

**PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE**

Report No.: AB7553

Operation Name	Indonesia Financial Sector Reform and Modernization DPL-2 (FIRM 2 DPL)
Region	East Asia and Pacific
Country	Indonesia
Sector	Banking (30%); General finance sector (50%); Non-compulsory pensions and insurance (10%); Capital markets (10%)
Operation ID	P145550
Lending Instrument	Development Policy Lending
Borrower(s)	Ministry of Finance
Implementing Agency	Ministry of Finance, Coordinating Ministry for Economic Affairs
Date PID Prepared	March 18, 2014
Estimated Date of Appraisal	March 28, 2014
Estimated Date of Board Approval	July 1, 2014
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

The proposed Second Indonesia Financial Sector Reform and Modernization Development Policy Loan (FIRM 2 DPL) aims to promote the development of a sound, efficient and inclusive financial sector to help the Government of Indonesia (GOI) achieve its medium-term economic development and poverty reduction goals.

The proposed operation has been designed to support the Government of Indonesia to achieve its medium term goal of accelerating economic growth and promoting inclusive development. In its recent Master Plan for Acceleration and Expansion of Indonesia's Economic Development (MP3EI), the Government has articulated its vision to turn Indonesia's economy into one of the world's ten largest by 2025. A sound, stable, and efficient financial sector is expected to contribute to the achievement of these goals. They are also a prerequisite for boosting shared prosperity and reducing poverty in Indonesia. As such, the operation is fully aligned with the World Bank Group (WBG) Country Partnership Strategy for Indonesia for the period of FY2013-2015 (CPS).

The FIRM 2 DPL supports a set of critical policy and institutional reforms at a time of significant uncertainty in the global economic environment. While Indonesia's economy demonstrated notable resilience to the global financial crisis of 2008-9, since 2011 the economy has faced increased pressure. This pressure has been marked by a depreciation in the rupiah and emergence of a current account deficit of 2.7 percent of GDP, compared with a small surplus in

2011. Indonesia's markets have also been affected by the anticipation of US Federal Reserve "tapering" since 2013. Ultimately, these developments have reinforced the urgency of high level policy makers in Indonesia to carry out key financial sector reforms, and the proposed operation supports the Government to implement the highest priority reforms.

Following on the first FIRM DPL, the operation is timely in continuing to support the Government at a crucial stage of transition in the financial sector regulatory framework. Specifically, in October 2011, Indonesia enacted the Indonesia Financial Services Authority Law establishing a new integrated financial regulator (Otoritas Jasa Keuangan, or "OJK"). In accordance with the Law, the new institution assumed responsibility for non-bank financial institution supervision from the Ministry of Finance in January 2013 and banking supervision from Bank Indonesia a year later in January 2014. While the establishment of OJK presents both transitional and operational risks, it also creates an important opportunity for the Indonesian authorities to lay the basis for quality financial supervision and regulation and sound and stable development of the financial sector.

II. Operation Objectives

The objective of the operation is to promote the development of a stable, efficient and inclusive financial sector to help the Government of Indonesia (GOI) achieve its medium-term economic development and poverty reduction goals. The main areas of policy and institutional reform supported under the loan will be: (i) reinforcing financial system stability; (ii) promoting financial sector diversification; and (iii) enhancing financial inclusion.

The expected outcomes of this operation will be: (i) improved financial system stability through effective supervision and regulation; (ii) increased financial sector diversification through development of non-bank financial institutions; and (iii) enhanced financial inclusion for underserved groups and the poor.

The Coordinating Ministry for Economic Affairs and the Ministry of Finance will be the implementing agencies for the operation. Other institutions including the Indonesia Financial Services Authority (OJK), Bank Indonesia (BI), the Indonesia Deposit Insurance Corporation (LPS), and the National Team for Poverty Reduction (TNP2K) have been closely involved in identifying the prior actions.

III. Rationale for Bank Involvement

A sound, stable, and efficient financial sector is expected to contribute to the achievement of boosting shared prosperity and reducing poverty in Indonesia. As such, the operation is fully aligned with the World Bank Group Country Partnership Strategy for Indonesia for the period of FY2013-2015 (CPS). While the loan is a stand-alone operation, it builds directly on the first Financial Sector and Investment Climate Reform and Modernization DPL (FIRM DPL), approved by the World Bank Board in November 2012.

The proposed operation forms an integral part of Indonesia's DPL program—including three sectoral DPLs in 2012 and 2013 (the FIRM DPL, the Institutional, Tax

Administration, Social and Investment DPLs, and the Connectivity DPLs). The proposed operation also complements the US\$ 2 billion Program for Economic Resilience, Investment and Social Assistance in Indonesia DPL-DDO (PERISAI), which focuses on bolstering Indonesia’s resilience to the impact of the global financial crisis. While PERISAI focused on short-term measures to enhance financial crisis preparedness, this operation advances the Government’s medium-term policy and institutional reform agenda.

IV. Tentative financing

Source:		(\$m.)
Borrower		0
International Bank for Reconstruction and Development		500
	Total	500

V. Institutional and Implementation Arrangements

As the implementing agency for the operation, the Coordinating Ministry for Economic Affairs will be primarily responsible for overall monitoring of outcomes team. The Ministry of Finance, OJK, Bank Indonesia and the National Team for Poverty Reduction (TNP2K) will be closely involved in monitoring the reforms and impact at the institution level as part of their existing mandate. The National Strategy for Financial Inclusion also places heavy emphasis on defining key performance indicators related to financial inclusion. As such, the Bank is providing technical assistance in this area given that the monitoring arrangements are expected to influence policy design. The Bank team will support this endeavor with the relevant technical staff of the institutions mentioned above.

VI. Risks and Risk Mitigation

Continued strong performance by the Government on its reform agenda and the achievement of its medium-term objectives are subject to several risks. These include macroeconomic, political, and institutional.

External balance pressures may intensify, disrupting the Government’s reform program. These pressures could result from US “tapering” or from a fall in commodity prices. Following significant monetary policy and exchange rate adjustments, Indonesia’s current account deficit is narrowing. The Government has also been proactive, including readying the Bank-supported US\$ 2 billion PERISAI DPL-DDO, and has taken steps to enhance crisis preparedness. This DPL is specifically designed to help bolster financial sector stability through an improved financial sector regulatory framework, and financial deepening to help mitigate external financing risks.

The elections scheduled for mid-2014 may delay implementation of some key reform measures. Regardless of the outcome of the elections, there is a broad consensus that has emerged among both high level policy makers and technical staff of key institutions on the criticality of financial sector stability and deepening.

The establishment of the Indonesia Financial Services Authority (“OJK”) presents a number of operational and transitional risks that could affect ongoing financial sector supervision and regulation. Despite these transitional risks, this change provides an opportunity for Indonesia to lay the groundwork to enhance the quality of overall financial supervision in line with well recognized good international practices.

The large number of implementing agencies and varying institutional capacities may create coordination and implementations challenges. Several programs and partnerships that the Bank already has in place are designed to support the Government in mitigating this risk. In addition, the DPL also explicitly aims to support coordination among the various institutions responsible for financial sector policy development through its coordination platform.

VII. Poverty and Social Impacts and Environment Aspects

The proposed policy actions under this operation are expected to have positive social effects, by helping to create an overall favorable economic environment for growth and poverty reduction and by supporting specific measures targeted toward the poor and vulnerable groups. Prior actions to improve financial sector stability and diversification are part of a broader GOI effort to create a stable economic environment. In doing so, it will reduce the level of risk of job loss faced by poor and vulnerable households during times of crisis. In the past, poor and vulnerable households were hurt by the Asian Financial Crisis in 1997-1998; formal sector employment rates fell steeply as many households fell into poverty, so that 23 percent of Indonesia’s population was below the poverty line by 1999. The GOI has made important strides since that time in establishing economic stability, and the proposed DPL aims to further bolster these efforts.

Several reforms, particularly under financial sector diversification and financial inclusion, also target the poor and vulnerable. Measures supported under the loan are designed to encourage the development of financial products tailored to these groups in particular.

VIII. Contact point

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