

## **BANK INDONESIA'S ROLE IN DEEPENING THE FOREIGN EXCHANGE MARKET AS A PART OF PROMOTING FINANCIAL STABILITY**

As a trade-dependent country, foreign exchange market plays a critical role in Indonesian economy. The shallow foreign exchange market tends to affect exchange rate stability, especially in the event of market shocks. The shallow foreign exchange market is characterized by limited hedging instruments available, limited market participants, and segmentation among market players that tends to cause high volatility.

In order to create a more resilient financial market, Bank Indonesia has launched the Financial Market Deepening Blueprint that comprehensively sets the strategy of financial market deepening, including foreign exchange market. The strategy covers several aspects, namely 1) instrument and investor based, 2) infrastructure, 3) regulation and standardization, 4) institutional support, and 5) education and socialization.

The first aspect – instrument and investor based- focuses on the strategy to reduce the imbalance of foreign exchange supply and demand and to increase the volume of derivative transaction, particularly for hedging purposes. Beside the effort to increase the number of instruments allowed under Bank Indonesia Regulation, Bank Indonesia also encourages market players to implement risk management, especially foreign exchange risk by the use of hedging instruments. By considering that stated own companies and corporation (Non-Bank) with foreign debt/liabilities play a significant role in the spot market, BI has been encouraging them to hedge their foreign currency exposures. This also aims at increasing the number of market participants for FX derivatives market. This effort is also in accordance to BI regulation no. 16/21/2014 dated 29 December 2014 that requires Non-Bank Corporation to hedge at least 25% of their net foreign exchange exposure, as part of the implementation of prudential principle in managing external debt.

The second aspect – infrastructure- focuses on the effort to increase market efficiency, credibility, and transparency by developing a strong market infrastructures. To increase market credibility, in 2014 Bank Indonesia and Indonesia Foreign Exchange Market Committee (IFEMC) introduced the code of conduct (CoC) of Indonesia Financial Market. This CoC is intended to regulate the behavior of market players and to enhance discipline and integrity of the players in the domestic financial market. Currently, Bank Indonesia is running a pilot project of central counterparty clearing (CCP) that aiming at lowering the counterparty credit risk, increasing market efficiency, and strengthen the financial market surveillance. In addition, Bank Indonesia is planning to set up the standardization of derivatives contracts and its supporting regulations to support and promote safe, efficient OTC derivatives market.

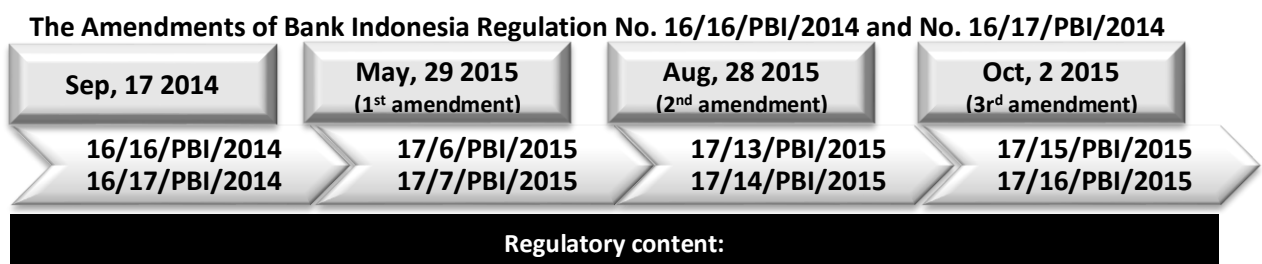
The third aspect - regulation and standardization – is currently considered as the most crucial aspect in developing domestic foreign exchange markets. In terms of regulation, in September 2014, Bank Indonesia issued Regulation No. 16/16/PBI/2014 concerning Foreign Exchange Transactions against Rupiah between Banks and Domestic Parties; and Regulation No. 16/17/PBI/2014 concerning Foreign Exchange Transactions against Rupiah between Banks and Foreign Parties. Before the issuance of these regulations, stipulations of foreign exchange transactions were scattered on several regulations

that might be a little bit confusing for some people. Therefore, along with Bank Indonesia's intention to promote foreign exchange market deepening through a clearer guidelines on FX transactions and flexibility to market participants, Bank Indonesia enhanced the previous FX regulations in to two regulations (PBI No. 16/16/PBI/2014 and No. 16/17/PBI/2014). These regulations stipulate some requirements that should be met in conducting foreign exchange transactions which include, among others: underlying requirements for transactions above certain volume (threshold), the scope of underlying transactions, transaction documents, settlement methods (full/net settlement), prohibited transactions, etc.

To keep abreast of the changes in global and domestic market condition as well as promoting financial stability, Bank Indonesia Regulation No. 16/16/PBI/2014 concerning foreign exchange transaction against IDR between banks and domestic party clients and Bank Indonesia Regulation No. 16/17/PBI/2014 concerning foreign exchange transaction against IDR between banks and foreign party clients have been amended for 3 times during 2015. The amendments to these regulations are aimed at:

1. increasing market flexibility in conducting foreign exchange transactions, especially derivative transactions for hedging purposes,
2. promoting the supply of dollar, particularly in the form of foreign exchange derivative supply,
3. limiting unnecessary/speculative dollar demand that may raise Rupiah volatility.

The summary of the amendments are as follow:



**PBI No. 16/16/PBI/2014, revocation of:**

PBI No. 10/28/PBI/2008  
PBI No. 10/37/PBI/2008  
PBI No. 11/14/PBI/2009

**PBI No. 16/17/PBI/2014, revocation of:**

PBI No. 7/14/PBI/2005  
PBI No. 10/28/PBI/2008  
PBI No. 10/37/PBI/2008  
PBI No. 11/14/PBI/2009  
PBI No. 14/10/PBI/2012  
PBI No. 16/9/PBI/2014

These previous regulations had set specific requirements regarding foreign exchange transaction against IDR between bank and domestic party clients; and bank and foreign party clients, such as: requirement to submit underlying document when conducting FX transaction for certain amount, coverage of underlying transactions, tenor for derivative transaction, etc.

- **Cross currency swap** is subject to these regulations.
- In conducting foreign exchange transactions against IDR, Banks are required to **implement effective risk management system and customer education program.**
- The scope of underlying transactions **includes income and expense estimation** for trade and investment activities.
- Specifically for PBI No. 17/6/PBI/2015, domestic party clients may use **bank credit or financing as an underlying** for derivative transaction.
- Specifically for PBI No. 17/7/PBI/2015, there is **no more minimum tenure for derivative transaction** conducted with foreign party clients.

Lower the maximum limit (threshold) of foreign currency purchase without underlying to **USD25,000.00** from USD 100,000.00.

- Increase the maximum limit (threshold) of foreign currency selling without underlying to **USD 5,000,000.00** from USD 1,000,000.00.
- **Customer's ownership of foreign currency in domestic accounts as well as offshore accounts** may be used as an underlying for foreign currency selling and Rupiah transfer to foreign client's account.
- **Undisbursed loan/credit facility is not eligible** to be an underlying transaction.
- Banks must **comply with Bank Indonesia regulation governing the obligation to use Rupiah** in the territory of Indonesia.

As foreign exchange market deepening should be the concerns of many parties (such as: market players, governments, associations, investors, etc), all parties must contribute to succeed the program. Therefore, the fourth aspect – institutional support – focuses on building partnership with related institutions, among others: the Financial Service Authority (OJK), the Ministry of Finance (MoF), the Ministry of National Development Planning, Banking Association, Indonesia Foreign exchange Market Committee (IFEMC), etc. In this respect, several collaborative programs in promoting foreign exchange market deepening have been made. In collaboration with MoF, Bank Indonesia promotes debt management strategy that taking more financial market deepening aspect in to considerations in order to create higher liquidity on government bonds market that will attract more capital inflows. In addition, Bank Indonesia together with MoF and OJK are going to build closer coordination by establishing inter-institutional forum that will focus on economic financing and financial market deepening. Meanwhile, Bank Indonesia will still continue to build stronger coordination and effective partnership with other institutions to succeed financial market deepening.

However, to build an effective partnership there should be a better understanding of each related party about the importance of foreign exchange market deepening and how it affects the financial stability. Hence, the final aspect – education and socialization – should play a significant role to build a better understanding and ownership of this program among the related parties. This aspect is very substantial because it is considered as the driver of the four other aspects. Therefore, Bank Indonesia will intensify socialization and education programs to build the awareness about the importance of financial market deepening, especially for investors, small banks, corporations, auditors and law enforcement agencies.

Henceforth, Bank Indonesia will continue to strengthen the measures to develop domestic foreign exchange market by focusing on the effort to diversify the instruments, to increase the amount of market participants, and to encourage the availability of market infrastructures.

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