

Indonesia's Islamic Finance Development and Risk Management Framework & Infrastructure

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Executive Summary of Indonesia's Financial Sector

Executive Summary

OJK has achieved some substantial progress since its inception...

- Indonesia adopts an integrated supervision model through the enactment of OJK Law. The transfers of capital markets and NBFIs supervision from Ministry of Finance (31 December 2012) and banking supervision from Bank Indonesia (31 December 2013) were performed successfully.
- A wide array of programs and initiatives have been undertaken to assure that financial sector could support Indonesia's strong economic growth, as well as to enhance consumer protection. OJK successfully achieved its strategic goals in 2013. Priority programs for 2014 have been set, including the formulation of integrated supervision framework.

Domestic financial sector remains robust and supporting strong economic growth...

- During the second half of 2013, a series of unfavorable conditions in global and domestic environments generated considerable pressures, including on domestic financial sector. The stock index declined and bond yields spiked, but then start to stabilize in early 2014.
- After being affected by the weakening market, domestic institutional investors (mutual funds, insurers, pension funds) recovered quickly and their financial condition generally remains strong. Sound risk management has led to relatively stable investment value.
- Banking sector remains strong, supported by robust liquidity resilience and capital adequacy. Domestic banks demonstrate a healthy funding base and low credit risk, making them less vulnerable to external shocks.

Key priorities and programs have been clearly set...

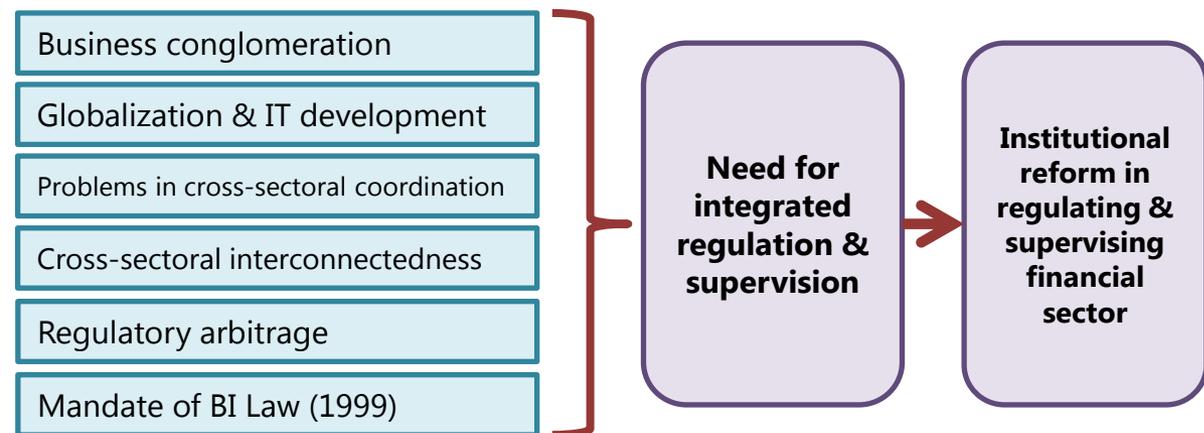
- Policies to develop the banking sector are focused on the improvement of banks' preparedness in anticipating ever-increasing demands, industrial revitalization, and global regulatory landscape.
- In the capital market sector, key priorities include deepening domestic capital market, improving market infrastructure and enforcement, and enhancing debt market.
- Key programs in the NBFIs sector include the enhancement of regulations, supervision, and enforcement, as well as preparations to supervise Social Security Agency (BPJS) and microfinance.
- In the area of consumer education and protection, OJK is continuously improving its financial consumer care, financial literacy programs, and consumer protection infrastructure.

A Glimpse about Indonesia Financial Services Authority (IFSA) or OJK

OJK establishment has born a new era in financial supervision

After long years of discussions, the OJK Law was enacted in November 2011. This enactment has born a new era in the regulation and supervision of Indonesia's financial sector. Supervisory roles on financial sector, previously conducted by Bank Indonesia and Ministry of Finance, are to be held by OJK.

OJK establishment was triggered by some features developing in financial sector.



OJK has three objectives as stipulated in the Law.

- 1** Assuring that activities in the financial services sector are conducted in an orderly, fair, transparent, and accountable manner
- 2** Creating a sustainable and stable financial services sector
- 3** Protecting the interests of consumers and the public

The transfers of supervisory roles from predecessor institutions were conducted gradually.

2011	2012	2013	2014	2015
21 November	31 December	31 December	1 January	1 January
<ul style="list-style-type: none"> The enactment of OJK Law 	<ul style="list-style-type: none"> Transfer of capital market & NBFIs supervision from Ministry of Finance 	<ul style="list-style-type: none"> Transfer of banking supervision from Bank Indonesia 	<ul style="list-style-type: none"> Supervision on Social Security Agency for Health (<i>BPJS Kesehatan</i>) 	<ul style="list-style-type: none"> Supervision on Social Security Agency for Workers (<i>BPJS Ketenagakerjaan</i>) Supervision on microfinance institutions

Moving towards integrated supervision system

The establishment of OJK is not merely a transfer of financial sector regulation and supervision previously conducted by Bank Indonesia & Ministry of Finance. OJK should be able to strengthen the existing supervisory system. Upon the joining of banking supervision, the expansive task of integrated supervision over the financial services sector has begun.

Background

- Integrated supervision is crucial as conglomerates gain an increasingly strong foothold in the financial sector.
- In 2013, OJK began measures to harmonise regulations across all financial services sectors through risk-based supervision.
- The concept of integrated supervision will be implemented gradually in line with the aspirations and preparedness of the industry.

Roadmap

- Preparation of conglomeration supervision methods, covering supervision cycle, calculation methods for capital adequacy, & conglomeration rating methods.
- Preparation of internal regulation concerning the implementation of integrated supervision.
- Preparation of organization & human resources to support implementation.
- Preparation of information systems & reporting framework.

2013

- Establishment of internal regulation as a legal base
- Formation of an integrated supervision committee

2014

- Establishment and implementation of guidance for Know Your Financial Conglomerates (KYFC)
- Setting up the quality assurance process, including panel forum
- Establishment of other related regulation (integrated risk management, GCG, capital adequacy requirement)

2015 onwards

- Implementation of risk-based supervision on financial conglomerations
- Monitoring of implementation

Recent Development of Indonesia's Islamic Finance

Indonesia was affected by the 2013 global downturn, yet now recovers quickly

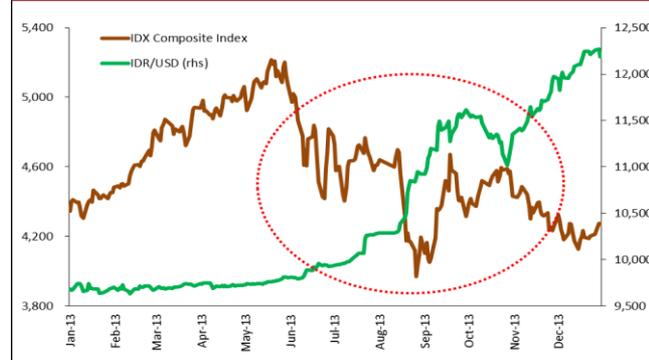
The macroeconomic environment in 2013 was very challenging. This condition then put pressures on the domestic financial market. Nevertheless, amidst global challenges, Indonesia's 2013 economic growth was among the highest in the region.

Challenges in 2013:

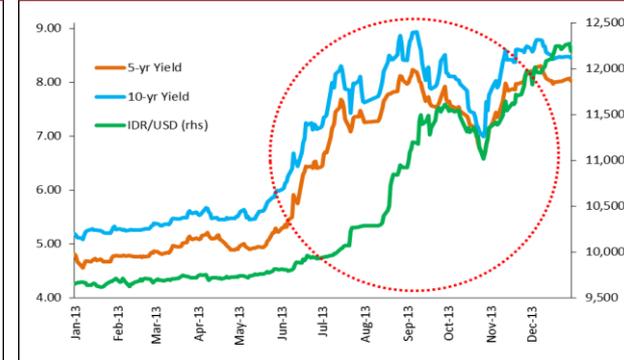
- Foreign outflow in equity market
- Current account deficit widened
- Inflation spiked
- Rupiah weakened
- FX reserves declined
- Commodity prices declined

- Responding to the challenges, Bank Indonesia & the Government carried out stabilization policies (incl. policy packages) to steer the economy to the right track. By late Q4-2013, the turmoil started to ease.
- Indonesia's economic growth was among the highest in the region. Foreign direct investments continued to grow. Gov't debt market still enjoyed foreign inflow.
- In early 2014, domestic financial market rebounds.

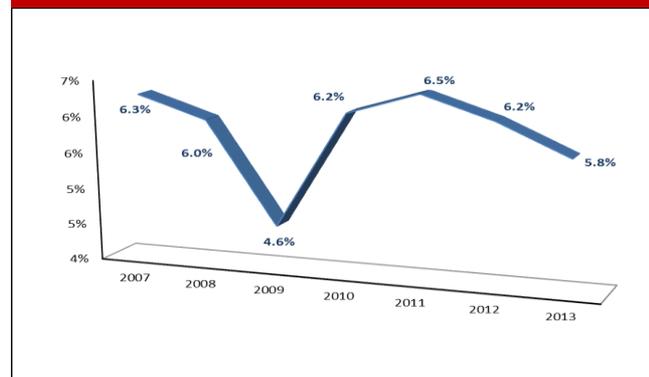
Stock index declined



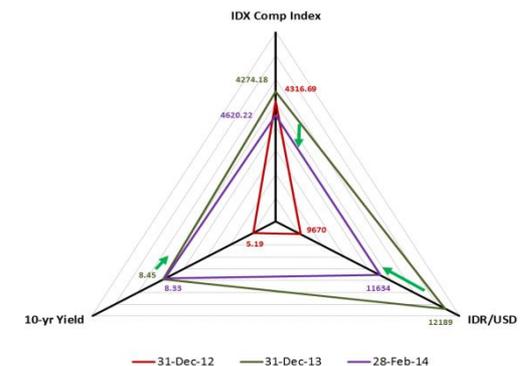
Government bond yields hiked



Indonesia succeeded in maintaining growth



Financial market demonstrates recovery in early 2014...



Bright prospect of Indonesia's financial sector

The utilization of financial services among Indonesians is relatively low. Hence, the country's financial sector has huge potential to continuously grow. This would be particularly supported by industrial revitalization, growing middle-class, and improved financial literacy.

The utilization of financial services in Indonesia: Findings from OJK's Financial Literacy National Survey

	Understanding on Financial Products & Services	Utilization of Financial Products & Services
Banking	37.2%	76.0%
Insurance	22.5%	13.2%
Pawnshop	20.4%	4.2%
Multifinance	10.4%	5.3%
Pension Funds	7.1%	1.3%
Capital Market	2.3%	0.1%

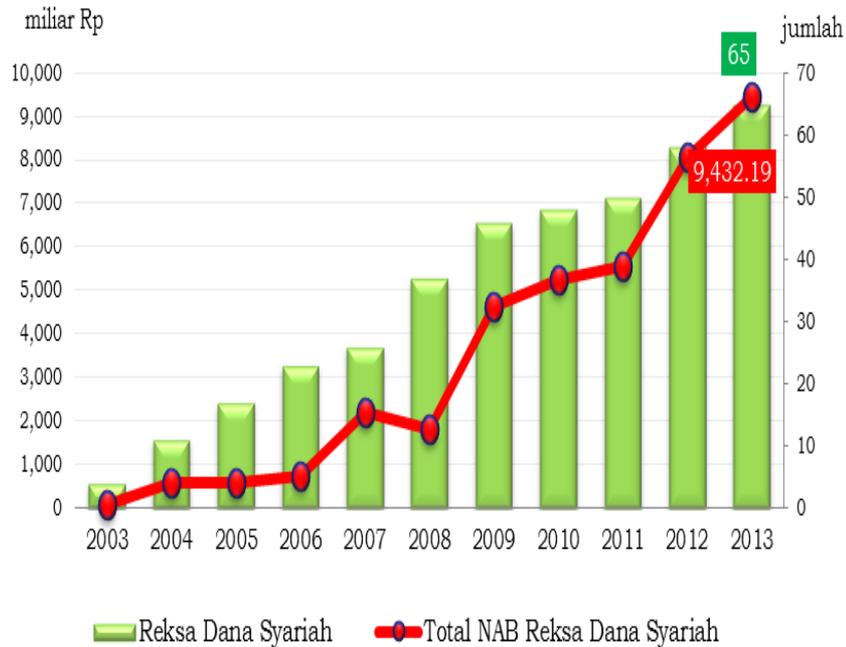
Three factors, among others, behind the bright prospect of Indonesia's financial sector:

Potential of growing financing needs due to industrial revitalization	Growing middle-class	Improved financial literacy
<ul style="list-style-type: none"> ▪ Indonesia is expected to move toward revitalized manufacturing industry, producing products with higher value added. ▪ In line with this condition, supported by better business climate, financing demands would continuously grow. ▪ OJK will assure that financial sector is ready to anticipate this growing demands. 	<ul style="list-style-type: none"> ▪ Indonesia is expected to enjoy demographic bonus in 2020-2030. In addition, the middle-class population is also growing. ▪ McKinsey (2012) estimated that 135-170 million Indonesians will join the consuming class by 2030. ▪ Growing middle-class means growing demands for business & consumer financing, investment products, insurance, & pension funds. 	<ul style="list-style-type: none"> ▪ Relatively low level of financial literacy among Indonesians highlights the importance of financial literacy improvement. ▪ OJK has made substantial progress in financial education during the past year. Our efforts are now supported by players in financial sector. ▪ Higher level of financial literacy then boosts the utilization of financial products & services.

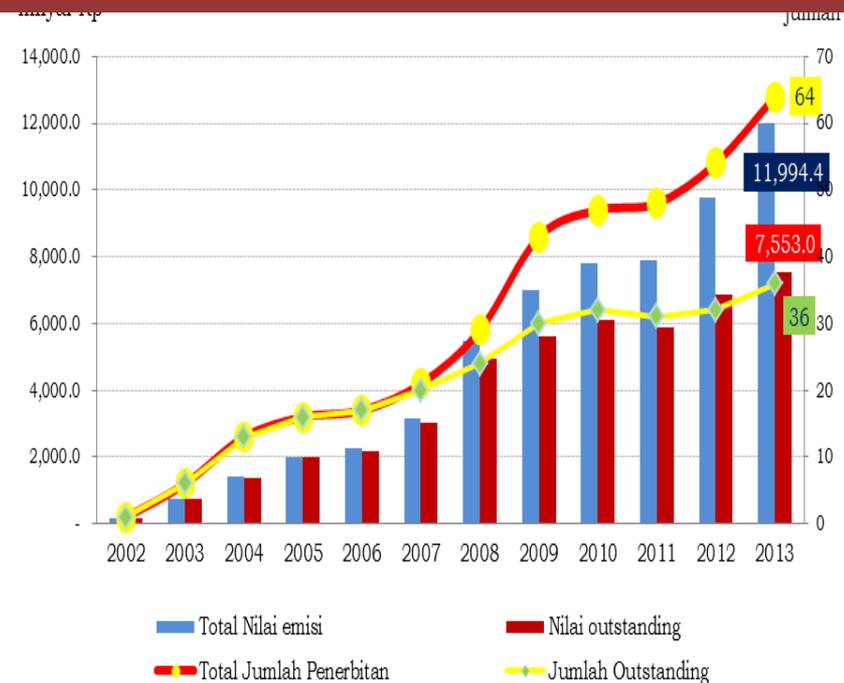
Development of Islamic Banking (BUS+UUS)

Indicator	2009	2010	2011	2012	2013
Islamic Commercial Bank (BUS)	6	11	11	11	11
Islamic Business Division (UUS)	25	23	24	24	23
Islamic Rural Bank (BPRS)	138	150	155	158	163
Offices	998	1,477	1,737	2,262	2,588
Total Asset (Rp. Trillion)	66.1	97.2	145.47	195.02	242.28
<i>Growth of Asset (yoy)</i>	33%	48%	49%	34%	24%
<i>Market Share</i>	2.61%	3.24%	3.98%	4,58%	4.89%
DPK (deposit)	52.3	76.04	115.41	147.51	183.53
Financing	46.9	68.18	102.66	147.51	184.12
CAR	10.77%	16.25%	16.63%	14.13%	14.44%
FDR	89.7%	89.67%	88.94%	100.0%	100.32%
NPF (gross)	4.01%	3.02%	2.52%	2.22%	2.62%
ROA	1.48%	1.67%	1.79%	2.14%	2.00%
ROE	25.81%	17.58%	15.73%	24.06%	17.24%

Islamic Mutual Fund (reksa dana)



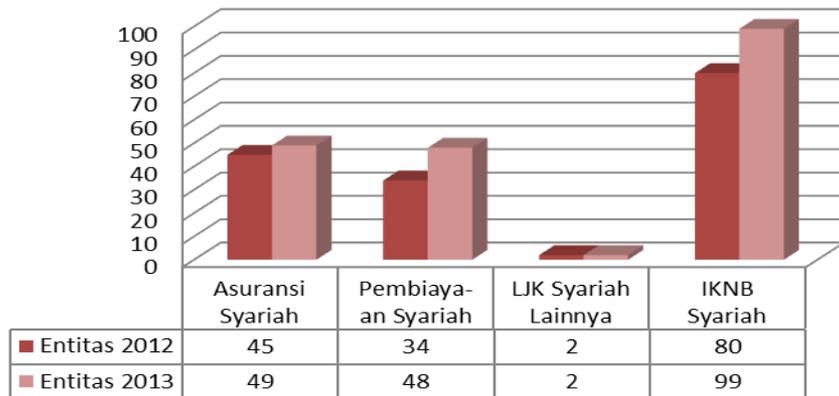
Corporate Sukuk



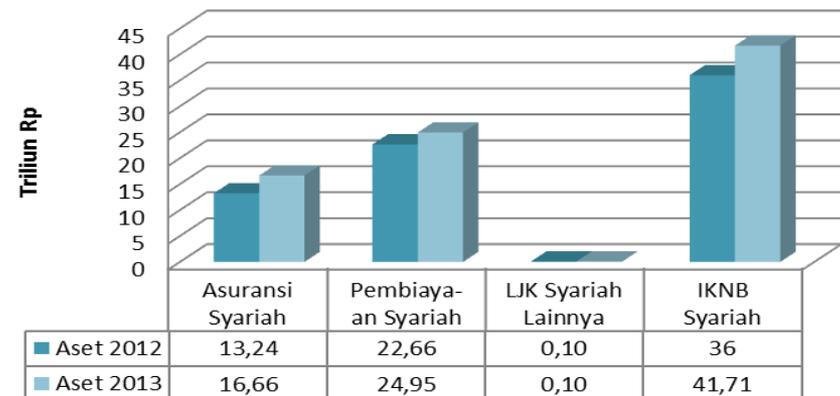
- With its impressive growth rate, **Indonesia Islamic Banking industry has even extended its influence to other Islamic financial sectors** such as capital market, insurance, finance company and other non bank financial institutions.
- In addition to these financial institutions, Indonesia also has more than 5000 Baitul Maal wat Tamwil, and more than 500 private Zakah institutions.

Development of Entity and Asset of Islamic IKNB

Entitas IKNB Syariah 2012-2013



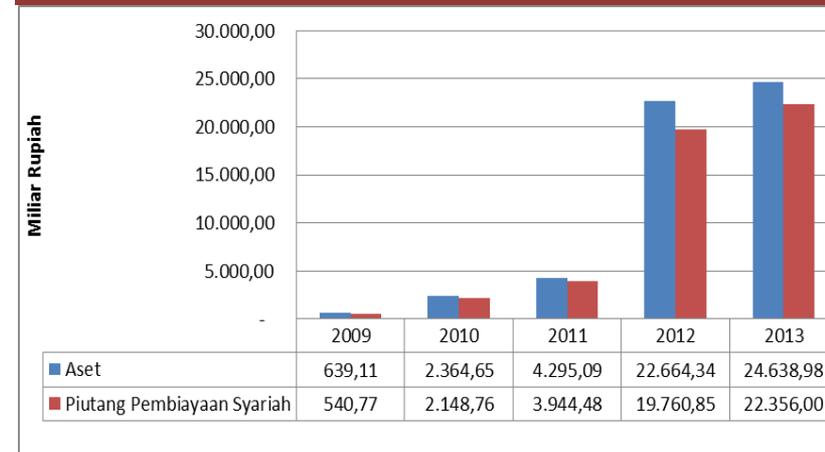
Aset IKNB Syariah 2012 - 2013



Development of Islamic Multifinance (Pembiayaan) and Venture Capital (modal ventura)

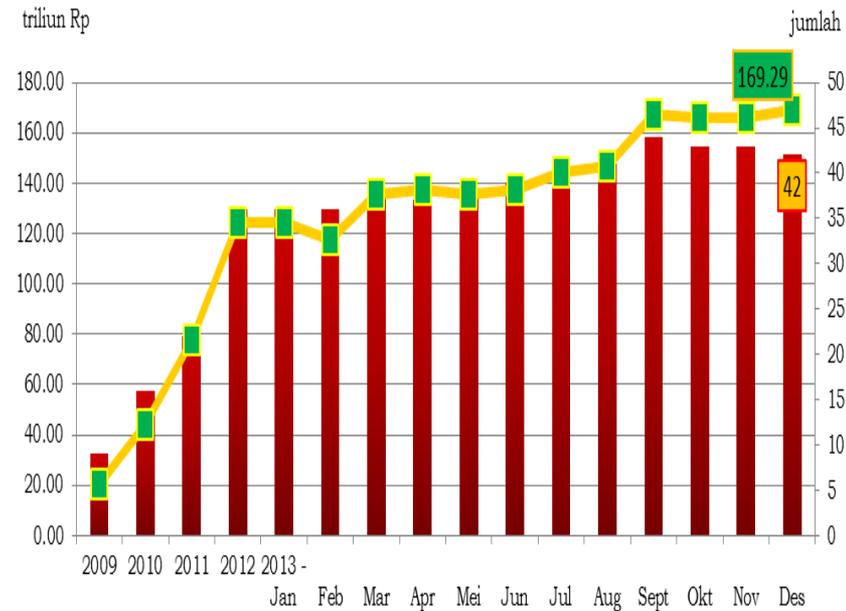
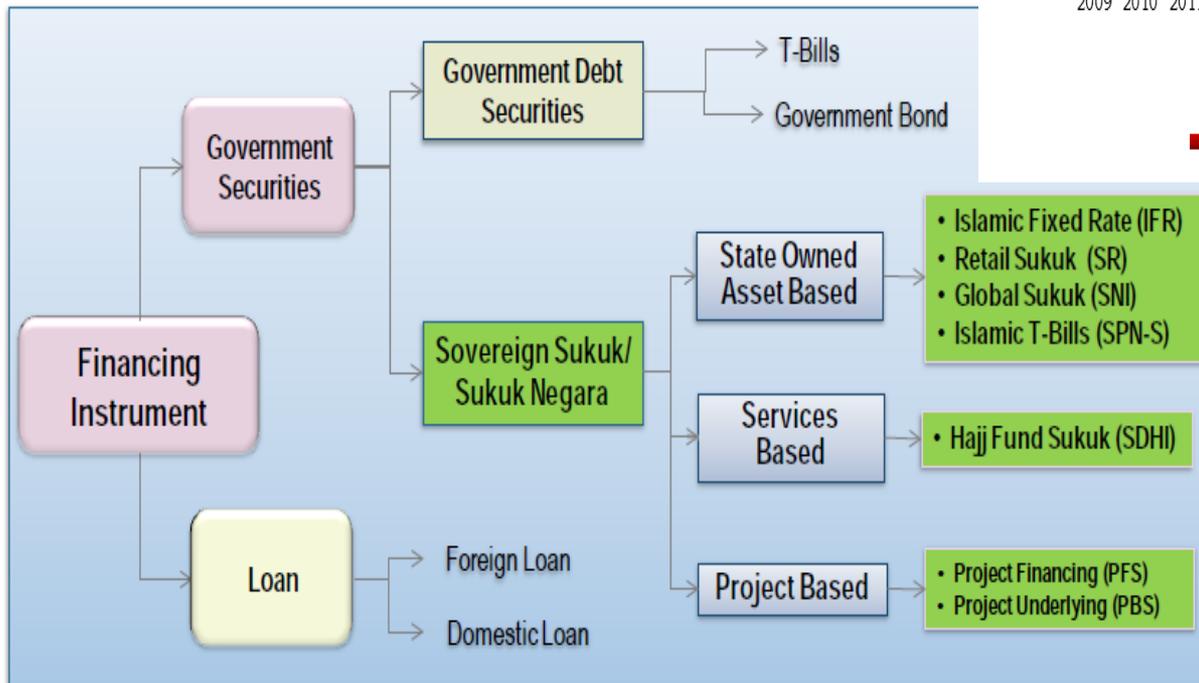
	2009	2010	2011	2012	2013
Pembiayaan murni syariah	2	2	2	2	2
Pembiayaan yang mempunyai Unit Usaha Syariah	5	9	12	32	42
Perusahaan Modal Ventura murni syariah	-	-	-	-	4
Jumlah	7	11	14	34	48

Growth of Asset and Receivable (Piutang) of Islamic Multifinance (Pembiayaan)



Sukuk Negara as State Budget Financing Instrument

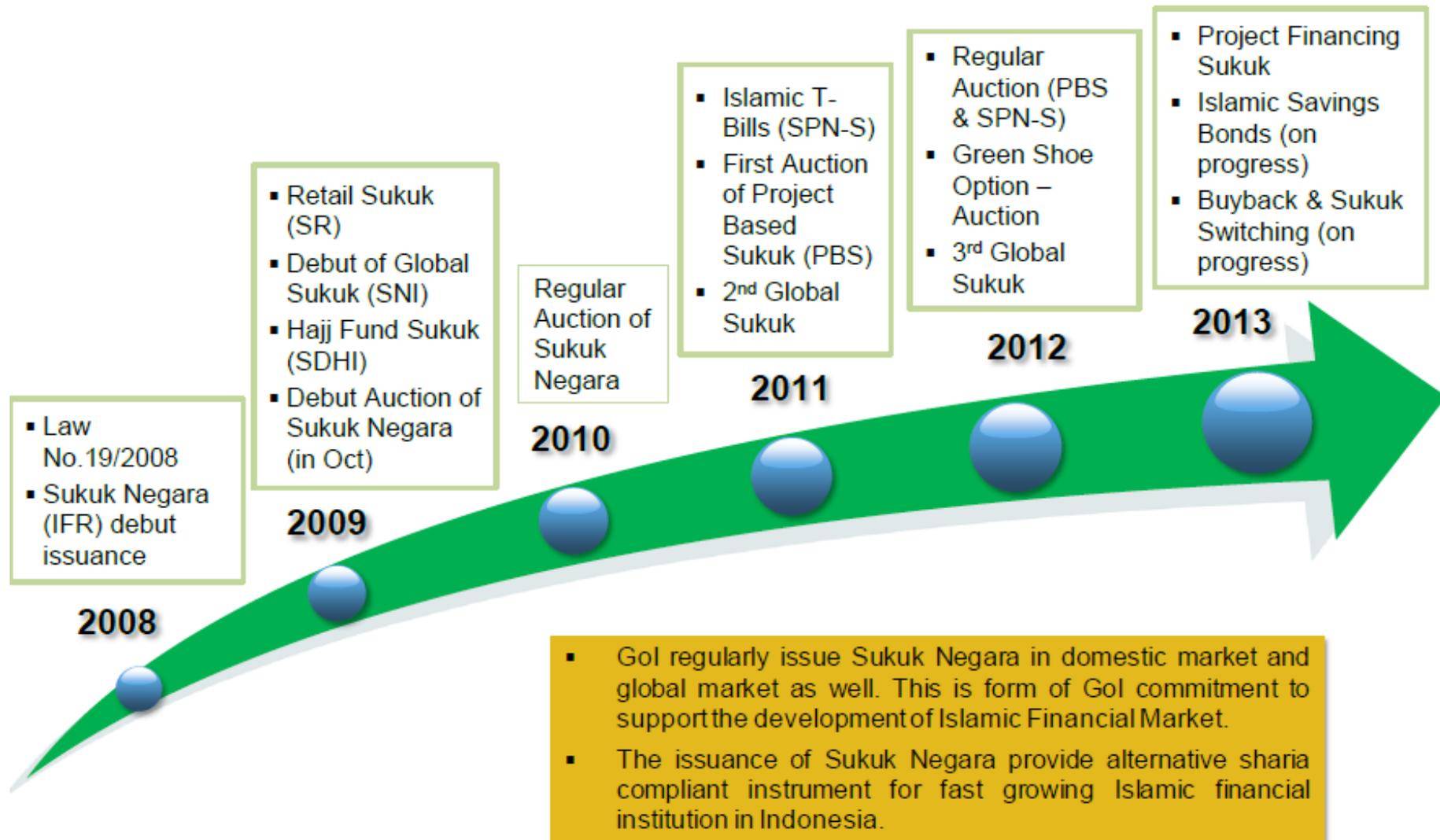
- ✿ Indonesia is running on State Budget deficit policy.
- ✿ The deficit is financed through:
 - **Government Securities Issuance** (domestic and global)
 - **Foreign Financing** (bilateral, multilateral, and commercial loan)



Outstanding Sovereign Sukuk/Sukuk Negara (SBSN) in Dec 2013 Rp.169.3 Trillion or ±US\$ 15.4 billion



Road Map of *Sukuk Negara*

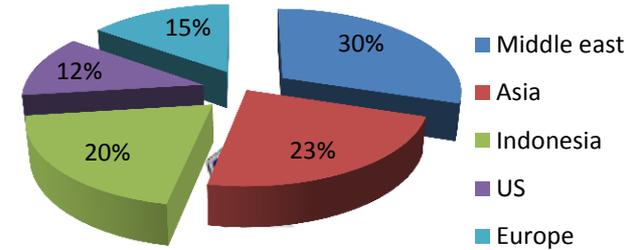




Sukuk Negara Product Development



Series	Islamic Fixed Rate (IFR)	Retail Sukuk (SR)	Sukuk Negara Indonesia (SNI)	Islamic T-Bills (SPN-S)	Hajj Fund Sukuk (SDHI)	Project Based Sukuk (PBS)
Aqad	Ijara Sale & Lease Back				Ijara al-Khadamat	Ijara Asset to be Leased
Underlying	State Owned Assets				Hajj Services	Government Projects
Coupon Rate	Fixed Rate					
Tradability	Tradable				Non-Tradable	Tradable
Issuance Methods	- Bookbuilding - Auction	Bookbuilding	Bookbuilding	Auction	Private Placement	Auction
Characteristics	IDR Sukuk for wholesale investors. Mid to long term tenors, semi annual coupon	IDR Sukuk for retail Indonesian investors, monthly coupon payment	USD denominated Sukuk, issued in international market, semi annual coupon	IDR Sukuk, mature in 6 months, discounted basis	Private placement, short term, monthly coupon	IDR Sukuk, mid to long term tenors, semi annual coupon



Tight Pricing Compared to Global 10-Year Sovereign Sukuks

Distribution of investor

The rate reflecting the soundness of national economy & financial also risk management (good coordination central bank & government : issuance, asset, bond stabilization ; Sharia structured/ opinion

The recent ROI Sukuk has priced inside nearly all other global 10-year sovereign sukuk and only 6 bps wider than Qatar's recent deal, despite being rated 7 and 8 notches lower by Moody's and S&P, highlighting the market's

Issuer	Date of Issue	Maturity	Tenor (years)	Deal Size (USD mm)	Periodic Distribution Rate (%)	Moody's Rating	S&P Rating	Fitch Rating	Spread to Benchmark UST (bps)
GLOBAL 10-YEAR SUKUKS									
Republic of Indonesia	14-Nov-12	21-Nov-22	10.0	1,000	3.300	Baa3	BB+	BBB-	170.0
State of Qatar	11-Jul-12	18-Jan-23	10.5	2,000	3.241	Aa2	AA	NR	174.1
Dubai	25-Apr-12	2-May-22	10.0	650	6.450	NR	NR	NR	445.7
Malaysia	28-Jun-11	6-Jul-21	10.0	800	4.646	A3	A-	NR	165.0

- ✓ Indonesia is one of only a handful of sovereigns in the world to have tapped the Sukuk market at a 10-year tenor
- ✓ Investors and markets remain extremely receptive towards Indonesia as a credit, allowing the Republic to price at similar levels to Qatar, despite Qatar being one of the wealthiest nations in the world on a per capita basis and rated 7 to 9 notches higher by rating agencies

Risk Management and Crisis Management Framework

Recent financial crisis emphasis the need of financial risk management in systemic/macro and individual/micro ..



Micro :

- Prudential → Bank's regulation on : i.e. capital, asset quality, bank rating/soundness, risk based supervision, risk management , GCG
- Sharia → quality and quantity of sharia supervisory board (SSB) supported by infrastructure → Independence National Sharia Board (outside bank's regulator), fit & proper of Bank's SSB, twice a year Bank SSB's reporting and financial report publication (transparency and governance), SSB's training & certification, Bank's supported to SSB

Macro :

- Financial Safety Net → Last of lender resort and FLI-FPJPS-FPD Bank's Mechanism, Deposit Insurance , interbank money market and SBIS (liquidity), Bond Stabilization Framework, Jamkrindo
- Crisis Management Protocol → Financial Stability Forum among Authority(FKSSK)

Problems & Uniqueness in Risk Management in Islamic Banking

- Every Sharia contract connects/relates with performance of real sector. Interest rate often do not reflect the performance of real sector.
- Market risk applies directly/indirectly in Islamic contract.
- Due to its early stage of development, Islamic banking industry faces lack of infrastructure, technology, regulation, lack of eligible human resources, lack of product innovation, etc → might invite risk into the operation of Islamic bank.
- Islamic banks are free from interest rate risk but indirectly impacted by it, because of the majority portion of interest rate base economies in the world..

Unique risk factors relating to Islamic bank i.e :

- liquidity-originated market risk
- transformation of market risk to credit risk during different stages of contract (e.g.murabaha)
- market risk arising from ownership of non-financial asset

- Profit Loss Sharing/PLS contract (ideally suggested scheme in Islamic bank) fundamentally increase risk coz difficult to monitor
- Lack of standardization → more varieties of ways in financing.
- Scarcity of hedging instrument, not well developed interbank money market/short term Islamic instrument

PLS contract difficult to monitor

- The nature of the *mudarabah contract* does not give the bank appropriate rights to monitor the *mudarib* or to participate in management of the project, which makes it difficult to assess and manage credit risk.
- The bank is not in a position to know or decide how the activities of the *mudarib* can be monitored accurately, especially if losses are claimed. This risk is especially present in markets where information asymmetry is high and transparency in financial disclosure by the *mudarib* is low

(Greuning, 2007)

- A. Financial risk** is the exposures that result in a direct financial loss to the assets or liabilities of a bank. Besides credit, market risk and liquidity risk, Islamic banks face equity investment risk.
- ❖ Credit risk relates to the performance of entrepreneurs: failure to fulfill their payment obligations, settlement, clearing, → **capital charge of RWA (min. 8%)**
 - ❖ Market risk happens due to unfavorable price movement or economic/financial condition i.e. RoR risk, exchange rate. Islamic banks bear risk of tradable, marketable, leaseable asset & mark up risk.
 - Mark up risk is risk because of fluctuation of benchmark rate or inaccurate/unfavorable mark up determination (murabahah).
 - Rate of Return (RoR) risk, attributed to changes in account holders's expectations of the return of investment → Displaced commercial risk occurs when depositors switch their deposit into conventional one which offers more profitable/attractive return  **use income smoothing taken from bank's return (require: certain customer/condition, SSB opinion)**
- risk mngt of FX → Capital charge for market risk (NOP < 20%)**
- ❖ Liquidity risk attributed to adverse cash flow in situations arising mainly out of changing market risk/credit risk/ops' risk exposure

Financial risk

- Credit risk would take the form :
 - settlement/payment risk arising when one party to a deal pays money (e.g. in a *Salam* or *Istishnā'* contract) or delivers assets (e.g., in a *Murābahah* contract) before receiving its own assets or cash, thereby, exposing it to potential loss.
 - non-payment of the share of the bank by the entrepreneur when it is due (PLS financing such *Mudārabah* and *Mushārahah*), due to the asymmetric information problem in which bank do not have sufficient information on the actual profit of the firm.
 - counterparty risk due to nonperformance of a trading partner (as *Murābahah* contracts are trading contracts)

Some factors affecting credit risk in Islamic bank :

- less sophistication in risk management practice
- Incentive to (opportunistic not sharia behaviour) clients to default due to leniency towards default



- Use risk weight asset in CAR regulation and asset quality regulation (provision of losses)
- Sharia Financing guarantees (Jamkrindo)

Financial risk

- Liquidity risk arises from difficulties in obtaining cash :
 - from borrowings (at reasonable cost) ; or
 - through sale of assets (at reasonable cost).

The liquidity risk arising from both sources is critical for Islamic banks. As interest based loans are prohibited by *Shari'ah*.

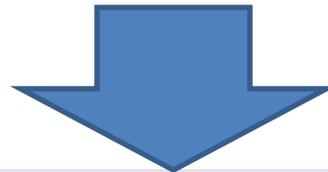
Furthermore, *Shari'ah* does not allow the sale of debt, other than its face value. Thus, to raise funds by selling debt-based assets is not an option for Islamic financial institutions

Liquidity Risk is Important, Why ?

- ❖ One of the BIS response/focus (beside capital) after the global financial crisis in 2008
- ❖ Basel III consist i.e Liquidity risk principle and liquidity risk indicator (1 month = Liquidity Coverage Ratio and 1 yr = Net Stable Fund Ratio)
- ❖ Islamic Banking/Finance in the world can not negligence what happened in the conventional bank/finance cause the world's economies still dominated by conventional bank/finance → there's always impacted to Islamic bank whatever happen in conventional bank
- ❖ IFSB created Liquidity Risk Management WG and the establishment of IILM.

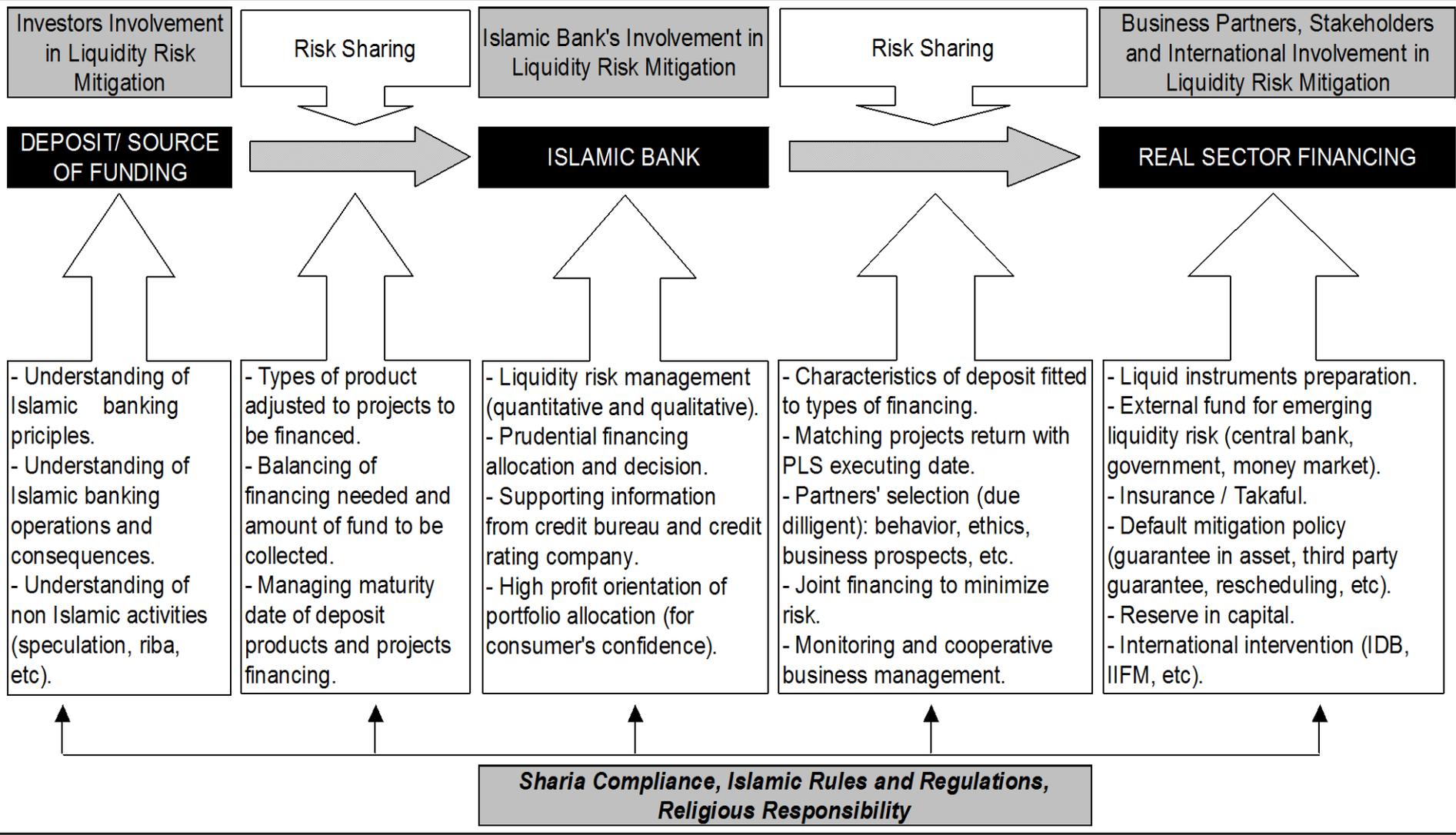
Islamic banks are prone to face serious liquidity risks :

- ❖ *Fiqh* restriction on the securitization of the existing assets of Islamic banks (predominantly debt in nature) → Islamic banks asset are not as liquid as conventional
- ❖ slow development of financial instruments → Islamic banks not able to raise funds quickly from the markets (there is no well developed inter-Islamic banks money market & size smaller give higher price for issuing instruments)
- ❖ the need of sharia compliance financial safety net and Lender of Last Resort (LLR) facilitie.
- ❖ Less developed and formal liquidity management systems in place. Should develop, financial instruments and markets, which can utilize the excess utility of the Islamic banks for income earning and also for being ready & better prepared if liquidity crisis coming...



Financial deepening → develop Sharia interbank money market (instruments : SIMA, SIKa)
Central bank facility/Instruments → SBIS, FASBIS, FLIS-FPJPS and FPDs if structural problem occurs (coordinating with government)
Governments instruments & policy → sovereign sukuk

Sharia Approaches on Liquidity Risk: Best Practices in Islamic Banks



- B. Business risk** links with the performance of bank's business and internal action i.e. business policy, infrastructure, payment system
Thus business risk deals with (i) management risk which asks how is bank's planning, organizing, monitoring, reporting, etc and (ii) strategic risk is like R&D, product design, etc.
- C. Operational risk**, bank fails to manage people, system, legal, external risk
- **People (relationship, ethics, process, etc)**; particularly arises as the banks may not have enough qualified professionals (capacity and capability) to conduct the Islamic banking operations
 - **System (hardware, software, etc)**: given the different nature of business the computer software (particularly risk management) available in the market for conventional banks may not be appropriate for Islamic banks. This gives rise to system risks of developing and using informational technologies in Islamic banks
 - **Legal (compliance and control risk)**;
 - **External risk (event, clients, security, supervisory, etc)**.



capital charge for operational risk
(15% of gross income)

Besides those risks in previous slide, Islamic bank also face :

- **Fiduciary Risk:**

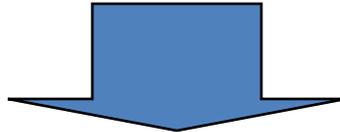
- A lower rate of return than the market rate also introduces fiduciary risk, when depositors/investors interpret a low rate of return as breaching of investment contract or mismanagement of funds by the bank (AAOIFI).
- Fiduciary risk can be caused by breach of contract by the Islamic bank. For example, the bank may not be able to fully comply with the *Sharī'ah* requirements of various contracts. While, the justification for the Islamic banks' business is compliance with the *Sharī'ah*, an inability to do so or not doing so willfully can cause a serious confidence problem and deposit withdrawal



Sharia governance → fit & proper test SSB & product, reporting & accountability task of SSB, bank's support of SSB's task
Supervisory actions & mediation

Systemic Risk

Systemic risk → the probability that failure of even a small bank could result in the contagion effect and the whole banking/payment system could be disrupted



This could lead to a financial crisis, decline in the value of assets in place, impairing growth taking capabilities of the economy, creating unemployment, decreasing economic welfare and even causing social and political instability

To avoid systemic risk, protect the integrity of market, safeguard the interest of depositors → need safety net arrangements.

Safety net arrangement :

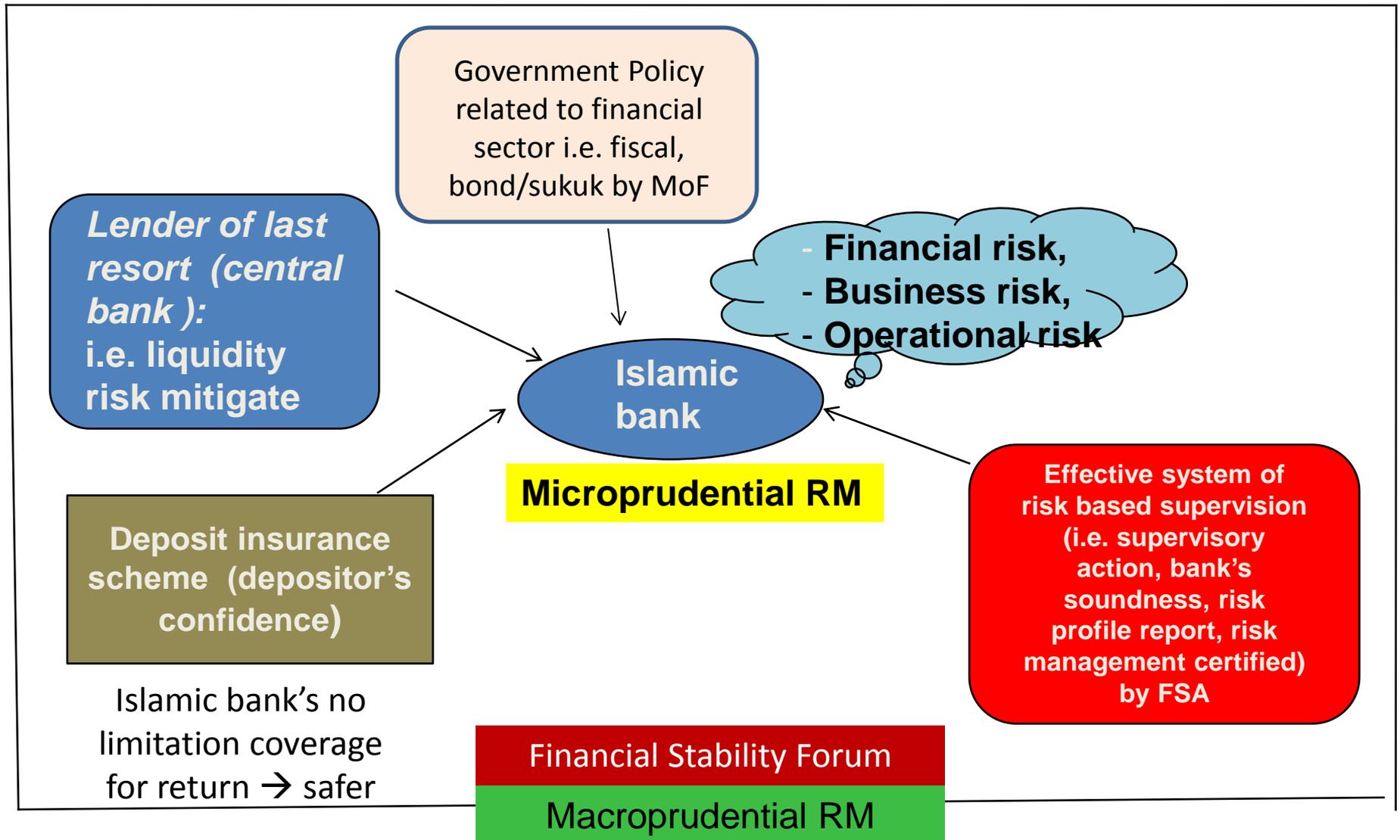
- The lender of the last resort facility of central bank, that prevent bank runs by providing liquidity facility to bank in times of crisis
- The deposit insurance scheme, providing protection to depositors in case of bank failure

Systemic Risk

- ❖ To make the banking and financial system operate in properly manner, need conduct business and prudential regulation.
- ❖ Prudential regulation → systemic safety by ensuring the soundness of individual bank through application of set standards and guidelines across banking system.
- ❖ The instruments used, could be :
 - (i) maintenance of a minimum level of risk based capital,
 - (ii) effective system of risk based supervision, and (iii)
 - the timely disclosure of information about risk management and processes.

Islamic Banking Framework on Risk Mgt :

(microprudential and macroprudential)



FKSSK: Promoting strong coordination among institutions

The OJK Law has mandated the formation of the Financial System Stability Coordination Forum (FKSSK), obliged to monitor and evaluate financial system stability. The members of FKSSK include Minister of Finance, Governor of Bank Indonesia, Chairman of BOC of OJK, & Chairman of BOC of Indonesia Deposit Insurance Corporation. Coordination among four members is strong & solid.



Ministry of Finance

Fiscal Policy & Debt Management

- Crisis management
- Fiscal cost for crisis resolution



Bank Indonesia

Monetary & Macroprudential Policy,
Payment System

- Lender of last resort



Indonesia Financial Services Authority

Regulation & Supervision

- Microprudential & market conduct
- Consumer protection



Indonesia Deposit Insurance Corp.

Deposit Insurance

- Resolution of failed banks
- Insurance claims

Crisis Management Protocol

- The FKSSK manages the Nationwide Crisis Management Protocol (CMP) Framework as guidance and procedures for national crisis prevention and mitigation measures.
- The nationwide CMP incorporates the Exchange Rate, Banking, Non-Bank Financial Institution, Capital Market, Government Bonds Market (SBN), and Fiscal CMPs.
- Coordination meeting is conducted regularly to discuss and assess the current level of financial system stability and current issues related to the financial system.

FKSSK Activities

- FKSSK meeting (ministerial level)
- FKSSK deputies meeting
- Meetings of FKSSK Secretariat & technical team
- Crisis simulation
- Working groups on financial stability issues
- National crisis binder
- SOP on crisis management

Crisis management within OJK

As stipulated in the memorandum of understanding signed by FKSK members, each FKSSK members' institution shall have a crisis management protocol. In 2013, OJK has established an internal regulation as a legal base & guidelines for crisis prevention & mitigation within the OJK's authority.

Surveillance activities within OJK are conducted through three lines.

Coverage of OJK's CMP

- Organization
- Surveillance activities
- Decision making in different level of stability (normal, aware, alert, indicated as crisis)
- Data & information exchange
- Execution of decisions
- Communication

1st Line Individual risk assessment

- Risk analysis on each individual bank or non-bank financial institution
- Executed by supervisors of banks, capital market, NBFIs

2nd Line Sectoral risk assessment

- Risk analysis on each industrial sector (banking, capital market, NBFIs)
- Executed by surveillance coordinator of each sector

3rd Line Cross-sectoral risk assessment

- Macroeconomic analysis
- Cross-sectoral analysis
- Executed by CMP Secretariat



**Wass. Wr. Wb.
Thank You....Terima Kasih..
End of Presentation**