Dynamics of the Insurance Policy Protection Program

Lucyana Delarosa, S.H. and the MKK Insurance team

The OJK has been endeavoring to adapt Indonesian accounting standards to those of *International Financial Reporting Standards* (the "**IFRS**"). The local accounting standards – the Indonesian Financial Accounting Standards are to conform to IFRS ones for the sake of transparency and integration into the world financial system.

In addition, in another move to foster such integration, Indonesia is mulling over its planned *Policyholder Protection Program* (the "**Program**"). Implementing the Program would go a long way in helping the country adopt international best practices, and the benefits for insurance companies and policyholders are unquestionable. This program is mandated in the New Insurance Law, i.e. Law No. 40 of 2014 (the "**New Law"**), which calls for all insurance and Sharia insurance companies to be members of the Program.

> *Article 53: (1) Perusahaan Asuransi dan Perusahaan Asuransi Syariah wajib menjadi peserta program penjaminan polis. (Insurance and Sharia Insurance companies shall be participants in the policy guarantee program).*

The exact details of the program, financing requirements, conditions, requirements, commitments, etc. will be set out in a new law not later than three years as of the date of promulgation of the New Law.

> *Article 53: (4): Undang-undang sebagaimana dimaksud pada ayat (2) dibentuk paling lama 3 (tiga) tahun sejak Undang-Undang ini diundangkan. (The law referred to in paragraph (2) will be set out at the latest 3 (three) years after this law was promulgated.)*

By virtue of the New Law, every insurance company has to become a member of the Program. The Program will be modeled after the *Indonesian Deposit Insurance Corporation* (www.lps.go.id), which applies to the banking sector. The Program will require insurance, reinsurance, Sharia insurance and reinsurance companies to disburse all claims without exception.

When the Program goes live, the obligation to maintain separate Guarantee Funds will cease. The Program will take on the role of a collective back-up fund to settle claims or as a remedy to insolvencies, and thus, there will be no further need to maintain a separate company-funded Guarantee Fund:

> *Article 53 (3) Pada saat program penjaminan polis berlaku berdasarkan undang-undang sebagaimana dimaksud pada ayat (2), ketentuan mengenai Dana Jaminan sebagaimana dimaksud dalam Pasal 8 ayat (2) huruf d dan Pasal 20 dinyatakan tidak berlaku untuk Perusahaan Asuransi dan Perusahaan Asuransi Syariah. (When the guarantee program policy goes into effect on the basis of the law referred to in paragraph (2), the provisions regarding the Guarantee Fund referred to in Article 8 paragraph (2) d and Article 20 shall be declared to no longer be in effect for insurance and Sharia Insurance Companies.)*

Not only would introduction of such a Program bring Indonesia more in line with international practice, but it would also foster ASEAN AEC integration and put the country in line with its regional peers. For example, Singapore already has such a program which was instituted in 2011. The Singapore program, the **SDIC (**www.sdic.org.sg), started officially in 2005 to cover the deposits of registered banks up to S$50,000 but by 2011, insurance was added as well to guarantee the pay-outs of claims. Coverage for insurance companies includes all individuals, companies, and non-legal entities, such as associations, et al, up to a certain capped amount.

Securitization: setting the stage

The MKK Securitization Team

Securitization is a sophisticated financial action and is intended to effect a true sale of a security comprised of future receivables from originator to investor. While removing the asset from the balance sheet of the originator, securitization allows him to sell an illiquid asset by turning it into a security paid from the ongoing collection of receivables. This can have many benefits for the originator, such as reducing currency risk, country risk and credit risk, among others, while investors can obtain higher returns for assuming these risks. It can be a strategic and relatively inexpensive way of raising capital compared to issuing other debt and equity securities. Oftentimes an SPV will be created as a platform to hold the securities, especially if they are debt securities, or if the investor is an offshore entity. Moving the securities offshore may also provide a benefit by separating the asset from the originator who may be subject to unfavorable terms because of his location, political risk, currency risk, among others. There are dangers, as evidenced by the US mortgage crisis, where lax supervision and ratings of securities led to a major financial crisis. Oversight and strict valuation standards in performing asset valuations are thus imperative.

1. Legal regime

Indonesian law is largely open to the concept of securitization and certain conceptual structures exist that enable its use. A true sale of securitized assets is acknowledged, evidenced by the fact that they are not deemed to be part of a bankruptcy estate, for example. Although the OJK now has supervisory powers over the securitization market, Bank Indonesia, Bapapem and the Tax Office have all issued various regulations in respect of securitization, notably:

1. Law No.8 of 1995, regarding the Capital Markets
2. Bapepam Regulation No.V.G.5, regarding Investment Manager Functions Relating to Asset-Backed Securities
3. Bapepam Regulation No.VI.A.2, regarding Functions of Bank Custodians Related to Asset-Backed Securities
4. Bapepam Regulation No.IX.C.9, regarding Registration Statement for Asset Backed Securities in a Public Offering
5. Bapepam Regulation No.IX.C.10, regarding Guidelines for Form and Content of Prospectus for a Public Offering of Asset Backed Securities

6. Bapepam Regulation No.IX.K.1, regarding Guidelines for Asset-Backed Securities in a Collective Investment Contract
7. Bank Indonesia Regulation No.7/4/PBI/2005, regarding Prudential Principles in Asset Securitization for Commercial Banks
8. Decision of the Director General of Tax Number Kep-147/PJ/2003 dated 13 May 2003, regarding Tax Take over Taxable Profit from Receivables from KIK–EBA and Various Investments

In the late 1990s, international investment banks promoted securitization as a solution to Asia's financing problems and embarked on a tour of Asian capitals to promote the practice. Bapapem took interest in securitization and issued a reg in 1997 that created a structure called a KIK-EBA (*Kontrakt Investmen Kolektif – Beragun Efek Aset, "**KIK**"*) which was meant to foster the securitization market.

Unfortunately, certain structures built into the reg led to a situation which made it very difficult to actually carry out securitizations: for one, The Bapapem reg established the KIK as a contractual arrangement between two parties: as such, there was no provision for an SPV which was not deemed to be necessary. The reg stipulated that the KIK was between an investment manager and the custodian (the bank). However, the concept of a manager was perhaps incorrectly formulated since there is little to manage: a securitization is not a mutual fund whose composition is ever changing and requires supervision: the receivables in a securitization are determined at the outset and do not change.

However, it does constitute a bankruptcy-remote structure with which securitizations can be carried out (neither the custodian nor the manager can attach the receivables, which are not included in a bankruptcy estate). There is legal certainty as to the nature of the receivables as well, since in the eight laws and regulations cited above, the various receivables that are eligible for securitization have been stipulated to be, among others, motorcycle leasing receivables, credit card receivables, mortgage receivables, commercial paper receivables and any other future receivables. Thus, the stage was set.

The Asian Financial Crisis unfortunately changed the financial scene, and the instability and inherent currency risk greatly dampened enthusiasm for the securitization model. Asia recovered from the crisis, albeit slowly, and the topic of securitization slowly made the rounds again.

BI Reg 7/4/PBI/2005 dated 20 January 2005 on Prudential Principles for Asset Securitization Activities was promulgated to encourage securitization and in 2009, a revision to the 1997 Bapapem reg was made, which better defined the role of the manager and made provision for the establishment of an onshore SPV for a quasi-mutual fund. The first publicly-listed securitizations were carried out in Indonesia at around this time by Bank Tabungan Negara, BTN, a state-owned bank, in relation to the securitization of housing mortgages from up until 2013.

2. Examples of private securitizations

In fact, many securitizations have been carried out in Indonesia, although mainly on the basis of a private sale. Over the years, MKK has assisted in a number of securitization transactions, such as:

1. The securitization of Citibank credit card receivables – being the first on-shore Indonesian law securitization transaction (1990);

2. Advising the Ministry of Finance on debt securitization legislation (1990s);

3. Advising Deutsche Bank in a the sale of a portfolio of motorcycle loans of PT Summit Otto Finance Asset Purchase in the amount of US$4.1 million for securitization (1996);

4. Representing the arranger (PT ABS Finance) and the trustee (Chase) in the securitization of the auto loan receivables of Bunas Finance (1997);

5. US$900 million offering of structured export notes by IndoCoal Exports (Cayman) Limited, under a modification of its structured export notes program established in 2005, backed by coal sale receivables of PT Kaltim Prima Coal and PT Arutmin Indonesia, two Indonesian coal producing subsidiaries of Bumi Resources (October 2006). This transaction was awarded "*SE Asia Structured Finance & Securitization Deal of the Year*" for 2006 by **Asian Legal Business**;

6. Advising a major Japanese bank on a potential securitization arrangement (2009)

No government approval is required if the transaction is not a public one (there is only a reporting requirement to the OJK). It is a simple process between two private entities that memorialize their agreement in a Sale and Purchase agreement which is executed by a cessie. In the absence of a law on securitization, the law firm handling the transaction must structure it according to existing legal structures to be found in the eight laws and regulations listed above. Creating an SPV is often a problem since such a structure does not exist in Indonesian law. The concept of a trust, whereby there is an owner/trustee who disburses proceeds to investors, cannot be used since it also does not exist in Indonesian law. As a result of the foregoing, complete legal and conceptual structures that would encourage and enable securitization are currently not clearly set out in a stand-alone piece of legislation.

3. OJK draft: dress rehearsal

However, this may change: the OJK recently issued a very sophisticated working paper pertaining to securitization, signaling that it is preparing to issue a regulation in this regard ("Proposed New Reg"). The OJK working paper (the "Paper") deals with a list of definitions that cover concepts and terms in securitization, including ratings, tranches, supervision, oversight and many other concepts that are essential to establishing the legal regime for securitization.

Interestingly, not only is the concept of securitization dealt with in the Proposed New Reg, but also that of synthetic securitization. Synthetic securitization is sometimes referred to as a 'non-true sale securitization", an apparent oxymoron. However, it is a useful instrument used in the West to spin off credit risk from assets, while retaining those assets on one's balance sheet. Another way of thinking of synthetic securitization is of a credit protection contract. The originator (the bank) and the investor enter into a contract whereby credit risk (and sometimes also currency and political risk) is shifted from the originator to the investor, leaving however the securities on the balance sheet of the originator. This is an important nuance because banks are often subject to onerous minimum asset balance sheet requirement and this allows them to free up capital that otherwise would have been shifted off their balance sheets. This move generally improves their liquidity and has other benefits as well.

Conclusion

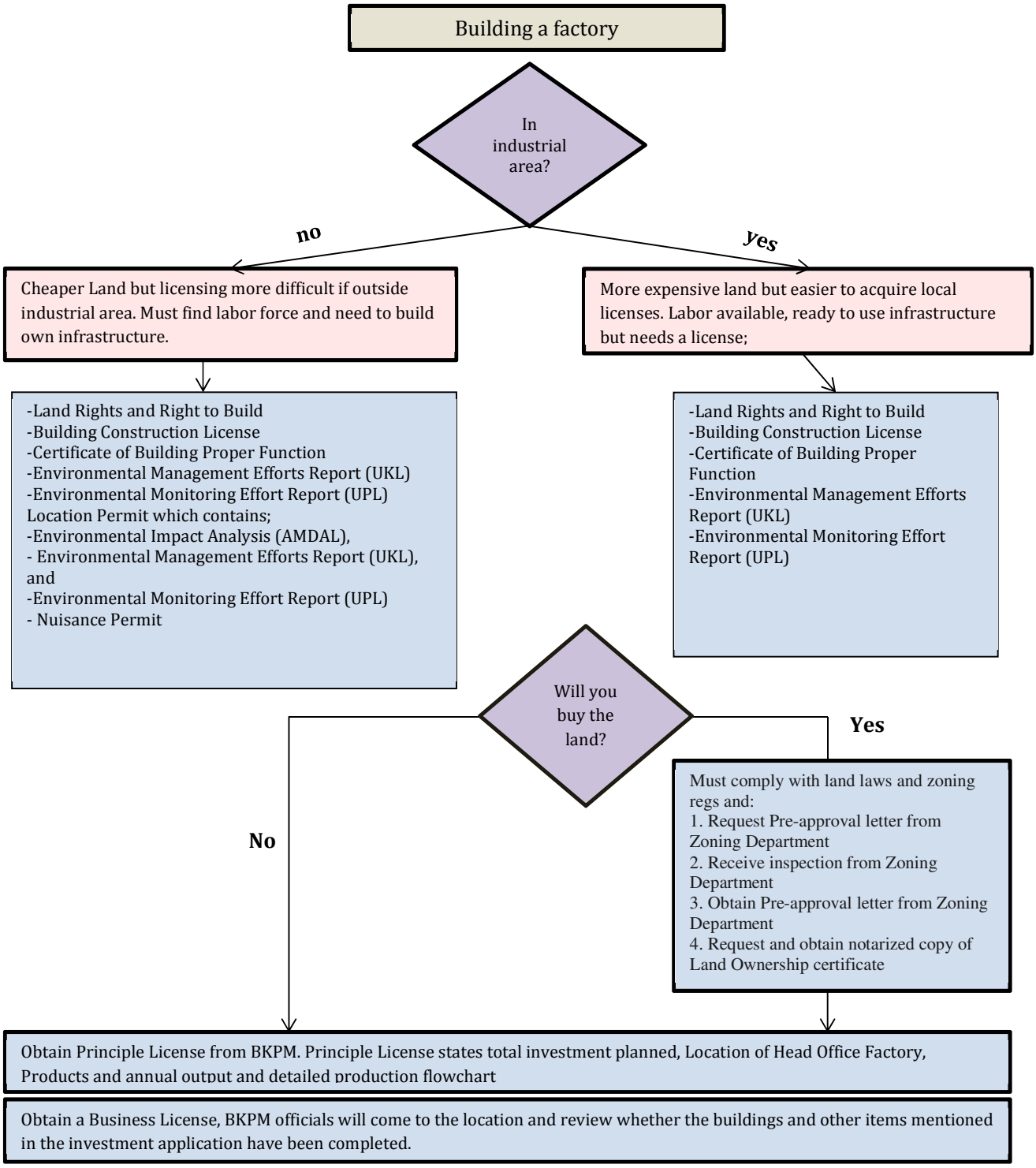
We hope that going forward the issuing of the Proposed New Reg will contribute to the OJK's avowed aim of deepening the financial markets in Indonesia and of providing new and effective tools to raise capital and to improve financial efficiency.

It has been a long time since the last cross-border securitization and the time is perhaps now ripe for a new series of such transactions. Local banks and insurance companies are looking for new asset classes to invest in and if the legal regime is established, local and foreign buyers would potentially be interested.

Securitization and synthetic securitization, if regulated and monitored correctly, can be useful instruments and bolster the country's banking sector. In addition, if an international securitization can be developed, it will provide financing for car loans and mortgages, thus lowering interest rates for consumers. The OJK must be careful to learn from the mistakes of US regulators and create a system for oversight that will properly rate and monitor the quality of securitized receivables. Assessment and monitoring become difficult when second and third layers appear. The Proposed New Reg thus offers many new opportunities that prospective buyers and sellers of future receivables should take note of.

Factory construction

MKK team (with research by Siti Nabila)



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