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Commentary

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Bank Indonesia Revises and Clarifies Regulation on Foreign Borrowings by Indonesian Companies

Revised regulation and circular provide more certainty for investors and borrowers, but continue to limit access to foreign capital for many Indonesian businesses.

Bank Indonesia, the Indonesian central bank (BI), recently issued amended regulations to explain and comment on the controversial offshore borrowing regulations that it originally issued in October 2014. While the amended regulations leave the key restrictions from the original regulations intact, they do clarify a number of practical concerns that borrowers and investors had raised, and provide some useful insights into how BI intends to implement the new restrictions on foreign borrowings. Key positive refinements include clarifying the calculation of the minimum hedging and liquidity ratios and the application of the minimum ratings requirement. Further questions remain, however, on the specifics of how BI will implement the amended rules.

Background

On 29 December 2014, Bank Indonesia, the Indonesian central bank (BI), issued BI Regulation No. 16/21/PBI/2014 on the Implementation of Prudential Principles in the Management of Offshore Borrowing for Non-Bank Institutions (the Amended Regulation). The Amended Regulation, which came into effect on 1January 2015, revokes and replaces BI Regulation No. 16/20/PBI/2014 which BI issued on 28 October 2014 (the Original Regulation). We discussed the Original Regulation in our Client Alert published here.[1] In addition, on 30 December 2014, Bank Indonesia issued Circular Letter No. 16/24/DKEM (the Circular Letter) to explain and comment on the implementation of the Amended Regulation.

Hedging and liquidity ratios explained

As with its predecessor, the Amended Regulation provides for an initial implementation phase that will run from 1 January to 31 December 2015. During this period, non-bank borrowers will be required to hedge at least 20 percent of the amount by which (a) their foreign currency liabilities that will fall due in the following two consecutive three-month periods exceeds (b) their foreign currency assets. In addition, non-bank borrowers are required to maintain a liquidity ratio (defined as the ratio of foreign currency assets to foreign currency liabilities set to mature in the ensuing three months) of 50 percent. Commencing 1 January 2016, the minimum hedging ratio will be increased to 25 percent, while the minimum liquidity ratio will be raised to 70 percent.

While the Amended Regulation preserves the technical hedging and liquidity requirements that were introduced in the Original Regulation, the Circular Letter contains some important clarifications as to how Indonesian borrowers are to calculate their foreign currency exposure. Specifically, the definition of "foreign currency assets" has been expanded from forward, swap and options transactions to include

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receivables and inventory, in addition to cash, giro, saving, deposit, marketable securities and claims.. The Amended Regulation also clarifies the definition of “foreign currency liabilities” to expressly exclude liabilities which are in the process of being rolled over or refinanced.

The addition of receivables and inventory to the definition of foreign currency assets appears to be targeted at Indonesian companies whose products are denominated primarily in foreign currency, such as commodities and natural resources. These businesses may now count the value of their foreign-currency denominated inventories and receivables against their overall hedging and liquidity obligations, thereby reducing the amount of the overall foreign currency exposure that they will have to hedge. However, some ambiguity remains in the specifics of how these new guidelines are to be implemented. For example, an Indonesian company that purchases raw materials in US dollars, Euros and Japanese yen may well find itself struggling to determine the “true” value of its “foreign currency assets.” Similarly, businesses whose products are sold both domestically and internationally will need to develop a convincing methodology to determine what portion (if any) of their inventory can be offset against their foreign currency liabilities. The inclusion of claims from forward, swap and option transactions has also been carried over to the Amended Regulation without any additional guidance, raising significant questions as to how these assets are to be valued. In the case of options, for example, whether a “claim” refers to the present value of the option as at the end of the quarter, or the underlying notional amount of the contract, will substantially impact the final calculation of both the hedging and liquidity ratios for many Indonesian borrowers, depending on how they choose to hedge their exposures.

In addition, the Amended Regulation has removed the general exclusion permitted under the Original Regulation for offshore loans that were extended in the form of “trade credits” (which were previously defined as credit facilities provided by offshore suppliers relating to specific goods and services transactions). This change means that foreign-currency supplier credits will count as offshore liabilities for purposes of the hedging and liquidity requirements of the Amended Regulation. In its place, BI has introduced a new exclusion to exempt certain qualified non-bank institutions that record their financial statements in US dollars from the Amended Regulation’s hedging requirements. The Circular Letter further clarifies this new exclusion by imposing the additional requirements that borrowers seeking exempt status must have an export to total revenue ratio in excess of 50 percent, as well as explicit approval from the Ministry of Finance.

BI has also provided a carve-out for smaller businesses by introducing in the Circular Letter a minimum threshold of USD100,000 or its equivalent. Borrowers whose foreign currency liabilities exceed their foreign currency assets by less than this minimum amount will be exempted from the hedging requirements of the Amended Regulation.

The Amended Regulation introduces an important new refinement — a requirement that all hedging transactions must be conducted with Indonesian banks, effective 1 January, 2017. This new rule appears to be in line with BI’s recent efforts to build the domestic foreign exchange markets and reduce currency volatility, and likely signals that these objectives will continue to drive regulatory changes in 2015. Given the nascent state of the domestic foreign-exchange derivatives market in Indonesia, much will need to be done in the coming years in order for this requirement to be practically feasible for both Indonesian borrowers as well as Indonesian banks.

Credit rating requirement loosened; exclusions expanded

One of the Original Regulation’s most controversial elements was its imposition of a minimum “BB” credit rating requirement on Indonesian non-bank borrowers who incurred foreign-currency external

indebtedness starting from 1 January 2016. The Amended Regulation and the Circular Letter contain a twofold response to these key concerns.

First, the Amended Regulation clarifies that the minimum "BB" ratings requirement that was previously imposed by the Original Regulation includes a rating of "BB-" as the minimum acceptable rating. More importantly, the Circular Letter includes a crucial clarification that credit ratings provided by domestic rating agencies will be treated equally to those of foreign or international rating agencies. Given that domestic rating agencies in Indonesia historically have provided ratings that are significantly more favorable than ratings granted by international rating agencies. This statement of policy likely will spur Indonesian issuers to seek ratings from domestic rating agencies.

Neither the Amended Regulation nor the Circular Letter provides any specific guidance as to whether BI would accept a "BB-" rating from a domestic rating agency which is issued alongside of a lower rating from an international rating agency. Foreign investors will continue to focus on this area, particularly because cross-border debt capital markets deals typically require ratings from international rating agencies in order to be marketable to investors.

Of the 21 international debt capital markets transactions that Indonesian issuers completed from 2010 to 2014, 15 were rated below the "BB-" specified minimum by one or more international rating agencies. There is thus a significant likelihood that issuers will encounter "split" ratings where their corporate rating from Pefindo may exceed the "BB-" minimum, even as international agencies rate their debt securities well below that threshold. BI has not given any clear guidance as to how it would deal with such "split" rating situations, but if this trend continues we expect that Pefindo could experience significant pressure over time to align its ratings with those of the larger international agencies. This would once again cause the rating requirement in the Amended Regulation to become an increasingly significant barrier for Indonesian enterprises seeking to access the international debt markets.

Secondly, the Amended Regulation and the Circular Letter significantly expand the categories of exemptions from the minimum ratings requirement to include the following:

- External foreign currency indebtedness used to refinance existing external foreign currency indebtedness. The Circular Letter clarifies that this exemption is available for refinancings of external indebtedness if the amount of the refinanced indebtedness does not increase by more than US$2 million or five percent of the original indebtedness (whichever is greater).

- External foreign currency indebtedness for the financing of infrastructure projects if (a) all funds are borrowed from bilateral or multilateral international creditor agencies; or (b) the loan is syndicated and more than 50 percent of the financing commitment is provided by international creditor agencies. The Circular Letter specifically defines "international creditor agencies" to include government agencies, autonomous public agencies, export credit agencies and multilateral players, such as USAID, Exim Bank, EDC, KfW, JBIC, JICA, IMF, IBRD, IFC and ADB.

- External foreign currency indebtedness for the financing of infrastructure projects of central or regional governments.

- External foreign currency indebtedness secured by bilateral or multilateral international creditor agencies.

- External foreign currency indebtedness in the form of trade credits.

- External foreign currency indebtedness in form of any other loan which cannot be classified as a loan agreement, debt securities or trade credits. The Circular Letter explains that this category includes other indebtedness such as insurance claims and dividends which have been confirmed or declared, but not yet paid.

The addition of syndicated project loans, as well as indebtedness secured by international creditor agencies, to the list of exempted indebtedness should be a particularly welcome addition for infrastructure and project financings. However, given that these exemptions apply only to the credit rating requirement, borrowers and lenders will still need to carefully consider the structuring of payments and debt service accounts to satisfy the Amended Regulation's hedging and liquidity ratio requirements.

BI has also included some useful guidance in the Amended Regulation to permit Indonesian borrowers to rely on their issuer ratings when incurring external indebtedness, rather than having to obtain issue-specific ratings for each tranche of external indebtedness. However, as discussed above, some ambiguity remains as to how BI would view "split" ratings, or issuers whose debt securities are rated below the "BB-" threshold — even if those issuers had previously obtained "BB-" or higher ratings that were technically still within the two-year validity period.

The Amended Regulation includes additional stipulations that all ratings will be valid for a maximum of two years after they have been issued, and Indonesian borrowers who incur debt with credit support from their holding companies are permitted to rely upon their holding company's credit rating. The Circular Letter further provides that borrowers incorporated within a joint venture scheme may rely on the majority shareholder's credit rating.

Compliance and enforcement unchanged

The compliance and enforcement provisions from the Original Regulation have been left unchanged in the Amended Regulation. Non-bank institutions in Indonesia are required to submit quarterly reports to BI detailing their hedging and liquidity ratios for each quarter, commencing from the end of the first calendar quarter of 2015. In addition, commencing in the last quarter of 2015, BI will begin imposing administrative sanctions in the form of warning letters to "related parties" in the transaction, including to the lenders who are providing the non-compliant debt, the Ministry of Finance, the Minister of State Owned Enterprises (in the case of borrowers that are state-owned enterprises), the Financial Services Authority (OJK) and the Indonesia Stock Exchange (in the case of listed-company borrowers).

Conclusion

As noted above, the Amended Regulation and the Circular Letter represent a step forward in clarifying how the new rules will be implemented. BI's refinements to the hedging and liquidity requirements of the regulation help to address some of the Original Regulation's practical deficiencies. Similarly, the clarifications to the rating requirement should give investors and borrowers a better sense of how BI intends to enforce the controversial minimum rating requirements for offshore debt.

Much of the controversy surrounding the Original Regulation arose from concerns that it would restrict access to the foreign debt markets to a small minority of borrowers in Indonesia. By clarifying the impact of the new hedging, liquidity and the minimum rating requirements, the changes in the Amended Regulation and the Circular Letter appear to leave some room for seasoned Indonesian borrowers, particularly those that have substantial foreign-currency business dealings, to access the foreign debt markets. However, many Indonesian businesses will remain unable to amass the necessary liquidity or to obtain the appropriate minimum ratings, and consequently will be limited to the Indonesian domestic financing markets to satisfy their need for growth capital. This accords with BI's stated objective of

reducing the overall exposure of Indonesian borrowers to the currency and liquidity risks which result from an overdependence on foreign capital. However, the new regulation's key underlying risk remains — that it will entrench the position of larger Indonesian enterprises at the expense of smaller businesses. This will have significant implications for Indonesian enterprise as a whole, and could have a long-term impact on how investors perceive Indonesian credits.

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Endnotes

[1] For information regarding the Original BI 16 Regulation, see Latham & Watkins Client Alert Number 1766, "New Bank Indonesia Regulation Imposes Significant Limitations on Foreign Borrowings by Indonesian Companies," 11 November 11 2014.