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REPORT ON THE POTENTIAL FOR THE UTILIZATION OF MUNICIPAL BONDS IN INDONESIA AND THE USE OF LOCAL CURRENCY GUARANTEES

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THE POTENTIAL FOR THE UTILIZATION OF MUNICIPAL BONDS IN INDONESIA AND THE USE OF LOCAL GOVERNMENT GUARANTIES

THE POTENTIAL FOR THE UTILIZATION OF MUNICIPAL BONDS IN INDONESIA AND THE USE OF LOCAL CURRENCY GUARANTIES

I PURPOSE AND CONTEXT OF THE STUDY

The purpose of this study was to examine the potential for the use of municipal bonds as a means of financing the expanding infrastructure requirements of local governments in Indonesia. In addition, the possibility of utilizing a guaranty mechanism to enhance the attractiveness and salability of municipal bonds in the domestic market as well as other borrowing by local governments or private companies engaged in the provision of urban services was examined. Finally, the study considered briefly the potential for corporate funding through the issuance of bonds.

It should be noted that considerable work has already been done by USAID in municipal finance and the capital market. First, a $100 million Housing Guaranty Program has been approved with $50 million already borrowed as of June 1990 supplemented by a major grant to provide 192 months of resident technical assistance, i.e., four full-time advisors for four years, plus short-term expertise and a training package. This program will provide assistance to the Government of Indonesia (GOI) in further developing its municipal finance system. The contract to cover the technical assistance and training was negotiated in June 1990. Included in the four advisor positions will be a municipal finance specialist.

Second, USAID will provide through its Financial Markets Project a resident team of advisors scheduled to arrive in mid-1990 to assist BAPEPAM, the Capital Exchange Executive Agency--the stock exchange, to expand and improve its operations. USAID has already assisted in the creation of this agency over the past five years by carrying out studies and through the provision of services of two personal services contractors.

There have been a number of key documents and studies prepared in connection with the above two projects, including the Project Papers, which bear directly on the subject being addressed in this paper. There is considerable material, for instance, relating to the structure of local government and its financing, and the history, development and current state of the capital markets. This paper will incorporate some of this material in summary form as part of the background supporting the conclusions. Annex 1 contains a list of the relevant materials.

It is useful, however, to quote from one of these papers in this introductory section to provide some perspective. In a paper titled Urban Strategy Assistance Indonesia prepared by Research Triangle Institute, the long-term contractor for the Municipal Finance Project, dated March 1990, the following comment is made.

> "Development of Long-Term Strategies in Municipal Credit Linked to Financial Markets Assistance
>
> While the GOI has received some assistance in the design of the RDA (Regional Development Account--a central government account intended, among other things, to increase the amount of loan financing going to local governments as opposed to grant financing), there has not been much attention paid to the long-term development of the credit system for urban authorities beyond the RDA. However, some of the most crucial debates over the RDA, such as interest rate policy, can only be settled in the framework of the future credit system.
>
> USAID is providing assistance to develop financial markets and should be in a position to assist in both policy analysis and support in the design of the long-term municipal credit system. Of most immediate concern is the role of the RDA in (a) helping local authorities become adept at debt management, and (b) serving as a bridge to wider mobilization of capital within Indonesia for urban

investments. What is needed is not the immediate creation of a municipal bond market (although some larger municipalities may be ready for this step) but the formulation of strategies and options to help GOI to move in this direction."

This paper will try to take this process another step along the way.

II FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

Municipal Bond Financing

There was some feeling at the beginning of this study that it might be worthwhile to undertake a pilot project with some municipality for a municipal bond issue as a means to demonstrate the potential for such financing in the future. However, it is the conclusion of this study that the issuance of municipal bonds by any level of local government at this time is not a feasible undertaking. The factors which support this conclusion are as follows:

The majority of the financing for local governments is still controlled by the central government and the development and implementation of major capital projects, including infrastructure, is also heavily controlled by the central government.

Most financing of infrastructure, which presumably would be the recipient of the proceeds of long-term bond issues, is still done on a grant basis from the central government to the local government so local governments think in these terms.

Most of the financing of infrastructure that does come on a loan basis to local governments comes from donor agencies through the central government and is usually at highly subsidized interest rates relative to current market rates for financing in Indonesia (and, of course, there are no long-term market loans in Indonesia at present).

The policy of the government is to generally decentralize the development and implementation of local infrastructure projects to the local government level (for some things, however, such as the telephone system, there is no intent to decentralize) and to finance a growing proportion of local urban infrastructure on a loan basis rather than a grant basis. This is to be carried out through the expanded development of a Regional Development Account (RDA--referred to above) located in the Ministry of Finance which will appraise projects and extend loans.

However, the procedures governing the operation of this account (which will really be a "fund") had not been finalized as of June 1, 1990. A draft of the procedures is contained as Annex 2. As of that time there was still considerable debate as to the interest rate to be charged for loans (the likely interest rate was to be 9 percent, down from 13 percent being considered at one time, and far below current market rates, although, as pointed out above, there are no long-term market rates). Also a matter of concern is whether municipalities and other local government levels or other local organizations such as municipal water companies have the capability and/or capacity to develop and manage major infrastructure projects. The primary central government agencies involved are the Ministries of Finance, Home Affairs and Public Works and BAPPENAS, the National Development Planning Board. The intent is to issue a formal legal instrument in the form of a joint decree.

There are regional development banks owned by the individual provincial governments and which lend to both local governments and private enterprises for development purposes. Several of these banks have issued bonds on the market to finance a portion of their activities. Such institutions could expand their financing on behalf of municipalities as an intermediate step.

Until these issues are settled and municipal governments and agencies have clearly established their ability to develop and manage projects, to have established adequate financial systems and to have demonstrated an ability to service loans in a timely manner, it is highly unlikely that the central government (Ministry of Finance--Ministry of Home Affairs) would approve any local governments or local government agencies borrowing on the capital market, either through the issuance of municipal bonds or long-term borrowing from commercial lenders.

It should also be noted that the central government currently does not do any borrowing itself on the domestic market nor does it have any long-term debt outstanding although it isn't quite clear whether this is by reason of policy or law. Bank Indonesia does issue short-term money market certificates, currently up to 90 days, auctioned to banks, but this is to control money supply, not to finance short-term government needs. It also buys short-term market certificates issued by corporations and endorsed by banks for the same purpose.

Assuming, however, that central government would give approval to local governments to borrow long-term in the markets, what would they face? Right now there is no bond market as such. All bond issues are, in effect, placed, not really sold, and then held in portfolios until they mature.

From 1983, when the first issue of bonds occurred on the Jakarta stock exchange, through the end of 1989, there had been 48 separate bond issues publicly issued totalling Rp 1.5 trillion. Only six of these issues, three of them leasing companies, were private, amounting to Rp 127.5 billion; the rest were government-owned organizations. Two private companies issued bonds totalling Rp 25 billion on the parallel market (over the counter).

Almost all of these issues carried a maturity of five years and all had a fixed interest rate. The exceptions were four issues by the government toll road authority, all in 1989, two for eight years and two for 12 years, supported by the revenues of the toll roads which have apparently turned out to be lucrative ventures. On May 25, 1990, the toll road authority announced a new issue of Rp 100 billion, the largest bond issue to date, with an eight-year maturity and with a floating interest rate at 2 percent above the state banks' deposit rate, currently 14.5 percent.

Almost all bonds are held by pension funds and life insurance companies, mostly government organizations, by far the largest of which is TASPEN, the pension fund for civil servants. According to the Director-General of TASPEN, assets currently are Rp 3.7 trillion of which approximately 30 percent or Rp 1.1 trillion is in bond holdings (see paragraph above which indicates that at the end of 1989 total bonds issued amounted to Rp 1.5 trillion).

There appears to be a continuing concern over the possibility of a devaluation that will hurt holders of long-term debt or obligations despite the fact that the government has no restrictions on convertibility of the rupiah, that it has allowed the rupiah to float so it is unlikely there would be the sudden shock that has occurred in the past and that inflation is only estimated at 6-8 percent, well within the current rates that bonds are selling for (18-19 percent). One aspect, however, which is mentioned above, is that there is no "market" for bonds: once purchased they are held until maturity.

Why isn't there a market for bonds if they can be sold in the first place? Why can't a holder of bonds engage a broker to sell some of the bonds in its portfolio at some appropriate price reflecting current interest rates? Because there's a perception that no one will buy the bonds. There's a sort of cumulative effect here; there's a fear on the part of potential buyers that they, in turn, won't be able to sell them at some point when they might want to. First, the bonds aren't really sold at all in the first place, they are placed as described above, and the placements are government directed, particularly to the government pension funds and insurance company where the bulk of the bonds go. Once they are placed and in somebody's portfolio, there's no pressure on anyone to buy them; the pressure is for placement of new issues.

Second, brokers only earn 2.5 percent commission selling bonds (new issues since there is no market for existing bonds) while they earn 4 percent for selling equities (no explanation for the difference in commissions). In any event, there's no incentive to seek bond business on the part of the brokers/underwriters, either new or resales, not only because of the commission rate but also because of a concern with new bond issues that they'll be stuck with an unsold part of the issue. In the Rp 50 billion issue by Bank Tabungan Negara, the government owned housing bank, last year, Rp 11 billion went unsold and the underwriter, at least initially, had to hold this Rp 11 billion in its own portfolio. The equities market, on the other hand, is booming, perhaps to its eventual detriment, and that's where the interest of brokers/underwriters lies.

Given the present stage of local governments' administrative, management and financial development, it is not likely that investors, given the choice, would invest in the securities of or lend long-term to local government entities. There is no rating agency to assess potential debt of local governments, or any other borrowing entity at this time, which might assist potential investors in their analysis of such debt.

Certainly the general obligation debt of local governments would appear unlikely to have any market. Revenue bonds would appear to have the best possibility at some point in the future but this would have to assume that the revenues would indeed support repayments. For instance, right now, interest rates for bonds are in the 18-19 percent range. The easiest of revenue bonds to structure at the local government level would be the bonds of municipal water companies. However, the central government sets water rates. The Indonesian constitution states that water is a public good. It would be very difficult politically for a municipality to raise water rates to increase collections to support repayments to cover a bond issue at commercial rates which would undoubtedly be necessary at this time. This is what's behind the ongoing debate as to what interest rate the central government should charge in loans from the RDA. In any event, as long as the municipalities are able to get low interest rates from the central government directly or as a pass-through from donors, they will have no interest in borrowing commercially.

In fact, because of the high interest rates currently prevailing in the Indonesian market relative to inflation, the President-Director of TASPEN said he would be willing to buy 15-year bonds to lock in these interest rates in his belief that interest rates are going to come down. This, of course, is the kind of perception that would eventually make a market for bonds at some time in the future. However, the possibility that interest rates will come down would be another reason that municipalities would be unlikely to seek long-term financing at this time that locked in high financing costs.

Both TASPEN and BUMIPUTERA, the largest life insurance company, indicated they would buy municipal bonds with a guaranty of government. BUMIPUTERA initially said that an issue of bonds by a municipality would carry an implied government guaranty and this would be sufficient. That is, that the government would not let a municipality default. That view was modified during further discussion to indicate that an explicit guaranty would be preferable. It was further indicated that other investors generally share this view, i.e., that municipal bonds carrying a government guaranty and with a "market" interest rate would be an acceptable investment.

This leads into the second major conclusion. An AID guaranty is not necessary to induce investors to invest in local government bonds or long-term borrowing. Once the problems cited above are overcome and the central government decides that municipalities, their agencies such as water companies, and other levels of local government can be approved to take on long-term debt, then a government guaranty, implicit or specific, will be sufficient. Until this point is reached, an AID offer to guaranty, say, a municipality's bond issue, would undoubtedly not be acceptable to government. Once the point is reached, it's not necessary.

Corporate Bond Financing

With regard to corporate bond financing, the mechanism is there for corporations to issue bonds. However, as pointed out earlier, only six out of 48 bond issues on the stock exchange through the end of 1985 were by private companies. The face amount of these issues amounted to only about 8 percent of the total. The bonds of government-owned corporations not only have an implicit government guaranty behind them but probably some government assistance in placing them with government pension funds. With an apparent reluctance on the part of the underwriters to take on bond issues it is probably a difficult way for private corporations to raise money. In addition, bond maturities are very short and interest rates high at present. It is likely that those private companies that need to raise money from the public sector probably find the equities market a more attractive place to do business right now.

A Role for AID Local Currency Guaranties

The Urban Strategy Assistance cited above devotes a chapter to Decentralization and Privatization of Urban Services. It lists a number of functions in some municipal areas which are now being carried out by the private sector. Examples include:

* construction and operation of water supply reservoirs and main transmission lines;
* contracting out solid waste management operations;
* operation of selected sanitation services;
* operation of small bus systems;
* industrial estate development.

It would appear clear that if these services by the private sector are to be expanded some longer term financing will be needed. In some cases, regional development banks owned by provincial governments likely could provide some of the financing. In other cases, commercial banks that are now going to have to make 20 percent of their loans to small business could provide some of the financing. However, this appears to be an area where the provision of an AID local currency could open up the availability of credit to enterprises that are credit worthy but might have diffculty getting credit or that could have the process significantly speeded up or that could get better terms. In most cases such financing requirements would appear better met through longer term borrowing but in some cases, e.g., construction of a water reservoir, a bond issue might be appropriate.

This study focused almost exclusively on the municipal bond issue so, with the exception of a brief discussion in Surabaya, did not get into the financing of such services. As a next step, the recommendation is to select three sizeable municipalities and do a detailed examination of what services are being provided now by the private sector, what services could be provided by the private sector, what the constraints are including finance, who would be the potential provider of the finance and what form would it likely take and what inducements, such as guaranty, would enhance the process.

Recommendations Concerning the Future of Municipal Bonds

Although this review concludes that the issuance of municipal bonds is not feasible at the present time, even a pilot project, at least until the government completes its transition to a working RDA, the culmination of the process now under way will eventually lead to municipalities, some obviously sooner than others, seeking and able to finance their infrastructure needs in the market. That is, government policy is to decentralize more authority to the local government level, is designed to assist local government to plan for, develop, manage and service its infrastructure facilities, will move increasingly to loan financing from grant financing, and will gradually move toward interest rates approaching market. Somewhere along this continuum some municipalities will be ready to issue bonds.

There are, however, things that can be done simultaneously to prepare both the market and the municipalities for the eventual issuance of bonds. The market includes not only the potential investors in municipal bonds but the intermediaries in the process, the underwriters and brokers. Both of the USAID projects cut across this area, i.e., the Financial Markets Project and the Municipal Finance Project, and have the capacity within the projects to provide needed technical assistance.

For instance, this study indicated a lack of interest on the part of underwriters in bond issues and in providing comprehensive, knowledgeable services related to this function. On the other side, the largest purchaser of bonds, TASPEN, indicated that there was also a lack of knowledge on the part of investors in the workings of the bond market. It is recommended as a next step that a comprehensive study be undertaken looking at underwriters and potential underwriters in the bond market to determine how this function can be expanded and strengthened and begin to lay the groundwork for eventual utilization of the market by municipalities.

III. HOW MUNICIPAL FINANCE WORKS NOW

A. Introduction

As indicated in Section I, the USAID has a major project in municipal finance which utilizes both Housing Guaranty resources and grant resources for technical assistance. That project's goal is to improve the shelter conditions of Indonesia's urban poor by facilitating the delivery of affordable shelter-related infrastructure through assisting in developing the municipal finance system. This report examines only one aspect of such a system, the potential for financing through the issuance of municipal bonds.

Four major papers, along with selected interviews, form the basis for the findings reached in this section:

Report on Municipal Finance in Indonesia by William Frej in September 1987

The Housing Guaranty Municipal Finance Project Paper in August 1988

Urban Strategy Assistance-Indonesia, a paper prepared by the Research Triangle Institute in March 1990

The Indonesia Municipal Finance Program: Second Year Assessment by the Urban Institute in August 1990.

All of these studies and reports deal with the municipal finance question across the board and provide comprehensive treatments of all aspects. This section provides only a brief review of how municipal finance works today and deals in more specificity with those aspects which bear on the possible financing of infrastructure through municipal bonds. It appears evident from the current situation and its complexities as the move toward decentralization and less subsidies from the central government continues, that the use of municipal bonds as a financing tool is some way off.

B. The Central Government Framework

The central government budget is prepared by the Ministry of Finance in consultation with other ministries and government institutions. The budget proposal is sent to the House of People's Representatives for approval in January prior to the beginning of the fiscal year in April. The central government budget does not incorporate the budgets of the 27 provincial governments, two special territories, municipalities or local governments. These entities are prohibited by law from borrowing funds and are required to balance their expenditures with local revenues and allocations and subsidies from the central government. Also excluded are the budgets of two special agencies, 31 state-owned financial institutions and 1 3 state-owned non-financial enterprises.

Central government expenditure is classified into two categories: recurrent expenditures and development expenditures comprising the public investment program. FY 89/90 expenditures were projected to be financed 69 percent from domestic revenues and 31 percent from foreign sources. The present government is running some surplus in the recurrent account. This is applied to the development budget along with foreign borrowing. The central government does not borrow domestically. It did issue bonds after independence but was unable to pay the holders until after the oil boom. Subsequently, no more domestic debt has been issued. Bank Indonesia, however, does issue short-term instruments as a tool of monetary control (see below). In addition, state-owned institutions borrow in the bill market (see also below).

At the national level, the Ministries of Finance, Home Affairs and Public Works along with BAPPENAS (the National Development Planning Board) are all involved in the planning, development, implementation and financing of urban infrastructure.

Several years ago the GOI developed a National Urban Policy Statement which encompasses six specific policies.

1. Development of urban infrastructure and the operation and maintenance thereof, in principle, is within the authority and mobility of local governments with the assistance and guidance of the provincial and central governments.
2. Planning, programming, and identifying investment priorities by all levels of government for urban development will continue to be improved by means of a decentralized and integrated approach.
3. In order to develop local governments' responsibility for providing urban infrastructure services, there will be further strengthening of local governments' capability to mobilize resources and optimize the use of funds.
4. In accordance with the principles of decentralization of urban infrastructure responsibilities, the government will, in addition to the pursuit of policy 3, endeavor to improve the financing system for urban infrastructure development.
5. The capability of provincial and local government staff and institutions will be enhanced by means of a coordinated program of local government manpower development.
6. Coordination and consultation among the various agencies and levels of government involved in the development of urban infrastructure and services wil continue to be strengthened.

Policy numbers 3 and 4 are the policies most directly affecting whether municipalities will eventually be permitted to issue bonds but the objectives of the other policy goals will be contributing factors. It is the degree to which these policy goals are being achieved which is the basis for the conclusions reached in this report.

C. Local Government Organization, Operation and Financing

Below the national level, Indonesia's governmental structure consists of four levels. Level I includes the 27 provinces plus Jakarta, and Aceh. Level II consists of 54 municipalities (urban areas ranging from 100,000 to several million people) and 292 regencies (remaining areas of the provinces). The third level includes some 3,500 districts and the fourth level 64,000 villages. Levels I and II have both legislative and executive branches but the governing officer (governors for provinces, mayors for municipalities) is appointed by the Ministry of Home Affairs. Both Levels I and II governments would appear to be eventual candidates for the issuance of bonds at some time in the future although the provision of most urban services occurs at the municipal level and trunk roads, for instance, are the responsibility of the central government. Provincial governments are, however, responsible for overseeing all of the work of municipalities and do provide some financial assistance.

However, there apparently is still little formal capacity at the local level to identify investment priorities, develop long-term capital investment programs and to operate and maintain facilities. Thus, responsibility for technical aspects of urban development is largely vested in the Ministry of Public Works. The Directorate General for Housing, Building and Planning (Cipta Karya) deals with water supply, sanitation and sewerage, solid waste, kampung improvement, etc. The Directorate General for Roads is responsible for national highways including those through urban areas, and the Directorate General for Irrigation and Water Resources is responsible for major drainage in urban areas.

Mid-term priorities for investments are established by BAPPENAS in the five-year plans. It also receives and approves specific projects and programs proposed each year by the sectoral departments and the plans prepared by the provincial and local agencies. The Ministry of Finance through the Directorate General for Internal Monetary Affairs monitors and has oversight of local government finances and loan schemes. The Directorate General for Taxation is responsible for the collection of certain assigned revenues and supervises the local property tax.

The Housing Guaranty Project Paper in 1988 pointed out that "the municipal finance system in Indonesia is a complex and still developing network of expenditures and revenues" and is in an evolving mode." That still appears to be the case.

Indonesia doesn't have a true credit system for local government or local government enterprises. Local governments are regulated by the Ministry of Home Affairs and dependent on the central government for funding. They have little autonomy and this affects their authority to raise funds. They have no access to capital markets; can't borrow from commercial banks. These restrictions are legal constraints. The laws relating to local governments are extremely vague and implemented by decrees.

The source of financing for Levels I and II governments is roughly 70-80 percent from the central government and the remainder from their own revenues; local taxes, e.g., hotel and restaurant tax; local charges and fees such as fees for waste collection and parking fees and profits from local municipal enterprises.

Funding from the central government consists of grants to cover wages of centrally-appointed staff, reassignment of revenues collected locally, primarily the property tax; central government grants, i.e., "INPRES" grants which are "block grants" to Level II and village level governments and "directed grants" for roads, bridges, education, etc., and some loans.

There are criteria governing the allocation of grants. A local government submits a proposal to the provincial government. If approved, the provincial government submits the proposal to the central government for approval by the Ministry of Home Affairs. A municipality can't apply directly to the MHA for a loan. But there are no clear regulations. Some loans to municipalities are generated by the technical ministries of the central government, e.g., MPW, which are financed by foreign donors.

Local government loan applications go to the Ministry of Finance (MOF). MOF makes a priority list which is sent to BAPPENAS for approval. However, very little of the Central Government financing to local government was in the form of loans up until the Regional Development Account (RDA - see below) was created. The interest rate on central government loans is 9 percent with a maximum term of 15 years and 5 years grace. Local governments also borrow in relatively small amounts from Regional Development Banks, which are primarily owned by the provinces, at rates ranging from 8-22 percent but such loans must be approved by the MHA.

The category of cash transfers from central government to local government known as INPRES falls into 7 categories. There are two major types: the first goes to the provincial level and villages which are free to program within broad guidelines. The second type are those which are earmarked for specific investments, e.g., roads and schools.

INPRES amounts of the first type are allocated as of this year on the basis of a formula, a partly equal amount to the 24 governments plus a portion based on size: Rp. 1.5 million to each village, municipalities are based on population, and provinces get Rp. 12

billion plus a formula based on land area. Earmarked funds take into account existing infrastructure or estimated needs.

Most borrowing under INPRES is through subsidiary loan agreements (SLAs). These are primarily World Bank funds borrowed by the GOI and passed through to the local government to finance a project such as water. Priorities are often established by donors who deal directly with the MPW and BAPPENAS. Some bilateral donors provide a grant to MPW to finance consultants to prepare the project. After the project is prepared the donor extends a loan. It is at this stage that the local government gets more involved in the process. MPW and BAPPENAS decide how to apportion the project loan between loan and grant components to the local government with a tendency now to increase the loan component. Finally, the MOF gets involved in drawing up the loan agreement between the MOF and the local government. The terms are set by the donors and BAPPENAS. SLAs can carry different terms reflecting the terms on the loan from a particular donor to the central government.

Although local governments can and do identify projects, there has apparently often been insufficient concern with financial and economic feasibility at the local level. Consequently, older loans show a high delinquency on the part of local governments because of the lack of clear cut feasibility of the project in the first place and/or the loan (project) was not generated at the local government.

The system has tended to be biased toward sectors and regions. Loans go to geographic regions, water supply and roads. Eighty percent of development projects have gone to the five regions with the largest cities. Small projects haven't received much support from donors.

To put some perspective on the projected financing needs for urban investments, planning for Repelita V, Indonesia's fifth five year development plan, indicated levels of from Rp. 5,500 billion to Rp. 8,200 billion (in 1988 this was about $3.3 to $4.9 billion). Since projection of resources to be available from central government sources and foreign aid still leave a significant gap, the local governments will have to develop other financing sources.

There are a number of changes in tax and other revenue policies that either have been undertaken or been under consideration in recent years, the most significant being changes in the property tax system. In addition, there have been changes in the longer-term planning for urban infrastructure which has been developed by the Ministries of Public Works, Home Affairs, Finance and BAPPENAS. This paper is concerned with the latter process and how this infrastructure is financed.

The program, the Integrated Urban Infrastructure Development Program (IUIDP), has assisted Level II governments to prepare: (1) five year rolling capital investment plans; (2) multi-year budgets for operation and maintenance; and (3) long-term financing plans which include grants, cost recovery mechanisms, and municipalities' other local resources. Eventually, these plans will include and in some cases already are including loan financing (see discussion of Regional Development Account below).

Efforts are continuing to reduce the financial requirements of the central government and shift more of the burden to local government and locally-generated revenues. One aspect of these efforts is to move more toward loan financing of infraststructure investment.

But the problem will be difficult. Because of how things are working now and the deeply established procedures of central government development of projects and a mix of grant and heavily subsidized financing, municipalities do not think in terms of financing infrastructure needs on a market basis. In fact, in the one field trip carried out as part of this study, the municipality of Surabaya indicated that if foreign donor financing being contemplated for a particular infrastructure project fell through, it would simply seek financing from another donor. And Surabaya is a municipality that has already borrowed through the MOF for bus terminals, roads, water supply and waste management.

D. The Regional Development Account

To address the municipal financing problem, the GOI established in 1986 a consolidated loan fund for local governments and their enterprises known as the Regional Development Account (RDA). Discussions concerning the establishment of such a fund had commenced in 1981. Initially, outstanding central government loans, from both domestic and foreign sources, made to local governments will be repaid into this account for further on-lending to local governments. All future loans are intended to be channeled through the RDA.

The intent of the RDA is to (a) encourage local authorities to increase their revenue generation capacity and to promote cost recovery and realistic service charges; (b) provide a single channel for foreign and local donors to finance local government projects; (c) evolve into a self-generating revolving loan fund; (d) encourage local authorities to be less dependent on central government and more involved with their own financial planning and programming; and (e) provide a vehicle for mobilizing and channeling private sector funds.

Although the RDA exists now it is still using old procedures and as of June 1990 it had not been capitalized. Capitalization was expected to come from the central government budget and foreign sources to go with repayments. There is an RDA account in Bank Indonesia which was opened in 1986 to start receiving repayments as described above. The Subdirectorate of Investments for Public Works and Communications in the MOF has prepared new operating manuals which will cover the internal processing in MOF of project financing requests. A borrowers manual and a technical manual have also been prepared but as of June 1990 had not as yet been distributed.

At that time there continued to be a debate about how the RDA will work although MOF is expected to play a major implementation role. Annex 2 is the Proposed General Policy Statement of the RDA as of March 1990. For RDA to be created a formal legal instrument must be issued in the form of a joint decree of the MOF and BAPPENAS. However, some elements within government still have concerns about the idea of an expanded loan facility to municipal governments and state enterprises.

Once an official announcement is made there will probably be a lot of demand for loans. It will then be necessary to solve the capitalization problem although it is not intended to set up RDA as a separate institution--just a financing facility.

RDA will operate utilizing MOF staff. Ideally, it should be a semi-independent financial institution with non-civil servant salaries. Another approach would be to use the Regional Development Banks as originators and servicers of loans with the RDA as a rediscount facility. However, given the history of RDA's development to date, these kinds of things would take considerable time to implement. The most important thing to do is to establish all the rules and procedures. If at some time, for instance, credit is a bottleneck you look for alternatives.

The sources of RDA money right now are as follows:

-- repayments on existing portfolio (there are 140 loans on the books, 40 of which are recent). Existing loans are counterpart loans through SLA's and some actual RDA loans;
-- central government budget - APBN;

-- foreign funds.

It is possible that in the future RDA will be a separate institution, develop its staff, address the issue of capitalization and raise funds. But the most important thing is to get it underway. One of the major issues facing RDA is the interst rate it should charge. At this point it can't use a market rate for many reasons. But it does need to develop a rate that will protect the Fund. This should cover inflation, administrative costs, some provision for bad debts and provision for growth. The rate that was initially decided on was 13 percent. It was based on 9 percent rate of borrowing, plus 2 percent for default insurance and 2 percent for administration. The 9 percent was based on what the government expected would be World Bank terms. Although the 13 percent rate was officially announced, there was too much opposition so the rate was modified to 9 percent. There now needs to be a longer term plan to gradually move to a higher rate. Some consideration is being given to using an adjustable rate structure.

It has also been proposed to set up a system linking grants and loans, particularly for local governments that will have difficulty in meeting borrowing costs. The intent would be to give a grant for the first portion of a project, then have the local government come to RDA to get a loan for the second part which would move it closer to a market rate.

There is a very real concern among some GOI officials that many if not most local governments will not be able to pay economic interest rates nor are they yet equipped to plan, develop and implement infrastructure projects on their own. The RDA can play a role in both strengthening local financial management and in beginning to shift the thinking away from the idea that planning and financing for infrastructure is a central government responsibility. Until that happens it is unrealistic for municipal governments to seek financing in the market.

IV OVERVIEW OF THE FINANCIAL SECTOR[1]

A. Bank Indonesia

Bank Indonesia is the central bank of Indonesia. It has traditionally implemented monetary policy through the regulation of credit in the economy but has supplemented this by the use of discount facilities and open market operations. Bank Indonesia also supervises and regulates financial institutions, with the exception of the investment, insurance and development finance companies and acts as lender of last resort to the banking system. It also holds the official foreign reserves of the Republic as well as the government's treasury accounts, making advances available to the government as necessary and advising on economic policy.

In addition to the traditional functions of a central bank, Bank Indonesia participates in various types of financial institutions, mainly to assist in the development of the financial system. These include three private development finance companies, a housing finance company and a credit insurance company for small business loans. Bank Indonesia has also provided "liquidity credits" to deposit-money banks to fund loans to development projects undertaken by government agencies and state-owned corporations and to refinance the general credit operations of deposit-money banks.

Starting in 1983 Bank Indonesia initiated a process of gradual deregulation and development of the banking system. This was followed by a wide-ranging series of deregulatory measures in the financial sector in October 1988 and March 1989. The new measures were designed to complement deregulatory reforms in the economy through increasing competition and efficiency in the banking and

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[1]Much of the material in this section was taken from a recent Shearson Lehman report on Indonesia.

other financial sectors, and through the promotion of capital markets.

B. Financial Institutions

Indonesia's financial institutions include banks, finance companies known as non-bank financial institutions (NBFIs), leasing companies and insurance companies. As of September 30, 1989, there were 97 commercial banks, 29 development banks, three savings banks, and a large number of small rural non-deposit-money banks. NBFIs included three development finance companies, nine investment finance companies, and a housing finance institution. Other financial institutions included 118 insurance companies, 83 leasing companies and a number of other institutions of lesser significance, such as pawn shops.

Commercial banking is dominated by five state-owned banks, each originally established to provide banking services to a specific sector of the economy. These distinctions no longer exist, except that one remains a specialized bank for agriculture. The principal sources of funds for state banks are demand, time and savings deposits, and credit from Bank Indonesia through refinancing facilities.

There are 76 private commercial banks owned and operated by Indonesia nationals of which 15 are licensed to deal in foreign exchange. Expansion of private commercial banks has been relatively rapid in recent years. Private national commercial banks have benefited from the liberalization policies, and as of March 1989 held some 31 percent of the rupiah deposit base. There are ten branches of foreign commercial banks in Indonesia.

The deregulatory measures introduced in October 1988 provided incentives for foreign banks as well as domestic banks in Indonesia. Thirteen new domestic private banks have been established, while eight joint venture banks have been approved. Foreign banks are now permitted to set up sub-branches in cities other than Jakarta.

The 29 development banks include one major bank owned by the Central Government, Bank Pembangunan Indonesia (BAPINDO). There are also 27 regional development banks wholly or partially owned by the provincial governments and one privately owned bank. In Indonesia, most long-term loans have final maturities of less than ten years, although in the case of BAPINDO the maximum maturity is 15 years. (See separate section on BAPINDO)

There are a large number of non-deposit money banks in Indonesia. There are also approximately 6,000 rural and village banks and credit cooperatives. Development finance companies and investment finance companies have been established since 1972 with the purpose of promoting the development of money and capital markets in Indonesia. They are permitted to issue and deal in commercial paper and long-term securities, issue CDs and to make equity investments and loans.

In 1980, the government approved the establishment of a new financial institution, specifically for financing house ownership, to supplement the large government-owned housing bank, Bank Tabungan Negara (BTN). This institution, P.T. Papan Sejahtera, is empowered to mobilize funds through the issuance of medium or long-term bonds and to extend medium and long-term loans for house purchases.

Total credits provided by the banking system, including direct lending by Bank Indonesia, increased by an average of 23.5 percent per annum between 1983 and 1988. As of March 31, 1989, total credits outstanding amounted to Rp. 466,526 billion, of which state banks including BAPINDO accounted for 65.1 percent, private banks and regional development banks 27.2 percent, branches of foreign banks 4.3 percent, and Bank Indonesia 3.4 percent. Of these credits 33.7 percent went to the manufacturing sector, 31.6 percent to the foreign and domestic trade sectors, 16.3 percent to the service sector, 18.4 percent to agriculture and other sectors.

C. Monetary Policy

Monetary policy is set and implemented by Bank Indonesia under the direction and coordination of the Monetary Council. To maintain stability of the rupiah, Bank Indonesia is empowered to control the money supply and to regulate domestic credit and interest rates, as well as the allocation of credit to the various sectors of the economy.

Bank Indonesia has the right to impose minimum reserve requirements as a means of regulating bank liquidity. Until October 1988, all banks were required to maintain liquid assets equal to 15.0 percent of current rupiah and foreign exchange liabilities. In October 1988 the minimum reserve requirement was reduced to 2.0 percent of current rupiah and foreign exchange liabilities.

In June 1983, the first of a series of major monetary deregulation measures was introduced, with the intent to make the banking system more responsive to market forces. All quantitative ceilings previously imposed on bank credit were removed. In parellel, Bank Indonesia curtailed the provision of direct credits to state-owned and private companies, restricting itself to providing investment liquidity credits to deposit-money banks for use in high priority sectors. As part of the monetary reform, measures also included the removal of ceilings on interest paid on rupiah time and savings deposits at state-owned commercial banks and BAPINDO. In addition, since July 1987, the 15 percent per annum interest rate payable on small deposits under the National Development Savings Scheme (TABANAS) has been extended to all amounts deposited under TABANAS. The result was that time and savings deposits denominated in rupiah with the deposit-money banks rose sharply as did loans by the deposit-money banks to the private sector.

In February 1984, two new discount facilities were introduced: the first is a short-term discount window with facilities of up to two weeks (renewable up to a maximum of 29 days) designed to assist in day-to-day fund management, and the second is a slightly longer term discount facility with availability periods of up to two months, renewable up to a maximum of four months. The extent to which a bank can have access to these new discount facilities depends on the size of its deposit base. An active interbank market has developed and the discount facilities of Bank Indonesia are therefore available only as a last resort.

To accommodate banking liquidity, Bank Indonesia introduced certificates of deposit (Sertificat Bank Indonesia--SBI) in February 1984, bearing maturities of one or three months. Implicit interest rates on SBIs issued to date have ranged from 13.0 percent to 18.0 percent per annum. As of June 30, 1989, the amount of SBIs outstanding equalled Rp. 2,631 billion.

In September 1984, in response to a shortage of liquidity in the interbank market, Bank Indonesia limited borrowing in this market to a maximum of 7.5 percent of a bank's total rupiah deposit base. Banks which were heavily dependent on interbank borrowing were allowed to borrow directly from Bank Indonesia under a special one-time credit facility which was fully repaid at the end of September 1985. With the restoration of liquidity to the market, Bank Indonesia raised the ceiling on interbank borrowing to 15 percent of rupiah deposits in August 1985.

To enhance the liquidity of both bank and corporate borrowers in the money market and to create a money market instrument appropriate for open market operations, Bank Indonesia introduced an additional short-term security, the SBPU, in February 1985 based on banks' loan assets. SBPUs include promissory notes issued by banks or NBFIs in the course of interbank borrowing; bills of exchange drawn by participants in trade transactions and accepted by a bank or NBFIs to commercial or industrial borrowers. The minimum maturity of SBPUs is 30 days and the maximum 180 days.

To encourage the development of a secondary market in these securities, a private securities house was authorized to trade money market securities that have been endorsed by banks or NBFIs. Banks and NBFIs wishing to raise funds may sell money market securities in the secondary market or discount them at Bank Indonesia at the prevailing discount rate. If Bank Indonesia wishes to provide liquidity to the banking system, it can purchase SPBUs; conversely, if it wishes to withdraw liquidity, it can issue SBIs or sell SBUs from its portfolio.

To increase its control of money supply, Bank Indonesia introduced a series of new measures in 1987 that included the auction of SBIs with a maturity of seven days, in addition to those already available with maturities of 15, 30, and 90 days. The method of conducting transactions in SBIs and SBPUs was improved.

In October 1988, Bank Indonesia introduced further reforms to enhance the effectiveness of monetary policy. SBIs can now be issued with maturities of up to one year, the auction system of SBIs has been diversified and the trading of SBFUs is now also conducted through auctions. To encourage the development of the interbank market, the limit on interbank loans, which was previously set at 15 percent of funds mobilized from third parties, has been terminated.

The rate for SBIs generally will be close to the overnight bank rate which in June 1990 was around 12 percent. At that time there was a lot of liquidity in the banks and bids for SBIs were low.

It should be noted that SBIs and SBPUs are used by the government to control money supply and not to finance the government's short-term needs. There has been no issuance of government debt since 1965 and all old debt has been paid off. The present government is running some surplus in the recurrent account. This is applied to the development budget along with foreign borrowings. Thus, there is no reference government long-term borrowing rate in the market.

V THE SECURITIES MARKET

A. Background and Organization

The securities market in Jakarta was reestablished in 1976 after a lapse of some 20 years. In August 1977 the government instituted a series of reform measures which included the establishment of the Capital Market Executive Agency, Bapepam, to regulate the capital market and operate the stock exchange and the creation of a state investment company, P.T. Danareksa, to underwrite securities offerings and form mutual funds and unit trusts. Bapepam has developed operating procedures and has functions similar to those of the U.S. Securities and Exchange Commission in administering and supervising the capital market. During the first half of 1989 the Bursa Parallel, an over-the-counter market, began operations. There is also a privately-owned stock exchange in Surabaya regulated by Bapepam.

All financial institutions trading securities on the stock exchange or the over-the-counter market must belong to the Association of Brokers and Dealers (PPUE). According to the USAID Capital Market Project Review in April, 1990, the stock exchange has 39 members, consisting of the six state-owned banks, eleven private commercial banks, nine non-bank financial institutions, eleven private brokers, P.T. Danareksa, and the state development bank, BAPINDO. The members of the exchange act only as brokers, finding buyers or sellers for their customers. They do not act as dealers, making a market by buying and selling for their own accounts.

All applications for listing on the stock exchange must be made through the underwriter which is to issue the prospectus. Issues are underwritten by one or more underwriters. The Indonesian Capital Market Fact Book - 1989 indicates that at the time of its publication there were eleven underwriters which included P.T. Danareksa and BAPINDO.

The formal organizational structure of the capital market and Bapepam is outlined in Annex 3.

B. The Equities Market

The first share issue to be listed on the Jakarta exchange took place in August 1977. However, until the end of 1988, the market experienced very slow growth. From 1984 through the end of 1987 there was no new equity issue and secondary trading was almost non-existent. Most of the 24 companies which had listed their shares up to that time did so only to accommodate the foreign investment law which required participation of Indonesian nationals in foreign companies operating in Indonesia and to take advantage of special tax incentives. Most of the issues were purchased and held by P.T. Danareksa. This large holding of shares by Danareksa was often used as an instrument to control the movement of individual share prices. Almost since its inception and until the end of April 1988, the composite stock index was below 100 with a very low turnover.

The stock market became more active after the government adopted deregulation measures in December 1987 which, among other things, removed the restrictions on share price movements (previously limited to a 4 percent daily allowable change), allowed foreign investors to invest in shares for up to 49 percent of the total paid-up capital of the listed company, and related the requirements for new share issues and company listings. Consequently, the stock index increased slowly until it reached the 100 level by the end of April 1988, and thereafter began to rise rapidly.

In December 1988, a package of reforms on the capital market was announced. This followed measures introduced in December 1987 and October 1988 and was aimed at promoting the further development of the capital market, expanding alternative sources of financing for the private sector and further promoting the mobilization of funds. The reform measures of December 1987 and October 1988 included the simplification of listing requirements and the establishment of an over-the-counter market ("the parallel market"). The December 1988 measures allowed the establishment of private stock exchanges, the first of which was established in Surabaya with the purpose of complementing the growth of the Jakarta exchange.

The 1987 and 1988 deregulation measures greatly improved the opportunities and rationale for companies to enter the capital markets and encouraged more active trading in the secondary market.

As of September 30, 1989, 33 companies were listed on the Jakarta stock exchange, with a total market capitalization of Rp. 774.4 billion. In addition four companies were traded on the parallel market. In 1989, eight foreign investment funds were set up to invest in Indonesian stocks.

The rapid and spectacular growth of the stock market after 1988, the succeeding share price booms, the continued increases in share prices from new issues and the rush to the market by many companies in a short period of time began to create problems and concerns for the Ministry of Finance in 1989 and there was support to return to a more regulated market. There was a feeling that the market was overheated and particularly vulnerable to wide swings in prices caused by speculation in the primary market which could eventually cause a crash eliminating all of the progress.

There was a lack of regulatory and supervisory control over the many new issues being approved and the activities and responsibilities of supporting participants in the market, such as underwriters and brokers, were not well controlled. The information contained in prospectuses is often very weak and the presentation of financial information is often inadequate. Furthermore, prospectuses are often released too late to enable an investor to reach an informed decision. The MOF set up a working group structure in 1989 to review stock market regulation, management, and operations under BAPEPAM as well as to review various other aspects of the Indonesian capital markets, including the role of underwriters, supporting professionals (e.g., accounting, legal) and Danareksa. The working group structure was dissolved at the end of 1989 and efforts focused on drafting a ministerial level decree and other enabling documents incorporating the results of the working groups. The decrees set forth the regulatory approach to the Securities Market Executive Agency (a new version of BAPEPAM), the securities exchanges, securities companies, capital market support functions, and capital market supporting professionals. Next steps include converting the Jakarta Stock Exchange into a private, automated body.

C. The Bond Market

1. Development and Current Status

The development of the bond market, such as it is, has also occurred slowly. The first bond issue was in March 1983 by P.T. Jasa Marga, the government-owned toll road company. The Rp 24 billion issue carried an interest rate of 15-1/2 percent with a maturity of five years. Through the end of 1987 all new bond issues were made by three government-owned institutions; P.T. Jasa Marga, Papan Sejahtera, a housing finance institution, and BAPINDO, the government development bank. Up until that point there had been 16 issues totalling Rp 536 billion, all with maturities of five years and interest rates ranging from 15-1/2 to 16-3/4 percent. Two issues of Rp 60 billion constituted the largest individual issues.

From 1988 on, other government agencies entered the market and in July 1988 IBJ Leasing became the first private company to float a bond issue, a Rp 10 billion issue at 18 percent for only three years. Through January 1990 there had been 48 issues totalling Rp 1,527 billion on the Jakarta stock exchange and an additional two issues totalling Rp 25 billion on the parallel market.

Of the 48 issues on the Jakarta exchange, 30 were by P.T. Jasa Marga, Papan Sejahtera and BAPINDO. The remaining 18 were by additional government-owned institutions, including several regional development banks, and seven private companies. The two issues on the parallel market were private companies. Of the total issues of Rp 1,552, only Rp 162.5 billion, or about 10 percent, was in the issues of the private companies.

All issues were for five years with the exception of the three-year IBJ Leasing issue and three somewhat longer issues by P.T. Jasa Marga, two for eight years and two for twelve years, one of the former being for Rp 75 billion. Interest rates have moved upward with some issues carrying rates of 19-1/2 percent (see Annex 4 which shows all bond issues through January 1990).

It should be noted that the issues of the government-owned companies are really placed, not sold, at the direction of the Ministry of Finance and are taken primarily by various government pension funds and insurance companies (see Section VIII below).

Nevertheless, changes are beginning to occur. One of the over-the-counter issues by a private company was on a floating rate basis. On May 25, 1990, P.T. Jasa Marga announced a Rp 100 billion issue, the largest issue up to this point. The issue will carry a maturity of eight years which, as noted, is longer than most issues to date. The interest rate is a floating rate at 2 percent over the three-month state bank deposit rate (14.5 percent in May 1990). That makes the 16.5 percent initial rate to Jasa Marga lower than its most recent rate. ASTRA, a large private conglomerate that had previously floated a Rp 60 billion bond issue in 1988, is planning to do a convertible bond issue.

Guarantors for bonds exist now (see Annex 5 which covers the supporting institutions for bond issues). They can be banks and NBFIs that have obtained a license from the Ministry of Finance. Presumably they guaranty the issues of private companies. The ASTRA convertible issue may be guaranteed by BAPINDO.

2. Factors Affecting the Bond Market

There is really no long-term bond market in Indonesia; anything longer than one month can almost be considered "long-term." The reason is probably historic. There apparently has been a great distrust in the domestic currency although it appears to be improving. There were several devaluation shocks which occurred in 1978, 1983 and 1986 amounting to some 30-40 percent each. This, combined with the fact that Indonesia has no foreign exchange controls, led to the banks keeping sizeable US dollar balances. Twenty to thirty percent of a bank's balance sheet may be in US dollars, reflecting a lingering caution.

There are other factors as well. It has not been until very recently that Bank Indonesia has made any efforts to develop money markets (as previously indicated, there is no domestic borrowing by GOI). Since the 1988 deregulation package, however, there has been an effort to broaden and deepen money markets although most of the Bank Indonesia issues are only for seven days. Banks, however, are now starting to trade these issues.

The foreign exchange rate is now managed so as to reduce the risk of a major devaluation. The rate is adjusted on a daily basis which eliminates the possibility of some big surprise.

With regard to taxes, the first bond issue of P.T. Jasa Marga, the government-owned toll road company, was tax exempt. Now, the interest paid on the bonds of all government-owned companies is taxable. Until 1988, the interest paid on bank deposits was tax exempt. An investor could get the same rate for bank deposits as on bonds. Now, the interest paid on bank deposits is subject to a 15 percent withholding but that's the final rate. The marginal income tax rate is 35 percent (applicable to interest paid on bonds) so bank deposits are still a good deal. So there is a question of why private investors would invest in bonds with all of the additional uncertainties associated with longer term illiquid (in Indonesia) investments.

Since bonds, as described above, are primarily issued by government-owned companies and are "placed" rather than sold to a small number of mostly government-related pension funds as directed by the Ministry of Finance, there is really no primary "market" as such. Bonds must be sold at par. That is, if you put an 18 percent interest rate on a bond issue, it must sell at par. It can't sell at a discount to reflect a higher yield. Some bond issues were sold at rates below market. Thus any sale of bonds in a secondary market, if one existed, would have to occur at a discount to the original purchase price and the holder would incur a loss. By not selling securities (and this includes stocks as well), however, investors are not required by Indonesian accounting regulations to recognize any loss that results from a drop in the market price. This reduces the possibility of the development of any secondary market. All bond sales are held to maturity; there is no market. This is a major reason why it is (would be) very difficult to sell bonds to private investors. It's simply impossible to sell bonds from a portfolio no matter what the price the investor is prepared to take.

There is a real constraint on issuing bonds by the government-owned companies. It is really only a two-month market, or window, in June and July. That is because they can't go to market until after the State Budget Agency has completed its audits.

The underwriting business appears to be a major constraint to the development of the bond market. For one thing, underwriters are not prepared to risk carrying a long-term security in the event an issue is not fully subscribed and, as pointed out above, there is no secondary market in which to sell the bonds at some later time. Underwriters have been preoccupied with the equities market because equities provide better margins (4 percent versus 2.5 percent for bonds), equities can be better retailed because of the appeal of capital gains, and bonds cannot be traded offshore while equities can. As a consequence, pricing and research services provided by underwriters on bond issues have not been very good. Any innovation in debt financing at this time would appear to have to come from the issuing institution.

Another problem that was cited in interviews was that the sinking fund requirement is a big problem for issuers (see Annex 6--Standards and Requirements for Bond Issues).

If a bond market were to develop, maturities would have to be lengthened gradually; it would be impossible to jump to, say, 15 or 20 years. That is, even with an explicit government guaranty, there wouldn't be any buyers for municipal bonds with maturities longer than five years.

To get a real bond market going, one approach could be to provide incentives for banks to hold bonds. For instance, in developed countries some banks have a large bond portfolio which provides liquidity and is part of their overall asset management. If an Indonesian bank could, say, count bond holdings as part of its liquidity requirements, it might start buying. As balance sheets changed, trading might start. This could then start to create a market.

VI THE DEVELOPMENT BANKS

As described earlier, the development banks include the Bank Pembangunan Indonesia (BAPINDO) which is owned by the central government and a series of regional development banks which are owned by individual provincial governments. Because of BAPINDO's overall importance in the capital markets and because the regional development institutions may eventually act as some sort of intermediaries as municipal governments evolve in their financial independence, it is useful to examine these institutions briefly.

BAPINDO

BAPINDO was founded 30 years ago to provide medium and long-term project financing. After the deregulation of 1983 it engaged in commercial banking as well, e.g., trade financing, export-import. However, it does this primarily for its own clients. That is, if it finances a project relating to exports, it might also finance trade activities for that company. More competition was introduced after the October 1988 deregulation package and BAPINDO now has current accounts and checking accounts and engages in foreign exchange trading.

The government appointed BAPINDO as the only bank licensed to do underwriting. It is now one of the biggest underwriters of equities and bonds. It also issues its own bonds each year.

Its clients are primarily private companies; maybe 5 percent are state-owned enterprises. Its loans range in maturity from 5-8 years up to 12 years although some may go as long as 15 years, e.g., to fund a plantation, you need to get 15-year financing. There is a strong market for project loan financing. The alternative to borrowing from BAPINDO for companies is shorter term loans from commercial banks which are rolled over.

For new project loans, BAPINDO now charges 19 percent on an adjustable basis. The loans are adjusted every 6 months based on the SPBO rate. Old clients get a base rate today of 17 percent, also adjustable.

BAPINDO has been raising money through issuance of new bonds each year starting in 1986. In May 1990 it had a bond issue of Rp 150 billion. It originally planned Rp 300 billion but scaled back. There was still a shorfall of Rp 10 billion on the sale of the issue. In general, BAPINDO has had no trouble in selling its bond issues. But, as indicated earlier, the bonds are only sold (placed); the buyer retains in its portfolio. There is no secondary market. The buyers of BAPINDO bonds are government institutional investors (state-owned banks, insurance companies) and pension funds. Only 1-2 percent of such an issue is sold to private sector.

BAPINDO gets some money externally and has a refinancing facility with Bank Indonesia. It has 25 branches. Deposits currently earn 17.5 percent in private banks but only 15.5 percent in state-owned banks. Total assets are Rp 4.8 trillion.

BAPINDO indicated it would be interested in underwriting a municipal bond issue. However, it feels approvals would be a problem. Even for Jakarta, say the City Council, the Ministry of Home Affairs would have to approve. BAPINDO feels the maturity couldn't be longer than 5-8 years with the interest rate comparable to a term deposit. There would be a need to convince investors through seminars, etc.

If, however, a municipal bond issue were guaranteed by government, the only remaining question would be interest rates. BAPINDO has had some discussions with a private investment bank on policy issues regarding municipal bonds.

Regional Development Banks

The 27 regional development banks are each owned entirely or mostly by the respective provincial government. They raise some money through savings. They also get money from Bank Indonesia at 4 percent to finance, say, small business or agriculture. They have not been instrumental in financing large capital projects. Their biggest loans might be on the order of Rp 5 billion.

Discussions with Danareksa indicated that the East Java, Central Java and North Sumatra Regional Banks have issued bonds--5-6 issues at 18.5 percent.

In the field visit to East Java Provincial Government in Surabaya, government officials indicated that the provincial government has never borrowed from a bank or NBFI to cover short-term needs but it does borrow from its regional development bank to cover temporary shortfalls. It can borrow up to Rp 150 million without approval of Ministry of Home Affairs.

The East Java RDB makes loans to all sectors. Some 20 percent goes to municipalities for such things as tourist development facilities, sports facilities, markets and bus terminals. The remaining 80 percent goes to private enterprise for mostly agriculture and small businesses. Loans to governmental entities have a five-year maximum term; agriculture loans would be for one year but can be rolled over. The bank gets its funds from deposits and earnings. The interest rate on loans is currently 18.5 to 19 percent which is considerably above what a municipality can borrow for from the Central Government. It is presumed that the East Java Regional Development Bank's operations are similar to other regional development banks.

The view was expressed in some interviews that the staffs of regional development banks are inadequate, that experience is limited and that financial resources are in short supply. Nevertheless, it appears that regional development banks may offer an intermediate step for municipal financing by issuing their own bonds, as some have already done.

VII LONG-TERM INVESTORS

The biggest buyers of bonds now are institutional investors with long-term funds: insurance companies, pension funds and a few private companies. About 85 percent of bond issues are placed with TASPEN and the pension funds of government agencies such as Pertamina, the oil company. There are a number of private sector pension funds but none of substance. TASPEN has 50 percent of the market, the second is Pertamina, and third, collectively, are the state-owned banks. Danareksa buys only 2-5 percent. Private institutions buy very little. Except for BUMIPUTERA, private insurance companies are very small. If TASPEN doesn't buy a substantial share of a government-owned company issue there would be a problem in placing that issue.

Government institutional investors, if registered, are tax exempt on their earnings. Private insurance companies, however, pay tax. The most likely potential investors in municipal securities would be the pension funds and life insurance companies described above. To get a better feel for how such institutions would view the bonds of municipalities interviews were conducted with BUMIPUTERA, the largest private life insurance company which, along with the government insurance companies, has some 70-80 percent of total premium income of insurance companies; and TASPEN, the government civil servants pension fund.

BUMIPUTERA

BUMIPUTERA, the largest private life insurance company, is a mutual company. There are a total of 30 life insurance companies, one government-owned, one mutual (BUMIPUTERA), and the rest are limited liability companies. The insurance companies are regulated by the Ministry of Finance (MOF) and a new insurance law is expected soon (May 1990). Currently an MOF decree of December 1988 governs what insurance companies can invest in.

As of April 1990 BUMIPUTERA had total assets of about Rp 363 billion of which approximately 250 billion were in investments (the remainder of assets were in current and fixed assets). Investments were spread over the following categories.

Time deposits	Rp 83 billion
Equity stocks	70
Bonds	5
Policy loans	65
Mortage loans	26
Real estate	1
	Rp 250 billion

Essentially, Bumiputera now invests as it sees fit. However, it cannot invest offshore, only domestically. It does, however, have about 50% of its time deposits in US dollar denominated accounts; at one time it was 100 percent.

Bumiputera's policy loans currently earn 18 percent and, although short term, can be rolled over. Its equity investments are primarily in subsidiary companies which it owns, has a majority interest in, or a joint venture. Included are a bank, a non-life insurance company and a joint venture with John Hancock for pension insurance.

Bonds in its relatively small bond portfolio include BAPINDO; Jasa Marga, the toll road company; BTN, the housing bank; and Papan Sejahtera, the housing finance agency in which it also has an equity interest. Some consideration will be given to increasing its bond portfolio to lock in the current high rates by selling some of its equity holdings and by utilizing new premium income. For instance, it's easy for banks to attract money at the current high rates but difficult to loan it out and rates could come down. But Bumiputera would still be looking for bonds with short maturities with a maximum term of 5 years, not 10 or 15 years. There is still a concern that the rupiah may depreciate in terms of foreign currencies. The concern is because Bumiputera's life insurance policies are linked to the US dollar; it has to do this for marketing purposes since other insurance companies do as well.

Regarding municipal bonds, Bumiputera would be interested in buying bonds issued by, say, a city such as Surabaya because there would be an implied guaranty by the central government. That is, if the central government approved the issuance of bonds by the city, there would be an implied backing by the government and this would be sufficient although an explicit guaranty would obviously be better. For instance, Bumiputera holds BTN bonds as an investment even though there has been some concern because of high deliquencies in the BTN portfolio. The feeling is that the government would not allow BTN to default. This is the generally held view of other investors.

However, Bumiputera must report semiannually to the MOF on the makeup of its investment portfolio. It must, for instance, get MOF approval to invest in stocks not listed on the stock exchange even though, as indicated above, it generally invests as it sees fit.

TASPEN

TASPEN, the government civil servants pension fund, collects 8 percent of salaries of which 3.25 percent is for its provident fund and 4.75 percent is for its pension fund. There is also a pension fund covering private workers called ASTEK. There are 267 government-owned companies of which some 100 are under ASTEK but have their pension funds managed by TASPEN. The remainder are directly managed by ASTEK. Supposedly all of these companies' pension funds should be managed by TASPEN as well.

Total assets by TASPEN are Rp. 1.3 trillion in the provident fund and Rp. 2.4 trillion in the pension fund. It collects some Rp. 20 billion per month and is paying out in benefits Rp. 1.42 billion per month. The difference along with its portfolio income indicates that TASPEN has substantial net funds to be invested each month.

Assets are distributed as follows:

Time deposits	60%;	average maturity 9 months;	average rate 16.5%
Bonds	30%		average rate 17.0%
Equities	10%		average rate 9-10%

TASPEN re-examines its investment mix every month. For instance, two years ago 80-90 percent of its assets were in time deposits. In theory TASPEN is free to make its own investment decisions but it works closely with the Ministry of Finance. With regard to a recent bond issue of ASTRA, TASPEN took 5 percent of the Rp. 60 billion issue. Most of its bond portfolio, however, is in the bonds of state corporations. It will, for instance, take 60 percent of the new BTN issue. If the bonds are listed on the stock exchange they are presumed to be sound because BAPEPAN has evaluated although TASPEN does undertake its own analysis. TASPEN targets a certain rate of return which it tries to achieve. For 1990 this target is 16 percent.

With regard to the possibility of TASPEN investing in municipal bonds, TASPEN indicated that there should be a trustee, a bank, to act as the paying agent and also a guarantor say, a government bank. TASPEN would be willing to consider investing in municipal bonds if there was such a guaranty and would be prepared to consider longer term issues, say 15 years, because its liabilities are long term but the interest rate would have to be appropriate. In fact, as with BUMIPUTERA, TASPEN would be interested in locking in today's high rates in a longer term bond if it was guaranteed. TASPEN prefers fixed rates. Although there are still worries about a devaluation and inflation, TASPEN feels that a floating rate would be a tough sel' difficult for investors to accept psychologically.

It is TASPEN's view that if a bond market is to mature, the holders of bonds must become more technically proficient. There is a lack of technical appreciation on the part of borrowers as to how a bond market operates. TASPEN itself has had short-term consultants in to train its staff.

VIII. SPECIFIC ISSUES RELATED TO MUNICIPAL BONDS

Municipal financing was done many years ago under the Dutch but there has been no municipal financing from the market for many years. There is clearly an adversion to governmental debt at the national level and this would likely extend to municipal debt which would have to be approved by the Ministry of Home Affairs. If the Central Government itself does not issue debt, it appears unlikely that it would approve municipalities doing so at the present time. Thus, the view is that approval of the idea of municipal bonds would be a long process. In addition to the approval of the MHA, the local municipal legislature or city council would also have to approve and, as discussed earlier, that doesn't appear to be in line with current thinking.

In the event that municipalities were to issue bonds, it is more likely they would be in the form of revenue bonds tied to specific projects rather than general obligation bonds for deficit financing purposes. Another approach as an interim measure would be for municipalities to seek financing through the regional development banks who might be better placed to issue bonds (see Section below).

If municipal bonds were to be issued they would need to fit into some system but the system doesn't exist. For instance, if there were GOI securities at one end of a spectrum (there aren't) and bonds issues by private companies at the other end (there are a few) municipal bonds might fit into the middle. But there really isn't any middle yet, just the issues of government-owned companies for financial institutions which are essentially placed. There's no point of reference for pricing purposes.

If a market for municipal bonds was eventually to emerge, it would likely initially consist of institutional investors. There is unlikely to be any interest on the part of individual investors.

Relative to the creation of a bond market, the question was raised about the need for a rating agency for bonds. But it's not enough just to have a rating agency. One consequence might be that municipal debt might be rated so low that it would never sell. The idea of a bond rating has been mostly a U.S. phenomenon although it's starting to catch on internationally.

On the side of the borrower there would either need to be an intermediary to float bonds on behalf of the borrowers (this could be a regional development bank) or local governments would have to float themselves. As of now, according to knowledgeable observers, this would only be possible in four or five jurisdictions at most. Most local governments are not at all familiar with debt obligations such as bonds.

Since the capital market is just evolving it would appear unlikely that investors are ready to accommodate municipalities as borrowers or issuers of bonds. The private market would have to lend at least at 30-40 percent or so to discount all the problems. Jakarta just received a loan under a subsidiary loan agreement SLA) for water supply at 9 percent. Thus, as long as such loans are available it would have no interest in going to the market for a 30-40 percent loan.

Such high rates would also effectively cut out the smaller local governments because of the fees. There is a need to educate the local governments about access to the credit system.

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REGIONAL DEVELOPMENT ACCOUNT

PROPOSED GENERAL POLICY STATEMENT

1. BACKGROUND AND OBJECTIVES

1.1. The introduction of the Regional Development Account (RDA) facility is part of a comprehensive reform of the system through which regional development programs and projects are financed. RDA is to be only one part of an integrated package of mechanisms for the financing of regional development --including loans, grants, and increased local revenue generation.

1.2. RDA is set up as a facility that promotes and facilitates borrowing by regional governments and regional government enterprises that can afford loan financing because of the strength of their local revenue base.

1.3. RDA will provide an accessible and dependable source of loan finance that allows regional governments to better plan and program development investments and that enables them to realize more rapidly their development potential.

1.4. RDA will stimulate regional governments to develop their revenue generation capacity and to improve revenue yields from local taxes and user charges.

1.5. RDA will rationalize and unify the system of regional government loan financing. By providing loans on consistent and common terms for all types of projects through a standard mechanism, RDA will promote equal treatment of regional governments.

1.6. RDA will improve the utilization of loan resources by raising the standards for project formulation and design.

1.7. RDA funding is directed towards local governments that can afford loan financing for at least some of their projects. By encouraging financially stronger regions to borrow for capital development purposes, they will be less dependent on central government transfers. This will allow more grant finance to be made available to regions with little potential for local resource mobilization. *RDA, therefore, should not be viewed as another grant mechanism in a new form*; it is not the appropriate channel for concessional financing to needy regions.

1.8. RDA's revolving fund will be set up on a durable and financially self-sustaining basis which, at a minimum, will preserve in constant rupiah terms the value of funds contributed, and which will recycle all payment receipts from borrowers into new loans.

1.9. Apart from the revolving fund, RDA will include a separate window to channel funds from foreign loans that are tied to specific projects.

2. PROJECT ELIGIBILITY

2.1. The following general principles determine eligibility for RDA loan financing:

a. the project financed must involve the development of public-sector services or infrastructure that cannot be provided by the private sector on a commercial basis through the free market in a way consistent with the objectives of national social policy;
b. the goods or services provided by the project must have social importance involving the basic welfare of the population;
c. the project must be one that falls within the scope of responsibility of the public entity requesting the loan, in accordance with applicable laws and regulations;
d. the project must be one that will earn revenue for the local government or public enterprise concerned, either (i) *direct revenue* obtained through user charges or (ii) *indirect revenue* obtained from the project beneficiaries by an increment in taxes; and
e. the project must conform to policy and technical requirements established by the relevant departments of the central government.

2.2. In addition, the project must involve the acquisition, construction, or major renewal or rehabilitation of a physical asset. If the project so qualifies, RDA funds may also be used for the acquisition of land upon which the facility will be constructed, the preparation of engineering documents, and working capital.

2.3. With respect to indirect-revenue-earning projects, eligibility for RDA loans depends on whether the project is of a type that will give rise to increments in tax revenue. It is not important how much indirect revenue is likely to be earned.

2.4. In the initial phase, RDA will concentrate its lending on direct-revenue-earning projects. However, projects that do not earn direct revenue will not be excluded from consideration. Typical direct-revenue-earning projects to be financed include: 61.5

a. water supply;
b. solid-waste disposal;
c. bus, taxi, or ferry terminals;
d. market development;
e. public transport;
f. infrastructure for public housing projects; and
g. slaughterhouses.

2.5. RDA will *not* finance pioneer-type projects that could well be undertaken by the private sector in a commercially viable manner if they were properly promoted.

2.6. In the first phase of RDA operations, credit schemes that involve on-lending to the private sector will not be eligible for RDA financing. A completely different sort of appraisal becomes necessary when this type of loan is considered. The idea of including such loans, however, will be studied for possible inclusion at a later stage.

2.7. Additional, more detailed, guidelines will be issued from time to time concerning the sectors and projects qualifying for RDA loans.

3. BORROWER ELIGIBILITY

3.1. Regional authorities (i.e. *Pemda Tingkat I* and *Tingkat II*) and regional government enterprises (*Badan Usaha Milik Daerah*) will be eligible to receive RDA loans.

3.2. Eligibility further depends on the expected financial capacity of regional government and regional enterprise borrowers to meet ensuing debt service obligations.

3.3. Borrowers must in the first instance comply with applicable regulations of the Ministry of Home Affairs with respect to the debt service coverage ratio.

3.4. RDA will also make its own assessment of the borrower's future ability to meet RDA debt service obligations from uncommitted revenues, based on cash flow projections submitted by the borrower and taking into account all relevant factors -- especially the degree of uncertainty surrounding the cash flow projections.

4. RDA STATUS, SET-UP, AND CAPITALIZATION

4.1. In the initial period of operations, RDA will exist as an account within Bank Indonesia and will not be a separate *legal* entity. The account will be administered and managed under the authority of the Minister of Finance. The Minister has delegated the authority for RDA administration to the Director General of Monetary Affairs who has designated the Director of Investment Funds (DDI) as responsible for day-to-day management of the account's operations.

4.2. RDA will prepare periodic financial statements that recognize its status as a distinct *financial* entity --e.g. balance sheet and income statement.

4.3. Capitalization of the revolving fund will come from domestic (*APBN*) and foreign sources and from loan repayments; at a later stage, RDA should be able to mobilize and channel additional funds from the private sector.

4.4. RDA's funding and accounts will be divided into two sub-accounts: (A) a revolving fund; and (B) a channeling mechanism for large foreign loans tied to specific projects.

4.5. *Sub-account A* will operate as a revolving fund -- i.e., the objective will be to preserve in RDA's capital the real (constant rupiah) value of the funds contributed.

4.6. When foreign funds are disbursed through RDA for loans tied to specific projects, the funds may be channeled through *sub-account B*, which will not operate as a revolving fund. Such loans, however, will be fully subject to RDA's standard loan terms and conditions with respect to the borrower. Moreover, debt service payments on such loans will be paid by the borrower into the RDA bank account.

5. LOAN TERMS AND CONDITIONS

5.1. The general terms and conditions the Ministry of Finance will apply for RDA loans will be common and uniform for all borrowers and all types of projects. Therefore, the RDA interest rate will be uniform and will not vary according to the type of project or according to the characteristics of the particular project, nor will it vary according to borrower.

5.2. The Minister of Finance will periodically determine and announce the common terms and conditions that will apply to RDA loans. The terms and conditions will include the following items, among others:

a. interest rate;
b. commitment fee;
c. maximum grace period;
d. maximum repayment period;
e. repayment method; and
f. maximum and minimum loan amounts.

5.3. The terms and conditions for RDA loans will be set at a level and in a way that will secure RDA's long term financial viability and self-sustainability. In order to preserve the real value of RDA's capital, a positive, real interest rate will be charged.

5.4. In the first phase of RDA operations, the interest rate will be set to cover:

a. the expected rate of inflation (estimated by a weighted moving average of inflation for the preceding three years);
b. the costs of administering the RDA facility at the DDI level; and
c. a provision for bad debt.

5.5. If, at a later stage, the private capital market will become a source of funds for RDA capitalization, the cost of these funds will be an additional element to be taken into consideration in setting the RDA interest rate.

5.6. RDA loans will be secured by a lien upon statutory *Pajak Bumi dan Bangunan (PBB)* transfers to regional governments. The Minister of Finance will announce the procedures and criteria for withholding PBB receipts.

5.7. The interest rate on each RDA loan will be the rate in effect on the date the Loan Agreement is signed. The interest rate will remain fixed over the term of each loan.

5.8. There will be an annual commitment fee charged on the amount by which actual undisbursed loan funds exceed *planned* undisbursed loan funds. The borrower must pay this fee as it accrues.

5.9. A grace period will be offered during which the borrower may delay repayment of loan principal. The maximum grace period will be five years. The grace period, if any, will usually cover only:

a. the loan disbursement period -- in the case of loans to local governments; and
b. the planned time for construction and installation of equipment and, if necessary, a start-up period -- in the case of loans to regional government enterprises.

5.10. There will generally not be a grace period for interest payments. An exception will be made for *regional government enterprises* which demonstrate either that they cannot raise the required revenue in early years or that the rapid tariff increases that would be necessary would cause an unreasonable burden on consumers. It is the borrower's responsibility to request and demonstrate the need for a grace period on interest payments. The maximum grace period will be five years.

5.11. Interest will accrue during the grace period on all outstanding principal, and unpaid interest will be added to the outstanding principal at the end of each accrual period.

5.12. Loan repayments will be made on an annuity basis in equal installments of combined principal and interest.

5.13. The repayment period will be a maximum of 15 years from the end of the grace period, but in no case will it be longer than the expected useful life of the major assets to be financed.

5.14. The minimum loan amount for any one RDA loan is two hundred million rupiah (Rp 200 million).

5.15. The maximum amount for any single loan financed from the revolving fund (sub-account A) is 5% of the revolving fund capital.

5.16. The Loan Agreement will contain a concise description of the project, including the inputs to be financed. Loan proceeds may be used only for items included in the project description.

5.17. After the project (as defined in the Loan Agreement) is completed and all required disbursements have been made, residual loan amounts will be cancelled.

6. RDA PROJECT/LOAN CYCLE

Institutional Division of RDA Functions and responsibilities

6.1. Regional governments (*Pemda Tk I* and *Tk II*) and their enterprises will be responsible for project identification, project proposal preparation, project implementation, and debt administration.

6.2. Provincial governments have responsibility for monitoring and guiding borrowing activities at local government level (*Tk II*). They will be expected to assist local governments in project identification and preparation as well as to monitor local government financial planning and management of revenue-earning facilities.

6.3. It is envisaged that pre-appraisal of technical, financial, economic, and institutional aspects of projects will take place at the provincial level. Central government ministries will provide guidance to the provincial appraisal unit during the appraisal process. DDI staff may also participate in the provincial appraisal process to ensure that RDA comments can be discussed and taken into consideration at an early stage of project preparation.

6.4. At the central government level, three departments, in addition to the Ministry of Finance, will play an important role in the RDA project/loan cycle:

a. *Bappenas* will set the overall policy framework regarding the sectoral and regional allocation of loan funds;

b. the *Ministry of Home Affairs* will work with regional governments to strengthen their capacity for financial planning and project preparation and analysis and will define borrowing limits based on the debt service coverage ratio; and

c. the *Ministry of Public Works* will issue technical guidelines and standards relating to project design and analysis, will offer related technical assistance to local governments where appropriate, and will also screen certain large and complex projects for technical feasibility before submission to RDA.

6.5. Within the central government, the Ministry of Finance (DDI) will be the final step of the loan application and project appraisal process. It will conduct its own appraisal of the projects and will give final approval to the loans. Ministry of Finance appraisal will focus particularly on the financial and economic feasibility of the project.

6.6. RDA institutional arrangements will be more fully developed in the light of on-going policy discussions within the central government regarding:

- the decentralization of infrastructure development functions;
- the increased discretion of regional governments in the preparation of investment programs and in the determination of central-government grant uses; and
- loan-grant linkages.

7. LOAN-GRANT LINKAGES

7.1. RDA should be seen as one part of a system for the financing of regional development projects. The financing of non-revenue-earning projects will continue to depend largely on grants. The financial feasibility of using RDA loans to finance local government projects will therefore depend in part on the amount of grants that are also made available. This may involve untied grants or grants that are targeted, for instance, to achieve basic-need goals within particular projects.

7.2. A related issue that affects the loan-grant mix in project financing concerns central government policies with regard to cost recovery in revenue-earning projects. The financial feasibility of a project receiving RDA loans will depend in part on how these policies are defined.

7.3. RDA encourages cost recovery through user charges whenever this is feasible, in line with the government's Statement of Urban Development Policies (*Kebijaksanaan Pembangunan Perkotaan di Indonesia*) in 1987. In particular, projects should adhere to specific government policy on cost recovery as it evolves in the different sectors.

7.4. It is likely, however, that RDA will become operational before definite decisions are reached on grant and cost-recovery issues. It may be expected, moreover, that in the initial period of RDA operations, no direct loan-grant linkages will yet have been established.

7.5. For this reason, an RDA loan will not be approved until *after* approval by the appropriate departments of all grant components in a project if they are required for financial feasibility. It will be the borrower's responsibility to obtain such prior approval. The borrower should provide satisfactory assurance of the future and timely availability of the needed grant funds (e.g. *DPRD* approval or commitment from technical department in case of *Dipnas* grant funds).

8. GUIDING PRINCIPLES FOR APPRAISAL AND APPROVAL

8.1. A local government or enterprise that wishes to borrow from RDA must submit a standard RDA loan application form.

8.2. If the development project for which the loan is requested involves investment costs of Rp 200 million or more, a Project Feasibility Report must be submitted with the loan application form.

8.3. If a loan is requested for a package of several smaller investment projects in the context of IUIDP, where each individual project costs less than Rp 200 million, separate Project Feasibility Reports are not necessary. Instead, the comprehensive program documents prepared by IUIDP are sufficient.

8.4. The Ministry of Finance, in consultation with Bappenas, will develop and maintain a process and standards for appraising projects submitted for RDA financing. The Ministry of Finance will be responsible for determining the feasibility of such projects and will have full autonomy in approving or rejecting an RDA loan application.

8.5. It is expected that RDA appraisal will take place at two levels. In line with current interdepartmental thinking, pre-appraisal will take place at Tk I. The pre-appraisal process and its conclusions will then be reviewed at the central level.

8.6. A loan application will be considered for RDA financing only if it has been reviewed and if applicable, has been approved by all other institutions, agencies, and central government departments that have authority and responsibilities in this matter.

8.7. The Ministry of Finance will issue an RDA Borrower's Manual that will provide instructions and guidelines for the preparation of loan applications and Project Feasibility Reports.

8.8. RDA appraisal of a project will involve two degrees of scrutiny: (a) an intensive examination of certain *financial* and *economic* aspects of the project; and (b) a more cursory review of the *technical* and *institutional* aspects of the project.

8.9. RDA will play an especially active role with regard to financial appraisal. RDA will focus its attention on evaluating the reasonableness of the cost and revenue estimates and the projected capability of the local government or enterprise to cover all project costs and make future loan repayments.

8.10. In the context of RDA projects, the principal focus of the economic appraisal will be on whether the total gain to project beneficiaries outweighs the costs incurred because of the project. It is important to reject those projects that are made financially feasible through direct or hidden subsidies but that do not provide sufficient benefits to users. Such projects place an unjustifiable drain on the resources available to local governments.

8.11. With regard to the technical (i.e. engineering) and institutional aspects of the project, RDA will not carry out an in-depth appraisal, nor will RDA generally define its own technical standards. RDA will rely primarily on appraisal by other appropriate departments. Nevertheless, RDA will take an active role in this area in two ways:

a. RDA may review the standards and criteria used by the other departments to ensure their acceptability;
b. without entering into highly technical details, RDA will make its own assessment, on a project-by-project basis, of whether the applicant has dealt with key engineering and institutional issues in a *comprehensive, coherent, and convincing way*.

8.12. Loan approval by the Ministry of Finance will depend on more than a determination of borrower and project eligibility and a positive appraisal of the project. Loan approval will also depend on conformity with policies and guidelines laid down by Bappenas concerning the use of loan funds within the national development planning framework and the sectoral and regional allocation of such funds.

9. INSTITUTIONAL STRENGTHENING FOR RDA OPERATIONALIZATION

9.1. RDA's success in achieving its basic objective, namely to facilitate regional government access to credit for financially feasible development projects, hinges on the capability of local authorities to perform the basic functions of financial planning, programing, and budgeting; project design, preparation, and implementation; and borrowing administration including assessment of borrowing capacity, loan application procedures, loan portfolio management and administration. It is clear hat many local governments and regional government enterprises do not yet have adequate expertise and skills in these areas.

9.2. Furthermore, the quality of RDA's performance depends heavily on the establishment of adequate appraisal, control, and monitoring capacity at the provincial government level.

9.3. Consequently, RDA can realize the objectives set for it only if parallel programs are developed and supported that provide for institutional strengthening at provincial (Tk I) and local (Tk II) government levels.

THE INDONESIAN CAPITAL MARKET ORGANIZATION

The organization of the Indonesian capital market is as follows:

A. Present structure of the Capital Market

1. Minister of Finance
   The Minister of Finance has the authority to determine the policy of the Capital Market.
2. Capital Market Policy Council.
   The Capital Market Policy Council consists of:
   - The Minister of Finance
   - The Minister of State for Administrative Reform/Vice Chairman of the National Development Planning Agency
   - The Minister of Trade
   - The Secretary of the Cabinet
   - The Governor of Bank Indonesia
   - The Chairman of the Capital Investment Coordinating Board
   - The Minister of Industry
   - The Junior Minister of Finance.

   The Council has the following main tasks :
   - to present policy alternatives to the Minister of Finance in the execution of his power in the field of the capital market.
   - to present policy alternatives to the Minister of Finance for the execution of his powers relating to PT Danareksa as a state corporation

B. Organization Structure of Bapepam

- Chairman
- Executive Secretary
- Bureau of Legal Affairs and Research
- Bureau of Stock Exchange Development and Intermediaries
- Bureau of Investigation and Evaluation
- Bureau of Issue Registration and Accountancy

1. The Chairman is responsible to the Minister of Finance for all activities of Bapepam. He shall manage Bapepam in accordance with policy directions and to develop an effective and efficient organization. The Chairman of Bapepam also issues implementing regulations on technical matters according to the prevailing rules, regulations and policy directions given by the Minister of Finance.

2. The Executive Secretary has the following main tasks:
   - to provide guidance and to coordinate the daily administration, planning and control of Bapepam activities.
   - to provide technical and administrative service to the Chairman
   - to prepare Bapepam working programs and to analyze the execution of Bapepam activities
   - to carry out functions on personnel, finance, material handling and other Bapepam administrative activities.
   - to assist the Chairman in the integration and synchronization of Bapepam activities.

3. Bureau of Legal Affairs and Research has the following main tasks:
   - to draft capital market regulations and give advice on subject related to the development of the capital market.
   - to conduct a legal audit of the companies going public
   - to give legal advice and to execute the promotional activities of capital market.
   - to analyze and to collect data regarding capital market activities.
   - to give advice on practical research methods relating to the capital market.

4. Bureau of Stock Exchange Development and Intermediaries has the following main tasks:
   - to developed and to supervise the operation of the Stock Exchange and the activities of intermediaries (brokers and dealers).
   - to operate the stock exchange
   - to supervise the over the counter securities trading
   - to process applications and licenses for securities brokers and dealers

5. Bureau of Investigation and Evaluation has the following main tasks :
   - to coordinate the evaluation of the companies which will sell securities through the capital market and to monitor the conditions and development of the companies who have listed their shares in the stock exchange.
   - to evaluate each application for listing on the stock exchange based on information described in the registration statement and in the prospectus.

6. Bureau of Issue, Registration and Accountancy has the following main tasks :
   - to review the registration statement and to analyze its accounting aspects.
   - to analyze the business activities and financial position of the Issuer.
   - to provide the Issuer with advice and technical assistance in accounting related matters.
   - to ensure that reasonable disclosure requirement is met.

ANNEX 4

BONDS ISSUED ON THE JAKARTA STOCK EXCHANGE
JANUARY 1983 - JANUARY 1990

No.	Companies	Approval Date	Listing Date	Interest Rate (%)	Period (Year)	Number of (Certificates)	Nominal Value (Rp)
007 1.	PT. JASA MARGA						
	- Jasa Marga I *)	Jan 15,1983	Mar 16,1983	15 1/2	5	200,000	23,718,000,000
	- Jasa Marga II Stage I *)	Sep 10,1983	Nov 07,1983	16 1/2	5	13,500	40,000,000,000
	- Jasa Marga II Stage II Serie C	Dec 23,1983	Feb 14,1984	16 1/2	5	3,600	20,000,000,000
	- Jasa Marga II Stage II Serie D	Dec 23,1983	Mar 13,1984	16 1/2	5	3,600	20,000,000,000
	- Jasa Marga II Stage II Serie E	Dec 23,1983	Apr 10,1984	16 1/2	5	3,600	20,000,000,000
	- Jasa Marga III Stage I Serie F	Dec 12,1984	Jan 07,1985	16 1/2	5	3,600	40,000,000,000
	- Jasa Marga III Stage II Serie	Dec 12,1984	Mar 11,1985	16 1/2	5	2,900	30,000,000,000
	- Jasa Marga IV Stage I Serie G	Nov 27,1985	Jan 06,1986	16 1/2	5	3,700	40,000,000,000
	- Jasa Marga IV Stage II Serie G	Dec 23,1985	Apr 04,1986	16 1/2	5	5,250	60,000,000,000
	- Jasa Marga V Serie H	Jun 10,1987	Jul 23,1987	16 3/8	5	5,250	60,000,000,000
	- Jasa Marga V Serie I	Oct 24,1987	Dec 07,1987	16 1/2	5	3,700	40,000,000,000
	- Jasa Marga VI Serie J	May 24,1988	Jul 08,1988	17	8	4,550	75,000,000,000
	- Jasa Marga VI Stage II Serie K	Dec 14,1988	Feb 20,1989	18	8	3,350	50,000,000,000
	- Income Index J. Marga Stage I	Jun 30,1989	Sep 29,1989	17 3/4	12	2,950	40,000,000,000
	- Income Index J. Marga Stage II	Jun 30,1989	Sep 29,1989	17 3/4	12	2,750	30,000,000,000
	+ VII Series J	1990	June, 1990	? mos rate + 2% (floating)	8	262,300	538,718,000,000
							100,000,000,000
007 2.	BANK PEMBANGUNAN INDONESIA						
	- Bapindo I *)	Jan 29,1983	Apr 04,1983	15 1/2	5	32,650	25,000,000,000
	- Bapindo II	Aug 28,1986	Oct 15,1986	15 3/4	5	3,745	50,000,000,000
	- Bapindo III Serie A	Mar 14,1988	May 02,1988	17	5	2,100	60,000,000,000
	- Bapindo III Serie B	Jun 27,1988	Aug 10,1988	17 1/2	5	1,900	40,000,000,000
	- Bapindo IV Serie C	Mar 6,1989	Apr 13,1989	18 3/4	5	1,520	50,000,000,000
	- Bapindo IV Serie D	Jun 13,1989	Jul 25,1989	18 3/4	5	1,520	50,000,000,000
	- Bapindo IV Serie E	Sep 18,1989	Nov 03,1989	18 3/4	5	1,520	50,000,000,000
	- Bapindo IV Serie F	Dec 19,1989	Jan 13,1989	17 1/2	5	1,700	50,000,000,000
						46,655	375,000,000,000

BEST AVAILABLE DOCUMENT

ANNEX 4 page 2

No.	Companies	Approval Date	Listing Date	Interest Rate (%)	Period (Year)	Number of (Certificates)	Nominal Value (Rp)
3.	PT. PAPAN SEJAHTERA						
	- Papan Sejahtera I *)	Apr 16,1983	Jun 29,1983	15 1/2	5	6,280	6,000,000,000
	- Papan Sejahtera II	Aug 29,1985	Oct 11,1985	16 1/2	5	3,490	30,000,000,000
	- Papan Sejahtera III	Nov 19,1987	Dec 23,1987	16 3/4	5	1,280	31,000,000,000
	- Papan Sejahtera IV	Oct 21,1988	Dec 14,1988	18	5	1,000	25,000,000,000
	- P. Sejahtera V Stage I	Mar 16,1989	May 16,1989	19	5	1,000	25,000,000,000
	- P. Sejahtera V Stage II	Jun 27,1989	Aug 21,1989	19	5	1,050	30,000,000,000
	- P. Sejahtera V Stage III	Oct 11,1989	Nov 22,1989	18 3/4	5	1,235	29,000,000,000
						15,335	176,000,000,000
4.	IBJ LEASING	Jun 15,1988	Jul 20,1988	18	3	3,050	10,000,000,000
5.	PT. ASTRA	Jun 23,1988	Aug 11,1988	18 1/2	5	4,790	60,000,000,000
6.	UPPINDO						
	- Uppindo I	Jun 29,1988	Aug 24,1988	17 3/4	5	1,000	25,000,000,000
	- Uppindo II	May 20,1989	Jul 07,1989	19	5	1,200	30,000,000,000
						2,200	55,000,000,000
7.	BPD JAWA TIMUR	Sep 30,1988	Nov 30,1988	18	5	1,000	25,000,000,000
8.	BPD JAWA TENGAH	Nov 25,1988	Jan 13,1989	18	5	1.000	25,000,000,000
9.	ASIA NUSAMAS LEASING	Dec 15,1988	Mar 06,1989	19	5	2,590	5,000,000,000
10.	BUKOPIN I	Mar 31,1989	Apr 24,1989	19 1/4	5	2,760	30,000,000,000
11.	BPD SUMBAR I	May 18,1989	Jul 08,1989	19 1/8	5	900	15,000,000,000
	- BPD Sumbar II	Dec 19,1989		18	5	850	10,000,000,000
						1,750	25,000,000,000
12.	BPD ACEH	Jun 12,1989	Jul 18,1989	19 1/4	5	1,600	5,000,000,000
13.	PT. GAJAH SURYA LEASING	Jun 12,1989	Aug 07,1989	19 1/4	5	2,000	7,500,000,000
14.	PT. SEMEN CIBINONG	Jun 14,1989	Aug 11,1989	floating	5	2,879	30,000,000,000
15.	PT. PEMB. DARMO GRANDE	Jun 15,1989	Sep 07,1989	19 1/2	5	1,398	15,000,000,000
16.	BPD DKI	Jun 26,1989	Aug 21,1989	19 1/8	5	1,000	25,000,000,000
17.	BPD SUMUT	Jun 27,1989	Aug 31,1989	19 1/4	5	820	10,000,000,000
18.	BANK TABUNGAN NEGARA	Jun 29,1989	Aug 10,1989	18 3/4	5	1,520	50,000,000,000
19.	PT. BBL LEASING	Jun 30,1989	Sep 08,1989	19 1/4	5	952	10,000,000,000
	Total :					355,599	1,527,218,000,000

Note : *) Has been fully paid.

BONDS ISSUED ON THE PARALLEL MARKET (OTC)
FEBRUARY 1989 - JANUARY 1990

No.	Company	Approval Date	Listing Date	Interest Rate (%)	Period (Year)	Number of (Certificates)	Nominal Value (Rp)
1.	PT. DHARMALA SAKTI S.	Feb 20,1989	Apr 03,1989	19 1/2	5	1,020	10,000,000,000
2.	PT. PANCA WIRATAMA S.	Jun 08,1989	Jul 20,1989	floating	5	1,620	15,000,000,000
	Total :					2,640	25,000,000,000

BEST AVAILABLE DOCUMENT

THE SUPPORTING INSTITUTIONS FOR BOND ISSUES

A. Trustee

The Trustee is appointed by the Issuer and has the main function to represent and to protect the interest of the bondholders, pursuant to the provisions of the trust agreement.

A Trustee must be appointed for each bond issue. Those who are eligible to act as a Trustee are Banks and Non-Bank Financial Institutions and other business entities in the financial sectors which have obtained a license from the Minister of Finance to act as a Trustee.

The application for a license to act as a Trustee must be submitted to the Minister of Finance with a copy to the Chairman of Bapepam, or for banks, a copy to the Board of Directors of Bank Indonesia by enclosing :

1. the Articles of Association.
2. the organizational chart
3. a copy of the operating license
4. the financial statements of the company for the latest year shall be audited by a registered public/government accountant.
5. the tax payer's Identity number.

B. Guarantor

A Guarantor is in institution that guarantees the repayment of the principal and payment of the interest obligation in the event that the Issuer fails to fulfill his obligation on its maturity date. Institutions which are eligible to act as a Guarantor shall be banks and non-bank financial institutions which have obtained a license to operate as Guarantor from the Minister of Finance. The application for the license shall be submitted to the Minister of Finance, with a copy to the Chairman of Bapepam and for banks, a copy shall be submitted to the Board of Directors of Bank Indonesia, together with the following documents:

1. the Articles of Association
2. the organizational chart
3. a copy of the operating license
4. the financial statements of the company for the latest year, audited by registered public/government accountant
5. tax payer's identity number

The operating license as a Guarantor for the Non-Bank Financial Institutions shall be issued by The Minister of Finance after having received the opinion of the Chairman of Bapepam, for banks, the operating license shall be issued after having received the opinion of the Chairman of Bapepam and the comments of the Board of Directors of Bank Indonesia, including :

1. its license for operating as a Guarantor.
2. its organizational chart, names of the management and experts and accompanied by their respective personal history (curriculum vitae).
3. the latest financial statements of the company which have been audited by a registered public/government accountant.

Guarantor and the Issuer shall enter into a guarantee agreement in the Indonesian language. For a bond issue, several guarantors may collectively issue the guarantee in the form of a syndicate of Guarantors. The total amount of the guarantee to be issued by a bank or a non-bank financial institutions as Guarantors shall not exceed two times its net worth. For the service rendered by the Guarantor, the Guarantor may collect a guarantee fee from the Issuer.

C. Underwriter :

An Underwriter is a financial institution which assumes the responsibility to sell the bonds or stock to be issued in the primary market based on the agreement between the Issuer and the Underwriter. In addition, an Underwriter has to also render services to the Issuer in connection with the public offering of securities. The Underwriter is allowed to underwrite the issue based on full commitment, best efforts, stand-by commitment or any other type of commitment.

In order to spread risk of underwriting, an Underwriter may form an underwriting syndicate with one member acting as a Managing/Led Underwriter.

The Underwriting fee shall be decided upon mutual agreement between the Underwriter and the Issuer. Institutions which are eligbile to act as underwriters are :

1. Non-Bank Financial Institutions;
2. Banks having licenses from the Minister of Finance to operate as underwriter;
3. Institutions or other undertaking bodies in the field of finance, appointed by the Minister of Finance.

Application for a license to act as an underwriter for a bank, shall be submitted to the Minister of Finance with a copy to the Chairman of BAPEPAM and the Board of Directors of Bank Indonesia, together with the following documents :

1. the Articles of Association;
2. the organizational chart;
3. a copy of operating license;
4. the financial statement of the company for the latest year, audited by a registered public/Government accountant;
5. tax payer's identity number

The operating license as Underwriter shall be issued by the Minister of Finance after having received the opinion of the Chairman of BAPEPAM.

Standard and Requirements for Bond Issue

1. **Listing of Bonds, on the Jakarta Stock Exchange**
According to the Decision of the Minister of Finance of the Republic of Indonesia No. 859/KMK.01/1987 dated December 23, 1987 and its implementation regulations, the public offering of bonds can only be carried out after the Issuer has obtained the necessary license from the Chairman of Bapepam.

   1) An Issuer intending to offers its bonds to the public, shall submit a Registration Statement to the Chairman of Bapepam through an underwriter. In filling the Registrations Statement, the following requirements must be met:
      a. be a corporation, a bank or a non-bank financial institution.
      b. be domiciled in Indonesia
      c. has minimum paid up capital of Rp 200 million
      d. have recorded profit for the last 2 (two) consecutive years.
      e. financial statements must have been audited by a registered public/government accountant for the last 2 (two) consecutive years, with an unqualified opinion for the latest year.
      f. any bond issue must be secured by the fixed assets owned by the Issuer.
      g. total liabilities including bonds to be issued shall not exceed 80% of total assets. In the event that this percentage is exceeded, a guarantor shall be appointed.
      h. for banks and non-bank financial institutions, the Minister of Finance will decide the total amount of bonds to be issued bassed on the ratio of total liabilities to equity (gearing ratio) of the Issuer.
      i. besides the above mentioned requirements, a bank must obtain recommendation from Bank Indonesia regarding the total of bonds that can be issued by the bank.

   ii) In addition, a bond issue must also comply with the following requirements:
      a. the bonds must be expressed in rupiah.
      b. the size of the issue must have a total nominal value of not less than Rp 100 million.
      c. the denomination of the bond must not be less than Rp. 10,000 (ten thousand rupiahs)
      d. a Trustee must be appointed for any bond issued
      e. the functions of Trustee, Guarantor and Underwriter must be carried out by a separate institution.
      f. a sinking fund must be established by the Issuer to secure the repayment of the bonds.

   Having obtained and offering license from the Chairman of Bapepam, the bond is eligible for its trading on the Stock Exchange and on the Parallel Market (Bursa paralel/OTC)

2. **Listing of bonds on the Parallel Market (Bursa paralel/OTC)**

   i. Eligible companies for listing :
      a. be a corporation, a bank or non-bank financial institution
      b. be domiciled in Indonesia
      c. have a minimum fully paid up capital of Rp 100 million
      d. audited financial statements (on short form) with an unqualified opinion from a registered public accountant
      e. the Issuer (including a new established company) should have a good future business prospects.
      f. no requirements to have a profit before going public.

   ii. Other relevant stipulations are :
      a. the license for going public will be provided within 30 days after completion of all information and all documents for going public to Bapepam.
      b. total liabilities including bonds to be issued, shall not exceed 80% of total assets, in the event that this percentage is exceeded a guarantor shall be appointed.
      c. for banks and non-bank financial institutions the Minister of Finance will decide the total amount of bonds which can be issued based on the ratio of total liabilities to equity (gearing ratio) of the Issuer.
      d. besides the above mentioned requirement, a bank must obtain a recommendation from Bank Indonesia regarding the total of bonds that can be issued by the bank.
      e. the bonds offered through the OTC market will be listed at the Standard Price List (Daftar Harga Pedoman) as stipulated by the Association for Money and Securities Trading (PPUE).