published over the last 15 years. However, practical progress in carrying out this financial deepening has been limited. The major reason for this, in our view, has been the absence of a coordinated effort across multiple regulators and the government, targeting all six elements of the capital markets ecosystem. In order to execute financial deepening, we recommend that the first and most critical initiative is to put in place a Financial Deepening Taskforce, headed by a suitably empowered senior authority, and comprising stakeholders from all relevant government ministries, regulators and other market participants.

Given that the breadth of issues that need to be addressed in Indonesia financial deepening come under the regulatory purview of The Financial Services Authority of Indonesia (OJK), the central bank Bank Indonesia (BI) and the Ministry of Finance (MoF), we recommend that the Financial Deepening Taskforce be led by a very senior government authority, possibly the office of the Vice President. A senior authority of this nature is absolutely essential, in order to be able to resolve deadlocks that could potentially arise between OJK, BI and the MoF.

While the Financial Deepening Taskforce would have overall responsibility for moving the Financial Deepening program forward, actual project execution would need to be carried out by project specific working groups established for the implementation of each proposed initiative. These working groups would need to report either to the overall Financial Deepening Taskforce, or to OJK/BI, depending on the type of initiative. To ensure that market participant views are adequately reflected, there should also be an Advisory Council comprising primarily of senior persons from industry with substantial expertise and experience in domestic and foreign financial markets. The Advisory Council would be expected to provide advice on reforms to be implemented, and an independent and ongoing assessment of progress made.

One final element required for the execution of financial deepening is adequate funding. This would certainly be needed for putting in place a couple of permanent members on the taskforce, executing specific projects, and bringing on board professional services firms to assist in the design of specific initiatives. Overall, the financial deepening effort will need to be implemented along the lines of a well-run transformation program, with clear metrics and milestones communicated to the market, and specific responsibilities assigned.

To restate the key point, Indonesia has the potential, with the right set of financial sector reforms, to emerge as a G7 economy by 2030. We hope that this white paper will provide valuable ideas to the relevant authorities as they start to embark on this critical reform journey.

1. THE CASE FOR FINANCIAL DEEPENING IN INDONESIA

1.1. DEFINING FINANCIAL DEEPENING AND WHY IT IS IMPERATIVE FOR INDONESIA

Financial markets have a critical role to play in the economy. They support economic growth by efficiently routing capital to productive investments, offering opportunities to investors for stable accumulation of private wealth, and increasing overall stability within the economy by diversifying sources of financing. Despite this critical role, financial markets need to be regulated as they make the economy potentially vulnerable to external shocks. Uncontrolled financial innovation can also reduce the stability of the overall financial system.

Financial deepening is usually understood as a process whereby the efficiency, depth (credit intermediation and market turnover), breadth (the range of markets and instruments), and reach (access) of financial markets is increased. Therefore, efficient and deep financial markets have four characteristics:

1. Funding access – Providing borrowers such as corporates and financial institutions with a choice of instruments for raising funding across maturities
2. Diversified investment options – Providing retail/institutional investors with a choice of products with varying maturities and risk-return profiles
3. Quality market infrastructure – Timely and convenient connectivity across market players
4. Risk management solutions – Availability of suitable assets to facilitate risk-sharing and diversification

While having efficient and deep financial markets is usually a common prerequisite for sustained economic growth, some countries have managed to grow successfully despite having relatively shallow financial markets. One example is Germany, where financial market depth is significantly below that of its peers. For instance, in 2013, Germany's ratio of outstanding corporate bonds to GDP was only 58%, compared to 140% for the UK. The German anomaly can be explained by some specific characteristics of its economy:

- High domestic savings rates: The ratio of gross savings to GDP is 26%, compared to 13% in the UK
- A risk-averse investor population content with returns on long-term bank deposits
- Bank shareholders relatively content with stable but low Return On Equity (ROE)

However, a similar growth path with such shallow financial markets is clearly not feasible for Indonesia, for a number of reasons:

- Banks are unable to ramp up lending given the high Loan-to-Deposit ratios, running at more than 90% for several banks
- A significant infrastructure financing gap: The infrastructure investments needed by Indonesia between 2010 and 2020 are estimated by the Asian Development Bank (ADB) at over US$450 BN[1]
- Inadequate bank funding to SME sector, which is crowded out in its quest for funding by large corporates. Deeper capital markets will allow corporates to obtain funding without support from banks, resulting in banks being forced to do more bilateral SME lending
- The need to provide above-inflation returns to retirement savings

1.2. THE STARTING POSITION

While the Indonesian economy has been consistently growing over the last ten years...

The Indonesian economy has witnessed one of the highest growth rates in the world over the last decade. During the period 2004 to 2013, real GDP in Indonesia grew at a Compound Annual Growth Rate (CAGR) of 5.9%, behind only China and India. Further, this growth was marked by relatively low volatility in comparison to other emerging market peers. Indonesian real GDP growth rates ranged from 4% to 6% during the last decade, while growth rates for Malaysia ranged from minus 2% to 7% during the same period.

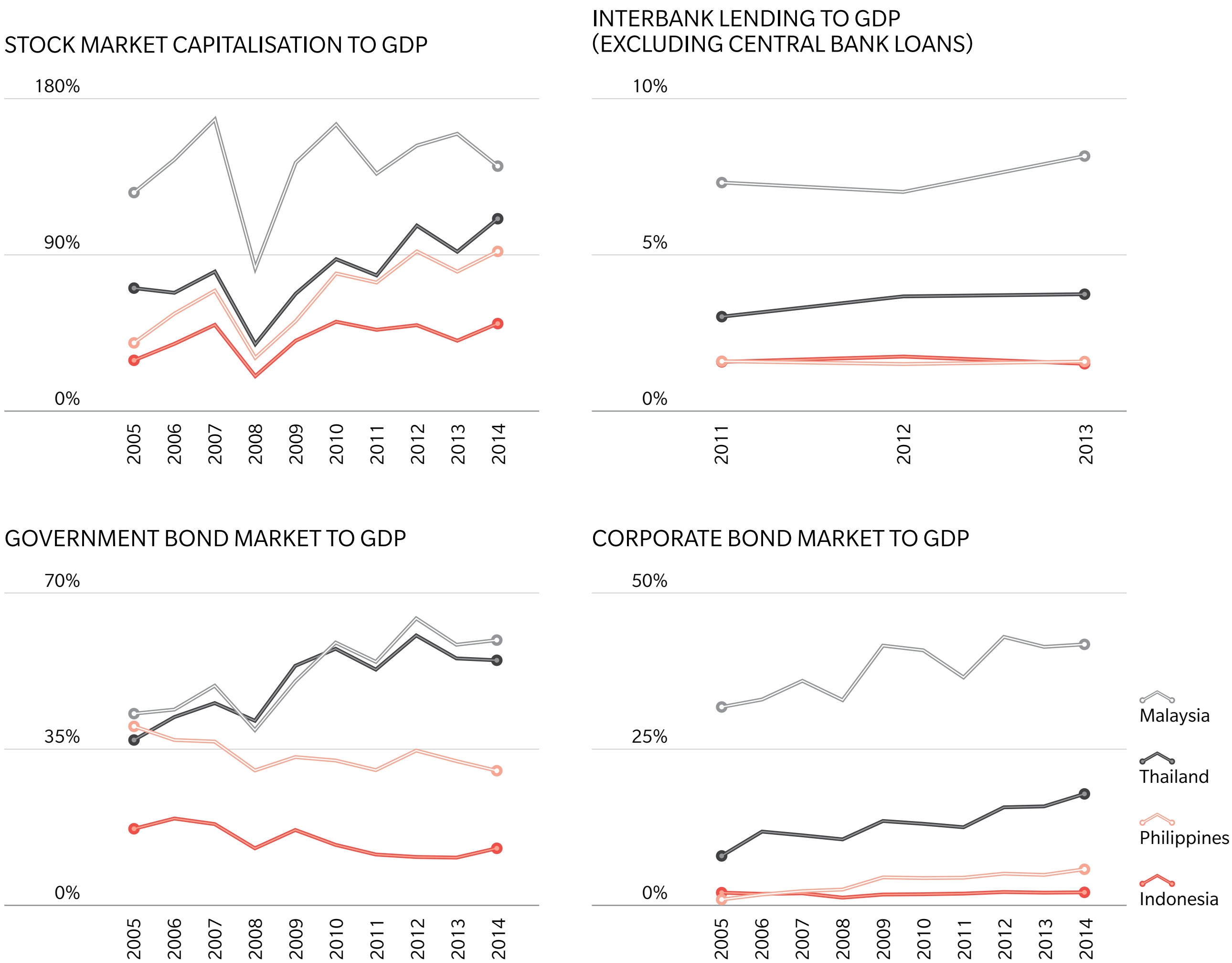
While Indonesia's economic growth has been strong in aggregate, the relative level of individual wealth remains low. The level of GDP per capita in 2013 is US$3,475 in current dollar terms, which is low compared to regional peers. Further, a significant number of Indonesians (around 45%) are estimated to live on less than US$2 a day. This indicates that in order to raise a significant share of the population above the poverty line, the country needs to maintain or increase its historical growth trajectory.

...Indonesian financial markets are very shallow compared to peers

Despite relatively stable GDP growth over the past decade, financial market depth in Indonesia is low compared to regional emerging market peers. Further, there has been limited progress over the past decade. The relative depth of financial markets measured by the ratio of stock market capitalisation to GDP, the volume of outstanding corporate and government bonds to GDP, and interbank loans to GDP, has roughly remained the same over the last decade. In contrast, other ASEAN markets, such as Malaysia and Thailand, have made significant progress over the same time period. This is reflected in Exhibit 1.

1 ADBI Working Paper Series (2010): "Estimating Demand for Infrastructure in Energy, Transport, Telecommunications, Water and Sanitation in Asia and the Pacific: 2010-2020"

Exhibit 1: The relative depth of financial markets in Indonesia is low compared to peers and has not progressed over the last 10 years



Source ADB AsianBondsOnline, The Economist Intelligence Unit, World Federation of Exchanges, CEIC, Central Banks of respective countries

In order to understand the root causes of low financial depth in Indonesia, it is necessary to analyze all six components of the financial markets ecosystem. These are as follows:

1. Capital users – including governments, and public and private sector companies
2. Capital providers – including domestic institutions (pension funds, insurers, mutual funds), government, individual investors and overseas institutions
3. Financial intermediaries – including brokers, banks, insurers and asset managers
4. Financial instruments across debt, equities, foreign exchange and money markets, including derivative products
5. Market infrastructure providers – including exchanges, depositories, custodians, rating agencies, credit bureaus and market data vendors
6. Regulatory, legal and macro environment – including regulations which impact on investments, securities, banking and insurance; dispute resolution and collateral enforcement mechanisms; and macro-economic stability, including inflation rates and exchange rates

Exhibit 2: Our review indicates that Indonesia has room for improvement across most dimensions of the financial market ecosystem

DIMENSION		METRICS FOR ASSESSMENT	CURRENT STATUS	RECENT TREND
1	Capital users	1A. Number of issuers (Bonds, Equity)		→
2	Capital providers	2A. Relative share of bank funding to bonds and equity		→
		2B. Ratio of foreign to local ownership (Bonds, Equity)		↗
3	Intermediaries	3A. Mutual Fund Assets to GDP		→
		3B Insurance to GDP		→
4	Instruments	4A. Market volume to GDP (Bonds, Equity)		→
		4B. Interbank Lending to GDP		→
		4C. Turnover (Equity, Bonds, FX)		→
		4D. Bid-ask spread		↘
5	Market infrastructure	5A. Credit bureau coverage		↗
		5B. World Bank – depth of credit information index		↗
6	Regulatory, legal and macro environment	6A. Level of inflation		↗
		6B. World Bank – ease of Doing Business index		↘
		6C World Bank – strength of legal rights index		↘
		6D. Time for issuance		↗
		6E. Tax related regulation		→

To investigate the root cause this low financial depth in Indonesia, we defined a set of metrics across each dimension of the financial market ecosystem. We then benchmarked Indonesia with regional peers such as Thailand, Philippines, Malaysia, India, China and Singapore. For each of the metrics, we evaluated the relative current status of Indonesia to peers, as well as Indonesia's recent trajectory for each market. Our assessment shows that Indonesia has room for improvement across nearly all metrics. Significantly, the position of Indonesia has been stable or declining across most metrics, with only five out of sixteen metrics showing a positive trend. This is reflected in Exhibit 2.

Below is an analysis of each of the six components of the Indonesia financial market ecosystem:

CAPITAL USERS

The number of Equity Capital Market (ECM) and Debt Capital Market (DCM) issuers in Indonesia is low compared to peers, and has remained relatively static at around 30 per year from 2010 to 2014. One of the reasons for low issuances is the lack of participation by some of the largest companies in the economy. For instance, at the end of 2014, there were only twenty State-Owned Enterprises (SOEs) listed in Indonesia, out of a total of 138 SOEs. In contrast, there were 116 ECM issuers in Malaysia in 2014 despite an economy that is around 2.6 times smaller than Indonesia's. Similarly, the number of ECM and DCM issuers in Thailand grew by approximately 150% and 50% respectively from 2010 to 2014 compared to relatively flat growth in Indonesia.

Despite available tax incentives for going public (listed companies with a free float above 40% are eligible for a 5% concession on corporate tax), the number of companies electing to list has remained low. This is driven by perceptions of a high regulatory burden imposed on listed companies, as well as by a reluctance to engage in greater disclosures, which could potentially lead to higher tax liabilities.

CAPITAL PROVIDERS

In comparison to peer markets, the Indonesian corporate sector is more heavily reliant on **bank funding**. Bank loans to corporates in Indonesia in 2014 comprised 58% of total funding (measured by the increase in banking loans[2], and ECM and DCM issuances). In contrast, the share of banking loans in total funding was approximately 29%, 33% and 22% in Malaysia, Thailand and Philippines respectively.

Aside from the dominant role of banks in providing funding, there is significant **foreign participation** in Indonesian markets, partly driven by the limited asset base of domestic institutions. The percentage of stocks transacted by foreigners, and the percentage of foreign ownership in government bonds, grew to 39% and 37% respectively in 2014, higher than in peer markets. For instance, the corresponding percentages for Thailand were 23% and 18% respectively. While high foreign ownership in Indonesia is a sign of an open capital market, it also reflects the limited strength of the domestic buy-side, and makes the market more vulnerable to shifts in global fund flows.

INTERMEDIARIES

The penetration of **insurance and mutual funds** in Indonesia is significantly lower than in peer markets. The ratios of insurance assets (life and non-life) to GDP, and mutual fund assets to GDP, were at 6.9% and 2.3% respectively in 2013. The relevant ratios for almost every peer country are significantly higher. For example, in India, ratios were at 18.4% and 7.4% respectively.

There are over 140 brokers in the **securities market**. The presence of too many brokers has led to low governance standards (such as a lack of segregation between proprietary and client assets), as well as intense competition and unrealistic pricing promises in primary market deals.

2 Due to availability of the data, new banking loans to corporates were estimated through the increase in banking loans to corporates. This understates an actual share of banking loans in total funding, but allows meaningful comparison between peers

The **pension industry** in Indonesia has received a fillip with the implementation of a more comprehensive social security framework under BPJS (the Indonesian social security administration body), seeking to provide universal coverage. This is likely to emerge as a large source of liquidity for the markets in the coming months. However, overall, the pension industry remains sub-scale, and players have a short-term focus to investing because their performance (particularly for defined benefit schemes) is measured annually. One other issue is that BPJS allows participants to withdraw funds without any penalty when changing jobs, which tends to lead to a more short-term mindset.

INSTRUMENTS

Liquidity of Bonds in Indonesia is low in comparison to peers. The turnover ratio[3] for government bonds was at 26% in 2013, while in Philippines it was at 49%, and it was at 60% in Thailand. Corporate bonds are significantly less liquid than government bonds. Turnover ratio for corporate bonds was at only 11% in 2013, compared to 47% in China. Some debt instruments which are common in other markets, such as floating rate bonds, inflation-linked bonds and asset-backed securities, are largely underdeveloped or even absent in Indonesia.

Indonesia's **bid-ask spreads** for government bonds are significantly higher than for peers. According to a survey by AsianBondsOnline carried out in early 2014, bid-ask spreads in Indonesia were six basis points (bps) for on-the-run government bonds, and 9.6 bps for off-the-run. In contrast, spreads in other ASEAN markets (Singapore, Malaysia and Thailand) ranged from 1.7 to 2.3 bps for on-the-run, and 3.5 to 4.3 for off-the run government bonds.

Liquidity in equity markets is low, but close to some of the emerging market peers. Turnover ratio[4] was at 36% in 2013, while ratios for Malaysia, India and Thailand were 32%, 24% and 102% respectively. Several equity-linked instruments that are common in other markets, such as Exchange-Traded Funds (ETFs), Real Estate Investment Trusts (REITs), and options and futures both for the index and for individual stocks, are underdeveloped or even absent in Indonesia.

Liquidity in FX markets is low compared to peers. FX turnover ratio[5] was at 1.2% in 2013 while ratios for Malaysia, Thailand and Philippines were all at 2.3%. While Indonesia has some FX derivatives, the share of spot trades was around 67% in 2013. There are very few deals in the FX forwards market beyond the three-month maturity bucket, which also impacts liquidity in the cross-currency swap market. FX options are currently not available.

Money market instruments are also less developed compared to emerging market peers. For example, the ratio of outstanding repurchase agreements (repos) to outstanding bonds is at approximately 0.4% in Indonesia while values for Malaysia and Philippines are 3.1% and 7.9% respectively. One reason for this is that non-bank players are currently not accessing the repo market. The interbank lending market is impacted by the four-tier classification system in place for banks, and lower-tier banks often find it hard to source liquidity due to counterparty risks and the absence of a proper settlement mechanism.

3 Ratio of Value of Bonds Trading to Outstanding Amount

4 Ratio of Value of Share Trading to Market Capitalisation

5 OTC foreign exchange turnover (daily average) to Import + Export (annual)

MARKET INFRASTRUCTURE

In terms of market infrastructure, Indonesia already has the basic building blocks in place. The Indonesia Stock Exchange (IDX) was formed in 2007 after the Surabaya Stock Exchange was merged with the Jakarta Stock Exchange. The Indonesian Clearing and Guarantee Corporation (KPEI) provides transaction clearing and settlement guarantee services for stock exchange transaction settlement, and for securities lending and borrowing services. In addition, the Indonesian Central Securities Depository (KSEI) provides services for securities depository and transaction settlement.

However, the infrastructure for **the FX and money markets** requires improvement. For FX, Indonesia needs to put in place mechanisms for settlement of Over-The-Counter (OTC) derivatives, and comply with the principles of The International Organisation of Securities Commissions (IOSCO), such as moving trades onto electronic trading platforms and the central clearance of all standardised OTC derivatives. There has been limited progress made in this regard. On the money market side, clearing and settlement mechanisms for inter-bank lending need to be strengthened.

The **coverage and quality of credit information** have improved recently and are close to peer group levels. Credit bureau coverage[6] increased to 46% in 2014 which is close to the Thailand level of 53% but is still lower than the 79% in Malaysia. The depth of credit information index[7] for Indonesia, as measured by the World Bank, has improved from 5 in 2010 to 6 in 2014. This is similar to peer levels (7 for Malaysia in 2014 and 6 for Thailand).

REGULATORY, LEGAL AND MACRO ENVIRONMENT

Indonesia's **inflation rate** has significantly decreased over the last few years, from 10.5% in 2005 to 6.4% in 2013. However inflation continues to be higher in Indonesia than for emerging market peers such as Thailand, Malaysia and Philippines, all of which have managed to keep inflation in the range between 2 and 4% in recent years.

Indonesia's **business environment** is not perceived as very friendly by global standards, and has been witnessing a negative trend. The strength of legal rights index[8], measured by the World Bank, decreased from 5th in 2010 to 4th in 2014. This was similar to the performance of regional emerging market peers. Indonesia is also ranked 114th in the ease of doing business[9] index by the World Bank, with only India ranked lower from our peer set, while Singapore and Malaysia were ranked 1st and 18th respectively.

The **approval time for DCM and ECM issuance** in Indonesia is significantly higher than in other markets. For example, maximum approval time for first time public issuance is 45 days in Indonesia, while it ranges from 14 to 21 days in Thailand, Malaysia and Singapore.

6 The number of individuals and firms listed in a public credit registry and public credit bureau with current information on repayment history, unpaid debts, or credit outstanding

7 Index measures rules affecting the scope, accessibility, and quality of credit information available through public or private credit registries (0=low to 8=high)

8 Index measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending (0=weak to 12=strong)

9 Index ranks economies from 1 to 189, with first place being the best. A high ranking (a low numerical rank) means that the regulatory environment is conducive to business operation

Taxation of foreign investors in Indonesia is higher than in most other markets. The withholding tax rate is at 20% in Indonesia, while it ranges from 0% to 15% in other markets. Only Philippines has a higher rate, at 30%. Capital gains tax ranges from 5% to 30% in Indonesia, while it is often eliminated in peer countries, or is at lower levels (5% to15%).

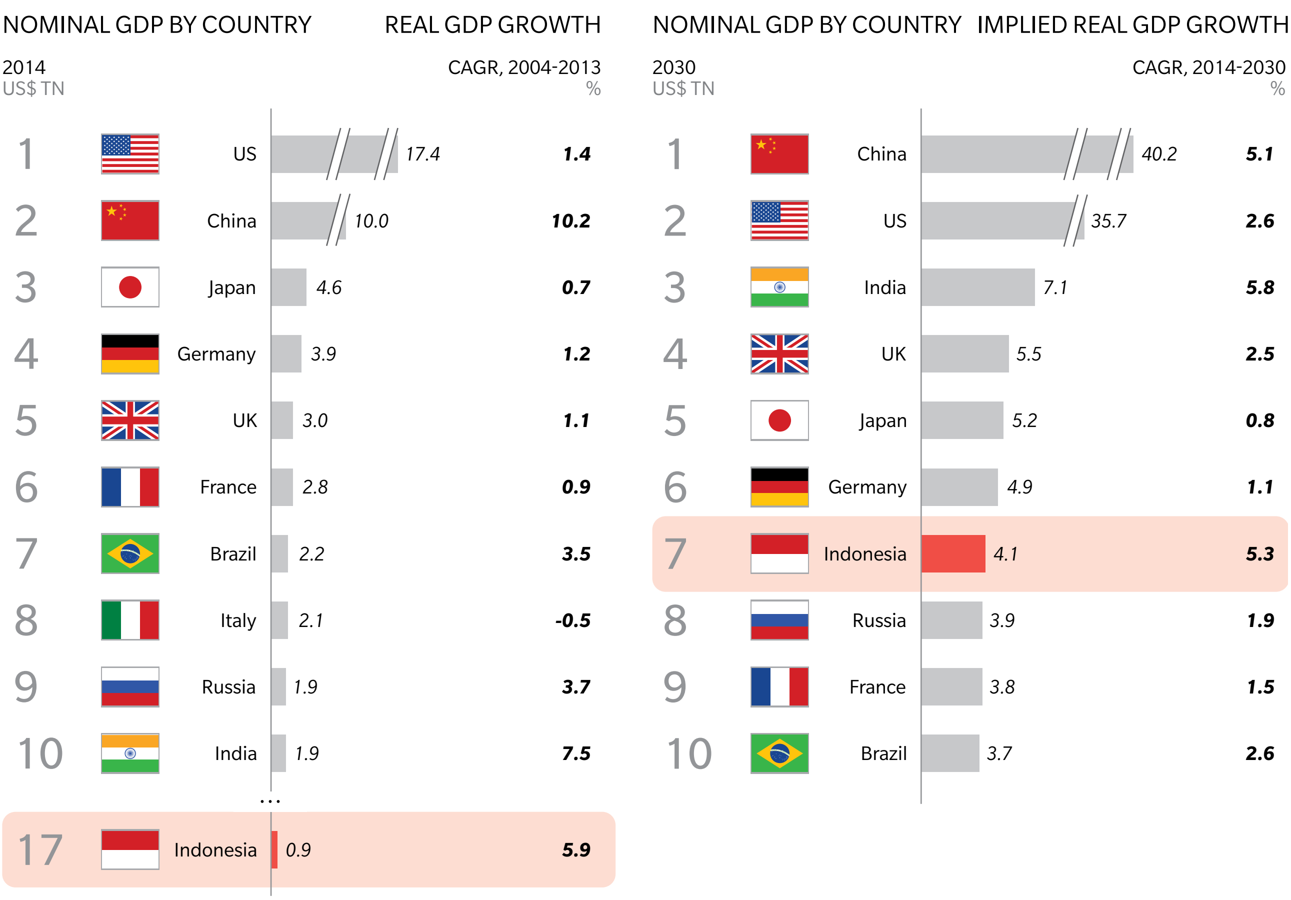
Finally, unlike most markets worldwide, there are **no tax incentives** provided to **retail investors** for investing in long-term savings and retirement products.

1.3. GROWTH ASPIRATIONS IN INDONESIA AND THE CASE FOR FINANCIAL REFORM

Indonesia can become a G7 economy by 2030

Indonesia is expected to continue its strong growth trajectory, supported by a number of factors such as the Asian resurgence fuelling demand, continuing urbanisation and a young population. By 2030, with adequate capital availability, as per estimates by Oxford Economics, Indonesia could reach approximately US$4 TN in annual GDP, and become a G7 economy (based on nominal GDP). This is reflected in Exhibit 3.

Exhibit 3: Global ranking of countries by nominal GDP in 2014 and 2030



Source Oxford Economics, Oliver Wyman analysis

To achieve its growth aspirations, Indonesia needs to rapidly deepen financial markets, or else risk US$600 BN of incremental GDP and its top ten ambitions

There is a clear empirical connection between economic development and financial deepening. Although there has been much debate on the causality between GDP per capita and financial deepening, the two tend to move hand in hand. Countries with higher GDP per capita usually have much deeper financial markets.

A number of earlier[10], and more recent[11] studies have tried to establish and quantify the link between financial markets deepening and economic development. We have used these studies to conduct a proprietary analysis to estimate the growth of capital required in Indonesia to sustain the country's overall growth aspirations for 2030. We have also evaluated the impact on economic growth should there be inadequate financial deepening and a resulting shortfall of capital.

We used a regression analysis to establish a link between financial depth and GDP growth[12]:

- For equity markets – the link between the ratio of common shareholders' equity to nominal GDP and per capita GDP
- For corporate bonds – the link between the ratio of corporate bonds to nominal GDP and per capita GDP

We then used the regression results to evaluate the level of capital required for Indonesia to achieve its GDP aspirations, and also to evaluate the impact on GDP growth if capital growth is not accelerated.

To achieve its GDP growth aspirations of US$4.1 TN by 2030, we estimate that the size of the total financial capital base (the sum of corporate bonds and equity markets) will need to grow by **six to eight times** and reach **US$4 TN to US$6 TN** in 2030. This implies a **13% to16%** annual growth rate in total capital to be sustained over the next 16 years, which is 10% higher than the growth rate achieved in the previous five years. This growth in capital markets in Indonesia will also lead to much wider participation in capital markets, with the number of bond issuers and listed companies increasing by **three to six times from current levels**, while the number of retail investors could grow by **10 to 15 times** from current levels.

10 Pioneering works of Goldsmith (1969), McKinnon (1973), and Shaw (1973) have shown that financial development stimulates economic growth

11 Greenwood (2011) had estimated that on average, a country could increase its GDP by 58 percent if it adopts the best financial practice in the world. A study published by Credit Suisse (2014) found a strong correlation between the depth of financial markets and economic productivity

12 The analysis was based on developed countries data for 1980-2014 years for the equity market, and 1990-2014 for the corporate bonds market. This approach assumes that Indonesian financial markets will follow the trajectory of developed markets over the longer term, and will have slower growth than current levels

However, if Indonesia does not embark on a series of targeted financial market reforms, the actual growth in capital markets will be slower than is required to fund GDP growth aspirations. Our analysis shows that if financial reform does not take place, and the deepening of financial markets does not accelerate, then Indonesia will not be able to attract sufficient capital to achieve growth. We estimate that in the absence of reform for financial deepening, Indonesia could shave off **approximately US$600 BN** in GDP by 2030, with GDP per capita down by 15%. In this scenario, Indonesia will **not be a top 10 country** in terms of aggregate nominal GDP.

Rapid reform in Indonesia is critical given that other economies in the region have also announced plans to target global capital

The urgency of reform is amplified by increasing competition for global capital in the region. If Indonesia does not enact timely reforms, it risks losing out to peer markets that are actively courting international investors.

In the next section, we review the development experience of other emerging markets, and also summarise contributions from market participants in Indonesia. We have used these two sources to devise a list of potential initiatives for Indonesia.

2. POTENTIAL INITIATIVES FOR FINANCIAL DEEPENING IN INDONESIA

In order to identify a set of potential initiatives which need to be carried out financial deepening is to be achieved, we conducted primary research in the form of interviews with 17 stakeholders in the Indonesia financial market ecosystem. We also closely analyzed the development experience of ten other peer markets across bond markets, equity markets, foreign exchange markets and money markets. The ten peer markets we reviewed comprise Malaysia, Thailand, Singapore, Philippines, China, India, Hong Kong, South Korea, Chile and South Africa.

2.1. FINDINGS FROM INTERVIEWS WITH MARKET STAKEHOLDERS

As a part of this research effort, we interviewed representatives from four leading banks, six local institutional investors and investment banks, two large Indonesian corporates, two foreign investors, together with representatives from OJK, the Ministry of Finance, Bank Indonesia, and the International Finance Corporation (IFC).

Key insights and takeaways from market participants are summarised below for six components of the financial market ecosystem.

CAPITAL USERS

It is estimated that there are around 2,500 to 3,000 corporates in Indonesia with an annual turnover of more than US$10 MM. However, most of them prefer bank loans to capital market products. Inefficiency appears to be a major issue. In the words of an interviewee of a large local corporate, “it takes around four to six months to finish the bond issuance process, which is two or even three times longer than the normal issuance time in other ASEAN countries”.

Aside from lengthy issuance times, a second challenge involves higher disclosures, which in turn result in higher tax payments. One representative from a leading institutional brokerage remarked that “private companies do not wish to list as they feel that this will open them up to greater disclosure and they could end up paying higher taxes”. Apart from the tax issue, “IPOs in Indonesia mostly happen when a company struggles in a sunset industry with limited growth upside, or if the company needs to be divided for inheritance purposes”.

A third issue is a perception among corporates that staying listed is costly given the amount of regulatory filings and shareholder communications that are required. As a leading corporate CFO put it, “I am not sure I would have gotten listed if I knew about the hassle. We have to do quarterly advertisements in newspapers, communicate in paper form with all our investors, and maintain a team to do very detailed filing and reporting. The government should reduce the cost burden of being listed and allow for electronic communications”.

Currently, the government provides listed companies that have more than 40% floating shares with a 5% income tax incentive. However, because of the aversion to list due to greater disclosure, the risk of higher taxes and concerns about the cost of being listed, the number of ECM deals has stayed relatively static at approximately 30 per year.

CAPITAL PROVIDERS

RETAIL INVESTORS

Retail participation in Indonesia capital markets is much lower than in most peer countries with currently only around 450,000 individual stock trading accounts. The major reasons cited by interviewees include the risk averse nature of Indonesian individuals, the low level of financial literacy and a lack of incentives for retail capital markets investments.

A leading regulator believes that "Indonesians are traditionally risk averse, and most existing equity investors are of Chinese origin, being more aggressive in their investment outlook." Further, Indonesian retail investors have limited awareness of mutual fund products, especially in lower-tier cities. "Currently more than 50% of mutual fund Assets Under Management (AUM) in Indonesia comes from Jakarta and nearly 95% comes from the top four cities", said a leading local fund manager. Finally, high bank deposit rates also discourage retail investors from putting money in mutual funds. "Unlike most markets," the fund manager continued, "there is no upfront tax incentive in Indonesia to persuade individuals to invest in capital market products."

FOREIGN INVESTORS

In the words of the Head of Capital Markets of a leading investment bank, "foreign investors have a high level of interest in Indonesia and the country is well-represented in portfolios, but there are obstacles such as a high tax rate, inadequate hedging instruments and low market liquidity." A leading mutual fund manager said that "current tax regulations such as a 20% withholding tax on bonds are a deterrent to foreign investors. The lack of volume of high quality paper is another key issue." Interviewees also pointed out that it is very hard for foreign investors to take a contrarian view in a largely unidirectional market.

DOMESTIC INSTITUTIONAL INVESTORS

Interviewees agree that there is a shortage of genuine long-term investors in Indonesia. A multilateral agency executive that has studied the Indonesia market said that "pension funds don't act as long-term investors as they have a short-term return mindset, particularly for defined benefit type schemes. Performance is currently measured annually against a fixed benchmark, and so pension funds will look at yield rather than deploy capital against long-dated assets." Further, a leading regulator observed that pension funds "allocate approximately one third of their assets in money markets instruments as they see these as a source of yield, not just liquidity. This is way higher than in other markets."

INTERMEDIARIES

Most of the interviewees raised the point that there are currently way too many capital market brokers in Indonesia. A leading foreign broker said that "Indonesia has too much competition resulting in unrealistic pricing and a failure to deliver. This upsets clients, who then go back to banking products." Another international broker said that "Indonesia today has over 140 brokers, while Malaysia at the same time has less than 30 stockbroking companies and investment banks." Meanwhile, a representative from a leading domestic securities firm said that "the major reason for an unconsolidated brokerage market is that Indonesia has the lowest entry barrier for brokers in the region, with capital requirements at only one fifth to one fortieth of the capital requirements in peer markets."

In the corporate bond market, secondary market liquidity is a challenge. The treasury head of a leading bank said that "although the government bond market is relatively well developed, there is no market maker to provide two-way prices and market making to facilitate corporate bond trading." He continued: "Banks cannot play this market making role given legal lending limit constraints." The lack of market makers results in very low liquidity levels in the secondary market. He further mentioned that "the government should explore appointing bond dealers who get a large portion of the issue at a discounted price, and can then farm out to investors, but in return need to make markets on an ongoing basis".

MARKET INFRASTRUCTURE

Most market participants agreed that the lack of a credible pricing benchmark is a challenge in the corporate bond market. The treasury head of a leading local bank said that "although the 5-20 year government bond curve is well established, there is no such curve in the less than five year and greater than 20 year window." In addition, a leading state-owned bank specified that "there is no clear guideline on risky asset pricing. It is very difficult to figure out the appropriate credit spread on AAA vs. BBB. This is hugely subjective."

Another challenge is the lack of market transparency in secondary markets. A representative from a global investment bank said "there is very limited information on bond ownership. Since it is very difficult to know who has the bonds, it is very difficult to deliver on large transactions."

In the money markets, small banks stressed that it is quite difficult for Buku 1 or 2 banks to obtain funding from larger banks (Buku 3 or 4) due to the reluctance of larger banks to take credit exposure on smaller banks. A representative from a leading local bank mentioned the need to "launch a money market clearing and settlement mechanism on the lines of the CBLO[13] in India to provide lower buku banks with a chance to access liquidity through the interbank market more easily."

13 The CBLO (Collateralised Lending and Borrowing Obligation) is a money market product developed by the Clearing Corporation of India (CCIL) and Reserve Bank of India (RBI). The details of the CBLO include an obligation for the borrower to repay the debt at a specified future date, and an expectation of the lender to receive the money on that future date, and they have a charge on the security (government bonds) that are held by the CCIL

Finally, an executive from a leading global investment bank remarked on the hedging challenges in Indonesia and how it was nearly impossible to obtain a quote to hedge long-dated exposures. Further, it was "one of the G20 members in Asia which has committed to abide by IOSCO guidelines[14] for OTC derivatives, but yet is probably the most behind in terms of implementation".

INSTRUMENTS

Most interviewees raised the point that there is a lack of sufficient instruments in the Indonesian capital markets. One head of sales and trading observed that "in equity markets, liquidity is very low beyond the LQ45 stocks, and there are no equity-linked exchange-traded funds or equity-linked derivatives, such as options and futures for both index and individual stocks". In the bond market, there are no interest rate futures and liquidity for interest rate swaps is low, making interest rate risk hedging difficult. As pointed out by a global investment bank representative, "payers even need to go to offshore markets to hedge their domestic exposure." In the money market, there are no floating rate notes, and last but not least, in the FX market, there is a total lack of long-dated cross-currency swaps.

REGULATIONS

Interviewees found regulations to be a major dampener to the growth of Indonesia capital markets, particularly in areas such as tax, inconsistent approaches across BI and OJK, restrictions in terms of even some basic product functionality and limited access in certain markets.

According to a leading treasury head, "the biggest factor impeding the growth of the Indonesia capital markets is an unfavorable tax environment. Withholding tax on bond coupons makes it unattractive for investors to place capital in Indonesia. There is partial relief if they are domiciled in Singapore or Philippines". Apart from tax, market participants also held the view that coordination among different regulators was a challenge. One bank treasury head pointed out how "BI encourages us to do repos but when we actually did a repo, my board of directors got a call from OJK asking us if we had liquidity challenges." There is a clear need for a more consistent approach to regulations and to communication with the market.

One interviewee reflected the views of several others, saying "that regulators in Indonesia had been very liberal in the past, but post-2008, they have now become too conservative. For example, banks are not allowed to engage in equity finance, or to short a bond. These are very basic functions available in nearly all other markets." Another interviewee pointed out how "liquidity in the money market is impacted by the fact that non-bank companies are not allowed to participate. We should be allowing asset managers and insurance companies, which frequently have liquidity mismatches, to be able to access this market." Another treasury head observed that "unlike most markets in the region, reserve reporting in Indonesia is required on a daily basis, as opposed to a fortnightly average. As a result, only the overnight call money market has developed, and there is low activity in windows of a longer duration."

14 IOSCO principles are based on four cornerstones: (1) Move trades onto electronic trading platforms; (2) Centrally clear all standardised OTC derivatives through a Central Clearing Counterparty ("CCP"); (3) Increase the level of standardisation in the OTC derivatives market; (4) Central reporting of transactions to a trade repository ("TR")

2.2. SUMMARY OF THE GROWTH EXPERIENCE IN PEER MARKETS

Apart from interviews with key market stakeholders, we also examined the market development experience in ten emerging markets – Malaysia, Thailand, Singapore, Philippines, China, India, Hong Kong, South Korea, Chile and South Africa. All these countries were successful in increasing financial depth in one or more of the bond, equity, FX or money markets through a series of targeted interventions. We have distilled the lessons learned across markets, and over the rest of this chapter, we describe the steps taken to develop the bond market, equity market, foreign exchange market and money market.

BOND MARKET DEVELOPMENT

The development of local currency bond markets is particularly important in the development domestic capital markets. It enables the raising and investing of capital in local currency, thereby minimising exposure to FX risk for domestic issuers and investors. We have identified eight sets of initiatives adopted across markets in developing local currency bond markets. These are discussed briefly below.

ISSUANCES TO BUILD THE GOVERNMENT YIELD CURVE

Several countries have invested in building up the government yield curve systematically. Two prominent examples are South Korea and Singapore.

The Korean government, for example, started to issue government bonds systematically for the purpose of developing the bond market. It would announce the required issuance of government bonds every month and year, generating more accurate expectations within the market. By separating monthly issuance by maturity, and distinguishing the day of bidding (Monday) from the issue day (Wednesday), the government took steps to align with market expectations.

Subsequently, in 2000, the Korean government launched the Fungible Issue System. Under this system, the coupon rates and maturities of Korean Treasury Bonds (KTBs) issued over certain periods of time are standardised. In the past, the maturities and coupon rates had differed each time KTBs were issued. The result was too many KTB types and low liquidity, since the amount of issuance of each type was rather small. The Fungible Issue System resolved this problem, and also helped to stabilise the reference interest rate. This was followed in 2009 by a KTB conversion offer system where off-the-run KTBs were exchanged for on-the-run.

The Singapore government similarly embarked on an effort to build a liquid government benchmark yield curve to act as a price discovery mechanism for issuers and investors. The government achieved this by progressively extending the yield curve by issuing bonds with longer maturity (such as 10-year, 15-year, 20-year and then 30-year bonds). In addition, it also established a public calendar of issuance so that the exact size of each treasury bill and bond issue is made known one week before the auction.

PROMOTING CORPORATE ISSUANCES

Most developing countries have the challenge of not having credible corporate bond issuers to attract investors and to help in the discovery of clear credit spreads. To solve this problem, the Singapore government was proactive in encouraging state-owned statutory boards to issue corporate bonds. For example, government agencies such as the Port Authority and the Housing Development Board became the first issuers for various maturities from 1998. The government also invited highly credible international organisations, such as the International Finance Corporation (IFC), to issue bonds in Singapore in 1998.

REMOVING RESTRICTIONS TO ENLARGE THE INVESTOR BASE

Governments and regulators can play a critical role in enlarging the investor base in domestic capital markets. For instance, between 2000 and 2010, Chile liberalised its domestic financial institutions through the MK I and MK II Capital Markets Reform programs. Under these programs, insurance providers were permitted to hold a wider range of securities, including derivatives against which they could hedge their bond holdings. A new class of fund provider was also permitted – "general fund administrators", which could simultaneously manage multiple types of fund, such as pension funds, investment funds and mortgage portfolios. In 2007, the government raised the limits to individual pension fund contributions and increased tax benefits applied to the contribution. Approval criteria were also broadened for licenses to operate banks, life insurance companies and pension funds so that market competition would be encouraged. All these initiatives resulted in a much larger investor base for domestic capital markets.

DEVELOPMENT OF MARKET INFRASTRUCTURE

Market infrastructure is critical in facilitating trading and risk mitigation. Several countries have invested heavily in market infrastructure in a bid to boost the bond market.

In South Africa, a Bond Exchange was established as early as 1996, and this already had a central securities depository. The regulators quickly put in place a clearing house and a guarantee fund to mitigate transaction settlement risks. In subsequent efforts to increase transparency and achieve centralised price discovery, the back-to-back deal booking system was introduced in 2004 for reporting and matching of trades. This was complemented by the ZAPrices service, which distributed collated information from market makers and inter-dealer brokers, and distributed it to external data providers.

In Thailand, a market association played a significant role in market development. The Thai Bond Dealing Centre became the Thai Bond Market Association (Thai BMA) in 2005, acting as an information hub and a self-regulatory organisation for the industry. The association provides bond information and pricing services for the market. It also creates market convention and standards and leads efforts in investor education programs. Moreover, mandatory membership for dealers and inter-dealer brokers, and the registration of all bonds at the Thai BMA, help to bring stability and integrity in the bond market.

BUILDING AN EFFECTIVE PRIMARY DEALER SYSTEM

Several countries have fostered bond market development by ensuring adequate liquidity at all times by installing a network of primary dealers. For instance, in Korea, a successful network of primary dealers was put in place in 1999. These primary dealers were required to purchase at least 10% of the volume of issued KTBs every month, and to offer quotes of at least ten bid and ask prices for benchmark KTBs. They also had duties related to the trading and holding of KTBs. In return, KTB primary dealers receive the benefits of exclusive participation in KTB auctions, and the rights to purchase KTBs through non-competitive bids and to receive financial loans at low interest rates.

Similarly, in Thailand in 2000, nine primary dealers were appointed to help support the primary and secondary debt markets. These primary dealers were required to maintain certain levels of primary and secondary market activity and act as market makers in government securities. In return, they were allowed to submit non-competitive bids in government debt auctions and advise on bond market development.

INTRODUCING NEW INSTRUMENTS

Several countries looked to deepen bond markets by launching new trading and hedging instruments. For instance, the Reserve Bank in India (RBI) introduced repo in corporate bonds in January 2010, and repo in corporate debt on commercial papers, certificates of deposits and non-convertible debentures with less than one year of original maturity in January 2013. The minimum haircut applicable on the market value of the corporate debt securities was also revised by the RBI to between 7.5% and 10% for AAA to AA-rated corporate bonds.

RBI also introduced Credit Default Swaps (CDS) to the market in December 2011 and required all trades to be reported. The launch of CDS provided Foreign Institutional Investors (FII) with much-needed hedging opportunities and helped increase FII participation in the corporate bond market. In January 2013, the RBI permitted CDS on unlisted but rated corporate bonds. CDS were also permitted on securities with an original maturity of up to one year.

TAX INCENTIVES

Several markets have provided tax incentives on bonds to spur growth. For instance, from 2000 to 2009, the Malaysian government provided attractive tax incentives to all participants to spur growth in the Islamic bond market (Sukuk). For bond issuers, the government removed income tax on the Special-Purpose Vehicle (SPV) put in place for issuing Sukuk. Issuance expenses and stamp duty for both Sukuk and conventional bonds were made tax-exempt. For bond investors, the government abolished stamp duty, capital gains tax, and withholding tax on local currency bonds and all Sukuk. For intermediaries, the government provided a three-year tax exemption for income from advising, distributing or underwriting Sukuk issuances.

IMPROVED REGULATIONS

Regulations have been simplified or streamlined in several markets to deepen bond markets. One of the major concerns expressed by foreign investors centers on a lack of investor protection and bankruptcy resolution capabilities in emerging markets. Several markets have invested heavily to improve the efficiency and effectiveness of resolving bankruptcy cases and business disputes. For example, Thailand reformed its bankruptcy law in 1999. Prior to this reform, all liquidation cases were held in the Thai civil court system, which handled all civil cases. However, these courts did not have an expertise in business matters or valuation. After the reform to the law, Thailand established a court specialised in bankruptcy cases with better-trained judges. In addition, before the reform, individual cases were often not held on consecutive days. If one day was not sufficient to settle a case, another would need to be scheduled, frequently weeks or months later. The new regulation required that the Bankruptcy Court will proceed with the trial of a case without adjournment until completion, unless an unavoidable problem arises.

Another example of the streamlining of regulatory process took place in Malaysia. Under the Capital Markets Masterplan in 2001, significant enhancements were made to the framework for primary market debt issuance. These included introducing a disclosure-based approval framework, introducing shelf-registration, eliminating the minimum rating requirement (although at least one rating is still mandatory), removing underwriting requirements, and eliminating restrictions on the utilization of proceeds from corporate bond issuances. Prior to the reform, the approval and issuance process would take up to four to six months; with the new disclosure-based framework, the Securities Commission is now mandated to approve applications for bond issuance within 14 days (a major improvement on the previous waiting time of one to three months), and the overall issuance process times were reduced to two to three months.

Finally, it is important to maintain a consistent regulatory approach between the central bank and the financial services regulator so that the market does not receive mixed signals. Further, there needs to be a clear balance between prudential regulations and the regulations designed to drive market development. Too much emphasis on the former has impeded the growth of capital markets in several countries, including Indonesia.

EQUITY MARKET DEVELOPMENT

Countries have taken several different approaches to strengthen their stock markets. Based on these experiences, we have identified seven sets of initiatives adopted across markets to develop equities.

ENCOURAGING LARGE SOE ISSUANCES

A number of countries demutualised some of their SOEs as a major initiative to add breadth and depth to the local stock market. For example, the Singapore government launched a privatisation scheme in March 1985. A Public Sector Divestment Committee (PSDC) was formed in January 1986 and examined 99 SOEs. After the examination, it recommended 15 for listing, 9 for further privatisation and 17 for total privatisation. In addition, the PSDC envisaged a ten-year period for implementing its recommendations on privatisation so that the market could absorb the shares effectively.

Between 1985 to1996, there were 16 newly-listed SOEs and 15 further sales of shares for Government-Linked Companies (GLCs) that were already listed. By April 2000, as a result of the privatisation program, SOEs controlled by Temasek Holdings accounted for about 25% of stock market capitalisation. The three largest listed Singapore companies by market capitalisation, the top five companies by turnover and the top four by total assets (excluding banks) were SOEs. Two of the five listed banks, including the largest, were also SOEs.

REMOVING RESTRICTIONS TO ENLARGE INVESTOR BASE

Several markets have looked to boost market liquidity by removing barriers to entry, hence attracting additional classes of investors. One prominent example is Korea. In 1999, the qualification for engaging in securities business was expanded from just authorised banks and trust companies to authorised corporations. This resulted in a broader base of companies engaging in securities business. Subsequently, in 2004, the Framework Act on Fund Management allowed the National Pension Fund and other funds to invest in the stock market. Further, the Trust Business Act was revised in 2005 to permit securities companies to engage in trust business. To increase foreign investor participation, the Foreign Investment and Foreign Capital Inducement Act of 1997 completely eliminated ceilings on foreign portfolio investments in Korean equities. As a result, by Dec 2013, foreign holdings of stock on the South Korea Stock Market (KOSPI) had exceeded 35%.

MARKET INFRASTRUCTURE DEVELOPMENT

Various countries have invested in infrastructure development to boost development of equity markets. In South Africa, the Johannesburg Stock Exchange (JSE) formed strategic partnerships to boost market efficiency and robustness. First, a cross-dealing agreement was signed with the London Stock Exchange (LSE), which made South African companies listed on the LSE available to local investors. The Johannesburg Stock Exchange also adopted LSE's trading system (JSE SETS), which was automated through an electronic clearing and settlement system (STRATE). Moreover, a real-time stock exchange news service was launched in 1997 to further enhance market transparency and investor confidence.

In India, there were significant infrastructure investments made to improve the efficiency of share trading. Compulsory dematerialisation of shares was introduced in 1998, and has resulted in lower trading costs, higher transaction speed and greater market liquidity. Online trading was launched in the early 2000s, and Indian stock markets gradually switched to a T+2 rolling settlement cycle by 2003. All these measures made buying shares a relatively straightforward and efficient process for investors.

Finally, in Thailand, a second-generation electronic trading system, ARMS, was introduced in 2008, which had 2.5 times the order capacity and twice the transaction capacity of the first-generation trading system. It also enabled real-time clustering. A third-generation trading system – SET CONNECT multi-market (combined cash and derivatives) platform was launched in 2012, which provided real-time cross-site redundancy, four times the order capacity and 125-times the message capacity of the second-generation ARMS.

INTRODUCING NEW INSTRUMENTS

Several countries actively developed new instruments for stock markets to facilitate trading and hedging. For example, India introduced a range of derivative instruments, such as index futures, stock futures, index options, and stock options. Lot sizes were deliberately kept small to facilitate retail participation in the derivatives markets, which have become important instruments for price discovery, portfolio diversification, and risk hedging. Various risk-containment measures, including margins, positions, and exposure limits, were also put in place to ensure the smooth functioning of the derivatives market. By 2013, equity derivatives turnover had reached more than 12.5 times that of the cash market.

Similarly, Thailand progressively launched a series of products that helped deepen the equity markets. ETF and property funds were launched in 2007, followed in 2009 by stock derivatives. In 2013, Thailand introduced infrastructure funds – listed instruments to facilitate infrastructure development. The funds were launched by companies looking to build out infrastructure such as those in the telecom and utilities sector.

The funds were closed-ended with a minimum size of THB2 BN and a requirement of at least THB1 BN to be invested per project, except for power projects, where only THB500 MM per project was required. A minimum of 75% of total assets had to be invested in infrastructure assets within six months of fund registration or capital-raising. Finally, Thailand imposed mandatory listing requirements on these funds. If greenfield projects comprised up to 30% of total assets of the fund, then the fund had to be listed in the Stock Exchange of Thailand. If however, greenfield projects comprised more than 30% of total assets of the fund, then the fund did not have to list immediately, but would have to do so when the greenfield projects were developed completely and could generate income within a maximum period of three years.

TAX INCENTIVES

A number of markets have introduced favorable tax treatment for equity investments to attract investor participation. For example, in 2001, Chile abolished capital gains tax on the sale of frequently traded shares. In India, equities are considered long-term capital if the holding period is one year or more. Long-term capital gains from equities are not taxed if shares are sold through recognised stock exchanges. Dividend income is also exempt from tax. Singapore does not impose any tax on dividends or any capital gains tax.

In Thailand, individual stock investors are exempt from capital gains tax on trading stocks. Further, a number of specific tax incentives were provided for the infrastructure funds mentioned earlier. A ten-year exemption on personal income tax was offered on the dividends distributed from infrastructure funds to individual unit holders. After ten years, investors are subject to the normal tax rate that is currently applicable to a mutual fund. In addition, infrastructure funds were also granted an exemption from Value-Added Tax (VAT), Specific Business Tax (SBT) and stamp duties for the transfer of the assets from the originator to the infrastructure fund.

STRENGTHENING MARKET INTERMEDIARIES

Regulators in several markets have encouraged the development of a strong financial intermediation industry through forced market consolidation and higher capital requirements. For instance, in 2000, all Malaysian stockbroking companies were required to merge with at least one other stockbroking company, while those aspiring to become Universal Brokers had to merge with three others.

The regulator also offered incentives to facilitate the market consolidation. Under the incentive program, stockbroking companies that entered into firm merger agreements to become Universal Brokers by 31 December 2000 were granted the right to open an additional branch for every license they surrendered to the Securities Commission. For example, a Universal Broker resulting from the merger of four stockbroking companies could have six branches (not counting the Principal Office).

Stockbroking companies that entered into firm merger agreements to become Universal Brokers by 31 December 2000, with a core capital of at least RM500 MM, were granted an additional bonus branch immediately upon fulfilling this condition. Moreover, stockbroking companies that completed consolidation before 31 December 2000 also enjoyed benefits from the tax incentives. As a result of the regulator-driven consolidation, the number of stockbroking companies fell from 47 in the early 2000s to 28 in 2014.

IMPROVING REGULATIONS

Several markets have launched specific regulations designed to foster development in the equity markets. For instance, in Chile, under the Capital Markets Reform I program in 2001, employees' pre-tax voluntary pension contributions were actively promoted. Further, investment limits for insurance company portfolios and mutual funds were relaxed to increase equity investments. The Capital Markets Reform III program amended mutual fund regulations to promote exchange-traded funds and streamlined the registration process for mutual funds. Relevant documentation of the fund may be marketed without waiting for it to be reviewed by the regulator.

Similarly, Thailand loosened regulatory requirements in the primary market. In 2013, it relaxed the regulations on public offerings of newly issued shares by a holding company. The requirement that it should hold at least 75% of its subsidiaries' shares was reduced to 50%. Further, in 2014, foreign companies were allowed to launch initial public offerings in Thailand, and simultaneous offerings of equities in Thailand and other countries.

FOREIGN EXCHANGE MARKET DEVELOPMENT

Countries have taken several different approaches to strengthen their foreign exchange markets. Based on experiences from other markets, we have identified five sets of initiatives which have been adopted to develop foreign exchange markets.

MARKET LIBERALISATION

Most markets have over time progressively liberalised exchange controls, resulting in increased foreign exchange volumes. In 2005, Malaysia simplified the rules for hedging for both non-residents, where any inflow or outflow of funds for committed transactions could be hedged, and for residents where hedging was allowed for most current and capital account transactions. Further, rules for domestic borrowing by non-resident controlled companies were fully liberalised, and higher thresholds were introduced for investments abroad, including the extension of credit to non-residents and lower restrictions for residents.

Rules on the retention of foreign currency by residents was also liberalised. In 2008, lending or borrowing in the Malaysian currency (MYR) by residents to or from non-residents was further simplified. Further, resident companies were free to borrow any amount in foreign currency from licensed onshore banks, and were also allowed to obtain any amount of foreign currency supplier's credit for capital goods from non-resident suppliers.

In 2010, residents were able to undertake settlement of international trade in goods and services in MYR with a non-resident. Threshold limits were removed on hedging for current account transactions by residents with licensed onshore banks, and all limits on cross-border foreign currency inter-company borrowings were also abolished. The Malaysia foreign exchange market saw a significant increase in daily turnover as a result of these changes introduced over time.

DEVELOPMENT OF NEW INSTRUMENTS

Several markets have systematically deepened the range of instruments available for hedging FX exposures. For instance, in 2003, India introduced additional hedging instruments, such as foreign currency-rupee options. It also allowed authorised dealers to use cross-currency options, Interest Rate Swaps (IRS), currency swaps, caps/collars and Forward Rate Agreements (FRAs) in the international FX market.

Similarly, Thailand had a predominantly spot market until 1997 when the economy was operating under a fixed exchange rate regime. However, once it moved to a floating rate regime, it was very quick to launch a wide range of competitively-priced FX hedging products, such as forwards, options, FX swaps and cross-currency swaps. Market development was actively promoted by the Bank of Thailand (BoT), which collaborated with commercial banks on the demand side to promote FX hedging through arranging seminars and providing related documents to educate the corporate sector, especially SMEs. On the supply side, the BoT ensured market liquidity by playing a major role in the FX swap market. It periodically absorbed THB liquidity while injecting USD liquidity into the market up to tenors of one-year, helping banks to efficiently manage their USD liquidity positions. In June 2012, the BoT coordinated with the Thailand Futures Exchange (TFEX) to launch the country's first currency futures as a new alternative for FX hedging.

IMPROVED MARKET INFRASTRUCTURE

The vast size of daily foreign exchange trading, combined with the global interdependencies of the forex market and payment systems, involve risks stemming from the settlement of forex trades on a gross basis. Settlement of forex transactions spans different time zones and payment systems, and counterparties assume various types of risks during the course of settlement. As a result, to address settlement risk, several markets have invested in strengthening market infrastructure. For instance, in 2001, India established a central clearing house – the Clearing Corporation of India Limited (CCIL).

The CCIL undertakes settlement of forex trades on a multilateral net basis through a process of novation, and all trades accepted are guaranteed for settlement. FX settlement risks are managed by setting exposure limits, and establishing a settlement guarantee fund. All participants are required to contribute to the settlement guarantee fund. The CCIL derives exposure limits based on a combination of each participant's contribution to the Settlement Guarantee Fund, their short-term credit ratings from a reputed credit rating agency, and the tier-I capital of each member.

On average, the CCIL daily settles over 80% of the market volume. In addition to the benefits of risk mitigation, CCIL's intermediation also provides its members with other tangible benefits, such as improved efficiency, lower operational cost and simpler reconciliation of accounts with correspondents.

FAVORABLE REGULATIONS

Several countries have introduced regulations to increase FX market participation and product adoption. One notable example is Chile, which set limits for pension funds on foreign exchange exposure from foreign investments. As a result, it created strong demand for long forward positions in OTC FX derivatives markets. Pension funds were also mandated to conduct their derivatives trading only with registered derivatives dealers, resulting in the establishment of a network of recognised FX dealers that were subject to public oversight and surveillance.

Chile also introduced lower capital charges on loans to borrowers who had hedged their foreign exchange exposures. This resulted in greater participation in derivatives, and presented regulatory incentives for lenders to encourage end-users of derivatives. Finally, derivatives counterparties were allowed to treat their derivatives claims against another firm on a net basis, so that the counterparty was secured from substantial losses by adopting net settlements. The amount of capital required to be held against derivatives positions by banks was also reduced.

SYSTEMATICALLY DEVELOPING CROSS-CURRENCY SWAPS BY INVITING GLOBAL ISSUANCES

One major problem associated with the FX market in many developing countries is the persistence of an unbalanced market. There are too many foreign currency borrowers who are looking to swap exposures to local currency. On the flip side, there are not enough players looking to swap out local currency exposures to foreign currency. This was the situation in Chile in the late 1990s. Local firms had large amounts of long-term obligations in US dollars, which they wanted to convert into peso obligations. However, there was limited interest in shifting from peso obligations to US dollar payments. This one-sided market was a deterrent to dealers in offering Cross Currency Swaps (CCS) to the market.

The situation changed after a series of transactions from 2000 whereby an entity with a high credit rating would borrow in Chilean pesos and then swap obligations into USD. To start with, in 2000, The World Bank issued a 5-year, CLP 55 BN bond, whose repayment was calculated to correspond with a USD interest rate. The World Bank then entered into a cross-currency swap with Chase. This provided Chase with a long-dated peso obligation, which it offset by offering CCS contracts to local banks and large Chilean firms that wanted to shift their US dollar-denominated debt payments into fixed peso payments. In 2001, a similar transaction, between the government of Uruguay and J.P. Morgan, extended the maturity of the local currency bond and the equivalent CCS to ten years.

MONEY MARKET DEVELOPMENT

Countries have taken various approaches to strengthen their money markets. Based on experiences from other markets, we have identified five sets of initiatives adopted to develop money markets.

BROAD RANGE OF MONEY MARKET PRODUCTS

Several markets offer a full suite of short-term instruments. For instance, Korea put in place a broad range of products at a very early stage of market development. The call money market was established in 1960, followed by monetary stabilisation bonds in 1961, repos with Bank of Korea in 1969, commercial paper in 1972, certificates of deposit in 1974, and third-party repos without the Bank of Korea in 1977.

In India, the RBI introduced a “Collateralised Borrowing and Lending Obligation” (CBLO) product as a money market instrument. It is a fully collateralised and secured instrument for borrowing and lending money with the purpose of managing liquidity. The product is accessible not just to banks, but to other financial institutions, as well as corporates.

Malaysia launched a Commodity Murabahah product, which was a cash deposit product for the Islamic Interbank Money Market, using crude palm oil as the underlying commodity. It also introduced floating-rate Bank Negara Monetary Notes, offered through competitive Dutch auctions via primary dealers. It also launched a Collateralised Murabahah, which combines a murabahah financing transaction with a sukuk as the pledged asset, enabling collateralised interbank transactions in the Islamic banking market.

DEVELOPING A LOCAL SHORT-TERM INTEREST RATE BENCHMARK

Several markets have actively worked to increase the credibility of a local currency short-term interest rate benchmark. This is essential for both money market transactions, as well as for interest rate swaps and for pricing forwards. One successful example is Malaysia, where the central bank was able to develop the Kuala Lumpur Interbank Offered Rate (KLIBOR).

This was achieved by putting in place stringent internal processes in selecting contributors to the benchmark. Rates submitted by contributors are closely monitored by the central bank, and rate contributors are required to provide credible two-way bid and offer prices. Credibility was ensured by providing a window for contributors to bid on prices offered by other contributors. In addition, more specific responsibilities were assigned to the board and senior management of financial institutions, and they were held directly accountable for the reliability of rates contributed daily.

OPEN PARTICIPATION TO NON-BANK PLAYERS

Many countries have systematically expanded participation in money markets beyond banks. In China, for example, major repo market participants beyond state-owned commercial banks, joint stock commercial banks, urban commercial banks and policy banks include insurance companies, security firms, and non-legal entities, such as securities investment funds and pension funds. Benefited by the lower entry barrier to money markets, there were more than 5,200 market participants in China by the end of 2013.

In India, the CBLO product is open to a wide range of players including banks, financial institutions, insurance companies, mutual funds, primary dealers, non-bank finance companies, corporates, and provident or pension funds.

Finally, in Korea, the call money markets are accessible not just to banks, but also to mutual funds, securities companies (up to 25% of their equity capital), and companies in the public financial sector. There is also a customer repo market, where households and corporations can invest with financial institutions, although collateral is restricted to government bonds and corporate bonds which are rated AAA.

SYSTEMATICALLY DEVELOP THE REPO MARKET

Several emerging markets have managed to develop vibrant repo markets. In Malaysia, repo volumes increased significantly in the 2000s after the central bank (BNM) launched measures to enhance liquidity in the ringgit bond market. These measures included active use of repos as a monetary policy instrument, introduction of the Institutional Securities Custodian Program (ISCAP) to enable borrowing and lending of securities, and a securities lending facility for principal dealers. The use of repo as a monetary policy instrument helped BNM to manage liquidity in the banking system, as well as to recirculate securities back into the market. By 2012, 15% of BNM's monetary operations were conducted via repo transactions.

Similarly, the Philippines is establishing an alternative repo model for the interbank market that uses a buy-sell back structure. These transactions will not be subject to reserve requirements, will be underpinned by a Global Master Repo Agreement (GMRA) and will allow collateral reuse. Meanwhile, the Monetary Authority of Singapore (MAS) is establishing a corporate bond repo facility in an effort to underpin liquidity in that market.

One other measure taken to deepen repo markets is to broaden the range of eligible collateral beyond sovereign bonds. For instance, in China, all bonds that are traded in the inter-bank market are used for repo transactions, including government bonds, central bank bills, financial bonds and corporate bonds.

EFFECTIVE SETTLEMENT MECHANISM

Risks in clearing and settlement usually make it difficult for lower-rated financial institutions to access liquidity in money markets. To mitigate counterparty risks in money market settlements, several countries have put in place new settlement mechanisms. In India, to eliminate counterparty risks in CBLO trading, the Clearing Corporation of India Ltd. (CCIL) was appointed as the central counterparty to all CBLO trades, and guarantees settlement. Members are allowed to borrow to the extent of the limit fixed after mark-to-market valuation of securities with appropriate haircut. The CCIL also stipulates an initial margin to address the interest rate risk in case the lenders do not honor their commitments.

All members of the CCIL are also required to contribute to a settlement fund. In the event of the failure of a trading member to meet settlement obligations, the fund is utilised to the extent required for successful completion of the settlement. As a consequence, credit risk is mitigated in the market place. The market has full confidence that settlement will take place in a timely fashion, and will be completed irrespective of defaults by isolated trading members.

2.3. IDENTIFYING POTENTIAL INITIATIVES FOR INDONESIA

We used a structured two-step approach to identify a long list of potential initiatives for Indonesia. We prepared a first list, based on stakeholder feedback, by considering the key issues across markets in Indonesia, and compared these issues with the development experience of other emerging markets. We then filtered this set of initiatives by eliminating those that were less relevant for Indonesia. Our approach is shown in Exhibit 4.

Exhibit 4: Two-step approach to identifying initiatives for Indonesia

STEP 1
IDENTIFIED LONG LIST OF INITIATIVES

Market development experience of other emerging markets

- Reviewed development experience of nine countries
- Across bond markets, equity markets, money markets and FX markets

+

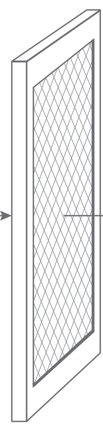
Feedback from market stakeholders

- Structured interviews with 15-20 participants across regulators, banks, asset managers, corporates and international investors

+

Initial Indonesia benchmarking

- Evaluating Indonesia across 16 defined metrics associated with the financial markets ecosystem



STEP 2
FILTER TO DETERMINE RELEVANCE FOR INDONESIA

From long list of initiatives, eliminate initiatives that are

- Not relevant for Indonesia because of the stage of market development e.g. setting up a listed private equity product
- Not aligned to Indonesia's short-term or medium-term priorities e.g. setting up infrastructure for high frequency trading

Check comprehensiveness of prioritised initiatives

- Cover all markets
- Cover all six components of the financial markets ecosystem
- Do not unduly favour one particular stakeholder group e.g. foreign investors

OUTPUT
FINAL LIST OF INITIATIVES FOR INDONESIA TO BE PRIORITISED

40 initiatives

- Overarching initiatives cutting across markets
- Initiatives that are specific to a market

Based on the above approach, we identified 40 initiatives for Indonesia. These initiatives have been grouped into five categories: over-arching initiatives common to all markets, and initiatives that are specific to bond markets, equity markets, foreign exchange markets and money markets. These 40 initiatives are shown in Exhibit 5.

Exhibit 5: List of 40 initiatives recommended for Indonesia

OVERARCHING INITIATIVES

1. Establish a taskforce on financial deepening comprising senior representatives from all relevant stakeholders e.g. MOF, BI, OJK, Banks, Insurance companies, Pension funds, IDX etc.
2. Encourage regular interactions between policy makers and market participants and move to a more transparent regulatory regime
3. Launch and strengthen development of plain vanilla products e.g. ABS, REITs, currency options, floating rate bonds and ETFs
4. Develop long term domestic institutional investors in the market
5. Introduce tax incentives to encourage long-term savings among retail investors
6. Introduce tax amnesty scheme to bring in additional capital into the markets
7. Conduct basic tax reforms e.g. refine tax treatment for Collective Investment Contract (CIC), reduce/eliminate withholding tax
8. Clarify legal rules for a trust e.g. refine mandates of CIC
9. Systematically develop asset management industry
10. Launch tiered issuance and expedite approvals
11. Consolidate bond and equity brokerage industry
12. Encourage Indonesian corporates to get listed and issue debt

BOND MARKET

13. Enlarge investor base for bonds market
14. Develop a more reliable yield curve
15. Allow Indonesia Government bonds to be settled overseas e.g. Euroclear
16. Increase market liquidity for corporate bonds
17. Strengthen current credit rating system
18. Establish electronic bond trading platform
19. Fix bankruptcy and dispute resolution laws e.g. for collateral enforcement
20. Establish mechanism for packaging and selling SMEs debt securities
21. Build a trading platform for SMEs debt securities
22. Improve credit guarantee mechanism for lower rated bond issuances
23. Launch interest rate futures

EQUITY MARKET

24. Enlarge investor base for equity market
25. Relax restrictions on banks in equity financing
26. Develop Equity derivatives including index options and futures as well as single stock options and futures
27. Improve corporate governance standards

FX MARKETS

28. Refine limits and rules for FX transactions
29. Allow banks to issue commodity futures
30. Develop and Improve clearing and settlement mechanisms for OTC derivatives
31. Get highly rated global entities to issue debt in IDR
32. Encourage banks to hedge FX exposures by offering a lower risk weight
33. Launch FX futures and improve regulations for derivatives

MONEY MARKETS

34. Improve clearing mechanisms for money markets
35. Systematically develop repo market
36. Develop collateralised money market product with non bank participation
37. Increase transparency of money market
38. Increase credibility of JIBOR
39. Improve regulations for banks in money markets
40. Introduce new money market instruments

A summary description of each of these initiatives is provided in Appendix.

We believe that these 40 initiatives will need to be executed in Indonesia over the next decade. However, not all of these initiatives are relevant in the short term and several are dependent on other initiatives.

In the next section, we discuss a prioritisation framework for the 40 initiatives, which we then use to group these initiatives into four waves of three years each. We then focus on the first two waves and discuss the specific sequencing of initiatives for the period 2015 to 2020. Finally, we provide recommendations on the governance framework required by Indonesia to execute these initiatives effectively.

3. THE WAY FORWARD FOR INDONESIA

3.1. PRIORITISATION OF INITIATIVES

There are several potential approaches to the sequencing of initiatives. They depend on the choices made on which investor groups to target, which markets to develop, whether to adopt an incremental or sudden big-bang approach, and so on. In order to prioritise the list of 40 initiatives that we defined for Indonesia, we have made five conscious choices. These choices have been made based on discussions with regulators and key stakeholders. The five strategic choices that we have used to shape the sequencing of the 40 initiatives are as follows:

Exhibit 6: Strategic options for development of Indonesia financial markets

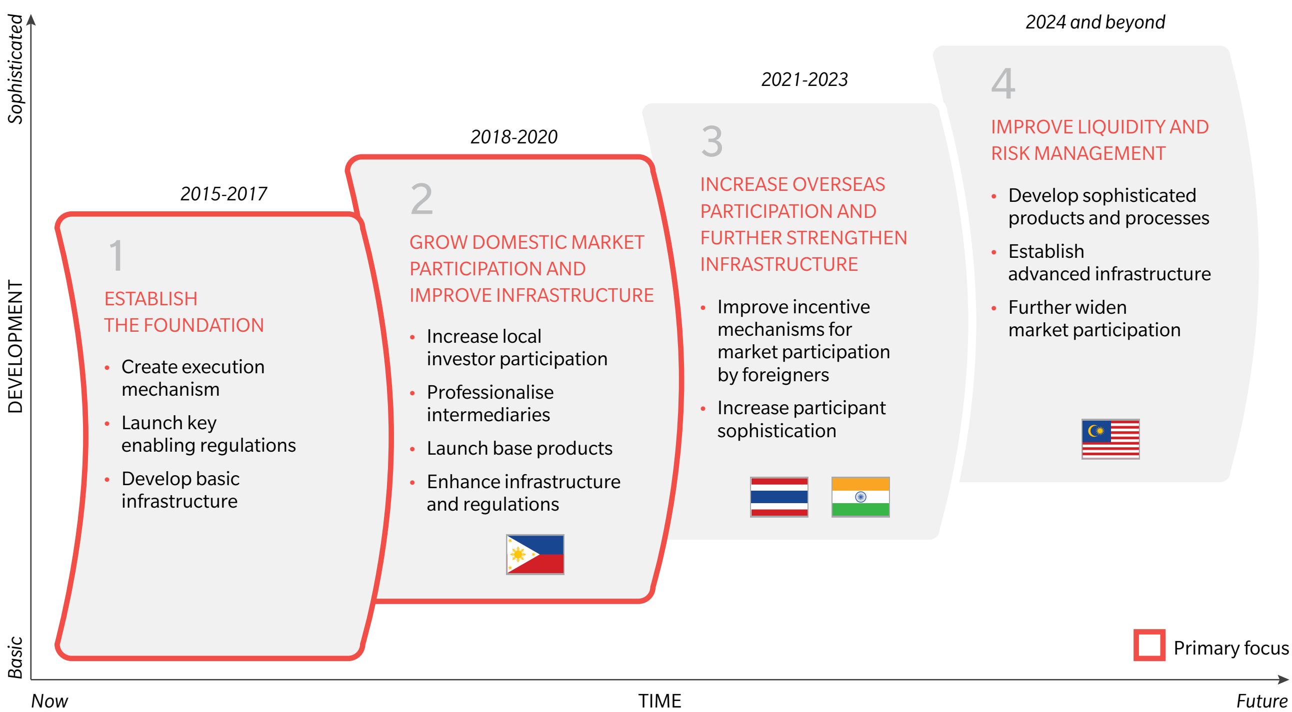
OPTIONS		CHOICES MADE AND IMPLICATIONS
1	Whether to complete foundational initiatives **or** launch growth initiatives **or** do both in parallel	Foundational initiatives to precede growth initiatives. First achieve a better functioning market.
2	Foster development of local institutional investors **or** local retail investors **or** global investors **or** develop in parallel	Development of local institutional and retail investors to be prioritised, followed by global investors
3	Deepen participation of existing players **or** open up to new players	First launch measures to increase participation of existing players before letting new players access the market
4	Develop markets sequentially **or** develop markets in parallel	Develop markets in parallel. Launch reform measures across bond, FX, equity and money markets, with a bias towards bond markets
5	Bridge product gaps gradually **or** launch products using a big bang approach	Bridge product gaps gradually. Launch simpler products first and stabilise before launching more complex products

Based on the above choices, we have defined four waves for developing the financial markets in Indonesia, which would gradually allow it to catch up with regional peers. These four waves are as follows:

1. Establish the foundation – 2015-2017
2. Grow domestic market participation and improve market infrastructure – 2018-2020
3. Increase overseas participation and further strengthen infrastructure – 2021-2023
4. Improve market liquidity and risk management capabilities – 2024 and beyond

The four stages are schematically depicted in Exhibit 7.

Exhibit 7: Four waves of developing the financial markets in Indonesia



1

Establish the foundation (2015-2017). First, this would involve putting in place a long-term execution mechanism to oversee overall reforms. Another important step is to implement changes in the tax and regulatory framework to accelerate the growth of markets. Finally, this stage also focuses on the development of plain vanilla products. The set of initiatives to be launched in 2015-2017 include:

- Establishing taskforce on financial deepening
- Ensuring regular interactions between policymakers and market players
- Developing long-term domestic institutional investors in the market
- Introducing new plain vanilla instruments
- Conducting base tax reforms
- Clarifying legal rules for a trust
- Launching tiered issuance and expediting approvals
- Building out the yield curve
- Encouraging Indonesian corporates, such as SOEs, to issue debt and equity
- Refining limits and rules for FX transactions
- Strengthening the clearing mechanism for money markets
- Improving regulations in money markets, such as Master Repo Agreement (MRA) adoption and fortnightly reporting
- Increasing credibility of JIBOR (Jakarta Interbank Offered Rate)

2

Grow domestic market participation and improve market infrastructure (2018-2020). This would focus on targeted development of domestic investors, enhancing infrastructure and increasing the quality of intermediaries. In addition, this state would involve developing key products such as FX swaps and repo to provide additional options for hedging and managing liquidity. The initiatives to be launched in 2018-2020 include:

- Introducing tax incentives to encourage long term savings for retail investors
- Systematically developing the asset management industry
- Consolidating the bond and equity brokerage industry
- Reforming bankruptcy and dispute resolution laws
- Allowing Indonesia government bonds to be settled overseas, such as through Euroclear
- Enhancing credit guarantees for lower-rated bond issuances
- Improving clearing and settlement mechanisms for OTC derivatives
- Coaxing highly-rated global entities to issue debt in Indonesian currency (IDR)
- Systematically developing the repo market

3

Increase overseas participation and further strengthen infrastructure (2021-2023). After sufficient development of the local investor base, we recommend opening up the market to further foreign participation. At the same time, it will be necessary to continue to improve market mechanisms. The initiatives to be launched in 2021-2023 include:

- Enlarging the investor base for the bonds market
- Strengthening the current credit rating system
- Enlarging the investor base for the equity market
- Improving corporate governance
- Introducing a tax amnesty scheme
- Incentivising banks to hedge FX exposures by offering a lower risk weight
- Launching FX futures and improving regulations for FX transactions
- Allowing banks to issue commodity futures
- Developing collateralised money market products with non-bank participation
- Increasing transparency of the money market

4

Improve liquidity and risk management (2024 and beyond). Once the markets mature, it would be feasible to introduce and develop more complex products and look to provide capital market solutions for the SME segment. Recommended initiatives for 2024 and beyond include:

- Developing interest rate and FX derivatives
- Increasing market liquidity for corporate bonds
- Establishing an electronic bond trading platform
- Creating a mechanism for the packaging and selling of SME debt securities
- Building a trading platform for SME debt securities
- Relaxing restrictions on banks in equity financing
- Launching more sophisticated equity derivatives
- Introducing new money market instruments

3.2. SEQUENCING OF WAVE 1 AND WAVE 2 INITIATIVES

Based on the five strategic choices that were used for sequencing the 40 initiatives, and after considering the dependencies across initiatives, we have also designed a proposed timeline for wave 1 and wave 2 initiatives to be implemented. The proposed timeline for implementation of the twenty-two wave 1 and wave 2 initiatives are shown in Exhibit 8.

Exhibit 8: Proposed implementation roadmap till 2020

For the purpose of this report, we have been fairly conservative in estimating the timelines for completing specific initiatives. In general, initiatives that are related to legal reform have been assumed to take the longest time to implement (up to 36 months). On the other hand, we have estimated that initiatives related to process improvement, which need to be executed by a single party, will be completed in 6-9 months. It should be noted that there has already been work done by different government institutions on some of these initiatives, but we do not have accurate details of their progress. Accordingly, the government entity that is responsible for the execution of financial deepening should treat the above sequencing as directional only, and should draw up a final implementation plan after consultations with the relevant personnel at BI, OJK and the Ministry of Finance, all of whom have had working groups and think tanks evaluating different aspects of financial deepening.

3.3 EXECUTING FINANCIAL DEEPENING IN INDONESIA

Financial deepening has been a hot topic in Indonesia. Multiple publications, reports and recommendations have been released over the last 15 years. However, as highlighted in previous sections, actual on-the-ground progress in implementing financial deepening has been limited. The major reason for this, in our view, has been the absence of a coordinated effort, between multiple regulators and the government, targeting all six elements of the capital markets ecosystem.

We recommend that in order to execute financial deepening, the first and most critical initiative is to put in place a Financial Deepening Taskforce, headed by a suitably empowered senior authority, and comprising stakeholders from all relevant government ministries, regulators and other market participants. To understand how other countries have executed financial sector reform, we have briefly profiled two country examples – Malaysia and Russia. These two examples are instructive, and have been used to draw up a recommended governance framework for execution in Indonesia.

MALAYSIA EXAMPLE – CAPITAL MARKETS MASTERPLAN I

After the Asian financial crisis in 1997, Malaysia embarked on a Capital Market Masterplan (CMP1) which spanned the period 2000-2010. The CMP1 aimed to build a capital market that would meet the country's capital and investment needs, and support long-term nation-building efforts. CMP1 provided a comprehensive roadmap for the orderly growth and diversification of Malaysia's capital market. The plan identified a number of strategic initiatives to strengthen fund-raising, promote the growth of the investment management industry, enhance market and intermediation competitiveness, provide a strong and facilitative regulatory regime and establish Malaysia as an international Islamic capital market center. By the end of 2010, 95% of the recommendations in CMP1 had been completed.

The key enabling factor for successful implementation of CMP1 was the establishment of an effective governance framework for execution. Key components of the governance mechanism were as follows:

- Securities Commission (SC) – The SC is the capital markets regulator in Malaysia. As CMP1 primarily focused on Capital Markets development, the Ministry of Finance delegated overall execution responsibility to the SC. The SC was also responsible for the implementation of recommendations that fell directly within its areas of responsibility
- Implementation Task Force – The SC established an Implementation Task Force to ensure effective and efficient implementation of all the initiatives of the Masterplan. This centralised structure enabled a consistent approach to implementation, and reduced the duplication of resources. The Task Force also played a significant role in administering performance management mechanisms and facilitating communication and public relations
- Senior Advisory Council – This was composed primarily of senior experts from the private sector. The Advisory Council provided independent advice on specific aspects of the development of the Malaysia capital markets, as well as an independent external view on the progress of the implementation of the Masterplan
- Working Committees – These were created for specific initiatives, and were responsible for the operational implementation of various recommendations. The Working Committees comprised representatives from industry associations, as well as other market participants from the private sector

RUSSIA EXAMPLE – MOSCOW INTERNATIONAL FINANCIAL CENTRE PROJECT

Russia launched the Moscow International Financial Centre (MIFC) project in 2008, with the main goal of establishing a high-tech, world-class, competitive financial market in Russia centered in Moscow. A secondary objective was to create more opportunities for individuals to join the finance sector. While this initiative is still ongoing, the chosen governance framework again emphasises the importance of very senior government involvement in driving the execution across multiple agencies.

Key governance mechanisms of the MIFC project are:

- Dedicated Task Force – The key function of the Taskforce is to draft and submit MIFC development plans to the President of the Russian Federation, and direct MIFC efforts in liaison with state authorities and finance market professionals
- Project Groups – Tasks are performed by both permanent and temporary task-specific Project Groups. Members of Project Groups are business people from investment and financial sectors, experts and finance ministry officials. MIFC Project Groups are normally co-chaired by one representative each from both business and government. The main task of the Project Groups is to draft balanced solutions for submission to state legislature

Government support through multi-level policy coordination is the cornerstone of the MIFC Project. Approval and performance supervision of the MIFC roadmap is carried out directly by the President and the Government.

RECOMMENDED GOVERNANCE APPROACH FOR INDONESIA

Indonesia has already launched several working groups to explore financial sector reform. One prominent example is the Indonesian Foreign Exchange Market Committee (IFEMC), comprising market participants and working closely with BI and OJK. BI also has its own working group looking at potential reforms in the Money Market and FX markets. There is another working group on financial deepening under the FSSK (Financial System Stability Forum), comprising representatives from both the Ministry of Finance and from BI.

Despite the presence of all these working groups, there is currently no entity taking an integrated view across markets. Moreover, several reforms in the markets, such as tax and legal changes, require actions that go well beyond the mandate of BI or OJK.

Consequently, there is a need for a governance mechanism where all stakeholders can meet to drive reform in an integrated and cohesive fashion. Accordingly, we recommend the creation of an Indonesia Financial Deepening Taskforce. This taskforce would be responsible for executing financial deepening in Indonesia by overseeing the execution of all initiatives, tracking overall progress, ensuring coordination across entities and tackling all roadblocks. This taskforce should work closely with the BI and OJK taskforces, who can oversee and execute stand-alone initiatives that can be executed within their own mandates.

Actual project execution should be carried out by project-specific working groups, established for the implementation of each proposed initiative. Depending on the type of initiative, these working groups would need to report either to the overall Financial Deepening Taskforce, or to BI or OJK.

To ensure that market participant views are adequately reflected, there should also be an Advisory Council comprising primarily of senior persons from industry with substantial expertise and experience in domestic and foreign financial markets. The Advisory Council would be expected to provide advice on reforms, and an independent assessment of progress made.

The proposed approach to the execution of Financial Deepening is shown in Exhibit 9 and 10.

Exhibit 9: Proposed governance framework for executing financial deepening

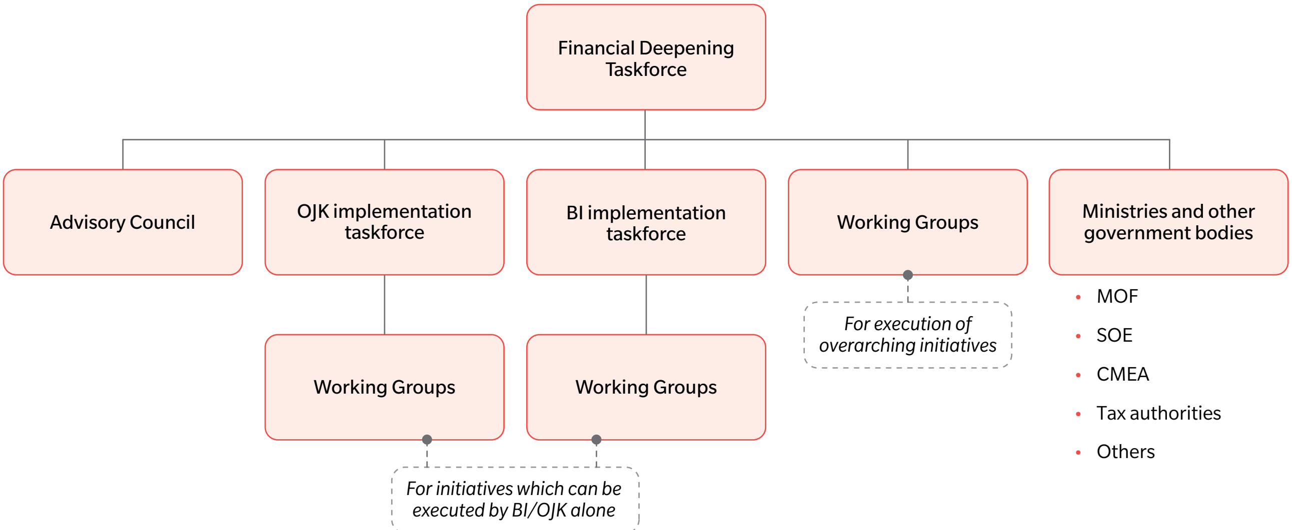


Exhibit 10: Proposed responsibilities for key governance bodies

GOVERNANCE BODY	RESPONSIBILITIES
Financial Deepening taskforce	• Oversight of all initiatives for the financial market reform • Coordinating the implementation of recommendations, including liaising with BI and OJK taskforces, the various Working groups and other bodies • Identifying and managing the resolution of issues which may arise during the course of implementation • Undertaking the monitoring of progress and performance assessment based on specific performance measures • Coordinating the communication program for reform
BI and OJK taskforces	• Oversight of specific financial markets reforms which are to be executed within BI/OJK and which don't require coordination with other entities • Coordinating the implementation of recommendations, including liaising with other Working Committees and other bodies • Identifying and managing resolution of issues which may arise in the course of implementation
Various Working Groups (for each initiative)	• Responsible for implementation of assigned initiatives
Advisory Council	• Advise the Implementation taskforces and Working Committees on the following: – New and potential developments in the capital markets globally and regionally, and their potential implications for Indonesia – Independent external views on the progress of implementation of the initiatives and required changes

The Financial Deepening Taskforce will need to comprise around 15 to 20 experienced professionals drawn from government bodies including:

- The Ministry of Finance
- The tax authorities
- Ministry of State-owned Enterprises
- The Ministry of Law
- OJK regulators across banking and capital markets
- Policy teams from Bank Indonesia
- Local banks, from both the public and private sector
- Foreign banks
- Large institutional investors, such as BPJS, asset managers and insurance companies
- Infrastructure providers, such as the Indonesia Stock Exchange

Given the complexity of the overall program, the taskforce will also need to include two full-time members to liaise with the various working groups as well as with other stakeholders.

Depending on the specific initiative, the composition of the working groups would vary quite significantly However, as a rule, the working group should comprise a mix of representatives from relevant regulatory and government bodies, industry associations, market participants from the public and private sector, specialist firms for select initiatives such as consulting firms and law firms, and independent global experts.

The Financial Deepening Taskforce should establish a performance monitoring mechanism and administer a communication program, since these are important factors for the success of the reform process. These are briefly described below:

- Performance Monitoring – There is a need to define and monitor execution of specific targets, such as timelines for initiatives, milestones, and targets for quantitative metrics reflecting the development of the market. Metrics to be tracked should include both broad market indicators (such as the stock market to GDP ratio, the bond market to GDP ratio, FX turnover, the number of retail investors, the insurance assets to GDP ratio, the strength of legal rights index, and so on) and more specific indicators (such as issuance time for equity and bonds, the number of companies that adopt new GMRA, the share of spot trades in the FX market, and so on)
- Communication program – The working group would need to design a communication program targeting all relevant financial market stakeholders, including the general public, domestic and foreign investors and intermediaries, existing and prospective issuers, market institutions, industry associations and other professional bodies. The communication channels should include press releases and other public communications, subject briefings, seminars, forums and conferences, information circulars, and guidance notes to industry groups, where necessary

Looking at similar global programs, there are several options with regard to the reporting lines for the Financial Deepening Taskforce. Each of these options has its own benefits and disadvantages. Three options are described briefly below:

- Vice President – The level of seniority allows efficient decision-making and resolution of deadlocks. However, a potential issue could be lack of adequate time to drive financial markets reform
- Ministry of Finance – This would allow one body to have overall oversight on financial markets. However, at the same time, due to the lack of a clear hierarchy, this might hinder the coordination between BI, OJK and MoF and the resulting execution
- OJK – Reform is administered by the main regulatory body. However, this may lead to challenges in execution as several areas such as tax, legal, FX and money market are partially outside the purview of OJK

Based on discussions with market participants, we recommend that the Financial Deepening Taskforce report to the "Government", where the "Government" will be represented by the Vice President and the Ministry of Finance.

Finally, successful execution of a financial deepening program of this nature will require financial funding. Based on global experience, there are three potential options for raising this funding:

- Government sponsorship – Direct sponsorship for capital markets development initiatives from the government budget
- Support from development aid agencies – Funds from development agencies such as The Asian Development Bank (ADB), World Bank, IMF
- Demutualisation of the local stock exchange – Raising funds for capital markets development initiatives through demutualisation of the stock exchange. As an example, Malaysia established a Capital Market Development Fund (CMDF) in 2002, using proceeds from the demutualisation of Bursa Malaysia. From the proceeds raised, 30% went to the Ministry of Finance, 30% to the CMDF and 40% to brokers

In the Indonesia context, we recommend raising the primary funding through a Fiscal Policy Agency, because it can also act as the center of development for the financial sector. At the same time, efforts can be made to search for other sources of funding from development aid agencies such as AusAID, IPAC (Australia), and ADB. Demutualisation is not an attractive option as the exchange was privatised in 1992.

In summary, Indonesia has the potential to emerge as a G7 economy by 2030, if right set of financial sector reforms are enacted. It is hoped that this white paper will provide valuable ideas to the relevant authorities as they start to embark on this critical reform journey.

APPENDIX – DESCRIPTION OF THE 40 INITIATIVES FOR INDONESIA

A summary description of the 40 initiatives recommended for Indonesia is given below.

OVERARCHING INITIATIVES

1. **Establish a taskforce on financial deepening comprising senior representatives from all relevant stakeholders – MOF, BI, OJK, banks, insurance companies, pension funds, IDX etc.**

   Indonesia needs to take an overarching view of financial deepening, and bring key stakeholders together on a common forum with sufficient empowerment to execute complex reforms across not just market-specific issues, but also legal and tax issues. The task force would need to be chaired by a very senior government official in order to be able to resolve deadlocks and settle disagreements among different stakeholders

2. **Encourage regular interactions between policymakers and market participants and move to a more transparent regulatory regime**

   Indonesia's financial regulators need to improve interactions with market participants to ensure that market views are adequately factored into policymaking. This can be achieved by building public awareness of planned policy changes via online consultation, organising conferences with key industry participants and setting up working committees with industry participants for detailed discussions

3. **Launch and strengthen development of plain vanilla products, such as ABS, REITs, currency options and ETFs**

   Indonesia still does not have a liquid market in products that are considered basic in other markets. These products include FX options, Asset Backed Securities (ABS), Real Estate Investment Trusts (REITs), and Exchange-traded Funds. These products provide market players with additional options for investments and hedging, and also add to market depth

4. **Develop long-term institutional investors in the market**

   There is currently a short-term mindset among domestic institutional investors in Indonesia. For instance, defined benefit pension funds focus on short-term investment returns, as performance measurement is carried out on an absolute yield basis. Indonesia needs to encourage pension funds and insurance companies to develop a long-term approach to investments by changing evaluation criteria, reducing incentives for people to withdraw pension savings between jobs, and providing suitable incentives for investing in longer-term insurance products

5. **Tax incentives to encourage long-term savings among retail investors**

   Unlike most markets, Indonesia does not offer incentives for long-term savings for retirement. Most Indonesian individuals currently invest in short-duration term deposits that are regularly rolled over. Policymakers should provide tax incentives to encourage long-term investments and savings from retail investors. Options include upfront exemption from taxable income up to a predefined ceiling for specific investments, no tax on coupon or dividends on specific investments, and no capital gains tax on specified investments

6. **Tax amnesty scheme to bring additional capital into the markets**

   It is estimated that over US$200 BN of Indonesian assets are held overseas, primarily in Singapore. Indonesia needs to develop a program to attract some of these funds back onshore through a suitably designed tax amnesty scheme

7. **Conduct basic tax reforms e.g. refine tax treatment for Collective Investment Contract (CIC), reduce/eliminate withholding tax**

   Currently, Indonesia imposes double taxation on CICs, which prevents the development of important products based on pass-through of assets (such as ABS and REITs). Policymakers could consider conducting tax reform so that CICs can be treated as a "pass through" entity for tax purposes with no tax imposed on the transfer of assets to and from the CIC vehicle. Policymakers could also consider reducing or eliminating the withholding tax on bonds to make bond investments more attractive for investors

8. **Clarify legal rules for a trust e.g. refine mandates of CIC**

   Indonesian law currently does not enable the concept of a financial trust, which hinders the development of products that are standard in other markets. Although Indonesia's legal system is not based on English Common Law principles, there needs to be legal reform to make it possible to establish trust companies in Indonesia, and allow CICs to be treated as a trust. This issue has been overcome in certain other markets, such as Quebec

9. **Systematically develop local asset management industry**

   There are less than one million individual investors in Indonesia mutual funds. Moreover, pension funds are forced to wait for bonds to be publicly listed before they can purchase them. To promote long-term investment in Indonesia, policymakers should run a targeted education program to emphasise the importance of longer-term investments and their advantages relative to term deposits. Policymakers could also consider simplifying the regulatory framework to provide more flexibility to mutual funds and pension funds, such as allowing pension funds to accept private placements of highly-rated corporate bonds

10. **Launch tiered issuance and expedite approvals**

    Many Indonesian corporates don't access capital markets because the issuance process and disclosure requirements are cumbersome. Regulators need to streamline the issuance process to reduce the end-to-end approval times to less than eight weeks in line with other markets. Regulators could also consider launching tiered disclosures schemes for frequent issuers, and for issuances targeted only at sophisticated investors

11. **Consolidate bond and equity brokerage industry**

    Indonesia has over 140 brokers today, as opposed to less than 40 brokers in Malaysia. The presence of many players has led to excessive competition, unrealistic pricing and instances of broker failure with the resultant loss of client assets. Policymakers should consider pushing for consolidation and strengthening in the brokerage industry by increasing the minimum capital required in this business. Currently, Indonesia capital requirements are at one fifth to one fortieth of capital requirements in peer markets

12. **Encourage Indonesian corporates to get listed and issue debt**

    One of the biggest issues in Indonesia capital markets is a lack of high quality paper both on the equity and debt side. The government needs to encourage issuance from large corporates and take the lead by encouraging large state-owned companies to list on the markets. Currently, only 20 out of 124 SOEs are listed. The government also needs to address the perception of lower tax scrutiny for unlisted companies. The regulatory burden of being listed needs to be reduced, and electronic communications should become the norm. Policymakers could also consider tax benefits for long-dated bonds and those with specific end uses, such as bonds with a maturity of more than five years and infrastructure bonds

BOND MARKET INITIATIVES

13. **Enlarge investor base for bond market**

    Given the successful experience in India and other peer countries, Indonesia could consider launching tax incentive programs to promote retail participation in bond markets. Minimum ticket size on bonds needs to be made affordable, and yields on a post-tax basis should be better than for term deposits. The government can also consider creating a market making mechanism after three years to provide investors with some liquidity

14. **Develop a more reliable yield curve**

    Currently the Indonesia sovereign yield curve is well established only in the 5-20 year bucket, and is not very well defined in the <5-year and >20-year maturity buckets. Indonesia needs to construct a short-end curve, and a very long-end curve through a more systematic program of government bond issues, and a potential fungible issue system along the lines of what was achieved in Korea

15. **Allow Indonesia Government bonds to be settled overseas e.g. through Euroclear**

    Based on the successful experience in other markets, especially Russia, Indonesia should launch offshore clearing for government bonds on an exchange such as Euroclear. This would make it easier for global investors to invest in Indonesia bonds, and would boost demand for Indonesian paper in global markets. This could result in lower financing costs

16. **Increase market liquidity for corporate bonds**

    Although market making for government bond through primary dealers is well established, there is insufficient market making for corporate bonds. Policymakers should design a mechanism to provide liquidity in the corporate bond market, for example by requiring underwriters to take the responsibility of market making in the bonds they have underwritten

17. **Strengthen current credit rating system**

    A credit rating system helps in the process of price discovery. The government needs to design policies to encourage companies to obtain a rating and improve the credibility of local rating agencies

18. **Establish electronic bond trading platform**

    An electronic bond trading platform would allow better price discovery in the market. Indonesia could consider establishing an electronic bond trading platform to ensure greater price transparency, match orders more efficiently, reduce bid-ask spreads and develop a credit spread curve

19. **Fix bankruptcy and dispute resolution laws e.g. for collateral enforcement**

    Laws related to bankruptcy and business dispute resolution are critical for debt investors given that they provide these investors with some recourse in case of a default. Indonesia needs to improve the existing legal framework, such as the time taken to resolve bankruptcy proceedings. One possible option is to put in place special bankruptcy courts similar to those in Thailand

20. **Establish mechanism for packaging and selling SME debt securities**

    In several markets, SME securitisation has enabled lower-rated companies to access the bond market. Indonesia could also consider setting up a securitisation vehicle which would source SME loans and package them into securities. The regulators could work with selected groups of banks to procure assets, and provide some credit enhancements to make the program more attractive for potential investors

21. **Build a trading platform for SME debt securities**

    A trading platform provides an additional source of funding for SMEs. Policymakers could consider developing a trading platform where SME debt instruments can be traded e.g. invoice discounting

22. **Improve credit guarantee mechanism for lower-rated bond issuances**

    Lower-rated issuers usually have few prospective buyers. Indonesia needs to enhance its existing credit guarantees mechanisms for lower-rated bonds, so that corporate bonds are more attractive to investors. Although there is an Indonesia Infrastructure Guarantee Fund in place, the credit rating of this entity is also low. Indonesia needs to introduce a more effective credit guarantee mechanism for bond issuances, particularly in infrastructure projects

23. **Launch interest rate futures**

    Interest rate futures are a fundamental hedging instrument for bond investors. A well-developed interest rate futures market will attract additional investors to the bond market, increase liquidity and provide investors with a hedging mechanism against adverse interest rate movements

EQUITY MARKET INITIATIVES

24. **Enlarge investor base for equity market**

    Indonesia has very limited retail participation in the equity markets, given that currently there are only around 450,000 individual stock trading accounts. Policymakers should design programs to promote retail participation in equity markets, such as through retail investor education to promote the concept of capital market investments, and tax incentives on select stock investments up to a threshold amount

25. **Relax restrictions on banks in equity financing**

    Several markets allow banks to own shares, trade in shares, provide loans against equity and provide IPO financing. However, in Indonesia, banks are not allowed to own shares. Regulators could consider allowing limited bank participation up to a specified percentage of bank capital. This will boost market liquidity, provide more flexibility to borrowers, and facilitate primary market investments for retail investors

26. **Develop equity derivatives, including index options and futures, as well as single stock options and futures**

    Currently equity derivatives in Indonesia are not available, resulting in a largely one-directional market since it is very hard to take a contrarian view. Equity derivatives are essential for boosting liquidity and providing a hedging mechanism for investors. Policymakers should therefore develop equity derivative products, such as stock futures, index options and stock options once the market has matured

27. **Improve corporate governance standards**

    Low corporate governance standards usually dampen investor appetite. Indonesia should strengthen corporate governance standards in areas such as the role and independence of non-executive directors, timely regulatory filings and better disclosure standards

FOREIGN EXCHANGE MARKET INITIATIVES

28. **Refine limits and rules for FX transactions**

    Currently, the liquidity of FX markets is low and most trades are in the spot market. Capital users also sometimes find it difficult to buy foreign currency from the market when they need to pay debt or dividends denominated in foreign currency. Policymakers should make suitable amendments to FX markets to boost market liquidity. These may include stricter enforcement of the repatriation of export proceeds, and stipulating that Bank Indonesia should periodically intervene, and act as a counterparty to boost liquidity in the cross-currency swap market, similar to the role played by the Bank of Thailand

29. **Allow banks to issue commodity futures**

    Several markets allow banks to offer commodity futures products to their clients, with suitable safeguards to prevent speculation. Indonesian policymakers could consider allowing banks to issue commodity futures to their clients as a bundled offering for clients with suitable underlying exposures. This would boost liquidity in the commodity futures market, and reduce risk for the corporate customer as well as for the bank

30. **Develop and improve clearing and settlement mechanisms for OTC derivatives**

    As a member of the G20, Indonesia has an implicit commitment to develop an OTC derivatives clearing and settlement mechanism. It also needs to establish a clearing and settlements mechanism for FX transactions to reduce counterparty risks, thereby increasing the efficiency and safety of the market

31. **Encourage highly-rated global entities to issue debt in IDR**

    Currently the FX swap market in Indonesia is one-sided, as Indonesian corporates mainly borrow USD floating. Given successful experiences in Chile, Indonesia could consider incentivising international institutions or other highly-rated entities to issue IDR-denominated debt to create demand for FX swaps. These issuers would swap out their IDR exposures into USD, creating a natural counterparty for local Indonesian corporates. This would result in significant additional liquidity and improved pricing in the cross-currency swap market

32. **Incentivise banks to hedge FX exposures by offering a lower risk weight**

    Banks are currently not incentivised to hedge open FX positions. Policymakers should consider implementing a lower risk weight for hedged exposures, thereby encouraging banks to hedge more, reduce the volatility on FX exposures for banks, and increase market liquidity

33. **Launch FX futures and improve regulations for derivatives**

    Foreign investors need instruments for hedging their FX exposures. Indonesia could consider launching exchange-traded FX derivatives, such as FX futures, to enable such hedging. Indonesia should also continue efforts to improve other related regulations for derivatives, such as netting and International Swaps and Derivatives Association (ISDA) agreements

MONEY MARKET INITIATIVES

34. **Improve clearing mechanisms for money markets**

    Currently, the Indonesia money market is very asymmetric, given that only a few large banks lend and all the others borrow, largely due to perceived counterparty risks when higher buku (tier) banks lend to lower-tier banks. Indonesia should develop a clearing mechanism in the money market to mitigate counterparty risks, and make it easier for lower buku banks to access inter-bank funding

35. **Systematically develop repo market**

    The Repo market provides an additional source of liquidity management for market participants. It also serves as a transmission mechanism between debt and money markets. Policymakers should consider widening participation in repo markets by allowing non-bank players to participate. Further, the eligible collateral for repo should be expanded from government securities to include equity and highly-rated corporate bonds. Finally, Indonesia should also look to develop a tri-party repo market, where a clearing bank acts as an agent between two transacting parties and mitigates the settlement risk

36. **Develop collateralised money market product with non-bank participation**

    Aside from repo markets, some countries have developed other money market instruments that are fully collateralised. One prominent example is the Collateralised Lending and Borrowing Obligation (CBLO) product in India whereby both bank and non-bank participants can borrow and lend fixed amounts, with the exposure limit based on the amount of collateral (government bonds) pledged with a clearing house (Clearing Corporation of India Limited – CCIL). Indonesia needs to consider developing a similar collateralised borrowing and lending product, with access for both banks and non-bank participants

37. **Increase transparency in the money market**

    Once the money market is developed with a flourishing repo market and a more active inter-bank market, there will be a need to establish a suitable reporting system for providing up-to-date information on money market transactions

38. **Increase credibility of JIBOR**

    Currently, JIBOR is not seen as a credible benchmark by market participants. Indonesia should make a systematic effort to improve the credibility of JIBOR by holding the board of directors accountable for benchmark quotes provided, and providing a window during which banks can "hit" each other's quotes. These measures will ensure that quotes provided by banks are credible

39. **Improve regulations for banks in money markets**

    Currently, Indonesia imposes a daily reserve reporting requirement on banks. This has resulted in the inter-bank market developing mostly as an overnight money market, with practically no transactions in longer maturity buckets. In addition, the current repo market is governed by a mini Master Repo Agreement, which over 20 banks have adopted. However, there is a proposal to introduce a Global Master Repo Agreement (GMRA), which is much more complex in nature, and more difficult to negotiate. This could potentially drive banks to exit the fledgling repo market as well. Accordingly, policymakers should consider moving away from imposing daily reporting on reserve requirements, to fortnightly reporting in line with many other markets. This will help to develop the inter-bank market beyond just overnight borrowings. Policymakers should also consider simplifying the GMRA, and adapting it to local market requirements to ensure it is adopted by the market

40. **Introduce new money market instruments**

    There are several money market products that are not currently in use in Indonesia and need to be launched or reintroduced. These include floating rate notes, certificates of deposit, and commercial paper

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