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PROBLEMS AND PROSPECTS FOR THE LIFE INSURANCE AND PENSIONS SECTOR IN INDONESIA

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1. Introduction

Life insurance and pension funds represent the major vehicles for long term savings in most developed economies. Life insurance originally grew out of the need for individuals to provide their dependents with a level of financial security in case of their premature death.

However with declining mortality rates and the advent of retirement from the paid labour force, many life insurance policies have become long term savings contracts. In essence, these policies then provided benefits which emphasised retirement rather than death.

Employer based pension funds commenced in the 19th century in the UK and the USA to provide employers with a mechanism of "retiring" their staff. As the pension industry developed on a world wide basis, life insurance companies with their skills and experience in long term individual life insurance policies, naturally offered a range of pension products. Indeed, for many life insurance companies, group pension business is now much more important than the original life business. A similar trend is likely to occur in Indonesia.

The Indonesian Government has recently introduced new life insurance and pensions legislation. However it is reasonable to conclude that most of the current optimism for the Indonesian life insurance industry is actually generated by the prospects for the pensions business.

For the purposes of this paper we will consider life insurance, pension funds and Social Insurance as individual components of the total set of long term contractual savings and, as such, each will generate effects on the level of savings, investments and the capital markets.

Section 2 of the paper will review the current Indonesian scene before Section 3 briefly comments on the taxation and savings aspects of private pensions. Section 4 will then discuss some of the problems in the industry in Indonesia while Section 5 will consider some of the prospects as these industries continue to develop. Section 6 presents the major conclusions of the paper.

2.2 Pension funds

Currently there are few pension funds that have actually been approved and these are mainly for State owned enterprises. It is claimed that over 500 funds have approval pending. This represents a large potential increase over the previous number of formal funds, in the form of about 194 Yayasans (foundations) which existed in 1992.

However, it should be noted that Yayasans were considered cumbersome and expensive to establish and maintain, and therefore a realistic alternative only for very large companies. Employers planning pension funds frequently delayed commencement of their proposed plans until a clear and simplified regulatory system was in place.

At the informal end of this market, it is known that prior to the Pension Law many companies made a practice of making ex gratia payments to employees on retirement. Such ex gratia payments represent little security for employees as the individual must rely on the employer continuing to exist and that the employer will maintain this practice.

In summary, information is not yet available to gauge the size of the private pension funds industry.

Pension funds for civilian and military Government employees are well documented, with 4.5 million members and assets of over Rp 6,000 billion. (PT TASPEN, 1990)

There are also pension funds for about 185 State owned enterprises. Membership figures for these are uncertain although assets exceed Rp 4,000 billion.

The Pension Law includes provisions governing the rights and obligations of both employers and employees. It is based on the following principles:

- Pension fund assets must be separate from those of the founding company. Separation from the assets of the employer : legally, for accounting purposes, and for investment purposes is a security measure.
- Assets of a pension fund can be used only to provide benefits for the fund's participants. This is an incorporation of the basic feature of 'trust law' as it exists in the British legal system.
- Pension programs must accumulate a sufficient level of funds to pay the benefits to the participants. Therefore, pension funds should be fully funded. The alternative to full funding is 'pay-as-you-go' - or the use of current revenue to pay pensions.
- Payment of retirement benefits will be made primarily on a periodic, rather than a lump-sum, basis. This requirement mirrors what is perceived to be the need provided by a pension fund, namely to provide income in retirement.
- The pension system is voluntary. Each company (employer) must decide, based on its financial capabilities, whether or not to offer pension benefits to its employees.
- Pension funds established in line with the new law are eligible for certain tax exemptions. Contributions to pension funds by both employers and employees

are tax deductible while pension benefits are taxable when received. Investment income to the pension fund from time deposits, certificates of deposit, savings accounts, and listed stocks and bonds are exempt from tax whereas pension fund investment income from real estate, foreign instruments and other types of investments is taxable. The general rationale for the tax treatment of pension funds is discussed below. In the Indonesian case, some investments are excluded from the tax exemption to reinforce the investment guidelines which aim to discourage them or limit the fund's weighting towards them.

Permitted assets for pension funds are:

* SBIs, time deposits, certificates of deposit with banks in Indonesia;
* Securities listed on Indonesian stock exchanges (but not options and warrants);
* Commercial paper issued by corporations in Indonesia;
* Direct investment including unlisted shares and unlisted notes with maturity of over one year and authorised under Indonesian law;
* Real estate in Indonesia in the process of being developed or already developed.

Pension funds have some time to comply with the investment guidelines.

Many of the above principles are based on pension fund practice in developed countries although the investment restrictions are much tighter than is normally the case. The taxation of fund investment income is also unusual with selected assets receiving tax favoured treatment. However, the general approach of making contributions tax deductible, investment income tax exempt and ultimately taxing the benefits is consistent with the practice in most developed countries. The reason for this tax support is further discussed in Section 3.

2.3 Life Insurance

There are currently 46 life insurance companies in Indonesia with assets of nearly Rp 2,000 billion. However, there is a vast disparity in size and operational *raison d'etre* between companies.

About 60% of the new policies for individual business is written by the two largest life insurance companies indicating an industry that may almost be considered to be duopolistic. This strong concentration compares with 24% of the market for the largest two companies in Australia, which is generally regarded as having a very high concentration of life insurance business.

However, there have been some significant new company success stories in Indonesia. These are mainly due to success in organising agency networks and a strategy of targeting high net worth individuals.

This strategy is beneficial to the company and the individual company's growth and profitability and also assists the life insurance industry increase its share of longer term savings. However, it does little to increase life insurance coverage amongst the population as a whole.

Marketing to a wide cross section of the population, both from a socio-economic and a geographic point of view, is currently the province of older life insurance companies. These companies were established many years ago with a manifesto to do exactly this. It is a less profitable marketing strategy in most countries, because of the need to maintain many branch offices in rural districts, and the high costs of servicing large numbers of small policies relative to the premium received. Further development of life insurance marketing to these groups may have to await substantial general economic development.

In this context, it is open to question whether a substantial proportion of the Indonesian population will be covered by life insurance in the foreseeable future. As well as limited ability to save on a low income and the reluctance of many companies to market to lower socio-economic groups, the extended family remains a 'non-insurance' solution to the need for protection in adverse circumstances.

To compare the development of the life insurance industry between countries, 'premium density' may be used as a measure. This is the total life insurance premiums received as a percentage of the GDP.

Typically, developed countries have a premium density in the order of 4%. Naturally there is a lag between economic development and life insurance affordability and awareness. The current Indonesian figure of less than 1% suggests that there is considerable scope for life insurance development. It is therefore not surprising that Indonesia is seen as an area of opportunity for this form of business.

As suggested above, Indonesian life insurance coverage is low at present, with the number of people having life insurance in some form being approximately 8% of the population. This compares with 30% in Australian and 27% in the USA. Many incomes are also low and thus the ability to save is limited.

The Indonesian life industry has seen significant growth with total assets rising from Rp 675 billion in 1987 to Rp 2331 billion in 1993. (Insurance Council of Indonesia, 1993). Much of this growth is due to the increased number of companies in a deregulated environment with the growth from 15 companies in 1983 to the existing 46. These new companies have targeted middle class individuals in urban areas so that their average premium per policy is considerably higher than for older companies which market through thousands of agencies throughout the country, including rural areas.

2.4 Regulation

As noted earlier, life insurance companies and pension funds are supervised by the Ministry of Finance. On the other hand, JAMSOSTEK, whilst addressing the social welfare of employees and their families with a more complete social insurance package, has a lower level of financial supervision. For example, there are no investment guidelines for the assets of the JAMSOSTEK fund as there are for the assets of pension funds and life insurance funds.

The new regulatory frameworks for life insurance and pension funds have laid an encouraging framework for development and have broad support from all players.

The efficiency of these industries to perform a capital raising function within the economy will largely depend on compliance with these regulatory systems.

Greatly enhanced capitalisation requirements for both private pension funds and life insurance companies are also being put in place. The aim is to insure, as far as possible, the security of savings. However, the other implications of these changes need consideration: for instance, the interaction between capital markets and these long term savings sectors. In addition to the requirements for the development of long dated financial instruments to match the long term liabilities of these industries, there are also the important issues of potential concentration of corporate ownership and control.

Regulation of these industries in line with trends in global developments for the contractual savings sector have been embraced in Indonesia. There appears to be concurrence with the view that only with proper regulatory control can this sector benefit directly from economic growth. Regulatory activities tend to initially focus on licensing. Beyond this, they are aimed at financial viability and soundness. At this point, there is little emphasis in Indonesia in the regulation of "consumer" issues. However, over time, this can be expected to change as these issues are currently being tackled in many developed economies.

3. Pensions: taxation and savings

3.1 The taxation treatment of private pensions

As noted above, most developed countries have provided taxation support and incentives for the development of private pension funds. Generally this has meant that the contributions and investment income of pension funds are tax exempt but that the ultimate benefits are taxable in the hands of the beneficiary. This approach may be known as the EET (or exempt, exempt, taxable) taxation approach to savings and stands in contrast to the normal taxation treatment of bank savings where the savings are made from after tax income, the interest income is taxable but the withdrawal is not subject to taxation. This second tax approach is known as the TTE (or taxation, taxation, exempt) approach.

The attraction to individuals of the EET approach is that the taxation is deferred until later in life and is often reduced because marginal tax rates are normally lower in retirement than during one's working career. Knox (1990) discusses the implications of these alternative taxation treatments in greater detail.

With the common acceptance of the EET approach for pensions on a world wide basis, and with its acceptance within the recent Indonesian legislation (subject to some minor variations), it is appropriate to ask why there is such general support for this level of taxation support by Governments when it means that their ultimate revenue is both deferred and possibly reduced. The following arguments summarise the reasons given:

1. To provide members of the community with a vehicle through which they can maintain their living standards and dignity after retirement. In essence, this argument suggests that Governments do not believe that individuals will save a sufficient level of money for retirement without significant financial 'carrots';

2. To increase the level of long term savings within the economy and thereby to provide capital for long term investment within the country. In turn, these investments will assist in economic development and growth as well as employment opportunities;

3. To provide individuals with compensation for a lack of access to their long term savings. Most pension arrangements do not permit members to access their funds during their employment years so that this inaccessibility can make pension savings less attractive than other forms of savings where accessibility is available.

4. To reduce the long term cost of the Government's social welfare bill on age pensions as fewer pensions and/or a lower level of pension will be needed if individuals have other sources of retirement income.

The strength of these arguments varies between countries and at different stages of economic development. The fourth argument is not currently relevant in Indonesia, as no age pension exists. It is the second argument, linked to the need to raise national savings, that is particularly pertinent for Indonesia at its current stage of development. Hence we will now consider the extent to which private pensions are likely to increase the national level of savings.

3.2 Do private pension funds increase the level of savings?

The impact of the growth of private pension funds on the national level of savings is a topic that has been debated for many decades without clear conclusions. In essence, it is a behavioural question and it is impossible to ascertain the savings and consumption patterns that individuals would have followed if there had been no private pension savings. However, in general, it is reasonable to conclude that tax supported voluntary pension savings increases the total level of savings by about 30-50% of every extra dollar saved in the pension fund. That is, there are some offsets that must be taken into account and the strength of these factors varies between countries, systems and over time.

It is therefore impossible to claim, without reservation, that pensions will increase the level of national savings. The result will depend on a number of factors including:

- the level of substitution between non-pension and pension saving;
- the level of taxation support which results in dissaving in the public sector;
- the level of compulsion in the pension system as a compulsory system must include some individuals who would otherwise choose not to save;
- the level of compliance within a compulsory system;
- the level of preservation (or lack of access to the savings) required by the regulations;
- any change of behaviour that may be caused by accrued pension benefits (eg early retirement);
- any change in the community's attitude to saving that may be caused by the taxation support or a compulsory system; and
- the use of the retirement benefits which includes whether they are paid as lump sums and consumed or paid as annuities, thereby retaining the accumulated capital for a longer period.

The Indonesian experience is still evolving. However, with the introduction of JAMSOSTEK and clear rules for pension funds it is likely that many individuals will be involved in long term contractual saving for the first time. This should increase the level of national savings although the ultimate benefit to the economy will largely depend on the level of compliance.

4. Problems

4.1 Compliance with regulation

The new regulatory frameworks for private pension funds and life insurance companies are encouraging developments and have broad support. However, these regimes will not fulfil the promise of promoting efficient industries and generating additional savings and long term capital if there is significant non-compliance.

Most of the relevant regulation is new. Participants come from a previously unregulated environment. It is yet to be demonstrated that supervision will be strong although a body of written regulations is now in place.

There are two major issues with regard to compliance:

* Will the industry comply with regulation?

* Will the supervisors effectively carry out their enforcement role?

For the pension industry, the greatest challenge will be to comply with the investment guidelines within the time frame specified. For existing pension funds, the rebalancing of investments to the categories and limits in the guidelines will depend on the liquidity and depth of the markets. Pension fund administrators will therefore need to implement an investment strategy to comply. Funds holding high levels of real estate will have to find a market, hopefully without a capital loss, to reduce their holdings to the approved levels. Some pension fund administrators may undertake little action hoping that the guidelines will be amended before the expiry date for compliance.

Investment guidelines for life insurance funds are similar to those for pension funds. Investments must be made in Indonesia, which presents problems for the many life insurance companies selling policies denominated in $US.

For life insurance companies there may be difficulty in complying with new reserving requirements which require capital injections into the company, unless growth is to be constrained. These requirements represent a compromise which is inappropriate for some companies and impossible for others to meet. Furthermore, the specific requirements will need further adjustment to allow for the new techniques being developed in many parts of the world. These techniques are designed to enable a company, at the same time as demonstrating solvency and capital adequacy, to measure profit on an appropriate basis. In Indonesia, it is unlikely that these developments can be introduced until there is further enhancement of the actuarial profession.

4.2 Life insurance companies - can growth continue?

Life insurance in Indonesia may develop the identity crisis which is evident in other countries. (Prime, 1994).

One reason for the problem is that there are many vehicles for long term savings and it can be difficult to distinguish between them. In essence, why should the life insurance industry operate under a different regulatory regime when there are also mutual funds, unit trusts, compulsory social insurance schemes, and pension funds - all potentially part of the same market. Within this competition for savings, the long term savings nature of life insurance is easily forgotten. For instance, to survive in the market, life policies have guaranteed cash values and other valuable benefits. These supplementary benefits are satisfactory if their pricing is assessed accurately. However, if not, the long term investment returns suffer thereby removing the major attraction of these policies.

Another difficulty is the shift away from products aimed at regular savings by the individual consumer. Initially, this type of policy was responsible for the establishment of the life insurance industry. However, such a product is now too expensive to service and companies like to concentrate on bulk business and high net worth individuals.

4.3 Will JAMSOSTEK direct savings from the private sector?

The new social insurance legislation mandating substantial contributions to provision for old age and other benefits, including medical coverage, for employees of all employers with 10 or more employees, is of such a scale that it will have an impact on the level of private sector savings, both within and beyond the life insurance and pensions industries. The extent of this is very difficult to assess as it will depend on the level of substitution between different forms of savings and the extra income available for savings from economic growth. It is interesting to note that the introduction of compulsory superannuation in Australia in 1992 has not caused a substantial rise in the level of national savings as the extra superannuation contributions were offset by lower savings elsewhere and benefit payouts, due to higher rates of retrenchments and early retirements during the recession. (Foster and Knox, 1994)

The impact of JAMSOSTEK on the size of the private pension sector is also difficult to assess. It has the potential to grow very large which will clearly affect the capital markets. Furthermore, it increases the cost of doing business in Indonesia and so affects competitiveness.

4.4 Can the necessary skills be developed quickly enough?

Each of the contractual savings components requires a level of sophisticated skills and experience for the industry to operate successfully. However, technical and specialised skills, such as in accounting, actuarial science and investment, are in short supply. In addition, information technology, administration systems and banking infrastructure for collection and payments processes are all required. Credible data collection and statistical analysis is also necessary for both administrative purposes and to engender public confidence.

In brief, as part of a large and rapidly growing financial industry, the contractual savings sector is currently resting upon a narrow infrastructure and skills base.

4.5 What are the implications of full funding?

Under the Pension Law, pension programs must accumulate a sufficient level of funds to fulfil the promises made to participants on which they or their dependants will rely in old age or on premature death. That is, pension funds must be fully funded.

Pension funds can take one of two forms - defined contribution or defined benefit. With defined contribution funds, the benefit is simply the accumulation, with interest, of the contributions made on behalf of the employee, net of administrative and any insurance costs. A defined contribution fund is therefore fully funded, by definition. Hence, within a defined contribution fund, the participant can be confident that the agreed percentage of salary is set aside for retirement savings, although s/he bears the risk in regard to future investment returns on these savings.

In contrast, within a defined benefit fund, the employer bears this investment risk as the promise is to pay a pension described as a certain proportion of salary. The greatest risk faced by the participant in a defined benefit fund is that the employer will not commit sufficient funds to the promise. If the employer should wind up the pension fund or, worse still, become bankrupt, without full funding, then the promise cannot be kept. However, it should be noted that, historically, the defined benefit pension fund participant has relied on the financial soundness of the employer and its integrity of intention to meet the promise, as much as on the level of funding. In most countries, pension funds for government employees are defined benefit and unfunded. A government's promise to pay pensions in the future is considered secure.

Most existing pension funds in Indonesia, in particular the large BUMN funds, are defined benefit. The benefits from these funds are defined in terms of the salary at retirement. Full funding requires contributions from the employer sufficient to provide vested (or accrued) benefits.

Currently, many of these funds are not full funded. Indeed, some are not funded at all with the employer making pension payments as they fall due (ie a pay-as-you-go system). A measure of the overall level of underfunding may amount to several trillion Rupiah. The implications, therefore, of sudden compliance with the 'full funding' requirement are immense. Initially there is the consideration of where such large amounts of capital would be found by the employer within the time limit. Then, assuming the funds are found, these large additional amounts need to be invested.

The availability of sufficient suitable investments, possible distortion of the capital markets and issues of ownership and control of substantial ventures are significant issues that will affect the future growth of the Indonesian economy. The growth of pension and social insurance funds, their concentration in the hands of powerful institutional investors and the growing determination of funds managers to act as owners rather than simply as investors is becoming a controversial issue on a global basis. For example, the issue of corporate governance is currently being debated internationally.

The requirement to fully fund, together with the experience of pay-as-you-go pension payments increasing year by year in an inflationary environment, is encouraging a move towards defined contribution funds.

4.6 Investment considerations

The new investment guidelines cover private pension funds and life insurance companies but exclude the Government employees pension funds and JAMSOSTEK. Nevertheless, these funds have expressed the intention of abiding by the spirit of the investment guidelines.

Compliance with investment guidelines will pose some problems. However, a greater problem in moving to a prudential investment regime for contractual savings funds is the absence of sufficient investment opportunities.

At present, all these funds are heavily invested in short term bank deposits, which are unsuitable to match their long term liabilities. Yet the long dated financial instruments required to match long term liabilities are currently in short supply.

The problem of mis-matching the term of assets to the term of liabilities potentially gives rise to similar problems to those experienced in the early 1980s with the mis-matching by currency of assets and liabilities with $US denominated life insurance policies. On this occasion, massive devaluation of the Rupiah caused a fall in the value of assets compared with the value of liabilities. In some cases, the result may have been technical insolvency.

However, the wisdom of matching assets and liabilities according to term is of no practical use when there is not a range of Government and other securities of all types, amounts and durations to meet the text book requirements.

New business growth in life insurance, or an expanding membership of pension funds, tends to lengthen the outstanding term of the liabilities so that it becomes even more difficult to match with corresponding assets. Within life insurance, certain product design features and cash flow testing can help, but the industry is basically dependent on a future significant development in the share and bond markets.

The prohibition in regard to the investment of life insurance and pension fund assets outside Indonesia is restrictive. For life insurance funds in particular, the large number of $US denominated policies need to be matched with assets in the same currency. Within Indonesia only $US denominated bank deposits are available, and this produces a major mis-match in regard to term. Further, for reasons of diversifying the investment risk, life insurance funds in many countries now maintain significant off-shore portfolios.

4.7 Consumer issues and life insurance distribution

Although not highlighted in Indonesian regulatory practice at present, there is a global trend towards the inclusion of consumer issues in regulation.

In Indonesia, as in other Asian countries, people are becoming prosperous, more educated and much better informed. They want a greater voice in the products they buy and regulators are listening.

The contractual savings area most affected is life insurance. Consumer issues are interrelated with life insurance distribution and expense control. Associated problems are now coming to the fore. The question will shortly be asked 'why are premiums more expensive in Indonesia and other Asian countries compared with developed countries?'

Life insurance distribution is largely through commissioned agents who represent one company only and often on a part time basis. Problems associated with such a distribution system are high commission costs, questionable sales practices such as the representation of the ultimate benefits on a very optimistic basis, and very high early withdrawal rates. At present, regulators and companies consider that these problems should be dealt with by improving the quality of agent services. Hence there is increased emphasis on training, raising the professionalism of agents, and the desirability of full time rather than part time agents. Yet, while these developments are laudable, they will not solve all the issues.

It is instructive to look at developments in Malaysia. The Malaysian market has exhibited healthy growth in terms of new business and recurring premium income, as well as in the size of assets accumulated. However, despite this encouraging trend the industry has difficulties which are a threat to long term expansion, particularly relative to other savings media. These concerns concentrate on areas of honest consumer communication, efficiency of distribution, and basic profitability and solvency. The Malaysian regulators are concerned with the efficiency with which the life industry is able to deliver insurance products. Recent guidelines require first year commission of no more than 60% of premium, management expenses not exceeding 30% of first year premium, and agency management structures of not more than 3 tiers. These guidelines have caused agents to defend their position and have been recalled for further debate.

The sudden influx of new life insurance companies into Indonesia has put great pressure on agent recruitment and retention. The general reaction is to make the compensation more attractive, leading to a spiral effect. Companies 'buy' existing agencies from their competitors or a group of agents on a negotiated basis thereby exacerbating their expense problems.

The Insurance Council of Indonesia is now publishing numbers of agents and agent productivity. The latest available statistics, for 1993, show 46 companies with 55,114 agents, and a productivity of 11 sales per agent per year. This productivity is very low, even by global standards which are considered too low. One of the substantial opportunities seen by the foreign joint venture companies is to import advanced selection, training, supervision and remuneration methods to increase agent productivity. Without a reduction in costs and increased productivity, the life insurance industry will not be able to compete with other savings products.

5. Prospects

5.1 Will aggregate savings increase?

The impact of saving through contractual savings institutions depends on their credibility. A system with low credibility will have a reduced impact on consumer behaviour in the voluntary savings market. Mandatory contributions to a non-credible system will be treated as taxes rather than forced savings. The total level of national savings under such a scheme depends on the ability for individuals to reduce other forms of savings (ie substitution) and the impact, if any, on the level of public savings. The effects of a compulsory system will also vary with the level of reserves accumulated and the behaviour of those who receive the benefits. Within the Indonesian context, it is likely that the national level of savings will rise as many low income earners will be saving when their voluntary behaviour would be to consume. However, the overall rate of increase in the level of savings will be less than the rise in contributions due to the substitution effect and possible dissaving in the public sector through taxation support.

While contractual savings may increase the total level of aggregate saving, it is also clear that they will cause a shift in favour of long term savings that can be used to promote the development of equity and bond markets. Hence these markets need to develop in parallel with the growth of contractual savings.

5.2 The development of JAMSOSTEK and private pension funds

The social insurance scheme JAMSOSTEK has the potential to become the largest contractual savings fund in Indonesia. The current membership of 6 million is expected to rise significantly as compliance under the new system is enforced and wider coverage comes into effect. The new system also mandates higher levels of contributions.

The introduction of the Pension Law will also bring substantial changes to this industry. Most prospects are positive, as borne out by the large number of applications waiting approval. However, the introduction of JAMSOSTEK with its wider coverage and higher compulsory contributions for old age provision will have a dampening effect on private pension fund growth, particularly in the case of smaller pension funds. Indeed small pension funds may opt to close and not register for approval. Many potential small pension funds may never eventuate.

The tax advantages conferred on pension fund contributions and investment income have already been mentioned. They will enhance the attractiveness of establishing a pension fund. These tax advantages can only be justified if they lead to additional long term savings being generated and/or a better standard of living in retirement.

Prospects for private pension funds are also contingent on employment. A traditional rationale for a company's pension fund is to attract and retain suitable personnel. Consequently, demand for labour is an important criterion. There is high demand for skilled labour and so it is likely that pension funds will be established by those employers who are anxious to attract and keep their skilled labour.

Irrespective of the numbers of pension funds actually established, the current trend is for them to be of defined contribution design. One of the reasons for this is the certainty of employer costs. There is also reluctance to engage in the complicated administration of pension payments and a consciousness of the high cost of actuarial reviews.

Consideration could be given to allowing employers to opt out of the JAMSOSTEK old age benefit provision requirements if they provide a pension fund offering superior benefits. This flexibility is available in other countries (eg United Kingdom) and is currently available for the medical coverage aspects of JAMSOSTEK. This would provide a significant boost to the prospects of the private pension funds industry.

To promote a diverse system, consideration should also be given to allowing other suitable institutions (life insurance companies are a particular example) to offer contracts providing benefits legislated under JAMSOSTEK on a competitive basis. This would lay a foundation of competition for efficient management and investment performance of old age provision funds, including both social insurance and private provision.

5.3 Investments

Development of investment management as an efficient service for the members of contractual savings programs depends both on the development and availability of suitable long term investments and on the presence of investment expertise within the companies.

The recent experience of life insurance companies in Singapore provides a useful illustration. Between 1980 and 1991, Singapore life insurance funds experienced a rapid build up of assets. How did the industry cope with this situation and deliver a level of investment return sufficient to support competitive product pricing? Industry statistics and market intelligence indicate a three point strategy:

- Asset allocation change - there was a move into the stock market and higher yielding investment avenues offshore with the corresponding higher risk profile.

- Expertise and resources - there are now a greater number of in house investment officers and greater use of outside professional fund managers.

- Rationalisation of the investment decision making process - delegation of investment decisions to a limited extent in order to respond quickly.

Similar features are emerging in Indonesia, although there are some different circumstances including the prohibition on offshore investment.

Prospects for the 1990s are that interest rates should remain low, when compared to previous years, and the scarcity in investment grade fixed rate bonds is expected to persist. The asset re-allocation process will continue as the industry re-focuses its investment strategy. The level of investments in non-interest generating assets, such as shares, should rise. In the search for better performing assets, the industry will also enhance its investment expertise, thus moving towards a more professional approach to investment management and the greater use of outside investment managers.

Small pension funds are particularly in need of outside investment management. Life insurance companies are currently precluded from carrying out this function. However, life insurance companies are major managers of long term funds and a change permitting them to manage a small pension fund would be an effective use of resources.

5.4 Life insurance companies

The clearest prospect for life insurance companies is a shift in focus to profit management. These companies are now facing a tougher and riskier business as competition is intensifying from inside and outside the life insurance industry. Profit margins of life insurance products are also shrinking such that the margin for management error has become much smaller. Many well established companies, who have been benefiting from fast economic growth and enjoying strong profit margins, face challenges in expense management.

The increasing costs of life insurance distribution need to be incorporated in pricing. In other countries, these pressures have led to development of new products, such as investment linked products where more of the risks of fluctuating investment values and rising expense levels are borne by the policyholder. Investment linked products are currently not permitted in Indonesia. This is said to be because of insufficient investment management resources within life insurance companies. While this may be true momentarily, it will be clear from the above that life insurance companies are expected to dramatically improve their investment management capability. Hence, this ruling should be reviewed in the near future.

Positive prospects arise from the provision for 'Financial Institution Pension Funds' (FIPFs) to be set up by banks and life insurance companies to accumulate retirement savings for the self-employed and employees where their employer chooses not to have a company pension fund. The self employed are also excluded from JAMSOSTEK coverage.

Another positive prospect is the requirement that defined contribution pension funds must use the lump sum retirement benefit to purchase an annuity from a life insurance company.

5.5 Consumer issues

There is pressure leading to commission limitations and disclosure requirements at least in regulatory guidance, if not in black letter law. The view is increasingly expressed that the regulatory body is responsible for promoting the image of the industry in the eyes of the consumer, and therefore must consider financial soundness in its broadest sense. The implication of this view is that the regulator must be concerned with cost efficiency of distribution mechanisms and the sales process all the way down to the marketing literature!

A consumer development noticeable in the USA is that of 'independent judges' of life insurance product value, namely ratings agencies (eg Moodys, Standard and Poor). These agencies provide independent advice on life insurance companies and products. They often lack the expertise to really analyse life insurance products but have, nevertheless, accelerated the demise of some non-viable companies. At the moment, they are not a notable feature in Indonesia. However, it is likely they will make an appearance.

6. Conclusions

Each problem for the pension and life insurance industries in Indonesia is also associated with a potential development or opportunity.

In respect of the broad contractual savings sector, the enormous potential of the mandatory social insurance scheme, JAMSOSTEK, cannot be ignored. If this scheme falls far short of its great potential it will be due to lack of confidence in the ability of the scheme to deliver benefits as promised and the lack of willingness to comply on the part of employers and employees. There is a considerable challenge to the scheme's management in establishing these credentials.

On the other hand, introduction of provisions to enable employers to 'contract out' of JAMSOSTEK on condition of providing superior private pension benefits would enhance prospects for the private pension fund industry and create a competitive environment for both the social insurance and private sectors.

The life insurance industry has been exhibiting strong growth and has further growth prospects. Nevertheless, issues of profit management, distribution difficulties, and identity of the industry remain. Overall prospects depend on the management of these issues, both by the regulators and by the industry itself.

Investment management is a major area which touches the credibility of each of the contractual savings sectors and its emergence and development will have a major impact on the future growth of the industries.

The regulatory environment developed for the prudential supervision of private contractual savings is encouraging. Continued leadership, in both the public and private sectors, provides the best basis for the future.

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