

CLIENT ALERT

2015 JANUARY 26

Bank Indonesia Tightens Up Corporate Offshore Debt Rules

1. Introduction

As pressure against the Rupiah continues and fears mount about the possible overleveraging of Indonesian corporates on the offshore debt markets following years of cheap credit, Bank Indonesia moved to limit exposure by issuing Regulation No. 16/20/PBI/2014 (“**PBI 16/20/2014**”), which requires non-bank corporations to satisfy a number of prudential requirements in the form of explicit hedging and liquidity ratios, and the need for a minimum credit rating. On 29 December 2014, PBI 16/20/2014 was effectively superseded by Regulation No. 16/21/PBI/2014 (the “**New Regulation**”) due to problems related to PBI 16/20/2014. The application of prudentiality will be supervised by Bank Indonesia through a system of reporting by non-bank corporations (rather than approval). The New Regulation only applies to non-bank corporations.

2. Offshore Debt

Offshore debt is defined as “debt owed by a resident to a non-resident, whether denominated in foreign currency and/or Rupiah, including financing provided in accordance with Sharia principles.”

3. Minimum Hedging Ratio

Under Article 3 of the New Regulation, the minimum hedging ratio is set at 25 percent of:

- a. The negative difference between foreign currency assets and foreign currency liabilities maturing within three months from the end of the last quarter; and
- b. The negative difference between foreign currency assets and foreign currency liabilities maturing between three and six months from the end of the last quarter.

BI Circular Letter No. 16/24/DKEM, dated 30 December 2014 (“**BI Circular Letter**”), stipulates that foreign currency assets include those in the form of cash, demand deposits, regular deposits, term deposits, accounts receivable, inventories, marketable securities and receivables from forwards, swaps and/or options transactions. Accounts receivable and inventory are excluded as foreign currency assets under PBI 16/20/2014. The accounts receivable which may be calculated as foreign currency assets are accounts receivable payable to residents and non-residents which become due and owing within three months from the end of the relevant quarter and/or within three to six months from the end of the relevant quarter, which are true-sale in nature or non-refundable, which have been adjusted for amortization, and where the underlying agreement is executed before 1 July 2015. Accounts receivable based on underlying agreements executed after 1 July 2015 may be counted as foreign exchange assets if they are related to strategic infrastructure projects and have obtained Bank Indonesia approval. Inventory which may be calculated as foreign currency assets consists of the inventory of exporters that had an export revenue to overall trading revenue ratio of more than 50% in the previous calendar year.

The New Regulation defines foreign currency liabilities as foreign currency liabilities to residents and non-residents, including obligations derived from forwards, swaps, and/or options which: (a) mature within three months from the end of the last quarter; and (b) mature between three and six months from the end of the last quarter. Foreign currency liabilities that are due but are in the process of being rolled over, revolved, or refinanced shall not be included as foreign currency liabilities as long as the non-bank corporation can prove such process through sufficient supporting documents.

By comparison with PBI 16/20/2014, which is silent with regard to hedging thresholds, the New Regulation sets the minimum hedging threshold as being a negative difference of USD 100,000. Hence, only

CLIENT ALERT

2015 JANUARY 26

corporations that have negative differences that are higher than USD 100,000 are obliged to fulfil the minimum hedging ratio.

However, the New Regulation applies a two-stage approach so as to avoid unnecessary difficulties for corporations having existing offshore debt. Accordingly, the minimum hedging ratio is set at 20 percent for 2015, with the 25 percent requirement only coming into effect at the start of 2016. In addition, the New Regulation provides that hedging transactions conducted in order to comply with the hedging ratio must be conducted through banks in Indonesia (either Indonesian banks or foreign banks having branches in Indonesia). Such provision will apply from the start of 2017.

Non-bank corporations whose financial statements are expressed in United States Dollar are excluded from the fulfilment of the minimum hedging ratio. Such exclusion is further specified in the BI Circular Letter, which is applicable if: (i) a corporation has a ratio of 50% of export revenue to its overall trading revenue in the previous one year; and (ii) has approval from the Ministry of Finance to use the United States Dollar in its accounting.

4. Minimum Liquidity Ratio

Article 4 of the New Regulation requires a minimum liquidity ratio of 70 percent, meaning that a corporation having offshore debt must have foreign currency assets that are capable of covering 70 percent of its foreign currency liabilities that are due to mature within three months from the end of the last quarter. In short, the lower the amount that must be hedged, the higher the liquidity of such corporations will be.

We note here that, although at some point a corporation may have fulfilled the minimum liquidity ratio, it will still be obliged to hedge if there is a negative difference between foreign currency assets and foreign currency liabilities that fulfils the threshold. Bank Indonesia's view on this matter is that, as long as a corporation's foreign currency assets are lower than foreign currency liabilities, there will always be the risk of it suffering losses in repaying the remaining foreign currency liabilities that cannot be covered by the foreign currency assets in case of a drop in the Rupiah. Hence, part must always be hedged so that the corporation can mitigate such risk.

The minimum liquidity ratio is applied at a reduced level of 50 percent for the first year of the New Regulation's operation, with the 70 percent requirement only coming into effect on 1 January 2016. In line with the minimum hedging ratio, the minimum liquidity ratio also applies to existing offshore debt incurred before 2015. Both ratios are determined based on Bank Indonesia's research into the application of hedging and liquidity ratios in Indonesia, which according to Bank Indonesia continue to be insufficient.

5. Minimum Credit Rating

Corporations taking out foreign-currency denominated debt post 1 January 2016 are required to have a minimum credit rating that is equivalent to "BB-" from a ratings agency that is recognized by Bank Indonesia. Such rating shall be current and apply to the corporation itself and/or its debt. According to the BI Circular Letter, the following ratings agencies are recognized by the central bank:

- (i). Local ratings agencies: (a) PT Pemeringkat Efek Indonesia (PEFINDO), (b) Finch Ratings Indonesia, and (c) Investments & Credit Rating Agency (ICRA) Indonesia.
- (ii). Overseas ratings agencies: (a) Moody's Investor Service, (b) Standard and Poor's, (c) Finch Ratings, (d) Japan Credit Rating Agency, and (e) Rating and Investment Information Inc.

An unrecognized ratings agency may apply for recognition to Bank Indonesia by submitting a license from an authorized institution in Indonesia, or, in the case of an overseas ratings agency, a statement of recognition of such ratings agency from an authorized institution in its country of origin.

The New Regulation provides that the credit rating conducted by such ratings agencies shall be the applicable rating over the corporation (issuer rating) and/or bonds (issue rating) where such ratings shall be valid for 2 years as of the issuance thereof. The New Regulation also allows a subsidiary to use its parent company's credit rating if (i) such corporation enters into an offshore loan with its parent company or is guaranteed by

CLIENT ALERT

2015 JANUARY 26

the parent company, or (ii) such corporation is a newly established corporation (less than 3 years since its incorporation).

It is important to note that the minimum rating requirement only applies to offshore debt incurred post 1 January 2016. This exemption recognizes the reality that credit ratings are primarily of importance with regard to debt, and that a year's grace period is necessary as many corporations would be unable to meet the requirement should it be imposed immediately.

Excluded from the minimum credit rating requirement are:

- (i). refinancing of offshore debt in foreign currency which does not increase the outstanding amount of the previous debt, or if it does increase, such increase shall not exceed (a) USD 2,000,000 or (b) 5% of the outstanding of the refinanced loans if such 5% is higher than USD 2,000,000;
- (ii). offshore debt in foreign currency for infrastructure projects from: (a) international lending agencies, such as the Asian Development Bank and the World Bank, (b) a syndication loan with more than a 50% contribution from an international bilateral or multilateral institution;
- (iii). offshore debt in foreign currency for central or regional government infrastructure projects;
- (iv). offshore debt in foreign currency which is secured by an international bilateral or multilateral institution;
- (v). offshore debt in foreign currency in the form of trade credit; or
- (vi). offshore debt in foreign currency in the form of other types of debt that are not included within the meaning of loan agreements, debt securities, and trade credit, including insurance claim and dividends that have been declared but not paid.

6. Oversight, Reporting and Sanctions

Non-bank corporations are required to report to Bank Indonesia on the application of the New Regulation and to furnish the necessary supporting documents. The procedure for making such reports is governed by the newly issued Bank Indonesia Regulation No. 16/22/PBI/2014 ("**PBI No. 16/22/2014**"). The central bank is authorized to inspect submitted documents to assess compliance, and may request clarifications, evidence, records or other supporting documents from the reporting corporation. It may also directly inspect the corporation or appoint a third party to do so.

Any breach of the New Regulation will be subject to administrative sanctions. However, under Article 15, these will only come into effect after receipt of a corporation's compliance report for the fourth quarter of 2015. If before such quarter a report submitted by the corporation shows that the minimum requirements are still not being fulfilled, Bank Indonesia will not impose any sanctions as it is very reasonable in Bank Indonesia's opinion that some corporations will need time to adjust.

Perhaps of particular importance, non-compliance will be reported by Bank Indonesia to a range of diverse entities, including the non-compliant corporation's overseas creditors, Ministry of State Enterprise (in the case of state enterprise), the Financial Services Authority, the Ministry of Finance (*in this case* the Directorate General of Taxes), and the Indonesia Stock Exchange (in the case of public companies).

The purpose of this sanction is to undermine a non-compliant corporation's reputation with the abovementioned entities/institutions. Bank Indonesia believes that each such entity/institution will, upon receiving a report, take whatever corrective steps may be necessary. For example, based on a Bank Indonesia report, the Financial Services Authority could inform the banks under its supervision to regard the corporation as being non-compliant, which would thus make it difficult for the corporation to secure loans from Indonesian banks. This would obviously serve as a deterrent against those unwilling to comply.

We note that there are conflicting Indonesian Supreme Court decisions as to whether or not an administrative sanction will affect the validity or enforceability of an offshore debt. Bank Indonesia in drafting the New Regulation has stated that it has no intention of invalidating, and indeed could not invalidate, offshore debts. Nevertheless, Bank Indonesia admits that it cannot preclude the Supreme Court from invalidating debts. Hence, we believe that this should serve as a sufficient basis for borrowers to comply with the New Regulation.

CLIENT ALERT

2015 JANUARY 26

Conclusion

The New Regulation (along with the BI Circular Letter) clearly shows once again that Bank Indonesia has learned well the lessons of the 1998 financial crisis, which was in part precipitated by the bursting of a corporate offshore debt bubble. With a world awash in cheap funds over the last few years, the temptation is always there to “borrow first, ask questions later.” Thus, the New Regulation is to be welcomed.

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