

Municipal Bonds: Opportunities and Challenges

Analyst: Niken Indriarsih

Municipal bonds and/or sukuk are the alternative financing sources to be issued by a local government in Indonesia through the public offering in the capital market that will be repaid in the medium to long term on its maturity dates. However, as to date there is no local government issued the municipal bonds although the government through Indonesia Financial Services Authority (Otoritas Jasa Keuangan/OJK) has released three regulations in December 2017, namely POJK no 61/POJK.04/2017 (registration statement documents in the context of public offering of municipal bonds and/or sukuk), POJK no 62/POJK.04/2017 (forms and content of prospectus and brief prospectus in the context of public offering of municipal bonds and/or sukuk, and POJK no 63/POJK.04/2017 (reports and announcement by the issuer of municipal bonds and/or sukuk). Currently, OJK is in the process to revise these regulations into one regulation.

We view that the issuance of municipal bonds will benefit the local government in obtaining funds to finance the infrastructure development to support the local economic growth. The issuance will also encourage for the improvement of the transparency, accountability, and information disclosure as the local government should publish the audited financial statements by the Audit Board of the Republic of Indonesia (Badan Pemeriksa Keuangan Republik Indonesia) on the website of the local government and Indonesian Stock Exchange or national daily newspaper periodically in a timely manner within nine months after the financial statements date and should also be transparent in managing the proceeds of the municipal bonds issuance as well as disclose any material fact or information that will affect their capability to service the financial obligations of municipal bonds from the issuance up to the maturity date.

What differentiates the municipal bonds from those issued by corporates

We view that the issuance of municipal bonds will diversify the investor's options to place its investment. Despite both being fixed income investment products, there are few things that differentiate the municipal bonds from the bonds issued by corporates. First, it is mandatory that the proceeds of the municipal bonds issuance will be used to finance the project or activity that will generate revenue or give benefit to the public, which is not the case for corporate bonds issuance where it can be used for working capital, investment or refinancing purposes. However, to mitigate additional complexity in the issuance, it is not specifically required that the source of repayment for the municipal bonds will be from the cash flow of that particular project.

Second, the issuance of municipal bonds needs a regulation issued by the local government to ensure the commitment to repay the municipal bonds should there be a change of the head of local government before the maturity date. Third, the issuance of municipal bonds needs the approval from the Ministry of Finance to ensure that the local government that will issue the municipal bonds has the capacity and capability to manage the bonds until its maturity date. In addition, the investor needs to assess the capability of a local government to service the financial obligations related to the issuance of municipal bonds if there is no rating, which is not required by the regulation. The rating requirement will be market driven whether the investor or the issuer needs a rating for the municipal bonds rather than regulatory driven. The investors usually need a rating that will help to measure the repayment risk and the bonds' coupon rate or yield.

Challenges faced by the local government in issuing municipal bonds

We view that those three factors mentioned above to some extent also pose challenges faced by the local government that may hinder the municipal bonds issuance although the pandemic since 2020 has also been one of the causes as the local government needed to refocus its budget and activities to contain the spread of Covid-19 and tackle the crisis.

The first challenge will be to prepare the manpower of the local government to be capable in managing the bonds before the issuance up to the maturity date. The local government that will issue the

municipal bonds should establish a debt management unit that will be the intermediary between the issuer and the holders of the municipal bonds, OJK, and other stakeholders as well as manage the proceeds and the repayment of municipal bonds until the maturity date. The local government should enhance the capacity of its manpower, particularly the understanding and knowledge about the capital market. The debt management unit will also have to deal with several parties or professions involving in the issuance of the municipal bonds, such as trustee, notary, law consultant, underwriter, credit rating agency, sharia supervisory board (in the case of municipal sukuk issuance); and ensure the compliance to POJK and other regulations related to the issuance of municipal bonds. The unit will also deal with investors and the public until the maturity dates and ensure the compliance to the regulations, particularly those related to the capital market applicable to the local government.

The second challenge is to select the project that will be financed by the proceeds from the issuance of municipal bonds, in which the project may generate revenue or public benefit. The local government should determine the project or activity as well as prepare the feasibility study. The project or the activity that will be financed by the proceeds of the bonds should also have the principal licenses needed, the ownership of the asset related to the project or activity, the prospect of the asset or the project including the estimation or forecast of the revenue generated from the project.

The third challenge is the approval from the Local House of Representative and the Ministry of Finance as well as the consideration from the Ministry of Home Affairs related to the issuance of municipal bonds. The approval from the Local House of Representative is needed related to the regulation about the issuance of the municipal bonds that will state or disclose at least the nominal amount, the use of proceeds, the issuance schedule if issued in several phases, commitment or responsibility for the debt service of both the repayment of the principal and the payment of the interest or yield and other expenses related to the issuance, the sinking fund, the collateralized asset (if any) and other information related to the issuance. This may pose another challenge for the local government as they need to communicate and enhance the understanding of the Local House of Representatives pertaining to the issuance plan.

Conclusion

Despite the challenges mentioned above, we expect that the support and better coordination among parties involved for the issuance of municipal bonds will ease the local government that has the capacity and capability. In our view, it will be limited to several provincial governments in Indonesia, with West Java expected as the pilot project in the near term as mentioned in the press release of the Coordinating Ministry of Economic Affairs in August 2023. We also expect that the new regulations will facilitate the local government that has the capability or potential to issue municipal bonds without neglecting the investors' safety.

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