

The Problems of Structured Product and its Regulations in Indonesia

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Abstract

Derivative is one of financial innovation product. Development of that derivative innovation has facilitated the growth of financial types, especially financial instrument in structured product. This derivative transaction have raised many problems in 2008 in Indonesia, some of them put derivative transaction as a gambling. Derivative transaction is like two sides of a coin. The first side could be hedging. As a hedging means there is a guaranteed value of wealth which gives security from currency fluctuation. While the other side being speculative product that has gambling unsure. Since derivative (structured product) dispute in 2008-2009, Monetary Authority has issued Bank Indonesia Regulation. PBI No. 11/26/PBI/2009 that established on 1st July 2009, about the principles of prudential regulation on implementation of structured product activity by commercial bank. Then the regulation followed by another regulations related to principles of prudential regulations of derivative transaction. All of these regulations contain are prohibitions. The thesis will be discussed about the efficient rules made should not only contain prohibitions, but also the advantages, how to make parties better off than they were before. Therefore it is hoped with efficiency achievement, law will be as a tool of social engineering in Indonesia.

Keywords: Structured Product, Hedging, Efficiency, Prudential Regulation

Introduction

The end of fixed exchange rate in the world (Bretton Woods Agreement) has contributed to development of derivative products globally. Rapid financial innovation from those banking sector has led to development of derivative products in Indonesia. Development of that derivative innovation has facilitated the growth of financial types and instrument structures, including the high-complexity one, especially financial instrument in structured product type. Derivative transaction is an output of financial innovation and financial system globalization, "Development of derivative products considered as a revolution that as important as industrialization." Foreign currency derivative transaction is one of example of financial reconstruction which involved technology to cross over countries (cross border), which is called sui generis (unique in its characteristics) :

1. Defined as a sophisticated yet risky output of financial innovation development.
2. Globally and involving many different law jurisdiction

3. Due to derivative transaction sophistication, therefore there is no special regulation derivative contract as a named agreement, where as using freedom of contract.

Law No. 24 year 1999 on Foreign Exchange and Exchange Rate System (Foreign Exchange Law), defined as an important momentum to Indonesia entry to free trade and exchange regime. Regulation in that law caused foreign exchange system and foreign exchange rate in Indonesia went liberally. Free-floating exchange rate made currency exchange movement is volatile. High volatility has caused problems of derivative contract regulation on 2008. That was foreign exchange derivative problem, which was proposed by Bank to customer, was not a hedging product but a speculative one. Different from hedging, structured product aim is to acquire income or return enhancement that forced purchase and sales transactions of foreign exchange to Rupiah for a speculative aim, which was expected from rupiah's instability. Based on Bank Indonesia's data on December 2008, total of foreign exchange transactions were 40.9 trillions rupiah from total of derivative products' value of 60-70 trillions rupiah.

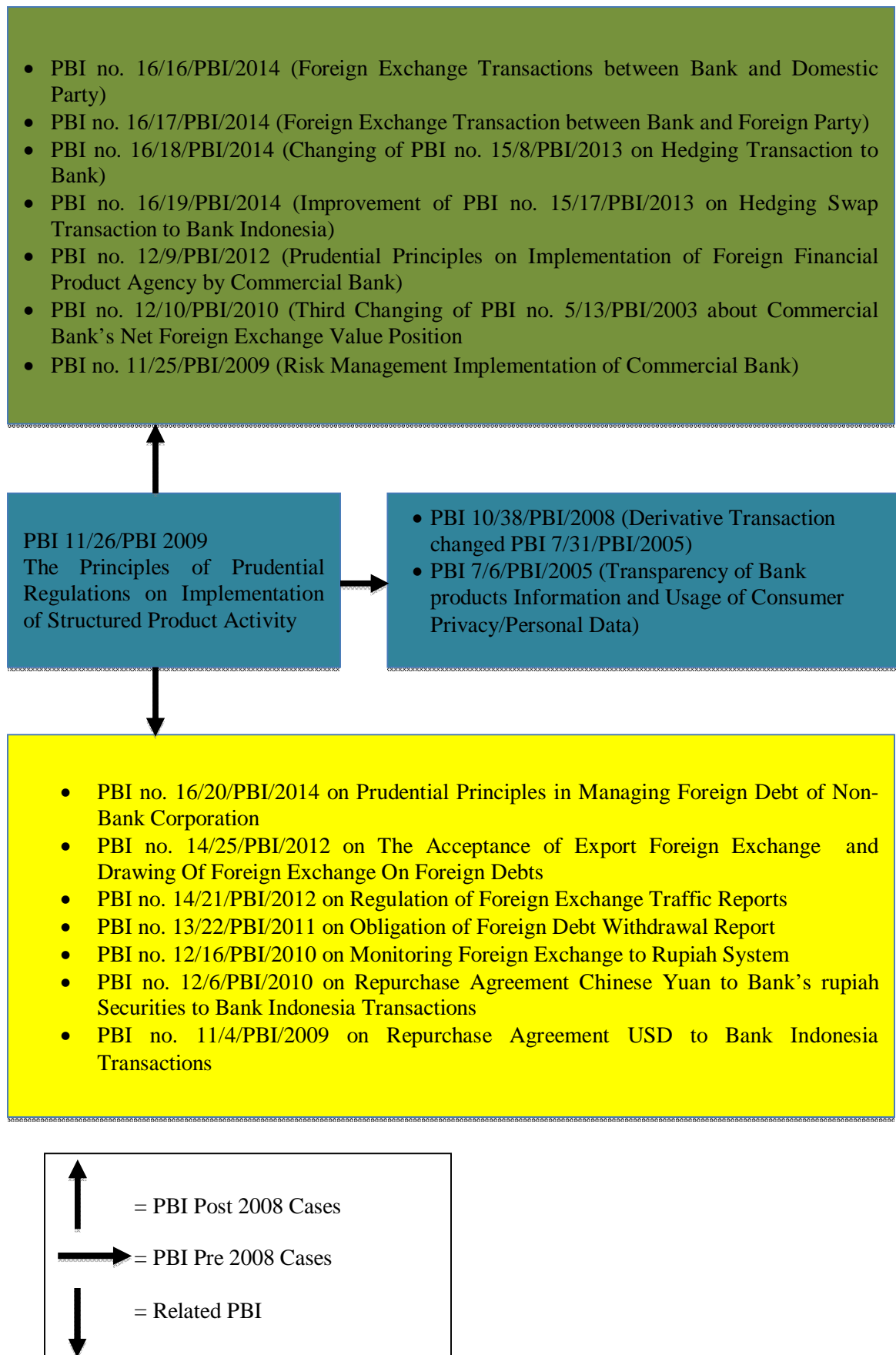
Monetary crisis in Indonesia on 2008 has caused problems, banking system turned fragile, and causing fluctuation of currency exchange changed into private sectors crisis and banking crisis, which led to many dispute of foreign exchange derivative transactions (structured product) in Indonesia. Customers are felt disadvantaged and accused Bank claimed Bank did misused of condition (misbruik van omstandigheden – undue influence). One thing that was interesting to analyze is every accusation based on the same reason, which is Bank has manipulated product by proposing hedging that was speculative product. Some of foreign exchange derivative cases which were interested due to financial crisis on 2008 that are:

1. Case “PT Toba Surimi Industries (SURIMI) vs. The Hongkong and Shanghai Banking Corporation Ltd (HSBC)”
2. Case No. 3162/K/Pdt/2011 “PT. Gunung Bintan Abadi vs. PT. Bank CIMB NiagaTbk.”
3. Case No. 859K/Pdt/2013: Standard Chartered Bank vs. PT. Nubika Jaya
4. Case No. 398/Pdt.G/2010/PN.Jkt.Sel “PT. Citoputra Indoprime vs PT. CIMB NiagaTbk (dhl. PT. Bank LIPPO Tbk)”
5. Case no. 708K/Pdt/Sus/2009 “PT. Bank Danamon Indonesia Tbk vs. PT. EsaKertas Nusantara”

Lesson learned from those cases on 2008 is derivative transaction is like two sides of a coin, the first side could be hedging which gives security from currency fluctuation, while the other side being speculative product that has gambling unsure. According to those experiences, regulator needs to give attention in derivative advances by highlighted on derivative benefits that give security by making derivative rules. Rules made should not only contain prohibition, but also if beneficiary, there should be made about obligations to using derivative as hedging. Regulator should be stated weaknesses and strengths of derivative products to public, such as:

1. Risk problems related to derivative products
2. Uncertainty of law due to unclear or insufficient regulations, especially in straightening and strengthen hedging, thus will divided clearly between hedging and speculation.
3. Open access information for market participator and regulator (public disclosure)
4. Consumers' Protection especially retail unsophisticated (investor protection)

Since derivative (structured product) dispute in 2008, Monetary Authority has issued Bank Indonesia Regulation (Peraturan Bank Indonesia or PBI). One of the PBI, which importantly regulated foreign currency derivative, is PBI No. 11/26/PBI/2009 that established on 1st July 2009, on the principles of prudential regulation on implementation of structured product activity by Commercial Bank. Then followed by another regulation related to principles of prudential regulations of derivative transaction. Numerous regulations after foreign exchange derivative transaction cases happened, include of regulation that straightly regulate about derivative transaction and other supporting regulations, which connected to foreign exchange derivative transaction. Based on those regulations issued by Bank Indonesia, are these:



If we analyzed further, even though regulations related to ruled derivative are in common, the truth are those are functioning in tightening foreign derivative transaction accessibility, especially structured product, such as prohibition of structured product's marketing, allowed structured product must based on base variable which is exchange value and/or interest rate. Based on law regulation codification data, which involved derivative transaction, are already in common, but those are not sufficient in giving positive impact to development of derivative laws. In other words, prohibition acts are already stated, but obligation in using derivative, as a hedging is not stated explicitly. Therefore, law as a tool of social engineering is not functioning properly. Those rules are not supporting establishment of monetary stability. One of the examples is there is no obligation for people to hedging in nation that allowing free floating rate system, is a danger that suddenly can occurred and threatened nation's monetary stability.

Based on Bank Indonesia's data, total value of foreign exchange derivative transactions on Financial Crisis 2008 was reaching 60-70 trillion rupiahs. Compared to 2014, foreign exchange derivative transactions in Indonesia have some significant growth, valued on 193.6 Billion USD in Q3 2014. However, if we split the composition of forward hedging, were only 5%, or 9.7 Billion USD and swap hedging were 23% or 44.5 Billion USD, and the rest which are not hedged are 72% or 139.4 Billion USD. Those data are becoming one of the reason there is an obligation for a nation that follow free foreign exchange and floating rate system regime, to obligate people or firm to hedging as an obligation or foreign debt which will be due soon. If hedging was not an obligation, monetary stability is hard to achieve. Below is USD vs. Rupiah fluctuation rate period September 2014 to March 2015:



Source: www.yahoo.com

Monetary instability of a nation is an obstacle for incoming investment. Investors' considerations to avoid investing in a nation, which have low currency value and unstable, is their reason to avoid currency risk. In order to avoid currency risk, it is necessary to prepare good hedging rules. Hedging is becoming a nation need with fast growth emerging market, such as Indonesia. Economy weakening or higher economy risk are causing capital outflow. However incoming capital inflow are larger into money market and stock market, not in real investments, therefore if economy risk is increases, foreign money are go back immediately as hot money. It can be said that without good hedging facilities will be hard to expect international investors. When derivative are aimed as a hedging, therefore derivative itself called financial engineering. Hedging means there is a guaranteed value of wealth, in other words, wealth received is genuine.

Foreign exchange derivative transaction usually called "zero sum game", because there is a winning side and in the other side of the world, there is a losing side. Thus, some people called there is a speculative issue in this transaction, even some of them put derivative transaction as a gambling. This paradigm should be straightened because this will lead to a law consequence that is not suitable with derivative transaction nature. In order to know the difference between derivative transaction and gambling, it is needed to understand the concept of "trading" in derivative transaction. Trading concept will differentiate between derivative transactions with gambling games.

Trading concept in derivative transaction involving trading strategic elements, price changing factors, fundamental analysis, technique analysis, how to deal with loss, and timing.

In order to support writer's arguments that hedging act is a right act to a nation with a free foreign exchange and floating rate such as Indonesia. Writer will measure pareto cost efficiency, which is a rational option to allocate the most valuable resource. In economic analysis, efficiency in this case is focused on to ethic criteria in order to establish social statements (social decision making) that related to control human welfare. Philosophically, a company with no profit will not be able to survive at least in the same type and owner. Company should gain sufficient profit to pay interest rate, currency loss cost and others. On the other hands, an operated company has corporate social responsibilities in order to maintain foreign exchange demand and supply by hedging foreign debt that will be due soon. With this method, company will help to maintain Rupiah stability, which will give positive impact of Indonesia's macroeconomics and rupiah stability.

The pareto approach may seem to offer a solution to the problem of measuring satisfaction. A change is said to be pareto superior if it makes at least one person better off and no one worse off. Such a change by definition increases the total amount of (human) happiness in the world. The advantage of the pareto approach is that it requires information only about marginal and not about total utilities. And there seems ready at hand an operational device for achieving pareto superiority, the voluntary transaction, which by definition makes both parties better off than they were before.

Economic analysis used is based on number assumptions on profit and loss financial report, which gave clear and real map to micro condition that hoped as a main consideration in stated macro regulation or regulator principle to state hedging protection rules, personal or companies which have foreign debt but rupiah profit, as follows:

1. First Scenario (Hedging)

"PTA" is an importer company; purchased a machinery amount of 700,000 USD from United States dated 2 January 2014. Payment of that machinery funded by import credit from "Bank B" amount of 700,000 USD with due date which must paid in full amount of 31 December 2014. Interest rate is 6% per annum. With security reason of debt payment, "PT A" conduct hedging, which is forward contract with "Bank B" to purchase 700,000 USD as debt due date on 31 December 2014. Bank will decide the currency forward for that transaction is 10,700 Rupiah / 1 USD, thus on the due date "PT A" should pay total forward rate as Rp. 7,490,000,000. This calculation is come from:

$$\text{Forward Rate} = \text{Spot Rate} + \text{Premium}$$

$$\text{Rp. 7,490,000,000.} = (\text{Rp. 10,000.} + \text{Rp. 700.}) \times \text{USD 700,000.}$$

On forward due date at 31 December 2014 there is a depreciation that made currency rate at Rp. 13,000 / 1 USD. Thus, "PT A" is gain profit Rp. 2,300. / 1 USD or Rp. 1,610,000,000. (Rp. 2,300 X USD 700,000.) Therefore, "PT A" income statement is:

"PT A"		
Income Statement		
31 December 2014		
Remarks	In Rupiah (Rp.)	Percentage (%)
Net Sales	10,000,000,000	100%
Cost of Goods Sold	(7,000,000,000)	-70%
Gross Profit	3,000,000,000	30%
Operating Cost	(1,000,000,000)	-10%
Operating Profit	2,000,000,000	20%
Bank Interest Rate Cost	(420,000,000)	-4.2%
Hedging Cost	(490,000,000)	-4.9%
Net Profit	1,090,000,000	10.9%

First Scenario explains rational calculation with usage of pareto cost efficiency, which by using hedging facility "PT A" gain profit about 10.9% even though there is Rupiah depreciation of 30% from Rp. 10,000 / 1 USD to Rp. 13,000 / 1 USD.

2. Second Scenario (Non-Hedging)

In this scenario, a Rupiah-based company “PT C” did not saving or hedging their debt from “Bank B” amount of 700,000 USD with interest rate of 6% per annum. This will be due at 31 December 2014. “PT C” predicted that Rupiah will be stable to United States Dollar on Rp. 10,000 / 1 USD. From that prediction, “PT C” preferred to purchase Dollar on the spot by the due date. But, “PT C” prediction is not correct because there was a depreciation from Rp. 10,000 / 1 USD to Rp. 13,000. / 1 USD. Therefore, “PT C” is get currency loss amount of Rp. 2,100,000,000. (Rp. 13,000 X 700,000 USD). Therefore, “PT C” income statement is:

“PT C” Income Statement 31 December 2014		
Remarks	In Rupiah (Rp.)	Percentage (%)
Net Sales	10,000,000,000	100%
Cost of Goods Sold	(7,000,000,000)	-70%
Gross Profit	3,000,000,000	30%
Operating Cost	(1,000,000,000)	-10%
Operating Profit	2,000,000,000	20%
Bank Interest Rate Cost	(420,000,000)	-4.2%
Hedging Cost	(2,100,000,000)	-20.1%
Net Profit	(520,000,000)	-5.2%

Second Scenario explains that company had currency loss of 5.2% due to company is not using hedging for their debt caused by Rupiah depreciation of 30% from Rp. 10,000 / 1 USD to Rp. 13,000 / 1 USD.

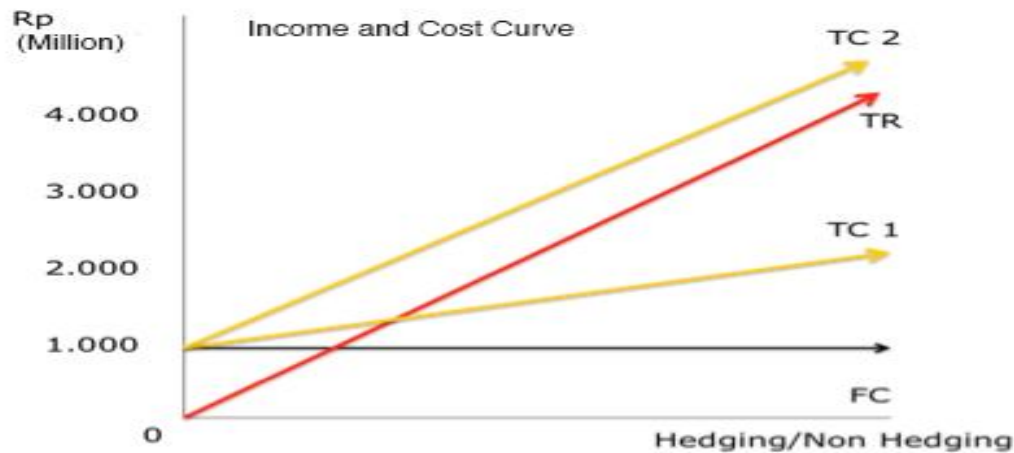
Comparison of efficiency level calculation based on first scenario “PT A” and second scenario “PT C” is clearly visible in Cost Structured Analysis Table to measure comparison of cost between company who uses hedging and non-hedging as follows:

Cost Structured Comparison Analysis Table

Hedging PT A and Non-Hedging PT C

Cost Structured Analysis	Comparison (Rupiah)		Efficiency D=(B-C)
	Non Hedging (PT C)	Hedging (PT A)	
A	B = (TC 2)	C = (TC 1)	D
TR	(520,000,000)	1,090,000,000	1,610,000,000
TC	3,520,000,000	1,910,000,000	
TVC	2,520,000,000	910,000,000	
FC	1,000,000,000	1,000,000,000	0

Curves below showed comparison between Total Cost of two companies, “PT A” with TC1 line and “PT C” with TC2 line. These two comparisons in a curve showed income curve and cost curve. In microeconomics analysis that still feasible, in terms of revenue is written with TR. Compounding of two costs which usually constant fixed cost and changing cost due to currency exchange or variable cost is called total cost or TC. If company has TR line above TC line that means company still receives profit, however if TR is below TC line that means company had loss.



Based on analysis and rational consideration of Economic Analysis of Law of “PT A” and “PT C” scenarios, which are hedging and non-hedging, we can deduct a conclusion, hedging is a win-win solution which both parties have better efficiency to people, Bank, and Nation to avoid risk of loss of foreign exchange derivative transaction. This conclusion is needed to convince people that hedging option is a good option because:

1. For consumer, hedging will give benefit to parties who have foreign debt, because can predict and calculate the profit will be gained in the future, so will be avoided form uncertainty of currency exchange fluctuation.
2. For Bank, hedging obligation for consumer is a prudential act to maintain bad debt due to Rupiah depreciation.
3. For Nation, hedging in macroeconomics are able to maintain monetary stability and guarantee foreign currency availability in market is predictable.

Therefore, hedging is a right way to allocate the most valuable resources for consumers, bank, and government. Based on those consideration, writer suggested that law and regulations are made in order to hedging used by personal use or companies could be settled and will give positive and significant impact in order to maintain monetary stability in Indonesia.

Based on above pareto efficiency analysis result, concluded that hedging act give positive impact to people, bank, and regulator. However, based on law side, there are still problems that should be fixed in hedging rules establishment, as follows:

1. From Law of contract, hedging is included in private law section. Actually, every foreign exchange derivative transaction always started with foreign derivative contract between Bank and consumer. Theoretically, contract made between two parties, which are consumer and bank are included in private law section. In other words, relationship between bank and consumer in foreign derivative transaction is private which based on an agreement or contract. This contract based on act of contract freedom that is a universal law of law agreement.
2. Current regulation related to foreign exchange derivative transaction (hedging) is also in private law territory. Government regulations, such as Ministry of State-Owned Enterprises (BUMN Ministry) Regulation PER 09/MBU/2013 year 2013 about General Policy of Hedging of State Owned Enterprises and Regulations of Finance Ministry No. 12.PMK/08/2013 about Hedging Transaction of Government Debt Management; which are managing involved parties in government’s hedging transactions. Those regulations are casuistic; where those regulations just covered minor part of hedging problems. Beside than that, Bank Indonesia Regulations (PBI) already covered hedging regulations. However, all of those regulations’ attractions are limited to internally, which are only State Owned Enterprises and Banks. Banking Authorities in Indonesia (Bank Indonesia and Financial Services Authority (OJK)) issued PBI according to derivative transaction, focusing on prudential regulations or carefulness regulations in derivative transaction with purpose of that every Bank should operating their activities with carefulness, therefore will avoid them from bankruptcy. Some of the regulations issued of those Banking Authorities aimed to measure banking operational activities.

The problem is, even though foreign exchange derivative transactions are within private law section, but those transactions collectively are causing negative effect to whole society. Based on crisis experiences on 1998 and 2008 showed us there are shift from private law section to public law section. That means when private laws are causing loss or bad effect to a lot of people (public) safety, therefore public interest should be covered up.

Regulation about derivative transaction could be categorized as an act of mixed regulation between private and public law.

Regulator in this case is nation, must involved to make rules that are protecting all of society (public). Foreign derivative transaction within private law section should be considered as a public law section, in order to not only controlling bank but also to all of parties involved in business (public). Public interest regulation theory stated that government should issued a regulation that support efficient market activities and competition.

Law No. 24 year 1999 is a moment when free foreign exchange in Indonesia is established even though it only contains nine articles. This regulation has opened exceptional freedom that covered foreign exchange traffic in Indonesia. Based on this regulation, every citizen could freely owned and used foreign currency, freedom of using foreign exchange means that every citizen could freely do foreign exchange activities, such as for international trade, currency market transaction, and stock market transaction.

Law No. 24 year 1999 give enough space to Bank Indonesia to control foreign exchange traffic with PBI. Practically, Bank Indonesia has a limited authorization to issued policies regarding foreign exchange system and traffic. Bank Indonesia could only revised regulation within its section and its coverage as a central bank and Indonesian Monetary Authority. Bank Indonesia could not covered up beyond its authorities. The fact is, Bank Indonesia regulation by current PBI could not effectively to decrease fluctuation of rupiah exchange weakening. Even though Indonesia' foreign exchange is enjoyable more from foreign parties due to fluctuation of rupiah's condition and as a speculation commodity.

Thus, Bank Indonesia authorities are also limited since Law No. 21 year 2011 about Financial Service Authority was established. Within this regulation, Bank Indonesia current authorities are only limited within prudential macro coverage and Financial Service Authority (OJK) authorities are within prudential micro coverage. OJK founder are potential to bring difficulties to Bank Indonesia in order to achieve those aims due to that regulation has already amputated one of important instrument within Bank Indonesia's aim. Therefore, an integrated cooperation between Bank Indonesia and OJK are needed. Harmonization and synchronization are needed to divide thoroughly between task and responsibility within BI and OJK. Consistency and Ideas from Law Experts are needed by OJK to be discussed scientifically in order to avoid debating and uncertainty of law as an OJK act in the future.

Based on the above explanations, a few things can be concluded and recommended, namely:

Based on above facts, writer argues that it is the right time that hedging should be included in public law section by increasing the degree of PBI and OJK regulations into law. In writer's opinion, it is sequential with revision topic of Law No.24 year 1999 about Foreign Exchange traffic. Furthermore, it is the right time to criticize about free foreign exchange regime, in order to regulations about foreign exchange are not giving negative effects and disturb economy and real sectors. There are some important points according to constitution (UU) revision, which are:

1. Hedging, Bank and consumer (personal or companies) have to do hedging, especially to whoever have obligation in foreign currency but rupiah's income.
2. Foreign Exchange Regulation: Exporters have to do holding period for foreign export income (DHE) at Local Bank on certain period.
3. Harmonization between BI and OJK: divide clearly between BI authority and OJK authority, especially in controlling foreign exchange for Rupiah stability.

Thus, foreign exchange system and free-floating exchange rate are not something prohibited anymore in Indonesia. Foreign exchange system and free-floating exchange rate should be managed well with right and efficient regulations. It is hoped with efficiency achievement, therefore "Law as a tool of social engineering" could be running maximally in Indonesia.

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