

# Indonesian financial regulation: from the global economic recession to fintech

[Economics](#), [Currency](#)



## **Indonesian Financial Industry and Business Dynamics**

Indonesia is a young G20 country that obtained its independence from the Netherlands in 1945. Geographically composed mostly by coastal lowlands and mountains, Indonesia has the largest Muslim-majority nation in the world (Central Intelligence Agency 2017) and these characteristics are reflected in the structure of its Financial Industry and their mechanics. The Financial Industry is dominated by the Banking Institutions which hold 77. 2% of total assets (Bank Sentral Republik Indonesia 2018). Banks can be categorized as Commercial or Rural, and each can be Conventional or Sharia, the former being compliant with the Islamic law (OJK – Otoritas Jasa Keuangan 2018) (The Guardian 2013). According to the Indonesian Central Bank, in September 2018 there were 115 commercial banks and 1603 rural banks (Bank Sentral Republik Indonesia 2018). By sector, the largest contributor to Indonesian GDP is services including electricity, construction, transportation and communications, financial services and other services.

The manufacturing industry accounts for more than 25% and resource-based activities such as agriculture and mining (including petroleum) contribute the remaining portion (approximately 20-21%) (Titiheruw 2009). The majority of the loan distribution goes to export heavy industries such as the processing in the food industry, wholesale and retail trade and other non-industrial endeavors (Bank Sentral Republik Indonesia 2018) (EY 2017). However, the growth in the loan distribution for utilities, construction and other financial intermediaries correspond to “ government projects and business associated with the state-own enterprises” (EY 2017). During the latest Financial Crisis,

Indonesia was one of the few G20 countries that continue to grow positively (World Bank 2018) and recently it recovered its investment grade credit rating to Baa2 (Country Economy 2018). This is the result of different reforms that the Government implemented in order to better finance regulation in the institutions in the country since 2012 (OECD 2012).

For example, it was stipulated that the Indonesian Central Bank is an independent entity and operates without interference of the Government. As a result, in 2013 the regulatory and supervisory functions, as well as duties and authority in the banking sector moved from the Central Bank to the Otoritas Jasa Keuangan (OJK), which supervises the insurance and non-banking institutions (KPMG 2017). The composition of the Financial Industry in Indonesia is quite peculiar: of the top 4 banks, 3 are state-owned (KPMG 2017). Moreover, the top 10 banks in Indonesia hold 67% of the total assets (EY 2017). This unique characteristic also arises from different regulations the country has. In Indonesia, it is not allowed for a single person, entity or groups of companies to be the controlling shareholder (EY 2017) and in 2016, regulation for Information Technology Based Lending Services was released (KPMG 2017) to protect local banks (Oxford Business Group 2015).

## **The Global Economic Recession**

The Global Economic Recession (GER) began in early 2008 stemmed from the US sub-prime mortgage crisis. As a result of an increasingly connected world, financial systems globally were impacted by the sudden downturn of the American economy, including Indonesia. Indonesia was impacted by the GER mainly through its foreign trade, foreign direct investment in Indonesia,

and its nationals working abroad. Although the country did feel effects of the GER, Indonesia escaped relatively unscathed compared to other G20 nations; this is due in large part to the regulations previously discussed and implemented as part of the 1997-8 Asian financial crisis. A more in-depth analysis of the GER's impact on Indonesia will be undertaken in the following pages.

### 1. Signs to Act

In the first half of 2008, it did not seem like the GER would impact Indonesia as its economic growth targets were consistently being met or exceeded each quarter. The first sign of the GER creeping into Indonesia was in October 2008 when the GDP growth missed its quarterly target of 5.7% by half a percent and export growth dropped to its lowest levels in more than 20 years. Indonesian exports account for 30% of its GDP. As demand for commodities internationally decreased due to slowed global growth the price and quantity demanded of Indonesian commodities also decreased, straining its economy. Due to a depreciating exchange rate during the crisis, Indonesian companies also faced rising costs of its raw material imports. As Indonesia increasingly welcomed foreign investments after the Asian financial crisis of 1997, dependency on foreign direct investment also increased. By 2008, 67% of the market capitalization of equity in the Indonesian stock exchange was owned by foreign investors. The slowdown of growth in the global economy caused foreign investments to be withdrawn from the Indonesian market, reducing liquidity in its financial markets. From October to December 2008, foreign holdings of Indonesian government

securities (SUNs) dropped 28% and foreign holdings of Bank Indonesia certificates (SBIs) dropped 65%. (Titiharuw 2009) The Overseas Development Institute estimated in 2009 that Indonesian GDP needs to grow over 7% annually for unemployment and poverty rates to decrease. The slowdown in economic growth resulting from the GER hit export-oriented sectors such as manufacturing thus, as the GER hit its neighbouring countries, unemployment of nationals working abroad were also impacted and less money was sent home.

## 2. Monetary and Fiscal Policies

To combat the issues the Indonesian economy faced, The Central Bank of Indonesia implemented monetary policies to improve liquidity in the markets and control inflation. A couple of points included: lowering repurchase rate, reducing minimum reserve deposits, increasing government guarantee of banks by 2000%, increasing equity buyback of state-owned corporations, delay payment dates for forex swaps from one week to one month, and limit currency speculation by limiting foreign currency investment (Global Financial Crisis: Indonesia n. d. ). These policies were implemented in hopes of improving liquidity for the banks to lend money, improving consumer confidence in the strength of the economy, and minimizing inflation. The Indonesian government also increased its spending through a fiscal policy package expecting a 2.5% annual deficit through a reduction of revenue and increased spending. The government helped businesses by reducing commodity, fuel, and electricity prices, waiving duties on some imported raw materials, and reducing income taxes. Indonesians were also given a

reduction in personal income tax through a 20% increase of non-taxable income as well as handouts for certain qualifying families (Global Financial Crisis: Indonesia n. d. ). The intention of the fiscal policy package was to protect domestic growth to keep unemployment and poverty rates low.

### 3. iii. Factors that Helped Indonesia

In the midst of adverse financial conditions globally, Indonesia still managed a 4.6% GDP growth rate at the worst of the GER crisis. Strict regulations on Indonesian financial institutions meant that they had no direct exposure to the failing US mortgage-backed securities; they were not even present on the international markets that were trading these securities (Titiheruw 2009). Indonesian regulators also imposed stricter deposit ratios on Indonesian banks than what Basel I (the global standard prior to the financial crisis) recommended, which helped liquidity and consumer confidence. Additionally, despite the decrease in export growth, Indonesia was buoyed through the growth of the Chinese economy (mainly unharmed from the GER) as the Chinese had strong demands for Indonesian exports. Finally, positive weather conditions over the GER allowed for Indonesia to have successful harvests so that its citizens had sufficient food, and ensured the employment of the 40% of the population that worked in agriculture (Hill 2012).

### 4. Post-GER Review

Overall, Indonesia felt the impacts of the GER as growth slowed worldwide. However, due to the regulations implemented after the Asian financial crisis in 1997-8 and its experience from that time, the country was able to quickly

rise out of the recession with minimal impact to its growth. Figure 1 below shows that the monetary policy implemented by Bank Indonesia was not very successful in controlling inflation (their target is  $5\% \pm 1\%$  annually) during the crisis but the fiscal policy implemented by the Indonesian government was successful in its control of national unemployment.

The most recent government regulations on the financial industry in Indonesia reflect its acknowledgement of the increasing digitization of the world where the fintech industry plays a significant role. From 2016 to 2017, the government released new regulation targeting the growing fintech industry in the country. With the number of fintech transactions growing to 16.3% annual and investments in fintech of up to \$176.75 million in 2017 alone (The Jakarta Post 2018), the fintech space is becoming an important part of the financial industry. This is particularly true in Indonesia as Fintech has helped in increasing more rapidly the banked population of the country.

#### 1. The Sandbox: first Fintech Regulation in 2017

The first significant fintech regulation was introduced in 2017. There are three bodies that regulate the industry depending on the type of services that a company provides. The Central Bank of Indonesia (BI) regulates all fintech services that fall under payment instruments; the Indonesia Financial Services Authority (OJK) regulates P2P lending, insurance tech and crowd funding; and the ministry of Communication and Informatics (MOCIT) regulates the information technology aspect of the industry. As with most new technologies and start-ups an immediate issue arising from the distribution of regulatory power is categorizing which jurisdiction a fintech

product falls into. To resolve this issue, the 2017 fintech regulation created a regulatory Sandbox and BI Fintech Office. The regulatory Sandbox provides licensing for a fintech company to test its products. The results obtained in this sandbox environment are used in categorizing the product and assigning to the appropriate regulatory body. The BI fintech office on the other hand serves as focal point (or a one-stop shop) for all technology-based services from business intelligence to raw market data that are required for future industry growth.

## 2. Cryptocurrency: Stuck in the Sand

With this new fintech regulation of 2017, the government also took a stand on crypto currencies. Although about 1 million Indonesians deal in crypto currencies (Maulia 2018), the government in BI Regulation Number 19/12/PBI/2017 prohibited fintech firms from processing payments transactions that are denominated in virtual currency. This new regulation led to the voluntary closure of some bitcoin payment platforms like TokoBitcoin and Bitbayar. Nevertheless, other platforms like ArtaBit and Luno are still open despite stronger government crackdown (ICLG 2018). This shows the difficulty that may be experienced in trying to regulate this environment as non-voluntary compliance to new regulations might be hard to police considering the ability of fintech companies to exist without a physical structure in the country.

## 3. Consumer protection and ownership

The government has also tried to address the issue of ownership and protection of consumer rights. Beyond the simple requirement for



operational licences and basic permits, foreign participation in payment services is limited to 20% and foreign ownership in P2P services is capped at 85% (ICLG 2018). The high cap for foreign ownership in P2P services however needs to be revisited. A recent article in Bloomberg “ How China’s Peer-to-Peer Lending Crash Is Destroying Lives” examines the P2P industry in China and the frequent collapse of multiple companies and its negative impact on the finances of the populace shows the importance of government protection of funds. In the absence of facilities such as Depositor’s insurance in the fintech sector, it is important for the government to ensure that the ownership of these P2P companies are individuals and corporations who can be easily regulated within the Indonesian sphere. An estimated 85% foreign ownership represents a sizeable portion that potentially cannot be prosecuted in the case of fraud or mismanagement increasing the overall risk of these services.

#### 4. Overdue Simplification

Newer government regulations outside of fintech have been aimed at simplifying previous regulations and clarifying the rules of engagement in a more digitized world. New regulations were introduced governing the submission of reports through electronic reporting systems for Insurers or Public Companies with a goal of improving the efficiency and transparency of these reports. The regulation addresses factors such as the frequency of the reports, the retention limit and obligations as to the location and timing of these reports (Deloitte Indonesia 2018). Also, with money increasingly e-based and less cash based, Indonesia introduced new regulation that

focused on regularizing electronic money transactions. The focus of this regulation is to ensure consumer protection particularly with regards to data protection, prevention of money laundering and terrorism. By specifying minimum paid-in capital and introducing validity periods for licenses issued, the government introduced a means of exercising enforcement in case of regulation defaults which leads to the final point and most glaring deficiency in the Indonesia financial regulatory sphere.

#### 5. A path of good intentions

A lot of well-intentioned regulations are being introduced and implemented to ensure a stronger financial sector however, as can be seen with the case of the crypto currency traders, the biggest issue at hand is the weak enforcement of these regulations. The lack of legal protection for regulatory officers (Strategic Review 2013) and political interference impacts the efficacy of their jobs and hence limits the effects of these regulation. The Government needs now to focus on granting these regulators more enforcement avenues and protection to reap the full benefit of these regulations.