

ASIA-PACIFIC REGULATORS' AND INDUSTRY DIALOGUE

Session 2

Market Reforms in Pension Systems

Mr Yusman

Division Head, Bureau of Pension Fund, Ministry of Finance, Indonesia

SUMMARY PAPER

A Lesson from Indonesia

Introduction

Indonesian private pension funds have emerged long before the Pension Law was established in 1992. However, before 1992 the rules on pension funds were subtle and the protection of the participants was minimal. Under the Pension Law, the prudential regulations such as mandatory funding requirement and asset management rules are set to protect the pension members. The Law also introduces the Financial Institution Pension Fund (FIPF), a publicly-offered pension fund established by a bank or life insurance company.

About 85% of the Employer Pension Funds (EPF) are Defined Benefit (DB) plans. This fact does not change in the last ten years, and is not expected to change significantly for the next 5 years. As of 31 December 2006, the total assets of Indonesian private pension funds amounted to IDR 77.53 trillion with average annual growth of 20%.

Indonesian Private Pension Funds and Financial Markets

The portfolio of pension funds is certainly influenced by the financial market development. Before the economic crisis that hit Indonesia in 1997, time deposits accounted for about 55% of private pension funds assets. The rests were invested in property (14%), stocks (8%), bonds (10%), and direct investment (13%). The crisis had made the government introduce the Blanket Guarantee Program and increase the interest rate up to 70% p.a. in 1998. This drove the pension funds to put more money in time deposit. During the period of 1998 – 2002, the proportion of private pension funds assets invested in time deposits rose to 70% of assets. During that period, the investment in property and public shares decreased to 7.5% and 6% of total assets.

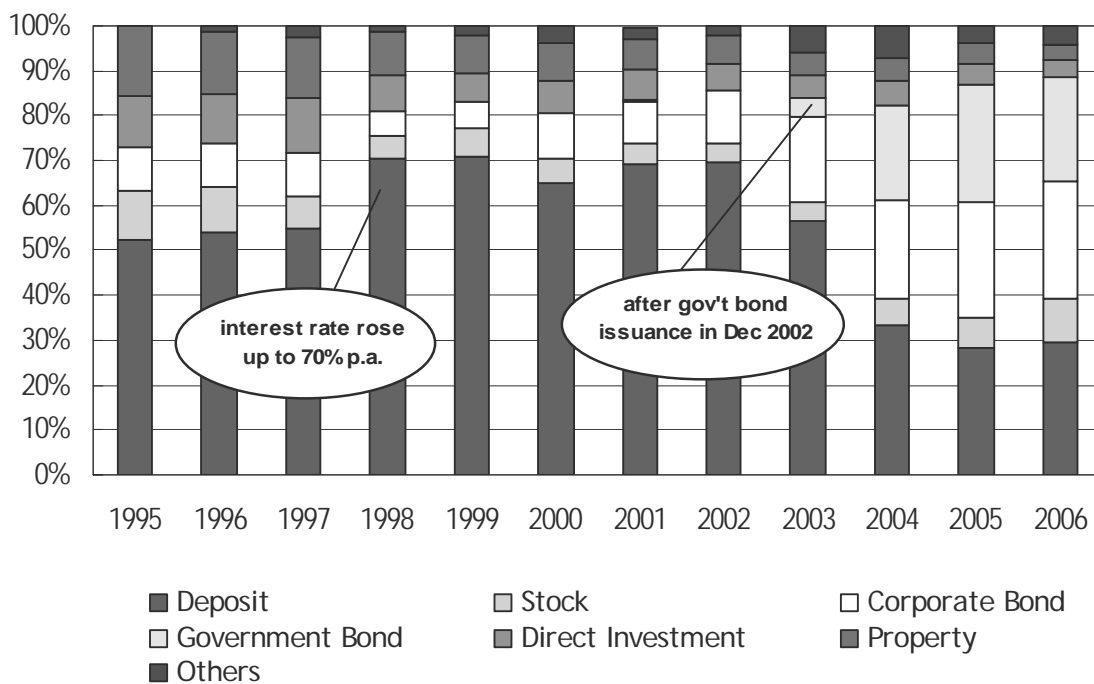
In December 2002, the government issued its first market-oriented government bond¹. The pension funds saw this instrument as a new alternative to generate income. By the end of 2003, about 4% of pension funds assets were invested in government bonds. Government bonds became more attractive to pension funds when the interest rates were gradually reduced by the central bank and the Deposit Insurance was in place to substitute the Blanket Guarantee Program on 2005. Unlike the Blanket Guarantee Program that provides 100%

¹ In 1999 the government issued bonds for bank restructuring program, but access to buy these bonds in the markets was limited

protection to bank customers, the Deposit Insurance only gives limited protection². Hence, pension funds reduced the proportion of time-deposits and increased their investment in government bonds. In the past three years, the private pension funds portfolio has changed significantly. As of 31st December 2006, time-deposits and government bonds were about 30% and 23% of pension funds assets respectively.

As Indonesia recovers from economic crisis, market confidence in the financial markets has slowly regained. After the crisis, other than government bond, corporate bonds and stocks also gain popularity in the markets. By the end of 2006, pension funds assets that were invested in corporate bonds and stocks were 26% and 10% of total assets respectively. The changes of pension funds portfolio during 1995 – 2006 can be seen from the graph below.

Indonesian Private Pension Funds Portfolio



In financial markets, pension funds play important roles as institutional investors. The nature of pension funds’ liabilities enables these financial institutions to accumulate funds in longer time horizon. In many countries, the accumulation of the funds can be very significant to make pension funds the major players in financial markets. Nevertheless, this is not the case in Indonesia.

As mentioned earlier, by the end of year 2006, Indonesian private pension funds industry has grown IDR 77,53 trillion of assets. This amount is relatively small compared with the Indonesia Stock Exchange’s market capitalization of IDR 1,249.07 trillion. From macroeconomic perspective, the size of Indonesian private pension funds is even smaller. Since 1992, the private pension funds assets accounted for around 2.5% of GDP. This size is hardly significant to influence the financial markets. In order to play more important role in

² Under the Law Number 24 Year 2004, the maximum amount of deposits guaranteed in one bank is IDR 100 million per person

the financial markets, Indonesian private pension funds should deal with the more fundamental issue: the development of private pension funds industry.

Indonesian private pension program is a voluntary program. However, its design takes the ideal form of pension program. Overall, the Pension Law has adopted the OECD's fifteen principles of the regulation of private occupational pensions schemes³. On the one side, the design gives maximum protection for old age income of the members. On the other side, the program does not really fit to the condition of Indonesia. With the absence of national social security programs, most people are still struggling for basic and short-term needs such as shelter, education, and health⁴. Since the Pension Law gives small space for flexibility, the private pension program becomes less attractive⁵.

Another major challenge of the development of private pension funds in Indonesia is the Law Number 40 Year 2004 on the National Social Security System. According to the Law, every person should join the National Social Security Program which includes pension program and old-age benefit program. To fund the program, every employer and individual should pay contribution. Currently, there is mandatory old-age benefit program under the Occupational Social Security Scheme. Under the scheme, employers and employees should contribute about 5.7% of the salary for the program. Until now, clear arrangement of how the existing mandatory program be integrated with the programs under the National Social Security System does not exist. Hence, there is uncertainty about the total cost that should be born by the employers and individuals. Consequently, employers are discouraged to establish the compulsory private pension program.

Conclusion

There is evidence that the portfolio of Indonesian private pension funds is affected by the changes in the financial markets, but this does not work conversely. The size of Indonesian private pension funds is still too small to influence the financial markets. In this case, reforms are required to support the growth of pension industry so that the pension industry could play bigger role in the financial markets.

³ Review of Indonesian Pension Law has been conducted by the Asian Development Bank in 2005

⁴ The National Social Security Programs are introduced in the Law Number 40 Year 2004, but the programs are expected to be effective in 2009.

⁵ For example, the locking-in principle and periodic-payment principle are often considered as the "disincentives" of pension program