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BY E-MAIL AND BY POST

2 June 2008

**Bank Indonesia  
Syafuddin Prawiranegara Tower 9<sup>th</sup> Floor  
Jl. MH Thamrin No. 2  
Jakarta 10350  
Indonesia**

**Attention: Ibu Treesna W. Suparyono**

Dear Sirs,

**Bank Indonesia Regulation Number 7/31/PBI/2005 (the “Derivatives Regulations”)**

Thank you for meeting with us on 8 May 2008 and for giving us the opportunity to make a presentation to members of Bank Indonesia. We are indeed honored and look forward to an on-going dialogue with Bank Indonesia on the Derivatives Regulations and on other matters of importance to the development of the “over-the-counter” or “OTC” derivatives market in Indonesia.

As you are aware, the International Swaps and Derivatives Association, Inc. (“ISDA”) is an international organization whose membership comprises over 800 of the world’s largest commercial, merchant and investment banks, corporations, government entities and other institutions. ISDA’s members represent a broad cross-section of the institutions that are dealers in and end-users of privately negotiated derivatives (“over-the-counter” or “OTC” derivatives) both in Asia and world-wide.

Over the years, ISDA has worked with regulatory and legislative authorities in many jurisdictions to support initiatives aimed at enhancing legal and regulatory certainty as it relates to the OTC derivatives industry.

## Introduction

ISDA is pleased to note that Bank Indonesia is taking the initiative to revisit the Derivatives Regulations in order to better support economic activities, and that industry feedback has been invited.

As requested, ISDA is pleased to provide some initial comments, and, once a draft of the revised Derivatives Regulations becomes available, we would be most happy to discuss the same with you and to submit further detailed comments for your consideration.

### 1. Range of Derivative Transactions

ISDA notes that, despite the wider definition of “Derivative Transactions” provided in Article 1, Article 7 of the Derivatives Regulations provides that banks can only carry out Derivative Transactions that are linked to foreign currency and/or interest rates. We note that this restriction has been in place since 1995 and has not been updated since then. In view of the more extensive use of various types of derivative transactions in the global markets, ISDA submits that the scope of derivative transactions that banks are permitted to carry out should be broadened to include at least those underliers (i.e., interest rates, exchange rates, commodities, equity and indices) already enumerated in the definition of “Derivative Transactions” in Article 1, including hybrid products (for example, bond options, which derive their value from a combination of factors such as interest rates or credit spreads).

ISDA understands that (a) credit derivatives are excluded from the definition of “Derivative Transactions” provided in Article 1 and are therefore not subject to the Derivatives Regulations, and (b) credit derivatives are dealt with by another regulation, namely, Bank Indonesia Regulation 7/3/PBI/2005 Concerning The Legal Lending Limit for Commercial Banks (“**LLL Regulation**”). The LLL Regulation states, amongst other things, that credit derivatives are to be taken into account in the legal lending limit calculation. We understand that there are banks who have interpreted this to mean that banks are permitted to enter into credit derivatives transactions. We also understand that there are other banks who have sought specific approval from Bank Indonesia before undertaking credit derivatives transactions. In this regard, ISDA would urge Bank Indonesia to consider issuing clearer guidelines governing credit derivatives in the revised regulations to obviate any uncertainty relating to credit derivatives.

Permitting a broader class of derivative transactions will give the banks and their customers a more comprehensive selection of risk management tools with which to manage the various different risks that arise. For example, credit derivatives facilitate the distribution of credit risk across a broader group of investors which enhances financial stability. Commodity derivatives facilitate the management of asset price risk which is in line with Bank Indonesia’s objective of inflation targeting.

We understand that Bank Indonesia’s concern about expanding the permitted scope of derivative transactions centers on the banks’ risk management capabilities in relation to such expanded scope. ISDA would suggest that Bank Indonesia deal with this very valid concern by requiring banks to apply to Bank Indonesia for permission to undertake derivatives relating to underliers

other than foreign currency, interest rates and credit derivatives. As a condition of its approval, Bank Indonesia will need to be satisfied that the applicant bank has in place the requisite risk management capabilities.

The commonly held interpretation of the Derivatives Regulations is that it applies not only to OTC derivatives but to derivatives embedded in structured products undertaken by the banks (such as foreign-exchange linked notes). ISDA would welcome confirmation in the revised regulations that this interpretation is correct. Currently, we understand that banks act as distributors of structured products with, or referencing, underliers other than foreign currency and/or interest rates issued by offshore financial institutions (since the banks cannot themselves issue such structured products). If Bank Indonesia accepts the submission to extend the scope of permitted underliers, this expanded scope should apply to both OTC derivatives and embedded derivatives since (a) the requisite risk management processes to manage the broadened scope would apply regardless of whether the derivative is in OTC or embedded form; and (b) from a “distributor” process standpoint, the banks should already have the requisite process in place since they currently distribute such structured products.

ISDA would also like to suggest that it would be helpful if all of Bank Indonesia’s regulations that deal with derivative transactions were to be merged or consolidated into one single set of regulations (for example, there could be a new specific section on credit derivatives in the revised regulations) or, alternatively, be the subject of an express carve-out and cross-reference.

## **2. Margin Trading**

ISDA notes that the Derivatives Regulations prohibit banks from carrying out Margin Trading involving Indonesian Rupiah (“IDR”) with customers. Margin Trading is defined as “a Derivative Transaction without notional amount, so that movement only takes place in the margin calculated from the notional amount with an exchange differential and/or interest rate differential that requires or does not require a margin deposit to guarantee the execution of the transaction”.

ISDA understands that the prohibition on IDR Margin Trading is intended to include all IDR derivative transactions where settlement is carried out on a net basis, i.e., that all IDR derivative transactions require the “full movement of funds”. ISDA appreciates that one of the key mandates of Bank Indonesia is maintaining the stability of the IDR exchange rate and to this end, that Bank Indonesia must focus on preventing speculative transactions involving the IDR. Given that there are currently no regulations prescribing the circumstances in which IDR derivative transactions can be entered into by non-bank residents, ISDA understands that Bank Indonesia’s stand is that all net-settled IDR derivative transactions cannot be allowed on the basis that they must be assumed (*prima facie*) to be entered into for speculative reasons. ISDA understands, however, that Bank Indonesia has given approval for certain IDR derivative transactions to be settled on a net basis instead of a “full funds flow” basis.

ISDA would like to suggest that it would lead to greater clarity and certainty if (a) the concepts of Margin Trading and net settlement could be distinguished in the revised regulations; and (b)

the circumstances in which Bank Indonesia would allow settlement of IDR derivative transactions on a net basis instead of a “full funds flow” basis could be elaborated upon.

Finally, ISDA submits that a more comprehensive review of the foreign exchange regulatory regime by the relevant governmental agencies should be undertaken. The benefits of settlement netting (which include reduction of credit, settlement and liquidity risk and consequentially, systemic risk, and lowering of transaction costs) are well-recognized by regulators globally. Instead of prohibiting settlement netting and thus giving up these benefits, it may be useful to consider prescribing the circumstances in which IDR derivative transactions can be entered into by non-bank residents (in a manner comparable to the situation with non-residents under Bank Indonesia Regulation 7/14/PBI/2005 Concerning Restrictions on Rupiah Transactions and Foreign Currency Lending by Banks).

### **3. Customer and Transaction Classification**

In line with global market practices, ISDA further would like Bank Indonesia to consider whether the revised regulations could allow banks to tailor their “distribution” process according to, amongst other things, (a) their classification of the level of sophistication of their customers, (b) the degree of complexity and risk level of the transactions or products involved, and (c) their assessment regarding the appropriateness of the transactions or products for the relevant customer segment.

### **4. Enforceability of Close-out Netting and Collateral Arrangements**

As mentioned during our meeting, ISDA’s member firms are supportive of the development of close-out netting legislation in Indonesia. The development of such legislation in Indonesia would enhance legal certainty with respect to Indonesian counterparties engaging in derivative transactions. As you know, close-out netting reduces credit risk at each level in the network of relationships between market participants as a party’s exposure to its counterparty’s default will be reduced to a net rather than a gross exposure, thereby reducing systemic risks. This leads to more efficient use of credit lines, lower costs due to reduced regulatory capital requirements, increased participation and thus improved liquidity in the local derivatives market. It also removes a pricing disadvantage for local counterparties as compared to counterparties from countries where close-out netting enforceability is well-established.

The Model Netting Act, as published by ISDA, was designed to assist governments in the development of legislation which will ensure that the protections of close-out netting and collateral arrangements are available to participants in their respective financial markets. While there are no laws or regulations in Indonesia that explicitly indicate that close-out netting would not be enforceable, the financial community’s view is that the adoption of specific legislation that recognizes the enforceability of bilateral and multi-branch close-out netting provisions and the enforceability of certain collateral arrangements is the most effective method in which to achieve such legal certainty and to foster the growth of the derivatives market. The Model Netting Act may be either enacted in full or utilized as a resource by regulators and legislators in designing their own legislation. The importance of close-out netting enforceability has been recognized, and reference has been made to the Model Netting Act as a template to draft suitable

legislation, by a number of countries, including South Korea, India and Pakistan in the Asia-Pacific region. The development of such legislation will protect current market participants from risks associated with insolvencies and will help attract more foreign participants and counterparties to the Indonesian marketplace. ISDA would also be pleased to assist Bank Indonesia and other relevant governmental agencies in this respect.

### **Conclusion**

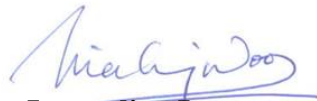
ISDA fully supports the review of the Derivatives Regulations and looks forward to further dialogue and providing more detailed comments when a draft of the new regulations becomes available. If the expected time-frame to implement the revised regulations would be more than two months, ISDA would propose that a “Q&A” on the current Derivatives Regulations be issued in the meantime. ISDA would be happy to lend assistance in the drafting and review of such “Q&A”.

Further, ISDA would urge Bank Indonesia and other relevant governmental agencies to consider the enactment of close-out netting legislation. ISDA would be happy to provide any assistance in this regard, including meeting with other regulators and legislators to elaborate on the importance of close-out netting legislation and enforceability of collateral arrangements.

If you or your colleagues have any questions, please do not hesitate to contact us by phone, e-mail or fax as per the above numbers.

Yours faithfully,

**For the International Swaps and Derivatives Association, Inc.**



**Jacqueline Low**  
**Senior Counsel Asia**



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