Financial market development in Indonesia

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Abstract

In the last two decades, financial market development in Indonesia has progressed mainly via industry-led initiatives. But this changed in 2014, the year in which the authorities started to play a more active role in the acceleration of financial market deepening via so-called policy-led initiatives. Indonesia's experience, on the one hand, indicates the need to encourage market participants to have greater role in leading the initiatives. On the other hand, financial stability has to be maintained at the same time. This two-pronged approach is the key feature of recent financial deepening in Indonesia.

Financial market development in Indonesia has a significant impact on monetary transmission and financial stability. Policy responses to optimise financial market deepening with the aim of strengthening the monetary policy transmission have consisted of reformulating the policy interest rate into the BI seven-day reverse repo rate (BI7DRR); implementing an averaging method for reserve requirements; and establishing a more credible benchmark money market rate. Meanwhile in managing financial stability, Bank Indonesia continuously promotes institutional resilience against financial risks. One notable initiative has been the development of hedging instruments to address currency and interest rate risks.

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Introduction

In the last two decades, financial market development in Indonesia has advanced mainly via industry-led initiatives. But this changed in 2014, the year in which the authorities started to play a more active role in the acceleration of financial market deepening via so-called policy-led initiatives. The shift was due mainly to, first, the limited role of financial markets as a source of financing for economic development, particularly infrastructure, and second, the growing need of market participants for risk mitigation. This approach was also influenced by the experience of the 1997 Asian crisis and the 2007–09 Great Financial Crisis, which inflicted massive costs from lost output on most emerging market economies. Simultaneously, ill-judged financial liberalisation exposed structural weaknesses and policy distortions.[2] This experience indicates the need to encourage market participants to have greater role in leading the initiatives. On the other hand, financial stability has to be maintained at the same time. This two-pronged approach is the key feature of financial deepening in Indonesia over the last decade.

Bank Indonesia has been actively involved in initiatives to develop financial markets. Policies for financial market deepening and development are designed to support monetary and financial stability as well as to support infrastructure financing. Financial market deepening officially became a national agenda item, when in 2015 Bank Indonesia together with the Ministry of Finance (MoF) and the Financial Services Authority (OJK) established the Coordination Forum on Financial Market Development. The National Strategy of Financial Market Development sets out a phased programme for completion in 2024, envisaging the development of deep, liquid, efficient, inclusive and prudent financial markets. The forum has set up programmes to develop financial markets in terms of their accessibility, instruments, financial market infrastructures, benchmark rates, and the regulatory framework.[3] Six markets are covered: the money market, foreign exchange, bonds, equities, sharia financing and structured products.

As a central bank, Bank Indonesia focuses on financial market development with two main goals. First, to support the effectiveness of monetary policy transmission and, second, to support economic financing including infrastructure. Deep and developed financial markets are less susceptible to global market spillovers, so that monetary policy transmission is more effective. Liquid and developed financial markets including derivatives markets will eventually improve the stability of financial system. Along with the development of derivative instruments for hedging purposes, there have also been initiatives to deregulate FX transactions vis-à-vis the Indonesian rupiah, develop money market instruments and improve two-way coordination with market participants to support financial market development programmes. Improving the liquidity of financial markets will include providing market participants with alternative short- and long-term financing instruments, including commercial paper and negotiable certificate of deposits as short-term instruments; as well as stocks and bonds, as long-term instruments.

[2] ADB Briefs, no 85, 2017.

[3] www.bi.go.id/en/moneter/pasar-keuangan/snpppk/Contents/default.aspx

Financial market development and monetary policy

Financial markets are central to monetary policy operations, where monetary transmission depends on financial market structure. The relationship between the deepening of financial markets and the effectiveness of monetary policy transmission is therefore a two-way street. Strengthening policy transmission through market-based instruments will encourage financial market deepening, much as the repo market encourages the development of the bond market. In the same way, the deepening of financial markets will increase the effectiveness of transmitting monetary policy.

After adopting its inflation targeting framework in 2007, Bank Indonesia has continued to enhance its monetary policy framework. **The first enhancement** in 2016 was to replace the BI rate with the BI seven-day reverse repo rate (BI7DRR). The new policy rate is expected to reflect the monetary policy stance as a tool for anchoring economic agents' inflation expectations. At the same time, the BI7DRR is used as a benchmark interest rate for transactions in financial markets and to influence general interest rates and banking interest rates. **The second enhancement** is the start of reserves requirement averaging in 2017, to deepen the money market and to reduce the need for banks to hold high precautionary reserves. This was also supported by regulation for the use of the local global master repurchase agreement (GMRA) and capacity-building with market participants.

Following this reform, there has been significant progress in the repo market. Daily repo transactions have increased quite substantially since 2016. Liquidity has also improved in the uncollateralised money market (interbank call money market). Within this framework, the interbank call money market rate must be maintained close to the policy rate and within the narrow range between the Deposit Facility (DF) and Lending Facility (LF) rates as the upper and lower boundaries marked by repo and reverse repo transactions. The short-term repo rate, which acts as the operational target, will affect the short and long interest rates, thus influencing financing conditions. In addition, Bank Indonesia also oversees the movement of the government bond yield by conducting monetary operations to buy and sell bonds in the secondary market.

To further support monetary policy transmissions, Bank Indonesia continues **its third enhancement** by introducing a reform of the benchmark rate. This initiative is designed to provide a more credible benchmark money market rate. In 2018, Bank Indonesia introduced the Indonesia Overnight Index Average (IndONIA) and enhanced the Jakarta Interbank Offered Rate (JIBOR) to create a credible short-term money market yield curve (or term structure). IndONIA is designed to serve as one of several money market benchmark rates, for use by market players as a reference in determining loan interest rates and financial instrument prices and performance.[4] IndONIA is an index of the interest rate for unsecured overnight interbank rupiah lending transactions. It is calculated periodically and made public. IndONIA is based on the average interest rate for unsecured overnight rupiah lending, as reported by all banks to Bank Indonesia. As an interest rate based on market transactions, IndONIA took over from overnight JIBOR as the money market benchmark rate on 2 January 2019. In the future, once the liquidity of all tenors in the money market

[4] www.bi.go.id/en/moneter/jibor/indonia/Contents/Default.aspx.

improves, IndONIA-based overnight index swap is expected to replace JIBOR for all other tenors.

JIBOR is the average of unsecured interbank lending indicative interest rates, as offered for rupiah lending in Indonesia for a tenor longer than overnight. JIBOR is determined by Bank Indonesia based on the indicative offer rates quoted by contributor banks. In order to increase the reliability and credibility of JIBOR, it is hittable for certain tenors and within a certain time frame. In addition, contributor banks must quote rates by underpinning them to the greatest extent possible with transactions data in order to better reflect market rates. In addition, the process of JIBOR quotations must be well governed. This is in line with the global best practice specified in the International Organization of Securities Commissions (IOSCO) principles for financial benchmarks.

In addition to the benchmark rate reform, Bank Indonesia continues to develop the money market by introducing a negotiable certificate of deposit (NCD) and commercial paper (CP) to support liquidity management for financial institutions and corporations. The development programme for short-term paper is also part of the effort to support economic financing.

Financial market development and financial stability

The exchange rate is a highly relevant link between financial market development and financial stability in emerging markets. As in many other countries, exchange rate stability plays an important role in achieving monetary and financial stability. Indonesia adopted a free-floating foreign exchange (FX) regime in 1999, so that the rupiah exchange rate is determined by market supply and demand. Hence, to support the stability of the exchange rate, Bank Indonesia plays an important role by keeping the FX market properly functioning. Moreover, a flexible exchange rate is a key feature of the inflation targeting regime. FX intervention is conducted only to smooth adjustments and only if volatility is seen as potentially disrupting the economy.

To stabilise the currency, since 2001 Bank Indonesia has adopted a policy of non-internationalisation for the rupiah. There are restrictions on the offshore transfer of the rupiah, and ownership of the rupiah onshore by non-residents must be authorised and documented. As a result, the rupiah is not accessible outside Indonesia, except for NDF transactions using the rupiah as the benchmark but settling in foreign currency. Rupiah can only be accessed and settled domestically in Indonesia.

FX market development was improved through deregulation and simplification of FX regulations in 2014 and further reformed in 2016. The regulation stipulating the requirements on underlying economic activity for FX transactions against the rupiah above a certain threshold has been improved to support economic activity while at the same time maintaining prudential principles. The introduction of more efficient hedging instruments, such as call spread options in 2016, supports improved risk management by market participants.

Since the financial market development programmes conducted by Bank Indonesia in 2014, the market has started to provide more liquid and efficient instruments. In the Indonesian FX market, the degree of interaction between the onshore and offshore markets has been quite high in recent years, especially for the offshore FX NDFs, which significantly influence the movement of the onshore rupiah

FX spot market. This high correlation between the two markets has somewhat affected the monetary transmission mechanism. In order to reduce the price volatility of NDF offshore market, which causes price volatility in the domestic spot market, in November 2018, Bank Indonesia introduced a new FX hedging instrument, the domestic non deliverable forward (DNDF), to provide a hedging alternative for market players, especially investors who own rupiah assets.[5] The instrument is similar to an NDF in the offshore market but is settled in domestic currency. Since the introduction of the DNDF, the price of offshore NDFs has largely moved in line with those of DNDFs and the spot market, which BI can access for stabilisation purposes.

Indonesia's financial market regulation continues to be principles-based, except where explicit monitoring and supervision by the financial authorities is required. In the FX market, for example, FX transactions above a certain threshold must still be based on underlying economic activity, such as trade and investment, and documented to that effect. Most FX derivative instruments in Indonesian market are "plain vanilla", and monitored closely by Bank Indonesia and the OJK. Only a limited range of structured derivative products is permitted.[6, 7]

In developing its FX market, Bank Indonesia, together with the Central Bank of Malaysia and the Bank of Thailand, has put in place a local currency settlement (LCS) framework to support trade and investment between the three countries. Introduced in January 2018, the framework has been adopted quite widely, with more than 500 customers using this framework regularly. One of the framework's aims is to mitigate the risk of overreliance on hard currencies, especially the US dollar. Further improvements to the LCS framework are expected soon.

In the market for interest rate hedging instruments, Bank Indonesia introduced an overnight index swap (OIS)/interest rate swap (IRS) in 2018, following the introduction of the IndONIA benchmark. This instrument is expected to further support the ability of banks and corporations to manage their liquidity and market risk.[8] This will help to strengthen the monetary transmission mechanism, support the formation of the yield curve and make price discovery more effective in the money and bond markets. Further development of the OIS market is expected to provide a benchmark yield curve based on real transactions rather than price quotations. Since the OIS is seen as a near-risk-free asset and based on other countries' experience, the OIS yield curve is potentially a good candidate for establishing a benchmark rate.

Additionally, in response to the G20's OTC derivative market reforms, Bank Indonesia has enhanced its financial market infrastructure by establishing regulations on market operators and central counterparties (CCPs). At the Pittsburgh Summit in September 2009, the G20 recommended five steps to reform the bilateral OTC derivative transactions, namely that all standardised OTC derivatives should be: (i) traded through exchange or electronic trading platforms (ETPs); (ii) cleared through a central counterparty (CCP); and (iii) reported through a trade repository. Non-

[5] BI Regulation No.20/10/PBI/2018 regarding domestic non-deliverable forwards.

[6] In 2008, some corporations and retail investors became insolvent due to the overuse or inappropriate use of structured products such as callable forwards, or knock-in/knock-out options with leverage.

[7] BI Regulation No.18/18/PBI/2016 and No.18/19/PBI/2016 regarding FX transactions against rupiah between banks and domestic party and foreign party.

[8] BI Regulation No. 20/13/PBI/2018 regarding interest rate hedging instruments.

cleared OTC derivatives should be (iv) subject to higher capital requirements; and (v) subject to margin requirements. The progress report shows that G20 countries are following these recommendations and continue to advance the implementation of the financial market reforms.[9]

In Indonesia, market operators are regulated to strengthen governance, interconnectivity and credibility in providing facilities for rupiah-related transactions in the domestic market. This regulation supports the implementation of requirements for OTC derivative transactions that must be traded through exchanges or ETPs. In addition, Bank Indonesia aims to develop a CCP for OTC derivative interest rates and exchange rates within the next two years.[10] The CCP is designed to support financial market risk management and to reduce interconnectedness between OTC derivative market participants, as well as to increase transparency and market efficiency through netting. Ultimately, the CCP will enhance the stability of the financial system.

Policy response in strengthening financial stability

Managing financial stability risks is a key part of a central bank's role. The task has become more challenging as financial globalisation increases both the interconnectedness of global market players and the volatility of capital flows among emerging market economies. In this light, Bank Indonesia is continuously reviewing and improving its policies with the aim of responding effectively to sudden shocks from capital reversals on the one hand but still promoting market mechanisms on the other. Thus, Bank Indonesia has implemented an array of different measures spanning monetary and macroprudential policy with the aim of mitigating financial stability risks. In recent years, these measures have included:

1. Regulating the exposure of non-bank corporations when issuing offshore debt, with three main prudential provisions: (1) for addressing currency risk: a hedging ratio (25% for up to three months, and three to six months, net FX liabilities must be fully hedged); (2) for addressing liquidity risk: a liquidity ratio (70% of FX liabilities that are due in three months must be in cash); and (3) for addressing credit risk: the minimum credit rating when issuing FX-denominated bonds must be equivalent to BB.
2. Managing currency risk exposures by developing a local currency settlement (LCS) framework to support trade and investment in Indonesia, Malaysia and Thailand. The framework was introduced in January 2018, and has been widely adopted. A key aim is to mitigate the risk of overreliance on hard currencies, especially the US dollar. This offers importers and exporters an alternative way of managing their currency risks. Further improvements to the LCS framework are expected in the near future.
3. Amending regulation to support the development of innovative FX hedging instruments to address currency and interest rate risks, such as local currency-settled non-deliverable forwards (DNDFs), call-spread options (CSOs) and overnight index swap-interest rate swaps (OIS-IRS).

[9] FSB, *OTC Derivatives Market Reforms: 2019 Progress Report on Implementation*, 2019.

[10] OTC derivative transactions in Indonesia are mostly related to the exchange rate.

4. Amending regulation on macroprudential intermediation ratios (an extended version of the loan-to-deposit ratio) with provision to expand the scope of loan and deposit items to include securities such as corporate bonds, medium-term notes and green bonds. The policy aims to broaden the investor base as well as to promote market liquidity.
5. Amending regulation on the macroprudential liquidity buffer (MLB) as a countercyclical tool to anticipate liquidity shock in banks. The main provision is that the bank is obliged to maintain 4% of third-party funding in the form of government bonds, as a buffer additional to the traditional reserve requirement that must be in form of cash (now 5.5% of third-party funding). In 2018, a new measure expanded from 50% to 100% the eligibility of the government bonds pledged as MLB to be used as collateral in repo transactions with Bank Indonesia. The policy is designed to broaden the investor base as well as to promote market liquidity.
6. Ensuring banks comply with macroprudential capital standards such as the countercyclical capital buffer (CCB).

Indonesia's financial market deepening since 2014 has shown encouraging results but a number of aspects could give rise to concern: (i) the high participation rate of foreign investors in the government bond and equity markets. However, this is not the case in other market segments such as corporate bonds and structured products; (ii) a narrow investor base as a result of the low accumulation of pension and insurance assets, and fund management practices which are still geared towards short-term and low-risk instruments; (iii) the significant role of the central bank as a liquidity provider for a number of instruments due to the undeveloped market; and (iv) a lack of adequate feedback from the domestic market for policy formulation, for instance, regarding inflation expectations, because of the limited range of instruments, low liquidity and inefficient prices.

In overcoming these various challenges, Bank Indonesia will pursue a number of strategies: (i) continue coordination with the OJK and the Ministry of Finance, among others, through the Coordination Forum on Financial Market Development, with the aim of harmonising the financial market deepening measures taken by each authority, in particular on cross-cutting issues such as long term saving, taxation and capital market development; (ii) strenghtening the legal framework for facilitating financial market transactions, by addressing, among others, non-netting jurisdiction issue and margining rules as part of incentive and dis-incentive regulations regarding the OTC derivative market reform; (iii) continue initiatives to encourage the development of innovative financial instruments, including the relaxation of some regulations; (iv) explore the appropriate incentive-disincentive model to encourage more participation, in particular from the private sector, in financial market transactions; and (v) develop financial market infrastructure (FMI) such as a central clearing counterparty (CCP), a multilateral and exchange trading platform (ETP), a trade repository and credible financial benchmarks – eg the further development of IndoNIA, JIBOR, and the Jakarta Interbank Spot Rate (JISDOR).