Role of Statutory Managers in insurance insolvency

by MKK Insurance Team (with research by Astrid Kohar, S.H., LL.M)

Safeguards against insolvency

In theory, it should be very difficult for an insurance company to become insolvent, given the numerous safeguards preventing such an eventuality. For one, there are regular reporting requirements to ensure the financial health of the company, known as **RBC** (Risk Based Capital). Second, there is the reserve fund held by all insurance companies which is meant to restore internal liquidity. And let's not forget reinsurance, an arrangement by which another larger underwriter holds a substantial amount of the risk borne by the carrier. In the New Insurance Law of 2014 (Law No. 40 of 2014, "**New Insurance Law**"), the Indonesian Financial Services Authority (*Otoritas Jasa Keuangan*, "**OJK**") signaled the establishment of a *Policy Protection Program* (the *"***Program***")* that would pool the 20 percent reserve funds held by all insurance companies. The purpose of the fund would be to provide funds of last resort to any insurance company that for whatever reason becomes insolvent.
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).

By virtue of the New Insurance 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 take on the role of a collective back-up fund to settle claims and as a remedy to insolvencies and thus, there will be no further need to maintain a separate company-funded reserve 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.)

Finally, in the New Insurance Law, yet another safeguard was instituted which is the right of the OJK to take over a troubled insurance company and put **Statutory Managers** ("**SM**") into position. The purpose of the Statutory Manager is, among others, to put the carrier back on the road to financial solvency and force the company to implement internal policies and protocols that will ensure this. Thus, while RBC reporting requirements are to ensure solvency on an operational basis, and the Program is to return a carrier to solvency in the event of collapse, the SM can be seen as an intermediate remedy between the two: before collapse, when warning signs of insolvency manifest themselves, the SM provision will kick in and the OJK will take over the company, much like a Captain taking over a ship on a collision course and steering it away from the iceberg in its path.

If we follow through on this analogy, the RBC is the ship's sonar which operates to warn the captain of the day to day dangers the ship faces; the Program is the lifeboats that rush in to save the passengers after the crash has happened, putting the SM as the regulator wresting control from the Captain to prevent the crash from ever happening, right before the moment of impact.

According to a recent Circular Letter No. 44/SEOJK.05/2016 on SM ("**SM CL"**), the OJK can exercise this function if a carrier endangers policyholders as a result of a weakened financial condition, if the carrier incurs sanctions because of non-compliance with the law, if the shareholders, directors or commissioners are suspected of criminal activity, if the carrier fails to carry out changes in management of the firm which are ordered by the regulator, if the carrier engages in activity which is not within the scope of its license, a SM can be put in place as well, among many other similar reasons.

In any of the foregoing cases and others which are too numerous to mention here but which are set out in Part (2) of the SM CL, upon a recommendation from the Executive Head of the Supervisory Board of Insurance, Pension, Financing and other Financial Bodies, the OJK's Board of Commissioners will order that a SM be appointed. The SM function will cease when the carrier has returned to financial solvency or when the reason for installing the SM has ceased or if it is impossible to remedy the situation. In the latter case, the more radical steps can be taken, such as revoking the business license of the carrier. Note that the OJK reserves the right to change the SM at any time if he/she is not performing his duties to the OJK's satisfaction.

Recent cases

The OJK's stance on insolvent insurance companies was tested in the Bumi Asih Jaya ("**BAJ**") case where the need for a SM was highlighted; unfortunately, BAJ was an illustration of what happens when an insurance company becomes negligent and does not heed the directions of the regulator. The case began before the promulgation of the New Insurance Law and thus, the OJK was unable to bring to bear the SM option. Instead, the OJK had no choice but to go through the court system.

The OJK had in fact considerable difficulties in having BAJ declared bankrupt. The OJK had revoked the company's business license as far back as 2013 by Decision of the Board of Commissioners of the OJK No KEP-112/D05/2013. The OJK made the bankruptcy petition as a result of BAJ being unable to honor its obligations to premium holders. BAJ contested the bankruptcy petition, referring to, among others, Article 51 (1) of the New Insurance Law, with three key arguments:

- BAJ claimed that such a petition may only be initiated by the premium holders themselves, and therefore filing a petition for bankruptcy did not reside with the OJK;
- BAJ also claimed that insurance claims cannot be categorized as debt/unpaid bills;
- BAJ claimed that the matter was not within the jurisdiction of the Commercial Court.

In its rebuttal, the OJK's lawyer contended that the Bankruptcy Law takes a very broad definition of bankrupt assets and as such, failing to pay out claims did constitute failure to pay debts/make good on financial obligations. The OJK maintained that it had the authority by virtue of the New Insurance Law to initiate bankruptcy proceedings at the Commercial Court. The Commercial Court rejected the bankruptcy petition stating it was outside its jurisdiction to make a ruling, but upon appeal, the Supreme Court upheld the OJK's petition.

This was an important decision in affirming the authority of the OJK as the regulatory body empowered to declare insurance companies bankrupt. Under Law No. 37/2004 on Bankruptcy, authority to submit a bankruptcy petition against an insurance/reinsurance company lies with the Minister of Finance; however, with the promulgation of Law No. 21/2011 on OJK ("**OJK Law**"), as of 31 December 2012, authority was vested with the OJK to petition for the bankruptcy of an insurance company and by this decision, the Supreme Court affirmed the OJK's authority.

The OJK issued the SM CL, perhaps to prevent this type of situation occurring again. The BAJ illustrated that going through the court system to assert its authority was long and a result could not be guaranteed. It was perhaps in part because of the BAJ case, that the OJK resolved to tighten up the rules on SM and use it to pre-empt a BAJ type case from occurring again: the SM was to be a phase before bankruptcy that would allow the regulator to head off bankruptcy and insolvency by directly intervening in a carrier's management and day to day operations.

The first test of SM occurred in October when the OJK issued a press release indicating that AJB Bumiputera 1912 was being put under the control of Statutory Managers to prevent insolvency. In its press release, the OJK stated that the SM would be in place starting from October 21, 2016 on the basis of the following laws:

- the OJK Law,
- the New Insurance Law
- POJK No. 41/POJK.05/2015 on Guidelines for Appointment of Statutory Managers in a Financial Institution

"*The task of the new Manager of AJB Bumiputera 1912 in the company restructuring program, the new Manager will be supported, among others, by a financial consultant from Pricewaterhouse Coopers, a tax Auditor from Rustam Consulting, an Actuary from PT Milliman Indonesia, of PT BNP Paribas and a securities company, such as PT Mandiri Sekuritas, PT Bahana Securities, PT Danareksa Securities and PT BNI securities Indonesia."*
Source: (OJK Press Release, SP No 107/DKNS/OJK/X/2016)

Final notes on SM

The role of the SM was only set out in broad brushstrokes in the new law. However, it is now evident that the application of the SM role is a resort of last measure to take over a company that has become severely under-capitalized and requires new management to guide it back onto the road of solvency. Ideally, the Program should never be used because there could be strong push-back from carriers that are solvent and would have to bear the burden of carriers that had become insolvent due to mismanagement or criminal activity. The Program should therefore always be considered as an option when no other options are available. In the eyes of the business community, due to obvious business considerations, SM is definitely the preferred option.

The OJK has taken a very wise step in applying the SM function as a means of heading off disaster. Its application in the AJB Bumiputera 1912 case will hopefully illustrate that SM can prevent insolvency and the long court proceedings that were experienced in the BAJ case. We will be monitoring the AJB Bumiputera 1912 case very closely. There could still be a long road ahead, but it does seem that the OJK's decision to put the SM into place was the move that makes the most sense in the current situation.

MKK insurance team

The Transformation of Indonesian Geothermal Funding

by Ferdinand Jullaga, S.H., LLM and Tommy Handono, S.H., LLM.

In order to support economic development, the Indonesian government aims to increase electricity supply to 35,000 MW by 2025. This objective may be achieved, among others, by construction of numerous power plants across Indonesia. As the country with the largest geothermal potential, Indonesia needs to develop its geothermal resources through development of geothermal power projects. One major setback for geothermal development is the risk inherent in development, including financing of geothermal power projects, particularly during the exploration stage.

Prior to the 35,000 MW program, the government designated the Geothermal Fund Facility (*Fasilitas Dana Geothermal)* ("**Geothermal Fund**") managed by Government Investment Unit/*Pusat Investasi Pemerintah* ("**PIP**") through Minister of Finance Regulation No 178/PMK.05/2011. The Geothermal Fund aims to accelerate geothermal power development by providing a loan and data/information to (i) the Local Government that will be tendering the working area; (ii) Geothermal Permit holder (IUP holder) and (iii) the holder of a geothermal concession (*kuasa penguasahaan panas bumi*).

Thus far, the Geothermal Fund has not been optimal as PIP, the administrator of Geothermal Fund, has been unable to offer flexibility in disbursements and cannot offer funding with attractive terms to prospective beneficiaries. Recently, the Indonesian Government decided to transfer the assets and authority of PIP to PT Sarana Multi Infrastructure ("**SMI**"), including the duties to manage the Geothermal Fund through Minister of Finance Regulation No. 232/PMK.06/2015 on the Shifting of Government Investment from PIP to Become State Capital Participation for SMI ("**MoF 232/2015**").

By this transfer, all of PIP's assets have been transferred to SMI, including funds in the amount of Rp. 3,129,500,000,000 (equal to USD 250 million) that were previously designated for the Geothermal Fund. MoF 232/2015 provides that the implementation of Geothermal Fund administration by SMI will be regulated in a separate implementing regulation. Pending the implementing regulation, SMI is not able to access the Geothermal Fund but is still allowed to utilize the fund, among others, for financing of infrastructure in general.

The transfer from PIP to SMI is intended to be a transformation in the management of Geothermal Fund and demonstrates the seriousness of the Government to develop the geothermal sector. There will be indeed a substantial modifications which are expected to attract investors. On the other hand, SMI is different in nature than PIP. SMI is a state owned enterprise in the form of a Limited Liability Company. Therefore, it is more flexible in terms of decision-making for disbursements than PIP which is a public service institution.

This is particularly important in terms of the risks associated with the implementation of the Geothermal Fund. Any loss suffered by PIP as a result of a disbursement from the Geothermal Fund may lead to state losses, as PIP is a unit within the government. This in turn could trigger the prevailing anti-corruption laws. One of the key aspects of corruption in Indonesia is the occurrence of a loss to the state. There are abundant risks in the implementation of any geothermal project and it is difficult to predict the capacity of a geothermal unit. As a result, PIP indeed had difficulties in disbursing the Geothermal Fund, as it had to be certain that the project would succeed as forecast and not cause a loss. That is not the case with SMI, which is not a government unit and thus does not operate under the same pressures.

The implementing regulation for management of the Geothermal Fund by SMI is still pending. However, SMI indicated in its annual report that it would introduce a new scheme for the Geothermal Fund by funding the drilling period during the exploration stage. This means that the risks in the exploration stage would be shared by SMI and investors. If the project turned out to be successful, it is reasonable for SMI to expect repayment of the disbursement from the Geothermal Fund with a reasonable profit margin. However, if the exploration result turned out to be negative, SMI may bear the loss of the funds it disbursed.

It is desired that by this arrangement, exploration of geothermal resources will be boosted significantly. This arrangement is significantly different from the one managed by PIP previously where PIP did not wish to bear any risk. Therefore, once this scheme is actually implemented in the near future, it is possible that it will attract investors to the geothermal sector since it reduces their risk with regard to investment costs. There are reports in the market, however, that this type of funding will be only be made to other state-owned

enterprises or subsidiaries of a state-owned enterprise. In this regard, PT Geodipa and PT Pertamina Geothermal Energy, among others, would probably be the entities that could benefit the most.

As the assets and duties of PIP have been assigned to SMI, SMI will be the largest infrastructure financing institution in Indonesia with various infrastructure sectors to be funded. The amount of capital to be managed by SMI is significant, as evidenced by the transfer of the investment funds of PIP derived from APBN 2006 to 2013, including investment into PT Perusahaan Listrik Negara and other agencies, all of which shall be transferred to SMI. By having a robust and dependable institution, the Geothermal Fund system should be more attractive and instill confidence in investors who are currently considering carrying out projects in the Indonesian geothermal sector.

Ship arrest: practical considerations

by Ahmad Djoyosugito, S.H., LLM.

Background

The purpose of ship arrest is to facilitate execution of a civil or criminal case, or it is carried out in extreme situations to ensure the safety of the crew. In this short discussion, we will see that ship arrest should be viewed as a measure of last resort to force settlement of outstanding claims.

What the law says

In the course of carrying out maritime activities, disputes may arise; maritime claims may be categorized as either 'dry', relating to financing, insurance, i.e. onshore matters, or 'wet', such as salvage, docking, refueling, i.e. offshore matters. Dry or wet disputes can trigger ship arrest.

Indonesia is party to the United Nations Shipping Arrest Convention of 1999 and also to the International Convention on Maritime Liens and Mortgages of 1993 (collectively the "**Conventions**"), which set out the principles and terms of ship arrest. The Conventions detail situations in which a ship can be detained for non-payment of debts, infractions and extraordinary situations which put the crew in peril. These two international conventions were enshrined in Indonesian Law in *Law No. 17 Year 2008 on Shipping* (referred to as "**Shipping Law**"). In section eight of Articles 222 and 223, the principles of ship arrest are set out. In these very brief articles, the district court is given the right to issue a "*Letter of Warrant*" for maritime cases. In the past, a lawsuit would have to be initiated against the offender but thanks to the Shipping Law, a maritime claim can be made without going through a time-consuming and expensive court procedure.

Procedure

The procedure to issue a Letter of Warrant by the district court in a civil case is simple. The petitioner submits a lawsuit and also makes a separate request in the form of a petition letter to the district court. The petition letter should contain all relevant information in respect of the counter party (the identity of the ship owner who will be the respondent in this case and the ship which is the object of the case).

On the strength of the petition letter, the district court can then issue a *Letter of Warrant* without first submitting a lawsuit if the petition letter is based on a maritime claim, as defined in the elucidation of Article 223 paragraph (1) of the Shipping Law. Typical grounds for a maritime claim are damages to a ship, salvage operation, failure to make good on operational fees or on pilotage operational fees, towage fees, failure to pay insurance premiums, although it can be any wet or dry maritime matter. The district court can then order the ship arrest in the location where the ship is currently anchored.

A ship arrest can also take place in relation to a criminal case, for example, if the ship is being used in criminal activities, such as illegal fishing, piracy or illegal transportation. In such cases, the district court may ask the police to directly intervene without a lawsuit having to be submitted. This petition should be made to the district court in the jurisdiction where the criminal offence has occurred.

Practical considerations

Ship arrest should only to be carried out when all other means fail since holding of the ship can result in substantial financial losses to the ship owner. Ship arrests in the past have even threatened the solvency of the parent company. If the respondent objects to the grounds of the ship arrest, he may in fact lodge a counter-claim, which could complicate matters even further It follows that, for both parties in the dispute, an out of court solution is the most desirable outcome. Obviously, time-consuming and lengthy court proceedings are not in anyone's interests.

The Shipping Law references an implementing regulation that is to provide further details and answer questions over the terms of the ship arrest, the duration of such arrest, as well as operational and procedural matters that are not dealt with in the articles of the law; unfortunately, to date, the implementing regulation has yet to be released. Notwithstanding the foregoing, ship arrests have been made on the basis of the law, and courts do issue Letters of Warrant and accept maritime claims.

Given the existence of the gray areas in the absence of detailed regulatory guidance, we advise all parties to seek proper legal representation in such matters and to always seek amicable solutions to disputes before turning to the courts for remedies.