FINANCIAL SERVICES SECTOR

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This policy brief is the result of an activity entitled "Economic Policymaking in Indonesia' which is jointly conducted by Centre for Strategic and International Studies (CSIS) and Economic Research Institute for ASEAN and East Asia (ERIA). This activity is a contribution from research community that is expected to assist the government in formulating more effective economic policies in the future. In this activity, CSIS and ERIA invited 16 economists with specific fields of expertise from some leading research institutions to conduct in-depth discussions on seven strategic issues facing Indonesian economy (infrastructure development, competitiveness, investment climate, food policy, services sector policy, fiscal policy, and social protection policy), which is then summarized into policy briefs covering each of the topics.

Dissemination of the findings and recommendations produced by this activity is conducted through several channels. First, this activity has made efforts to engage the relevant government officials through some Focus Group Discussions (FGD), the publication of High Level Policy Notes, and hearings with some strategic policymakers with regard to each of the strategic issues mentioned above. Secondly, this activity also conducts widespread public disseminations through Public Seminars on each of the strategic issues, along with publications of the Policy Briefs and supporting multimedia that can be accessed online through www.paradigmaekonomi.org.

FINANCIAL SERVICES SECTOR could be described as the heart of an economy, which allows smooth and well-functioning economic activities. One of its most important parts is the banking sector, which currently is the main financing source in the economy. Compared to the capital market (another financing alternative), the amount of banks' credits until May 2015 reached IDR 3,757 trillion. At the same time, the values of stock and bonds issued only varied around IDR 684 trillion and IDR 441 trillion. The assets of banking sector are also larger at IDR 5.838 when compared to the asset of multi-finance company (IDR 426 trillion) or mutual funds (IDR 267 trillion).

Given the importance of banking sector, it is such an irony that the access to banking sector in Indonesia is severely limited. Barely 20% of the population have access to extensive banking services, compared to India (35%) or China (64%). Total banking asset in Indonesia is also relatively smaller, at roughly 54% of GDP, below Philippines (84%) or Thailand (142%).

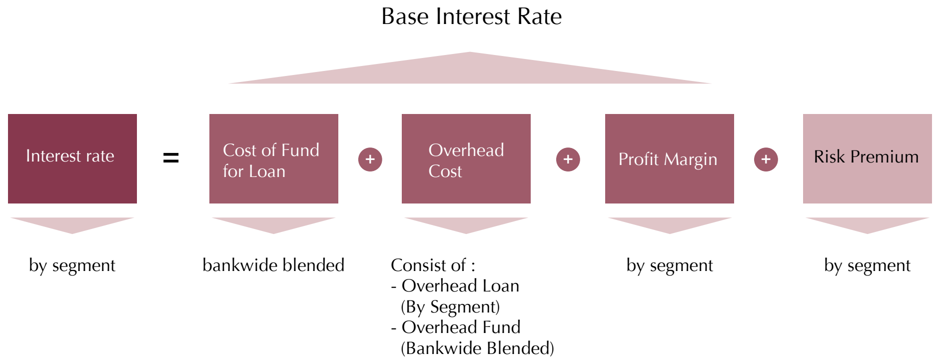
At the moment, rules and regulation of the banking sector are much better compared to how they were before. A lot of banks are lending to the business sectors with affiliated ownership. However, the banking market structure remains oligopolistic in nature despite competitions for third party funding from third parties and high credits transfers. As a result,

1. Most of banking liquidity are concentrated in the big banks.
2. Majority of third party funds are originated from long term deposits with short term tenure.
3. The amount of credit provision fund has also become the characteristic of the banking sector in Indonesia mainly because
    a. Shallow Financial Market: until now, the daily amount of transactions in the financial market varied around IDR 10-15 trillion. The role of financial market between banks, which insecured nature is crucial in liquidity management of the banks in Indonesia but generally have a segmented nature in small banks with lack of access towards financial market between banks. On top of that, repo market which previously thought to be secure is still very limited due to high doubts in the courts of law (for example, when one of the party faces bankruptcy), existence of double taxation, limitation of assets available for repo (for example, Non-Convertible Debentures and Commercial Pappers), and the repo transaction fee which is more expensive than the financial market between banks.
    b. Limited insurance schemes for deposits
    c. Highly unstable 'lender of the last resort' function

The above three factors, in turn result in the inefficient monetary policy transmission.

The policy to lower interest rate is not easy to execute, despite the latest move by Bank Indonesia to lower interest rate to 6.5% as of 16 June 2016. In general, the pricing strategy (or the determination of lending interest rate) of banks is depicted below.

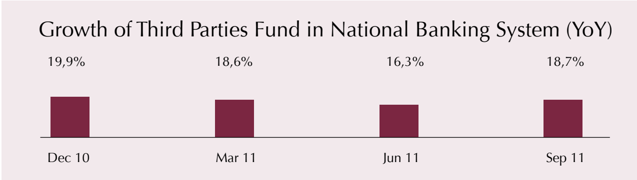
Figure 1

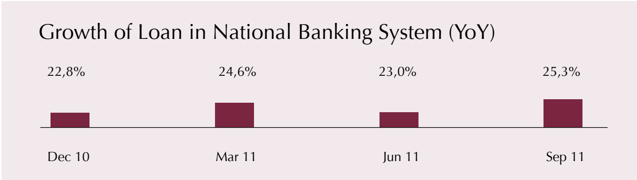


- The Cost of Funds for Credit (HPDK) component depends on the condition of liquidity in the economy. Currently, bank liquidity has become more limited, resulting in a high HPDK.
- The second component that determines the level of mortgage interest is overhead cost that consists of high overhead acquisition of funds. Sub-components other than the cost of the distribution and collection of credits depend on the customer segments served. In general, for corporate customers, overhead costs range from 1% while micro customers can reach to 10% due to the need to employ sales/marketing/collection to serve many micro clients.
- The third component is profit margin. It depends on the structure of the banking market's oligopolistic tendencies in high concentrations. The decline has to do with increasing competition, both between banks, for example consolidating with a small bank as well as other financing sources.
- The final component is the magnitude of the risk premium depending on the ability of risk management and banking.

Looking at the factors above, we can conclude that the first component (HPDK) and the second component (overhead cost) have a relatively same size for all banking segment, but the size of other components will be different accoeding to each of the market segment of each banks (which generally divided into corporations, retail, and consumption). Cost of Loanable funds are highly influenced by interest rate. With the decreasing interest rate as adjusted by BI rate, this particular component is experiencing a decrease. However, we need to focus on the fact that this may not happened when banks liquidity is tight. Banks liquidity is considered tight when the growth of credit is higher than funds. This happened in the year 2010-2011 as shown in Figure 2 below. In the condition where banks liquidity is tight, even if Bank Indonesia lowers BI rate, it is not easy for banks to lower their interest rate.

Figure 2





The second component is the most important in the strategy to decide on the bank interest rate, which is overhead cost. There are two types of overhead cost, funding overhead cost and credit overhead cost. Funding overhead cost is still relatively high (at 2-3%) as banks keep expanding their networks. As stated above, penetration and reach of banks nationally is still relatively low compared to other ASEAN countries or other Asian countries as illustrated in the Table 1 below.

Tabel 1. Comparison of reach and penetration of banks in a few countries

	Countries	Areas (km2)	Total Population (millions)	Branches / 1000 km2	Branches / 1000 adults	ATM / 1000 km2	Loan acct / 1000 adults	Deposit acct / 1000 adults
1	India	3,287,590	1,241.3	26.5	10.1	19.1	137.5	747.3
2	Thailand	514,000	69.5	11.4	11.0	73.4	272.5	1448.8
3	Malaysia	329,750	28.9	6.6	11.4	31.1	963.6	2063.3
4	Indonesia	1,919,440	238.2	7.1	7.7	13.2	196.9	504.7
5	Phillipines	300,000	95.7	23.5	11.8	28.4	N/A	N/A
6	South Korea	98,480	49.0	49.9	12.3	N/A	N/A	N/A
7	Japan	377,835	128.1	37.8	12.5	N/A	177.6	7172.4

Until now, banks keep expanding to push for improvement in delivering banking services to the people. The establishment of branches of ATM continuously happens in remote locations, which requires investments and large overhead cost. To push for lower interest rate, reduction of overhead cost fund can be done by allowance from banking authorities (OJK and BI) to banking sectors in order to collaborate with non-bank institution with wide range like PT. Pos Indonesia and PT. Pegadaian as distribution line for banking products in areas unreachable by banks.

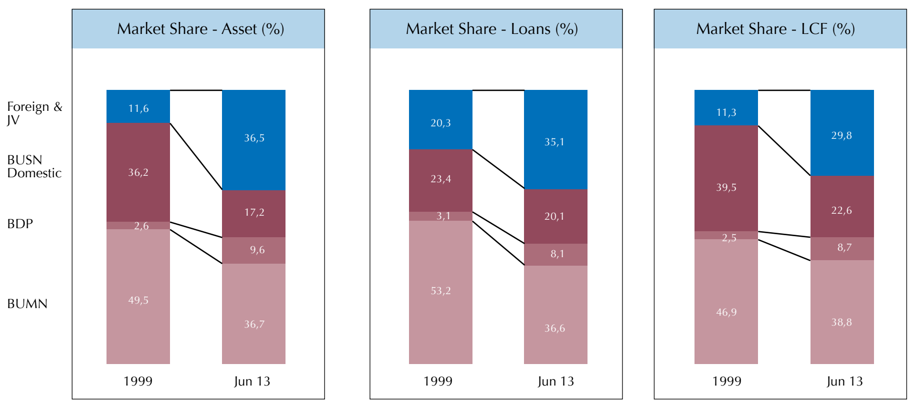
Another sub-component of overhead cost is credit overhead cost, whose size depends on the credit segments. Credit overhead cost includes the cost of distributing and billing credits. For corporation segment, the overhead cost credit is around 1% while the micro segment reaches more than 10%. The credit overhead cost in micro segment is very high mostly due to the size of manpower needed for distribution and billing, which needs to be done more often (weekly or even daily) with smaller credit amount compared to the corporation segment. On top of the high operation cost, the network expansion cost in the micro segment is also higher because the micro clients are greatly dispersed. Effective policies and efforts to reduce credit overhead cost are required to lower banks interest rate. However, bear in mind that the limitation of the credit overhead cost (for example, limiting the manpower) might create potential risk of reducing banks' operational quality in delivering services to the clients, especially the micro ones.

The third component in determining the level of bank lending is profit margin. Similar to credit overhead, profit margin in corporate segment is relatively lower compared to the micro segment. This is due to the differences in availability of product substitution in corporate and micro segment. In corporate segment, credit substitutes for banking products are many, as the clients could seek alternative financing through stock market and other means. In addition, corporate clients generally have a better bargaining position due to the high number of banks competing to distribute the loans. Thus, banks usually offer lower interest rate to corporate clients (hence lower profit margin set towards the corporate clients). Conversely, credit substitutes for banking products are fairly limited in the micro segment, as majority of alternative financing come from BPR and other informal sources (such as loan sharks), which charge exorbitant interest rate of as high as 10% per month. Because of the limited alternative of products, banks usually charge higher interest rate to the micro segment, compared to the corporate segment. The lowering of margin profit can be done through providing substitute products, for example by furthering the development of capital market and credit program like KUR as financing alternatives.

The final determinant of lending interest rate is risk premium. The magnitudes of risk premium assigned by banks for the clients are varied and depend on banks' risk appetite in selecting segments and targeting clients. Limiting risk premium to push the interest rate down is a quite difficult thing to do, as this limitation will hamper the growth of banks' lending distribution.

Another issue in the banking sector in Indonesia is connected to ownership of banks by foreign investors. Currently 12 out of 20 biggest private banks registered in Indonesia are owned by foreign investor[1]. The high business potential in Indonesia encourage the growth of foreign and joint-venture banks in Indonesia, resulting in more intense competition among banks. The image below describes the market share for asset, loans, and LCF (Liquidity Credit Facility) in the banking sector until the end of 2014.

Figure 3: Market Share for Asset, Loan, and LCF in Indonesia's Banking Sector, 1999-2014

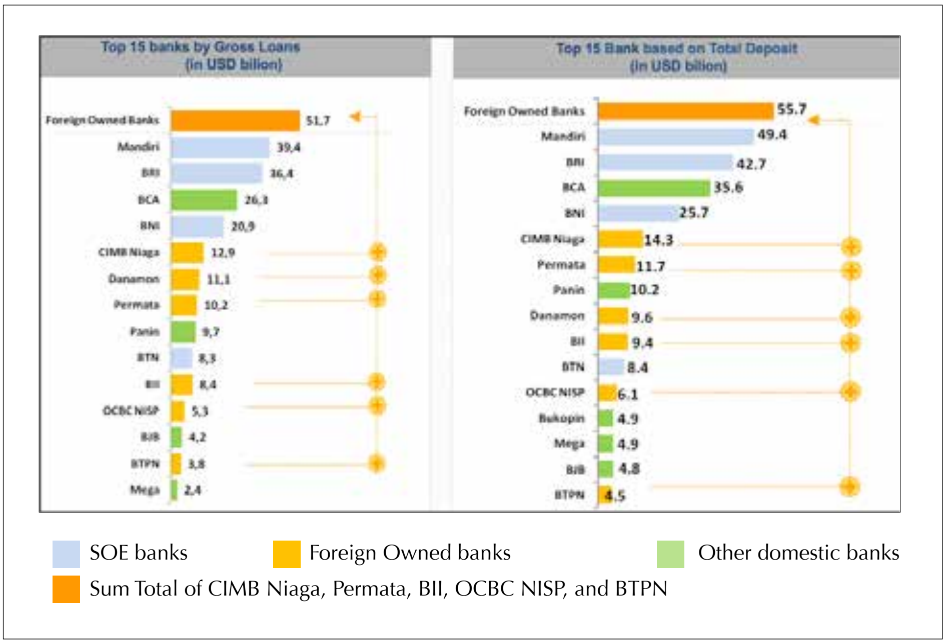


Note:
Foreign & JV = Foreign Banks, Joint Venture & Domestic Private Banks Owned by Foreigners
Domestic Private Banks = National Private Commercial Banks Fully Owned by Domestics

Source : Extracted from Publication of Banks & Bank Indonesia's Financial Statements

1 Banks are considered foreign-owned if more than 50% of their assets are owned by foreign financial institutions.

Regulations on foreign ownership in banking sector have to be carefully designed, as the expansion of access to formal financial sector is still very much required to achieve a more inclusive growth. An evidence of high degree of foreign penetration in Indonesia's banking sector is the domination in credit distribution (51.7%) and fund collection (55.7%) by foreign banks.



Source : Bloomberg Position at Desember 2013 Audited

The policies of restraining ownership over banks need to be formulated without discrimination against any particular group of foreign investors. Creating stricter regulations and supervisions over banks is a better policy choice, rather than a discriminative type of policy. One way of doing that is by requiring foreign banks to be registered as an Indonesian entity (domestically incorporated foreign bank) before operating in retail banking segment. This regulation must be enforced, even toward foreign banks that have been operating before this rule is enacted. This is necessary to create a level playing field for all banks.

Policy recommendations as a conclusion from all the elaboration above, with regard to two main issues (improving the transmission of policies to lower interest rate and regulate banks' ownership in Indonesia):

- Developing alternative source of financing through capital market and a more guided expansion of credit programs. Government needs to aggressively push to increase the target of KUR distribution, through more banks (including foreign banks). Moreover, given that KUR is guaranteed by the government, injection of funds to Jamkrindo and Askrindo are needed to improve the KUR's credit guarantee.
- Better regulation and supervision over banks is a better policy choice, rather than imposing a discriminative ownership policies.