INDONESIA'S BOND MARKET CHALLENGE

In Jakarta, an imported orange can cost much less than a homegrown one. As bizarre as it sounds, it is unfortunately a consequence of Indonesia's notoriously high logistics costs arising from inadequate infrastructure. While the Jokowi administration has prioritized infrastructure spending, there are state budget[1] limitations. The private sector needs to fill the funding gap; an effective way is to tap a wider investor base through capital markets but these are currently notably underdeveloped. If President Jokowi is to achieve his economic vision[2], Indonesia's financial landscape has to develop, diversify and evolve for the future.

Hengky Tambunan
Head of Fixed Income
Eastspring Investments, Indonesia

CURRENT STATE OF PLAY

A country's banking sector is usually the main channel for capital distribution. However being overly reliant on bank lending is a risk. External financial shocks can trigger a systemic banking crisis and impact the economy via credit disruption.

Indonesia falls into the bucket of countries with a bank-dominated financial sector. When it comes to the breadth and depth of the financial sector, Indonesia lags its Asian counterparts. Its bank deposit as a % of GDP is a paltry 38% (most Asian countries exceed 100%), its pension plan, insurance and mutual fund assets to GDP[3] are in single digit territory while its bond market capitalisation was 18% in 2016[4]. This ratio is among the lowest in Asia. A further breakdown reveals that corporate bonds account for a mere 2.5%. The bulk was driven by government debt issuance.

Fig. 1: Indonesia lags its Asian peers - Bond Market Capitalisation is a mere 18%[5]

MARKET	IN USD BN			IN % OF GDP		
	Gov	Corp	Total	Gov	Corp	Total
Japan	8966	671	9637	195.2	14.6	209.8
Korea	703	1011	1714	48.1	69.2	117.3
Malaysia	141	119	260	51.5	43.4	94.9
Singapore	133	97	230	47.1	34.2	81.3
Thailand	222	81	303	55.3	20.3	75.6
China	4974	2155	7129	46.4	20.1	66.5
Philippines	80	18	98	27.5	6.2	33.7
Vietnam	42	2	44	21.1	1	22.1
Indonesia	139	23	162	15.1	2.5	17.6

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Broadening the financial base not only supports the country's economic development but also enhances financial stability and reduces vulnerabilities to exchange rate shocks and sudden capital outflows.

A World Bank Group research[6] has shown that emerging market countries with robust government bond markets were better able to withstand the 2008 global financial crisis, averting major economic dislocations and helping its firms and citizens maintain financial solvency and liquidity.

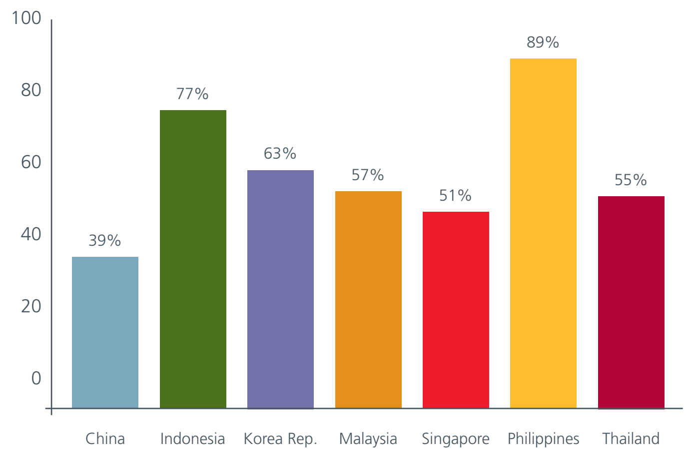
A TWO-WAY STREET IS NECESSARY

Well developed markets not only have a diverse group of institutional and private investors but also boast a variety of both government and corporate bonds. To work towards this goal, the Indonesian government can take a number of steps.

First and foremost, government-related entities or state-owned enterprises can lead the way by taking a prominent role in bond issuance and diversifying their funding sources. Asian countries serve as an example; Cagamas, the largest issuer of debt instruments in the Malaysian capital market was established as a joint venture between the government and the financial services industry. It issues corporate bonds and sukuk to finance the purchase of housing loans and receivables from financial institutions, selected corporations and the public sector. In Singapore, three of the five largest corporate issuers are government-related companies.

Next, education plays an important role; private companies can be shown the benefits of issuing bonds to meet their long-term financing needs. In a rising rate environment, the fixed interest rate payment obligation of a bond is a major advantage for corporate bond issuers. A bond also allows one to raise capital without diluting the shareholder value that comes with additional share issuance. Some markets with underdeveloped capital markets have even thought about restricting the proportion of borrowings by large corporates from banks to encourage the use of corporate bonds

Fig. 2: Concentration risk in Indonesia - Top 30 largest corporate bond issuers account for 77% of total issuance in 2016[7]



and commercial papers although this may not be well received by the business community.

Broadening the investor base has to work in tandem. Currently Indonesian banks are the largest investors in the local bond market although most of it is in government securities. Best practice dictates that banks hold a portion of their assets in liquid securities to fulfil their risk-weighted capital adequacy needs. Given this inclination, the option is to promote the growth of domestic non-bank financial institutions ("NBFIs") such as life insurance companies and pension funds. Compared to banks, NBFIs tend to hold much larger portions of their investment portfolios in corporate bonds relative to government bonds, probably in pursuit of higher yield. Countries with the most developed corporate bond markets tend to be those with the most developed NBFIs.

Improving the liquidity is another way to promote the bond market. More can be done to encourage investors to adopt a mark-to-market and trading culture which will help boost secondary market liquidity. To this end, better infrastructure, transparent credit ratings and less restrictive investment policies in pension and insurance funds would spur demand and broaden the investment base for corporate bonds.

Lastly, investor diversification can also be cultivated at the retail level by disseminating policies to incentivise the middle class population to place savings in mutual funds, investment-linked investment products and pension schemes.

CHALLENGES AND CONSIDERATIONS

Reducing the role of banks in Indonesia's development funding is a key priority for Indonesia's government and the Bank Indonesia (BI). On the other hand, one cannot totally sideline the banks. Active bank-led repo markets, for example, assist in the development of bond markets by deepening secondary market liquidity. A well-functioning repo market is a precondition for feasible market making system by dealers.

In theory the suggestions stated above seem straightforward but implementation is never easy. Investor confidence, for example, can be an issue given the past history of bond defaults. To rebuild confidence, the local credit rating agencies (CRAs) must be reliable, objective, independent and transparent. Proper regulatory frameworks must be in place to improve the accountability of CRAs and a consistent methodology has to be applied in the credit rating assessment process. Currently the OJK, the supervisory agency of CRAs only performs inspections on the adequacy of the system and procedure and does not supervise the contents of the credit rating reports.

One quick win to improve liquidity and spur demand is to open up the corporate bond market to foreign investors. On the flipside, greater international financial openness may make the economy vulnerable to volatile international capital flows that may threaten domestic financial stability. Policymakers should thus consider financial stability issues before considering this option. Ensuring a stable macroeconomic environment is essential to maintain a growing participation of foreign investors.

Sources: [1]Indonesia's estimated approximately IDR 4,800 trillion (or USD 370 billion) of infrastructure investment between 2015-2019. The central and regional government budgets can only contribute 41.3% of the total, while Indonesia's state-owned enterprises (SOE) can only contribute 22.2%, implying the remaining 36.5% needs to be supported by the private sector. Ministry of National Development Planning (Bappenas), Republic of Indonesia and JICA, 2014: Background Study for RPJMN 2015-2019, BAPPENAS internal analysis. [2]Indonesia will be the world's 4th largest economy by 2045. Source: Jakarta Post, Mar 2017. [3]OJK Indonesian Financial Service Authority data as at 2016. [4]Asian Development Bank data as at Dec 2016. [5]ADB per Dec 2016. [6]Public Debt Management in Emerging Market Economies: Has This Time Been Different?, World Bank, Policy Research Working Paper No. 5399, 2010. [7]ADB per Q2 2016.

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