Indonesia's Financial Market Deepening Initiative

Structural reform, including financial market deepening, is at the hearth of Government of Indonesia to ensure a strong, sustainable and balanced growth path. This commitment has become more pronounced after Indonesia weathered the recent financial turmoil as the Fedres flagged its intention to withdraw from its quantitative easing policy on May 2013. The initiative was taken noting that deepening the financial market is the very fundamental response to ensure the financial market resiliency, hence a strong and solid external sector. Series of policy packages are done both for the money market and capital market, with time frame ranging from immediate to medium and long-term. The commitment is also being monitored rigorously among others through the inter-Ministerial meetings such as the BI-OJK regular coordinating meeting and the FSSK (Forum Stabilitas Sistem Keuangan or Financial System Stability Committee).

Bank Indonesia has also contributed to the effort by pursuing efforts in the rupiah and domestic foreign exchange market. Policy measures have been stepped up since the second half 2013, which resulted encouraging outcomes. A special Task Force has been established to coordinate and integrate the financial deepening efforts in Bank Indonesia, so as its effectiveness can be ensured. The initiative also involves market players and leverages external experts from International Organizations and other central banks. This is a multi-year project with clear deliverables which addressing structural problem in money market. Monitoring of the program has also being done seriously, using the established reporting mechanism to the frequent Board of Governors' meetings,

The framework of money market deepening is about achieving solid and balanced progress in three pillars, namely the rupiah, spot and derivatives markets. The three segments of the money market have to work properly to ensure the price discovery mechanism, the availability of sufficient instruments needed by market players and the robust market volume. This trinity framework allows the financial market deepening efforts to be consistently and integratedly implemented across segment of money markets. By doing so, it is expected that the development in money market is growing on a strong footing and able to deliver stability through market-absorption capacity. In the rupiah money market, Bank Indonesia launched initiatives ranging from the introduction of new instruments to the adoption of a standard contract for repo transactions. A major breakthrough was being done to improve the price discovery mechanism in the spot market. Meanwhile, in the swap market, efforts have been focused to increase the volume of swap transactions for hedging purpose.

Thus far, the initiative has delivered encouraging outcomes. Currently, Indonesia has established a secured interbank money market with 65 banks participated in that Agreement. The Jakarta Interbank Spot Dollar Rate (JISDOR) has being introduced and adopted by the Singapore's market. The liquidity of the domestic foreign exchange market has significantly been improving with markedly increasing volume. More instruments and appropriate regulation have also being adopted to enlarge the swap transaction. In line with the authorities' efforts, the Indonesian Foreign Exchange Committee has being established with a balanced representation from banks. The progress, in turn, has supported the stability of rupiah exchange rate, supporting the achievement of macroeconomic and financial stability.

Summary of policy measures by Bank Indonesia in the money market and its current progress, focusing in the period since the second-half 2013, are as follows.

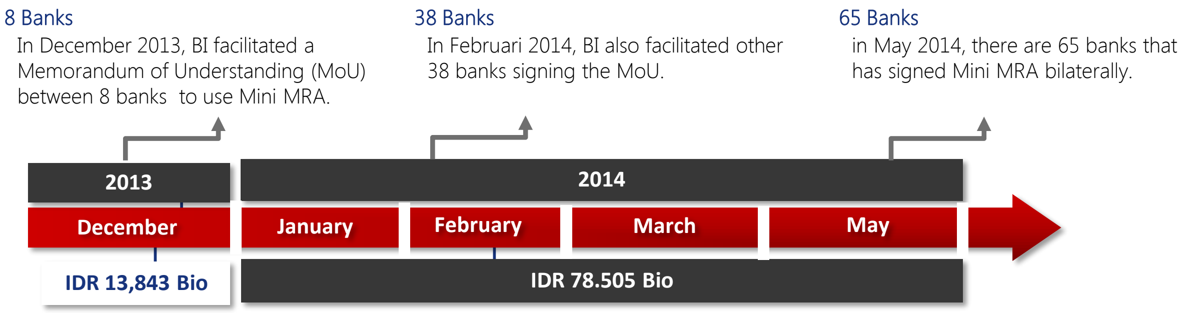
1. Rupiah Money Market Measures and Ongoing Progress

   The focus of rupiah money market measures is to develop the secured interbank money market and continuously strengthen market best practices. The development of the secured interbank market is important in complementing the interbank market. Currently, the volume of secured interbank market is some IDR801 billion per day from a very small amount previously. Development of the secured interbank market allows more competitive pricing and generates motives for banks to hold securities. Efforts for continuous strengthening of the market pricing benchmark & transparency are being pursued through improvements to the Jakarta Interbank Offer Rate (JIBOR). Meanwhile, the secured interbank market has been proliferated through the introduction of the Mini Master Repurchase Agreement (Mini-MRA).

   a. Jakarta Interbank Offered Rate (JIBOR). Bank Indonesia continuously ensures JIBOR to become a credible reference rate for widespread use in financial transactions in Indonesia. Recent initiative to update JIBOR with market best practices was being done through the enhancement of the calculation methodology in February 2013. The accuracy of calculation method was improved by eliminating significant outliers to obtain average rate of quoted rates by contributors. In doing so, it is expected the obtained rate better reflects market conditions. In line with the improvement, Bank Indonesia also continues to conduct daily monitoring to ensure that the quoted rates by contributors are truly reflecting the market rates. Currently, the IDR JIBOR is derived from the quotations of 30 banks while the USD JIBOR is based on quotations from 16 banks.

b. Mini Master Repurchase Agreement (Mini MRA). A prominent challenge in developing the secured interbank market was the widely accepted Master Repurchase Agreement (MRA) by all market players. This has become a long standing issue that hindered the formation of the interbank repo market. In response, Bank Indonesia facilitated the drafting of Mini Master Repurchase Agreement (Mini MRA) in December 2013 for development of secured interbank transactions for liquidity management. It is called the Mini MRA because: (1) it applies to interbank transactions only, (2) the underlying assets are limited to Bank Indonesia Certificates, Bank Indonesia Certificates of Deposit and Government Securities, and (3) it does not need to be accepted by the all market participants. The aim is to encourage the use of standard contracts of repo transactions, which then simplifies transaction processes and results in a more efficient interbank money market. At the first launching, only eight (8) banks adopted the Mini MRA, but since then, other banks have signed up. In February 2014, 38 banks had signed an MoU for this purpose. The number of banks is steadily climbing, with a total of 65 banks having signed Mini MRA as of May 2014.

Chart 1. Development of the Mini MRA



Regarding the volume of repo transactions, cumulative volume during December 2013 - May 2014, using the underlying instruments of Government Securities, Bank Indonesia Certificates and Bank Indonesia Certificates of Deposit, reached IDR78.5 trillion. By comparison in the January to November 2013 period, transaction volume was recorded at only IDR30.9 trillion. In March 2014, average repo volume transaction peaked at IDR1 trillion/day.

- Growing activity in repo transactions. The average daily repo transaction volume has also increased significantly. For the period of December 2013 - May 2014, volume reached IDR801 billion per day, significantly higher than that of January - November 2013 which charted only IDR136 billion per day. In terms of the average monthly number of repo transactions, only 12 transactions were recorded in January

- November 2013. Following the launch of the Mini MRA until May 2014, the average monthly number of repo transaction climbed to a level of 80 transactions per month.

- Pricing. Rates for secured interbank transactions have gradually eased in comparison to unsecured transactions in the same tenor. In May 2014, the average repo rate was 7.45% and interbank money market rate 7.96% for the 1-month tenor.

2. Domestic Foreign Exchange Market Measures and Ongoing Progress

Indonesia's domestic foreign exchange market has remained thin, shallow and less liquid relative to peers. Meanwhile, the limited number of instruments, less diversified investor base and range of market players as well as heavy reliance on the spot market also contributed the shallowness of the market. The double negative forces in the domestic foreign exchange market inevitably make the market less liquid and hinder activity by market players, as reflected from the large spread between bid-offer rates especially during stressed market periods.

As a result, the domestic market is very sensitive to a large in market demand – especially due to external shocks -- and depends heavily on the central bank as the main supplier in the market. This volatility has contributed to the complexity of monetary operations and potentially affects financial stability. Hence, measures have been taken in this area ranging from ensuring compliance with market best practices, in particular the price discovery mechanism and code of conduct for market players, to the encouragement of using more derivative transactions rather than relying heavily on spot transactions.

To date, the current daily volume of transaction (total of spot, swap and forward) ranges from USD1.9 billion to 3.4 billion, close to the volume before the global crisis in 2008. This was significantly improved from the volume of less USD 500 million during the stressed time. The CDS has also improved significantly to the level of around 140 bps.

a. Jakarta Interbank Spot Dollar Rate (JISDOR). To improve efficiency in price discovery in the foreign exchange (FX) markets, Bank Indonesia launched the Jakarta Interbank Spot Dollar Rate (JISDOR) in May 2013. The introduction of JISDOR is intended to provide a mechanism for a fair and objective reference rate, as it is derived from interbank transactions reported to BI's system for monitoring FX transactions against the rupiah. In this regard, Bank Indonesia's role is to facilitate the market as such a healthy and govern price discovery mechanism has been formed. Inevitably, the practice would boost the credibility of this reference rate. The existence of JISDOR has also contributed positively to the exchange rate stability, as it mitigates the possibility of dual pricing and encourages more market transactions.

With the JISDOR gaining credibility, in February 2014 the Singapore Foreign Exchange Markets Committee (SFEMC) recommended the usage of JISDOR for market participants in Singapore's market. This recognition of JISDOR as a USD/IDR benchmark rate, in turn, supports the deepening of domestic financial markets. Foreign exchange market activity has seen significant growth, reflected in the recent levels of interbank spot volume as high as USD1.5 to 2.0 billion per day, compared to USD200-500 million in mid-2013.

b. FX swaps auction and FX term deposits. The auctioning of FX Swaps and Term Deposits (TDs) between banks and Bank Indonesia comprises part of the liquidity management on the domestic financial market. This available selection of instruments is expected to provide greater flexibility to banks in managing their foreign exchange liquidity.

The holding of FX Swap auctions has a three-fold objective. First, FX swap auctions are part of the reinforcement of Bank Indonesia monetary operations for management of foreign currency and rupiah liquidity on the market. Second, FX swap auctions are intended for use by investors and business actors as instruments to hedge against risks to their foreign currency and rupiah liquidity needs posed by movement in the rupiah exchange rate. Third, FX Swap auctions represent one of the actions taken by Bank Indonesia to promote market deepening through more efficient and transparent price formation, in addition to enrich the available range of instruments, so that market actors do not need to rely solely on cash market instruments in managing their liquidity.

FX Term Deposit placements at Bank Indonesia are also expected to enrich the presently quite limited domestic outlets for placement of foreign currency funds. The limited domestic availability of instruments for foreign currency placements has resulted in a tendency for banks to place their foreign currency funds on offshore money markets. The FX Term Deposit is ultimately expected to boost efforts for deepening of the financial market.

c. Swap hedging. Bank Indonesia also introduced enhancements to the swap hedging instrument in January 2014. Improvements set forth in the regulation, among others, expansion of underlying transactions coverage, extension of transaction tenors, settlement by netting and pricing. The provision of hedge swap instruments for domestic market players is to address the limited use of medium-term and long term swap instruments.

d. **Hedging on Future Income**. Bank Indonesia is also continuously reviewing its regulations in order to strengthen monetary operation and maintain macroeconomic stability. Recently, Bank Indonesia updated its regulation concerning Restriction on Rupiah Transactions and Foreign Currency Lending by Banks. This comprises part of a series of actions for financial market deepening to support economic activity while maintaining exchange rate stability. The updated regulation allows market players greater flexibility in managing the currency exposure of future dividends. Future dividend may now be hedged in outright forward selling transactions, even though the dividend nominal and its payment date have not been decided yet.

e. **Introduction of Foreign Exchange Committee.** The acceleration of financial market deepening cannot be carries out by Bank Indonesia alone, but requires a strong coordination with market participants and related agencies. Communication and coordination between the regulatory body and market players, including associations related to the financial market, are essential. On April 1st, 2014, the Indonesia Foreign Exchange Market Committee (Indonesia FEMC) was inaugurated as a forum for market players and a strategic partner for Bank Indonesia and the Financial Services Authority. The Indonesia FEMC has a vision to build a credible, resilient, stable, consistently developing and conducive Indonesian financial market to support national economic development and international market competitiveness.

The FEMC also launched the Market Code of Conduct (CoC) in May 2014. This coded sets forth guidelines for the conduct of all market players in their transactions on the domestic financial market. This CoC is intended to regulate the behavior of market players and to enhance discipline and integrity of the players in the financial markets in Indonesia, and covers Senior Management, Management and Dealers involving in financial transactions directly and on day-to-day basis. This reference also provides a foundation on how market players are to behave, particularly in Over the Counter dealings according to the principles and norms applicable in an international financial market. The Indonesia FEMC issued this guidance after intense discussions conducted in cooperation with the market deepening team from the authority.

It is expected that this CoC will help the market players to understand the regulations and legislation related to financial markets in Indonesia, and also to comply with the regulation supported by the standards of integrity and high professionalism according to best market practices in financial market transactions. Market players are also expected to have a deep understanding of the basic and principles of behavior as set forth in writing and implied in this CoC.

3. Other supporting policies: Ensuring Sufficient Reserves of Liquidity.

   Bank Indonesia implemented the policy on the secondary reserve requirement to ensure adequate liquidity in the banking sector in support of monetary stability. The amendment to the secondary reserve requirement came into effect in October 2013, in which secondary reserves are to be raised progressively from 2.5% to 4% of third party funds. This policy is intended to ensure that banks hold sufficient reserves of liquidity to anticipate various risks related to banking operations, such as daily liquidity needs, fund withdrawals, transfers or clearing, while retaining the ability to carry out their intermediary function within the constraints of capital and liquidity conditions.

   This regulatory amendment also complemented the issuance of Bank Indonesia Certificates of Deposit as an added instrument for monetary operations. To increase the amount of liquid assets which can be calculated towards the secondary reserve requirement, Bank Indonesia Certificates of Deposit have been included as a component of the secondary reserve requirement since September 1, 2013. This policy is intended to encourage banks to place their funds in high quality, liquid assets. As such, in the event of liquidity problems, banks can immediately draw on these assets, among others by taking out repo transactions with Bank Indonesia. Incorporating such securities as a component of secondary reserve will also stimulate demand for money market securities.

Financial Market Deepening as part of Structural Reform.

Bank Indonesia is keenly aware that financial market deepening represents a fundamental response for support of financial market stability, and will keep pursuing this initiative. A clear map of the financial market deepening in the money market has been laid out. In addition, Bank Indonesia is active in building coordination among the relevant authorities, especially regarding to harmonization of rules and coordinated supervision, both essential to the sustainability and sound development of financial markets. In this regard, frequent meetings of the Financial System Stability Committee have been held, including meetings for development of the crisis management plan.