
Issuance of Municipal Bonds through Capital Markets as Financial Revenue for Regional Development

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M.S. Tumanggor¹

Abstract:

Purpose: *This paper aims to identify and analyze the potential of regional sources, such as regional revenue or fund-lending institutions either coming from foreign or local investors to develop the regions in the state of Indonesia.*

Approach/Methodology/Design: *This paper uses a normative research method that refers to legislation and regulations.*

Findings: *The capital markets are expected to be the key for the regional development. This paper also describes how regional governments could raise funds through capital market instruments which are, municipal bonds and its derivatives. Municipal bond is a regional loan offered to the public through the Initial Public Offering mechanism in the Capital Markets.*

Practical Implications: *As a consequence, the regional governments in Indonesia could minimize their dependence from the Central governments by issuing municipal bonds. This kind of borrowing could also support the Central Government to develop the national economy.*

Originality/value: *This paper mainly explore another prospective source of funding for regional government which proved to absorb a sufficient amount of capital by using municipal bonds financing.*

Keywords: *Municipal bonds, capital markets, regional government, Indonesia.*

JEL: *G1, G2.*

Paper Type: *Research article.*

¹*Universitas Bhayangkara Jakarta Raya, Ps. Minggu, South Jakarta, Special Capital Region of Jakarta 12550, Indonesia, e-mail: mstumanggor.uphjt@yahoo.com*

1. Introduction

Regional revenue is one of a key factors in financial autonomy implementation (Fadzil and Nyoto, 2011). Regional government is expected to have the sense of innovation in stimulating regional potential to raise revenue. The municipal bonds would be an alternative of financial sources for regional development as an innovative tool that need to be used by various local governments (Oates, 1999; De Mello Jr, 2000; Joumard and Kongsrud, 2003). The understanding of municipal bonds products and their derivatives are new financial instruments for regional government, agencies, regional parliament, society, and investors. They are also substantial elements to minimize the arising burden of legal dispute and economic losses (Krueger and Walker, 2008).

Municipal bonds is a security instrument that is relatively new in the Indonesian capital market, thereupon, it is not familiarly known by business entities and societies. The prudential principles of fund mobilization using municipal bonds as stated in Law Number 33 of 2004 claimed that municipal bonds are a regional loan offered to the public through the Initial Public Offering mechanism in the Capital Market (Hakim, 2017). Furthermore, Law No. 33 of 2004 states that municipal bonds are in Rupiah (IDR) currency, issued in the Indonesian capital market. Municipal bonds are used to finance public investment projects which provide benefits to society and generate revenue, and the revenue from public investment projects is used to pay back the principal and interest of the municipal bonds while the rest is sent to the Regional government Treasury.

The management of municipal bonds shall be carried out by a unit designated by the governor, regent or mayor. The unit is an existing work unit or a new work unit, where the work unit has an organizational structure, work tools, and human resource capacity to carry out the functions of the management of municipal bonds. The Regional government shall obtain the principal approval from the Minister of Finance on the plan to issue municipal bonds prior to the process in the capital market. Issuance of municipal bonds can only be done in the domestic capital market and in rupiah currency and implemented in accordance with the provisions of the laws and regulations in the capital market.

2. The Structure of Municipal Bonds

Bond is a debt declaration or readiness to pay for a certain amount of money at a specified time. Usually, the nominal value written is accompanied with certain circumstances. The assessment of bonds is relatively prone because of the revenue of the bonds, which is in the form of interest that will be periodically accepted. The bondholder will usually demand the higher rate of return than the risk-free rate. The rate of return demanded varied for each municipal bond. It depends on the risks each bond encounters (Sartono, 1996).

Moreover, the municipal bond as popular to be referred as "Munis" in developed countries is considered to be a secured security so that it is referred as "the safest of all senior securities." It can be understood that the regional government as the issuer and the guarantor are permanent institutions which have never experienced bankruptcy. According to information available, it is very rare municipal bonds to be defaulted in fulfilling their liability (Mysak, 2010; Poterba and Rueben, 1997). Municipal bonds are issued by Regional Government, sub-division of Regional Government, regional authority agency, regional-owned enterprises and private enterprises (private bond activity) supported or sponsored and/or guaranteed by regional government (Metcalf, 1991; Benito and Bastida, 2004; Temple, 1994; Fortune, 1998).

One of the fascinating benefits of municipal bonds is the tax-exempt facility (tax-exempted) as there is no tax for interest coming from this bond. The other fascinating characteristic of municipal bonds are in the form of incentives, bonuses, profit participation or revenue generation from their operations. These interesting features are the sweetener of municipal bonds so that creating stronger bond market demand, for example, bond with prizes (a house, a car etc.) and other incentives.

Preparations for the issuance of regional bonds by the regional head is forming by a preparation team whose task is to prepare the process for issuing regional bonds. After forming the preparation team, the regional government submits an application to issue Regional bonds for consideration by the Minister of the Interior and a letter of proposal for the plan to issue regional bonds to the Minister of Finance or Director General of Fiscal Balance. After receiving consideration from the Minister of Home Affairs and a proposal from the Minister of Finance, the Regional government must prepare a Regional Regulation in which the regional head must submit a regional regulation on the issuance of regional bonds to the authorities in the capital market sector with a copy to the Director General of Financial Balance before the effective statement of regional bonds. In addition, the regional government must make a determining worksheet, carry out preparatory activities, approval from the regional parliament, draft the local regulation bill, submit proposals to issue regional bonds to the Ministry of Finance, pre-registration, registration stages and public offerings. Before making a public offering, the Regional government must also submit a registration statement to the Indonesian capital market Agency to be declared that the issuance is effective.

The next stages of pre-registration where the regional government must appoint a capital market supporting profession or institution (public accountant, legal consultant, appraiser and notary) to carry out due diligence on legal and economic aspects, securities rating, preparation of registration statements, making agreements related and the determination of municipal bonds structure. The regional government is obliged to carry out the registration phase of the review of disclosure to the Financial Service Authority for the assessment of the listing requirements by the stock exchange, the marketing of the municipal bonds, the determination of the final interest rate, and the syndication establishment.

Before submitting registration statements to Financial Service Authority, regional government has to seek an agreement or permit from the executive body and legislative body. The initiative of issuing bond could be started with promoting a proposal from planning and development, and also from a petition of a society group enclosed with the feasibility study. Therefore, regional government is an obligor while the society/public is an investor or creditor, either individually or institutionally. The funds received from a public offering can be used to financing regional projects whether it generates or not the return of investment/revenue.

After the registration phase of the disclosure review at Financial Service Authority, the regional government offers and records public offering periods (1-5 working days), securities allotment, securities distribution, listing on the Indonesia Stock Exchange by submitting the results of the public offering report and submitting the accountant's audit report. Regional government has obligations after the issuance of financial administration for the receipt and use of funds for the issuance of municipal bonds and for activities financed from the issuance of municipal bonds, payment of obligations for the issuance of municipal bonds, and the repurchase and resale of municipal bonds.

The accountability for the management of municipal bonds and accountability for municipal bonds funds by delivering public information publications on reports on the implementation of municipal bonds management to the Minister of Finance and submission of audited Financial Statement of Regional government by the Audit Board of the Republic of Indonesia or the Audit Board of Development of the Republic Indonesia, Realization of municipal bonds Realization Report, and material information to Financial Service Authority.

The municipal bond proposal must be submitted by the Governor to a number of approvals from the provincial parliament and distributing it to the Ministry of Home Affairs with the aim of obtaining approval from the President. After that, the process of issuing municipal bonds would be issued in the capital market mechanism. For municipal bonds of sub regional government, the municipal bond proposal must be submitted by regional government, afterward, the regional government requests an approval from district parliament which then distributed to the Governor and finally obtained an approval from the Ministry of Home Affairs. Thereafter, the process of issuing municipal bonds would be conducted in the capital market mechanism.

3. System Guarantee of Municipal Bonds Issuance

The mechanism for the guarantee system and municipal bond offers are not much different from other securities emissions. An important difference lies in the case of the document made in the registration statement. The market is captured in the municipal bond marketing which can be expected as a citizen of the participating regions. In the case of large projects and very large bond emissions, the underwriter syndicate is needed to consist dozens of underwriters to ensure the guarantee and

marketing of full municipal bonds on the market. In the event that the development of the project is nuanced through fast areas or over sectoral and regional fast where infrastructure excellence has wide coverage, careful coordination of multi-finance is needed for a single project, and there may be matching funds from the central government and foreign funds to involve various institutions and regions (Gray and Cusatis, 1995; Mysak, 2010; Desy and Tamanggor, 2000).

Moreover, a variety of private firms and government agencies might provide some form of guarantee or insurance for the timely obligation payment of municipal bond. This enhancement of the creditworthiness of municipal bond affect the cost of borrowing by regional governments and the extent of the market for the securities issued by those Governments. The net cost of borrowing is affected by the cost of insurance, but also by the fact that the more secure guaranteed bonds with higher credit ratings can be marketed to investors at lower interest costs to the issuer (Johnson *et al.*, 2014; Singla and Luby, 2014; Möller, 2016).

There are two principal forms of private credit enhancement, bond insurance and standby letters of credit. In addition, there exists at least one other variant—the so-called guaranteed investment contract. Private insurance for municipal bonds may be purchased by regional governments at the time the bonds are offered to investors. The insurance is irrevocable and extends for the life of the issue. Premiums are negotiated individually between insurance firms and public agencies. The insurer agrees to guarantee the timely payment of principal and interest to investors in return for the one-time premium paid on the issue date of the securities. The second principal form of private credit enhancement is the standby letter of credit, a commitment by a commercial bank to pay principal and interest in the event the issuer cannot. Unlike private insurance extended for the life of security, letters of credit are extended for short periods, usually terms of five years or less.

4. Benefit of Municipal Bonds

A bond is simply a type of a loan taken out by companies. Investors lend company money when they buy its bonds. In exchange, the company pays an interest “coupon” (the annual interest rate paid on a bond, expressed as a percentage of face value) at predetermined intervals (usually annually or semiannually) and returns the principal on the maturity date, ending the loan. Unlike stocks, bonds can vary significantly based on the terms of the bond’s indenture, a legal document outlining the characteristics of the bond. Because each bond issue is different, it is important to understand the precise terms before investing. In particular, there are six important features to look for when considering a bond. There are several reasons for the benefit of issuing bond to the society or investor.

First, the maturity date of a bond is the date when the principal, or par, the amount of the bond will be paid to investors, and the company’s bond obligation will end. Second, a bond can be secured or unsecured. Unsecured bonds are called debentures;

their interest payments and the return of principal are guaranteed only by the credit of the issuing company. If the company fails, you may get little of your investment back. Second, a secured bond is a bond in which specific assets are pledged to bondholders if the company cannot repay the obligation. Third, when a firm goes bankrupt, it pays the money back to investors in a particular order as it liquidates. After a firm has sold off all its assets, it begins to pay out to investors. Senior debt is debt that must be paid first, followed by junior (subordinated) debt. Stockholders get whatever is left over. Fourth, the coupon amount is the amount of interest paid to bondholders, normally annually or semiannually. Fifth, while the majority of corporate bonds are taxable investments, there are some government and municipal bonds that are tax-exempt, meaning that income and capital gains realized on the bonds are not subject to the usual state and federal taxation since investors do not have to pay taxes on returns, tax-exempt bonds will have a lower interest than equivalent taxable bonds. An investor must calculate the tax-equivalent yield to compare the return with that of taxable instruments. Sixth, some bonds can be paid off by an issuer before maturity. If a bond has a call provision, it may be paid off at earlier dates, at the option of the company, usually at a slight premium to par.

Moreover, applying of municipal bonds is believed that can give multi dimension solution on a win-win solution for government, society, investor, and all capital market participants. Many parties will get benefit, business opportunities and advantages. Regional government can raise fund in order to be able to support its regional development and it is also expected to improve its image in transparency and responsibility side. It is also to improve the society prosperity by creating employment opportunities that arise from multiplying economic network or multiplier effect. Another benefit is to give investment alternative for investor, besides obtaining direct benefit from various infrastructures financed by Bond fund, yield and also other incentive and to create job opportunity for capital market supporting profession and agent and all capital market participants (Gray and Cusatis, 1995; Luby, 2012).

Regional governments with their potentials can choose the most urgent and needed infrastructure or project asked by the society. It will study and consider bond type finance which is most suitable to be issued for raising fund, as we elaborate later. The other advantage is to create multiplier effect in the form of incidence of economic activity network that supporting the main project. These will create many job opportunities for the society, so that the condition of win-win solution is reached for many parties.

Furthermore, municipal bond gives the tax-exempt status and safety, the average yield on municipal bonds is often significantly lower than corporate bonds, this assumes the comparable credit rating on both instruments. The municipal debt tends to be the safer option, which provides capital preservation and generates tax-free income, where a corporate bond typically generates high returns with potentially higher risk. Moreover, if an investor is able to sell his/her security with ease and with minimum transaction costs, that means the market for that particular security is relatively liquid and vice

versa. Municipal debts are generally less liquid than their corporate counterparts with comparable ratings. This is due to the relatively high daily trading volume of corporate debt than municipal bonds. Hence, the municipal debt holder may pay a price for his/her investment's premature sale or accessing the market for his/her purchase compared to corporate bonds.

5. Risks and Problems of Municipal Bonds

Municipal bonds have no risk so they can be classified as "the safest of all senior securities". However, it requires to be realized that it does not mean there is no risk behind. Nevertheless, it is not impossible that the Regional government fails to fulfill its liabilities. It has happened in the United States, but this case is very rare. To anticipate the risks to all investors both experienced and inexperienced, there are things to be paid attention such as fund provided for daily need for investment in capital market, availability of information, information concerning company condition (Poterba and Rueben, 1997; Slemrod and Greimel, 1999).

Even if the risks are minimal, municipal bonds still carry the risk. Credit or default risk is the risk that interest and principal payments due on the obligation will not be made as required. Another risk is prepayment risk as the risk that a given bond issue will be paid off earlier than expected, normally through a call provision. This can be bad news for investors because the company has an incentive to repay the obligation early when interest rates have declined substantially. Instead of continuing to hold a high-interest investment, investors are left to reinvest funds in a lower interest rate environment. Lastly, interest rate risk is the risk that interest rates will change significantly from what the investor expected. If interest rates significantly decline, the investor faces the possibility of prepayment. If interest rates increase, the investor will be stuck with an instrument yielding below market rates. The greater the time to maturity, the greater the interest rate risk for investor bears, because it is harder to predict market developments further out into the future. Some matters which need to be paid attention related to issuance of municipal bonds in Indonesia among others are law and political conditions, credit risk, regional government debt management and financial conditions.

6. Conclusion

The regional government intention to issue municipal bonds has not yet been able to attract investors because municipal bonds rating in Indonesia is still low even though the issuer is regional government. To anticipate this situation it requires some steps to be followed among them are multiplying fund received from international institutions such as the International Monetary Fund (IMF), developing secondary market in order to give active investors the capital gain and yield for their investment. Compared with government bond, municipal bonds has more value added. Municipal bond functions for hedging especially for illiquid securities. Interest hedging such as futures and options can be developed and enrich investment choices. In one hand, municipal bonds

is considered a rival of corporate bond in a portfolio, but in the other hand, it has potential to boost up corporate bond position which in the end can solve private sector problems. Municipal bonds drives the transparency of regional government policies. Thereby no decision comes from certain interest or various pressures. At the end regional government policies are able to become a kind of trust indicator to the government. However, it has to be considered that the monitoring of bond market is not tight enough, so that government, in this case Financial Service Authority has responsibility to monitor the bond market to create fair price and increase bond trading. Nevertheless, municipal bonds is expected to enlarge the bond market which is relatively small at present.

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