



IBC
Indonesian Business Council

FINANCIAL DEVELOPMENT FOR STRONG
AND EQUITABLE GROWTH:

POLICY PAPER 1

FINANCIAL PRODUCT INNOVATION TO ENHANCE FINANCING OPTIONS

July 2024

Financial Development for Strong and Equitable Growth:

POLICY PAPER 1

FINANCIAL PRODUCT INNOVATION TO ENHANCE FINANCING OPTIONS



This policy paper is part of a series derived from the “**Financial Development for Strong and Equitable Growth**” white paper, launched in February 2024. Each paper examines key issues of financial development using the components of the Financial Development Index developed by the IMF, which focuses on three critical elements: depth, access, and efficiency. These papers propose targeted strategies to enhance Indonesia’s financial landscape and foster sustainable economic growth.

The paper policy series consists of:

- 1. Financial Product Innovation to Enhance Financing Options**
2. Increasing MSME Access to Credit through Collateral Assets and Credit Information System
3. Enhancing Financial Efficiency through Banking Consolidation
4. Navigating the Road to Improve Sovereign Rating
5. Leveling Taxation Playing Field between Financial and Non-Financial Sectors
6. Managing Non-Performing Loan (NPL) through Asset Management
7. Expanding Financial Coverage through Reform Programs
8. Leveraging the Potential of Green Financing

Contents

Executive Summary	4
1. Background and Problem Identification	6
1.1 Shallowness of The Financial Sector and Their Impact	6
1.2 Dependence on Traditional Funding Models for Infrastructure Investments	8
1.3 Constraints on Regions in Achieving SDG Goals with Existing Financial Resources	8
1.4 Unmonetized Assets Held by Property Developers	9
1.5 Insufficient Support for MSMEs	9
2. Literature Review	11
2.1 Project Finance Bonds	11
2.2 Municipal Bonds	11
2.3 Real Estate Investment Trusts	12
2.4 Bond Guarantee Scheme	13
3. Research Findings and Discussions	14
3.1 Project Finance Bonds	14
3.1.1 Structure of Project Finance Bonds	14
3.1.2 Experience from Other Jurisdictions	15
3.1.3 Key Stakeholders in Infrastructure Project Financing	17
3.1.4 The Critical Need for Project Finance Bonds in Indonesian Infrastructure Development	17
3.1.5 Necessary Regulatory Changes for Successful Implementation of Project Finance Bonds	18
3.2 Municipal Bonds	19
3.2.1 Structure of Municipal Bonds	19
3.2.2 Global Perspectives and Lessons Learned	19
3.2.3 Indonesia's Experience with Municipal Debt Issuance	20
3.2.4 Key Provisions in Law Number 1 of 2022, for Municipal Bond Issuance	21
3.2.5 Regions Favorable for Municipal Bond Issuance	22
3.2.6 Regulatory Reforms to Facilitate Municipal Bond Market Development	23
3.3 Real Estate Investment Trust (REIT)	23
3.3.1 Structure of REIT	24
3.3.2 Global Experiences with REIT	25
3.3.3 Advantages of REIT Investments	26
3.3.4 The Importance of Adopting REIT Structures in Indonesia	27
3.3.5 Regulatory Changes Needed to Develop REITs as a Viable Asset Class	28
3.4 Debt Partial Guarantee Schemes	28
3.4.1 Framework for MSME Guarantee Scheme	29
3.4.2 Urgency of Credit Guarantee Schemes for Indonesia	30
3.4.3 Identifying Needed Regulatory Changes	31
4. Conclusion and Recommendations	33
4.1 Prepare The Necessary Regulatory Framework for the Issuance of Project Finance Bonds	33
4.2 Enable Issuance of Municipal Bonds Specifically to Achieve SDG Goals	33
4.3 Enable Issuance of Real Estate Investment Trusts (REITs)	34
4.4 Create an MSME Partial Guarantee Scheme	34
5. Recommendations for Regulatory Adjustments	35
References	39

Contents

Table 1. M2 to GDP Ratios Across Selected ASEAN Countries.....	6
Table 2. Financial Depth of Selected ASEAN-5 and BRICS (% To GDP)	7
Table 3. The Financial Situation of Construction SOEs	8
Table 4. The Financial Situation of Construction SOEs	9
Table 5. Main Differences between Corporate Loans and Project Finance Debt	14
Table 6. Examples of Unlisted Infrastructure Funds	15
Table 8. Top 5 Regions that Meet the Criteria for Issuing Municipal Bonds.....	23
Table 9. Performance of REITs Versus Other Asset Classes	25
Table 1. Lippo Karawaci REITS-LMIRT.....	26
Table 11. Lippo Karawaci First REIT Assets.....	27
Table 12. Advantages of Partial-Guarantee Scheme.....	29
Table 13. Recommendations for Regulatory Adjustments	35

List of Figures

Figure 1. Typical Parties Involved in a Typical Project Finance Deal	17
Figure 2. Typical REITS structure.....	24
Figure 3. LMIR Trust Structure	27



Executive Summary

Many studies have linked financial sector development to economic growth. This is particularly urgent for Indonesia as it strives to avoid the middle-income trap and progress to developed country status. Three key features of financial development – depth, access, and efficiency – are currently suboptimal. Indonesia’s financial market is currently shallow and has limited access. Regarding efficiency, the banking sector’s interest margins are among the highest in Southeast Asia. Furthermore, gaps or missing markets exist, such as a lack of hedging instruments.

Is the financial sector adequate to fund growth aspirations? A 2017 study estimated a 6% GDP funding gap for 2016–2025. This means that GDP growth will be 6% below potential over these ten years. With business as usual, the financial sector will constrain growth during this period. Several urgent constraints must be addressed, particularly funding for the energy transition and large-scale transportation projects. Limited resources in local governments challenge SDG achievement, MSMEs face restricted funding access despite the success of KUR, and many properties generating rental income have not been fully monetized. To overcome these challenges, several key initiatives are needed to expand infrastructure investments, enable local governments to issue debt, unlock property values, and facilitate MSME funding.

The government should prepare the necessary regulatory framework for the issuance of project finance bonds. This would enable the financing of projects beyond the capacity of sponsors’ balance sheets, thereby reducing credit risk. Longer-term project finance debt is suitable for longer-liability investors, such as pension funds, mutual funds, and insurance companies. These investments are essential for the energy transition and large transport projects. OJK institutional investors should participate in this instrument. The stock market should also allow this instrument for listing and trading.

The government should also enable the issuance of municipal bonds aimed at financing SDG-related projects. Most of these goals are the responsibility of local governments, which have limited budgets. However, not all regional governments are eligible for debt issuance; only those with the capacity to pay and manage debt would qualify. Municipal debt should be revenue-based, tied specifically to a project, rather than constituting a general obligation. To this end, the government should implement the regulation of Law Number 1/2022. Two issues that need special attention are the maturity of bonds beyond the term of office of the current local leader and the out-of-court settlement for situations of municipal bond defaults.

Another instrument to unlock the value of existing infrastructure is Real Estate Investment Trusts (REITs). In REITs, property pieces are sold as participation units to retail investors. The proceeds allow the construction of more properties. In Indonesia, Lippo has applied this structure to Lippo malls and hospitals, enabling the company to continue building new facilities. Unfortunately, the units were sold in Singapore. Regulatory changes would allow the sale of REITS units in Indonesia, potentially unlocking the value of existing hospitals, hotels, shopping malls, and other properties. This shift will enable retail investors to benefit from cash flow generated by property income, which is currently unavailable to them.

Support is recognized as essential for 62 million MSMEs, 99% of which operate on a micro-scale. This understanding is based on BPS data indicating that around 80 million people are engaged in the informal sector. Currently, the primary program aimed at assisting MSMEs is KUR (Kredit Usaha Rakyat), which offers interest subsidies and credit risk coverage. It would be advisable to reallocate some resources towards a partial credit scheme to broaden support for MSMEs, and address credit price distortions. Additionally, it is crucial to facilitate the participation of the private sector and global players. Key provisions include enhancing debtor selection processes and promoting increased investment loans.

Establishing a debtor database and improving accessibility to MSME bankruptcy handling are also recommended.

These various recommendations will overcome the shallowness of the financial depth which will ultimately improve the development of Indonesia's financial sector. In implementing the recommendations above, several adjustments are needed to current policies and regulations, including the following:

- **For project finance debt:**
 - Project financing debt guarantors (PT SMI and PII) should open global and domestic entities to guarantee project financing debt.
 - The government should permit institutional investors to purchase project finance bonds.
 - The government should allow mutual funds to utilize project finance bonds as underlying assets.
 - The Capital Market Supervisory Agency should ensure project finance bonds receive bond ratings and are traded in the stock market.

- **For municipal bonds:**
 - IIGF and PT SMI could provide partial guarantees.
 - The maturity of municipal bonds could be extended beyond the local government's term in office.
 - The government should create an out-of-court settlement scheme for local government debt.
 - The government should issue implementing regulations of Law 1/2022.
 - OJK should update several regulations to reflect newer laws.

- **For REITS issuance:**
 - The government should issue regulations to regulate the trust structure.
 - The government should exempt REITs from property sales tax
 - The government should levy income tax only on the end investor
 - OJK should provide clarity on regulations governing minority interests and affiliated parties.

- **For the debt guarantee scheme:**
 - The government should shift resources from KUR to a partial guarantee scheme.
 - The government should also increase the capitalization of Askrindo and Jamkrindo.
 - The guarantee scheme should ensure that distributing banks incur some credit risk for MSME-guaranteed loans.
 - The government should allow private sector and global players access to the guarantee scheme.
 - The government should create an out-of-court settlement for a defaulted MSME loan.

1. Background and Problem Identification

The Indonesian economy maintains a respectable growth trajectory. However, there is a pressing need for a larger and deeper financial sector to support continued development. Although growth in the financial sector positively influences economic expansion and poverty alleviation¹, there is still no consensus on the optimal sequence for developing the banking sector relative to the capital market. Now, the question arises: what contribution does the financial sector make to economic growth? Additionally, does the current state of the financial sector hinder growth and poverty alleviation? Could it have adverse effects on resource allocation and efficiency drives?

The shallowness of the financial sector has a significant impact on various problems. First, these limitations result in limited infrastructure funding, hampering the progress of important projects in infrastructure development. Second, the monetization of property assets is hampered by inadequate funding sources, reducing the potential for revenue and economic growth. Third, local governments' ability to raise funds is affected due to the limited financial instruments available, limiting their capacity to finance necessary local development programs. Lastly, access to finance for MSMEs is also limited, hindering growth and innovation in this sector and reducing their contribution to the overall economy.

In the Indonesian context, a shallow financial sector also restricts investors' options. Practically, a shallow financial sector hampers specific sectoral development. For instance, the repatriation of export proceeds is hindered due to limited foreign currency investment opportunities domestically. Moreover, the allure of higher interest rates on USD deposits in Singapore and the broader range of facilities provided by offshore banks for trade and debt payments deter investors from keeping export proceeds within the country.

The shallowness of the insurance sector incurs significant costs, as evidenced by the country's net payment of USD 1.9 billion to offshore insurers in 2023. Additionally, other financial services are costly, with the country shelling out USD 1.2 billion in 2023 for such services. It is worth noting that insurance premiums paid offshore are likely associated with natural resource production.

1.1 Shallowness of The Financial Sector and Their Impact

At the economy-wide level, the broad money (M2) to GDP ratio is a measure of the financial industry. Utilizing these statistics, Indonesia ranks among the lowest in ASEAN, as presented in Table 1 below.

Table 1. M2 to GDP Ratios Across Selected ASEAN Countries.²

Countries	M2/GDP (%)
Indonesia	43.8
Thailand	144
Malaysia	119
Philippines	86
Vietnam	122.5

¹ Asian Development Bank, 2009.

² World Bank database

The reasons behind Indonesia's small M2 to GDP ratio are complex. One factor is the prevalence of a large cash economy, with several types of payments made in kind rather than in cash. Over 5 million workers in the agriculture sector lack work contracts, falling into the category of casual workers. Many of them receive payments in kind, such as part of the harvested rice. Additionally, over 18 million household workers also require cash payments. This also underscores the high degree of informality in the labor market, particularly evident in the prevalent use of cash, especially in rural areas, where banking services are not extensively utilized.

Savings behavior also influences the M2 to GDP ratio through its impact on money velocity. With no social security system in place, most individuals must rely on their savings post-retirement. The low level of household debt helps explain Indonesia's low M2 to GDP ratio. The low debt often reflects lack of demand for financial products, including loans and credit. This situation is further compounded by low financial inclusion and literacy rates. In 2021, the participation rate of people who have accounts in Indonesia reached 51.76³, while Indonesia's latest financial literacy level reached 51 out of 100⁴. These figures show that Indonesia has quite low scores in these two aspects when compared with other countries. Other ASEAN countries such as Singapore, Thailand and Malaysia. Lack of financial inclusion means that most of the population does not have access to basic financial services while low literacy rates indicate they do not have sufficient knowledge about financial products and services. Ultimately, this combination restricts their ability to borrow, save, and invest effectively, perpetuating low levels of household debt and low M2.

A low M2 to GDP ratio signifies slow movement of money, leading to increased fund costs. Risk aversion prompts the accumulation of savings and short-term deposits in the banking sector. As of February 2024, 18% of third-party funds in the banking system were held for 1 to 3 months, with an additional 31% in savings accounts, indicating that close to 50% of bank funding was short-term. With such short-term funding, banks face liquidity risk when engaging in longer-term lending. To mitigate this risk, banks often allocate large portions of funds to the central bank and government bonds, limiting investible funds and driving costs up.

Other subsectors in the Indonesian financial system also show shallowness, as shown in Table 2. The asset ratio to GDP values for banks, capital markets, insurance, and pension funds are still quite low compared to those of ASEAN and BRICS countries. This implies that financial firms, particularly smaller banks and non-bank financial institutions, require greater scale to innovate. Authorities have advocated for product offerings and risk management advancements to address these challenges.

Table 2. Financial Depth of Selected ASEAN-5 and BRICS (% To GDP)⁵

Countries	Bank assets	Capital market capitalization	Insurance assets	Pension fund assets
Indonesia	59.5	48	5.8	6.9
Malaysia	198.6	109.9	20.3	59.9
Philippines	99.2	93.2	8.5	3.5
Thailand	146.6	120.9	23.2	6.9
Brazil	125.8	67	17.2	28.2
China	214.2	83.2	22.7	2.2
India	74.3	311.5	60.1	92.1

³ World Bank, 2021

⁴ OECD, 2023

⁵ IBC, 2024

1.2 Dependence on Traditional Funding Models for Infrastructure Investments

During the Joko Widodo administration, extensive infrastructure projects were initiated, spanning 1.7 thousand kilometers of toll roads, reservoirs, ports, airports, and other infrastructure developments outside Java.

Although the state budget functions as the main source of funding, a number of state-owned enterprises (BUMN) are also tasked with carrying out infrastructure development. However, several of these BUMNs face financial difficulties, as shown in Table 3. The information in Table 3 shows that the majority of State-Owned Enterprises (BUMN) revenues are currently experiencing a decline. This is due to reliance on traditional funding sources, such as bond issuance or short-term bank loans, which are not aligned with project cash inflows.

Table 3. The Financial Situation of Construction SOEs⁶

		2021	2022
Adhi Karya	Ebitda margin	9.7%	7.7%
	Net margin	0.5%	0.6%
PT PP	Ebitda margin	7.8%	10.7%
	Net margin	1.6%	1.4%
Waskita	Ebitda margin	5.2%	-1.8%
	Net margin	-9.0%	-12.4%
Wika	Ebitda margin	6.5%	8.6%
	Net margin	0.7%	-0.3%

In contrast, project finance is a common practice in other countries for funding major infrastructure projects. This approach effectively segregates the project's financial risks from those of the sponsors, providing a more sustainable funding solution.

1.3 Constraints on Regions in Achieving SDG Goals with Existing Financial Resources

Since the era of regional autonomy in 1999, most regional governments in Indonesia have faced serious challenges related to weak financial conditions. Although regional autonomy provides greater freedom for regional governments to manage their finances, many still need to improve their financial capabilities. This highlights the need for greater regulatory structures and institutional capacity support. In 2021, only six provinces will be able to cover more than a portion of their own spending.⁷ Most of the budget is allocated for personnel spending, while spending on capital goods procurement only reaches 15%. This reality shows that many local governments still experience difficulties in managing and allocating their budgets efficiently.

Several regions in Indonesia, such as Jakarta, West Java, Central Java, East Java, and South Sumatra, have better financial capacity to issue and pay regional debt. However, despite some examples of success, the gap between financially capable local governments and those still dependent on central assistance remains significant. Further efforts are needed to strengthen vulnerable local governments' financial capacity by improving current regulations.

⁶ Companies statement

⁷ UNDP, 2023

1.4 Unmonetized Assets Held by Property Developers

One of the main challenges that causes the financial sector in Indonesia to remain secret is the existence of assets that have not been properly monetized, or what are known as non-monetized assets. These assets are often properties that have high value but are not used optimally to generate sustainable income. When these assets are not monetized, it means they are not used to generate income or liquidity that can be reinvested into the economy.

This problem occurs for various reasons, including the lack of financial mechanisms or instruments that allow asset owners to monetize their properties. Additionally, complex and unclear regulations often hamper efforts to utilize these assets effectively. Limited access to market capital and lack of awareness or knowledge about how to monetize assets also contribute to this problem.

The impact on the financial sector is clear due to limited capital flows. When properties are not monetized, their potential to contribute to the economy is not maximized. This leads to a lack of liquidity in the market, which in turn limits the ability of companies and individuals to invest and expand. Additionally, non-monetized assets do not generate additional income for their owners, meaning significant revenue potential goes unutilized.

Overall, non-monetized assets hinder economic growth and reduce the efficiency of financial markets, making the financial sector less dynamic and more vulnerable to economic shocks.

1.5 Insufficient Support for MSMEs

A cornerstone of government support for MSMEs has been KUR (*Kredit Usaha Rakyat*). This scheme provides interest subsidies and credit guarantees. However, Kredit Usaha Rakyat (KUR) program, while designed to boost MSME financing, inadvertently distorts the credit market in two significant ways. The first is sectoral bias towards trading. Lenders often perceive the trading sector as less risky than other sectors like manufacturing or agriculture due to shorter business cycles and faster inventory turnover as shown in Table 4. This perception leads to a preference for providing KUR loans to trading businesses. Additionally, trading businesses typically have inventory that can serve as collateral, making it easier for them to obtain loans compared to MSMEs in sectors with less tangible assets. The trading sector also often promises quicker returns on investment, making it attractive to lenders who prioritize short-term profitability.

Table 4. The Financial Situation of Construction SOEs⁸

Region	Total Distribution (IDR Trillion)	Number of Debtors (Thousands)	Key Sectors
Java	150	2,500	Trade, Manufacturing, Agriculture
Sumatera	80	1,200	Trade, Plantations, Agriculture
Sulawesi	45	750	Trade, Fisheries, Agriculture
Kalimantan	35	500	Trade, Mining, Plantations
Bali and Nusa Tenggara	20	300	Trade, Tourism, Agriculture

⁸ Coordinating Ministry for Economic Affairs; Bank Indonesia (2023)

Maluku and Papua	10	150	Trade, Fisheries, Agriculture
Total	340	5,400	Trade, Agriculture, Manufacturing

The second is overemphasis on working capital loans. Working capital loans have shorter repayment periods and are generally considered less risky than investment loans, which are used for long-term asset acquisition or expansion. Lenders, therefore, prefer to extend KUR financing for working capital purposes. Many lenders lack the expertise and resources to thoroughly assess investment loan proposals, which often require in-depth analysis of business plans and growth projections. This leads them to favor simpler working capital loans. Working capital loans can quickly boost a business's cash flow and operational efficiency, making them a popular choice for MSMEs seeking immediate financial relief.

This distortion in the credit market has several adverse consequences. The preference for trading and working capital loans leaves limited funding for other sectors crucial for economic development, such as manufacturing, agriculture, and technology. The focus on short-term working capital needs discourages MSMEs from pursuing long-term investments in innovation, expansion, or technological upgrades, which are essential for sustainable growth. The allocation of credit is not based solely on the economic viability and growth potential of businesses but is skewed towards sectors and activities favored by lenders. This can lead to misallocation of resources and hinder overall economic productivity. Moreover, it puts pressure on guarantee institutions like Askrindo and Jamkrindo. These preferences can increase credit risk for lenders, which in turn can increase the likelihood of loan default or default by borrowers. As more and more loans are provided for working capital and trade, the potential risk for lenders also increases, meaning that collateral institutions such as Askrindo and Jamkrindo have to assume more of that risk. Therefore, there needs to be regulations that regulate the risks faced by debt guarantors.

In light of these challenges, this study aims to address the shallowness of the financial. Specifically, it addresses the issues of limited financing options for infrastructure projects, regions with constrained financial capacity, underutilized property assets, and inadequate MSME support.



Image credit: credgenics.com

2. Literature Review

This section explores various studies and experiences related to innovative financing structures. Examples include project finance bonds, which offer expanded options for financing infrastructure projects, and municipal bonds, which provide additional funding resources for regions to achieve SDG objectives. Additionally, it presents studies on how REIT structures have been employed to unlock significant property assets, while partial credit guarantees offer a viable alternative to current MSME interest subsidies.

2.1 Project Finance Bonds

Historically, project finance has enabled the execution of large, complex projects. For instance, the construction of the Suez Canal incurred cost overruns of more than 1900%. Project finance is a funding technique based on the expected cash flows generated by the project itself. However, project finance must address several risks, including new technology, regulations, delays in launch dates, cost overruns, sponsor performance, and political changes.⁹ The key to a successful project lies in minimal recourse but sufficient credit support for lenders to remain comfortable.

In 2014, 38% of global power projects were financed using a project finance scheme, with major projects spanning transportation and oil and gas sectors¹⁰. Global project finance-funded investments amounted to slightly less than USD 277 billion.

A significant characteristic of project finance debt is its financial structure based solely on the project, which is transparent to outsiders, unlike the complex structural factors and risks embedded in corporate debt¹¹. This transparency is especially crucial for complex infrastructure projects, particularly those spanning multiple jurisdictions and involving various sponsors.

Project finance is well-suited for multinational corporations developing infrastructure projects facing political risks. Project finance structures can mitigate specific risks through offtake agreements, supply arrangements, equipment supply contracts, and operations and maintenance contracts¹².

2.2 Municipal Bonds

Municipal bonds, or regional bonds, are financial instruments issued by local governments to fund public sector investments that generate income and societal benefits. The proceeds from this bond issuance are used to fund various development projects, such as drinking water services, waste and garbage handling, transportation, hospitals, traditional markets, entertainment venues, entertainment centers, and others. Municipal bonds could be a crucial funding source for achieving the Sustainable Development Goals, improving local government finances, and introducing additional financial instruments.

Several countries, including India, the Philippines, and Vietnam, have issued local government debt, with the US leading among developed nations. Local government debt is typically directed towards local infrastructure projects. In India, these instruments were used to fund the construction of schools, railways, and other local infrastructure. In Vietnam, municipal bonds were issued to develop social and economic development projects and profitable endeavors¹³. Meanwhile, in the Philippines, these instruments were issued to expand and maintain local infrastructure.¹⁴ Challenges in issuing municipal

⁹ Beidleman, 1990

¹⁰ Mulner, 2017

¹¹ Byoun, 2014

¹² Müllner, 2016

¹³ Moneycontrol

¹⁴ Philstar

bonds are similar in these countries, namely limited local government financial resources due to overreliance on the central government, poor accounting capabilities, and an inadequate legal framework at the regional level. Conversely, supporting factors in these countries include a vibrant domestic bond market, the development of a secondary market for municipal bonds, provincial committees responsible for debt management, and a municipal bond guarantor institution. Several criteria are used to select which regions are ready to issue municipal debt, such as the readiness of regional financial management, need (indicated by a social indicator below the national average), adequate economic condition, debt service ratio above a certain level, absence of arrears, and unqualified audit status from the national audit board (BPK).

2.3 Real Estate Investment Trusts

One of the critical developments in real estate financing has been the introduction of REITs (Real Estate Investment Trusts).¹⁵ The rise of REITs began in 1960 with new US regulations governing this type of investment instrument. The basis was an older concept of business trusts, but this time, it focused on real estate. Investors are equity holders of one or several pieces of property, which can be commercial, residential, or industrial.¹⁵

In the 1970s, a new form of REITs emerged: healthcare REITs. This type of REIT focuses on hospitals, medical clinics, senior housing, and other health-related facilities. The timing was opportune, as the US population was aging, and there was a need for health facilities.¹⁶

Currently, over 575 thousand properties are owned by REITs in the US, with 170 million Americans living in properties invested in by REITs. The assets owned by REITs exceed USD 4 trillion as of 2023¹⁷, with listed REITs owning over USD 2.5 trillion worth of properties. The market cap of listed REITs is around USD 1.4 trillion. Globally, there are over 893 REITs listed in over 40 countries, with a market cap of over USD 2.5 trillion.

In Indonesia, the early development of REITs, called DIRE (Dana Investasi Real Estate), faced tax hurdles where changes in property ownership were taxed. However, this changed in 2015 when the government issued a regulation eliminating double taxation of cash flow from the property to the trust (an SPV created to manage the properties owned by REITs investors). However, property purchases are still subject to tax, and later, when the property is sold, another tax is levied. With the issuance of an omnibus law on the financial sector in 2023, the trust structure could eliminate this double ownership tax structure.¹⁸

Utilizing the REIT structure, major property developers, including pieces of infrastructure, could be monetized, enabling the property developer to build new projects. At the same time, it provides investors access to income from the property sector without purchasing shares, bonds, or investing in mutual funds focusing on the property sector. The main difference in direct investment in properties is the large investments involved and the long selling horizon. On the other hand, owning shares or debt of property companies subjects investors to volatility, which sometimes can be significant. Conversely, REITs promise a steady income stream coming from the rental or lease income of already established properties.

The constraint to issuing REITs is the property tax, although relatively low at 1%, it could be levied twice, once on the purchase of the assets and once on disposal. Assets that can be put into REITs are those with steady rental income, with a long average lease. Additionally, during periods when trusts are not

¹⁵ Lee, Allen, 2020

¹⁶ REIT.com, op.cit

¹⁷ REIT.com, op.cit

¹⁸ Kahill Rowter, 2015

available as a legal structure, it is the founder or original owner of the properties that creates the SPV. Hopefully, once the trust structure becomes available, more transparency and credibility from an arms-length trust can raise investors' appetite for REITs.

2.4 Bond Guarantee Scheme

Sovereign guarantees can assist in developing local government bonds, especially in the initial stages. With the explicit central government guarantee, the rating of municipal bonds can be at the same level as the sovereign rating, AAA for domestic investors or equivalent to the sovereign rating for international investors.¹⁹ Interestingly, the cost of the central government guarantee (in terms of higher debt ratios) could conceivably be offset by the enhanced rating that regional government debt achieves. In the early 1990s, local governments in the Philippines financed investments primarily focused on water and electricity projects. However, in the late 2000s, central government loans to local governments began to dominate the financing space, leading to a slowdown in local government-issued debt.²⁰ Consequently, government loans became competitors to bank loans and local government bonds.

Bond or debt guarantee schemes also play a crucial role in providing MSMEs with access to financing.²¹ These schemes can substitute for the lack of MSME collateral by guaranteeing microloans, leasing, factoring, and other financial support.

For MSMEs, the advantages include access to commercially sound ventures and expert support to ensure the project and its financing are sound and economical. For banks participating in the scheme, the benefits include reduced risk exposure, an increased MSME lending portfolio, enhanced information regarding specific sectors, locations, and types of MSME borrowers, and better liquidity for collateral than traditional MSME lending. Guarantees can be public, private, or a mix of both. The mixed model is common among initial European Union (EU) member countries, whereas the public support model is more prevalent among new EU members.

An example is Invega, the sole institution dedicated to supporting MSMEs in Lithuania. Established in 2018, Invega's mandate is to develop markets serving MSMEs, invest in MSME business projects, and coordinate the development of financial instruments to support MSME activities. In 2023, Invega was involved in over 7,100 contracts valued at nearly EUR 470 million, reaching 11,600 customers. Its loan portfolio at the end of 2023 was EUR 1.4 billion.²²

Another important guarantee scheme is AECM, the European Association of Guarantee Institutions. Currently, there are 46 member institutions. As of 2022, there were 5.1 million supported MSMEs, with a total outstanding guarantee volume amounting to EUR 267 billion, and the average guarantee size was EUR 45 thousand.²³ In a few countries, the provision of guarantees is frowned upon due to past negative experiences in Latin America²⁴ and China²⁵. In contrast, other countries implement a partial loan guarantee for MSMEs, eliminating the need for collateral for most borrowers and reducing banks' credit risk. Banks bear some risk to discourage excessive lending, and funds spent on interest subsidies could be redirected to a partial guarantee. MSMEs are typically not sensitive to interest rates, especially at the micro level, but their main challenge lies in accessing loans.

19 Sharma, et.al., 2023

20 Philstar, op.cit.

21 Figueiredo and Gaspar, 2010

22 Figueiredo, op.cit.

23 AECM.EU, 2023

24 Cabarello, C., et. al., 2021

25 Zhang, 2014

3. Research Findings and Discussions

Based on literature reviews and benchmark analyses from various countries, this section identifies several strategies to address the challenges posed by a shallow financial sector. These challenges include limited options for infrastructure financing, unmonetized assets, insufficient regional government funding sources, and inadequate support for MSMEs. This following discussion will explore these strategies to enhance financing options and expand support for MSME financing.

3.1 Project Finance Bonds

Project finance bonds alleviate pressure on the sponsor’s balance sheet, enabling highly leveraged firms to continue developing infrastructure projects. This is particularly beneficial as these firms are repositories of expertise in constructing infrastructure projects.

3.1.1 Structure of Project Finance Bonds

As illustrated in Table 5, a fundamental distinction between project financing and traditional infrastructure investment lies in how the project’s financial viability is assessed. In project financing, the sponsor’s creditworthiness and financial health do not influence the project’s commercial and financial evaluation. Instead, the focus is solely on the project’s ability to generate sufficient cash flow to service debt and yield returns on invested capital.

Table 5. Main Differences between Corporate Loans and Project Finance Debt²⁶

Considerations	Corporate Debt	Project Finance
Guarantee	Existing assets of borrowers	Project assets themselves
Financial flexibility	Borrowers have less financial flexibility	Practically no impact on project sponsors
Accounting treatment	On balance sheet	Off balance sheet
The main considerations for extending the facility	- Corporate relations - Balance sheet strength - Profitability	Future cashflow
Amount of leverage	Borrowers’ balance sheet driven	Depends on project’s cash flow

Project finance, therefore, focuses on the structure and performance of the Special Purpose Vehicle (SPV), which is tailored to meet the needs of the project and its investors. Typically, the SPV is funded by equity or mezzanine debt, with project cash flows serving as the primary source for loan repayment. Mezzanine debt is a potent financing tool that, despite its higher risks and costs, offers attractive potential returns for investors. In this setup, the project assets are used as collateral, further securing the investment.

Furthermore, Project Finance is a financing structure used to fund large projects with the main collateral being assets and cash flows generated from the project itself. These loans are provided based on the project’s feasibility, rather than the company’s balance sheet. The risk assessment focuses on cash flow projections and the likelihood of project success. The funds are specifically used to finance approved projects, with the project assets and generated cash flow serving as the main collateral. Projects are often established as separate entities known as Special Purpose Vehicles (SPVs). Risks are assessed based on various factors that could impact the project, including technical, financial, and market considerations. Returns, interest payments, and principal amounts depend on the income

²⁶ Gatti, 2024

generated from the project. If the project fails, the lender can only claim the project's assets, not those of the parent company. Case studies indicate that project financing is commonly used in the infrastructure and energy sectors, where projects often require substantial initial investments and generate predictable cash flows²⁷.

Corporate loans are credit facilities provided to companies guaranteed by the company's overall balance sheet. This credit is awarded based on the company's financial strength, including its assets, liabilities, and equity. The funds from these loans can be utilized for various operational needs, such as working capital, business expansion, or debt restructuring. The guarantees for these loans are usually backed by tangible company assets, like buildings and machinery. The risk of the loan is assessed based on the company's performance and financial stability. Unlike project finance, the repayment of interest and principal on corporate loans is scheduled and is not contingent on the success of a specific project. A study by Johnson et al. (2019) on corporate lending demonstrates that companies with high leverage ratios tend to face higher loan interest rates due to the increased risk perceived by lenders.

In a project finance transaction, the project entity itself becomes the debtor, assuming all financial and legal responsibilities related to the loan. Once the project is completed, investors typically have limited or no recourse to the project sponsors, whose liability is constrained in terms of time, monetary amount, and performance, particularly during the initial setup phase. This allocation of liability effectively separates most project risks from those associated with the sponsor as a going concern. Risks related to the project's completion are shared proportionately among the investors based on their contributions. The cash flow generated by the project primarily addresses operational needs, with any surplus allocated to satisfying investors' returns. Collateral, often provided by the project sponsor, is used to mitigate the risk of investment failure.

3.1.2 Experience from Other Jurisdictions

In most jurisdictions, infrastructure investments suitable for project finance structures typically display characteristics such as very long lifespans, provision of essential public services, and low demand elasticity, meaning demand does not significantly change with price fluctuations. These projects often operate in natural monopoly settings within highly regulated sectors, offer returns linked to inflation, provide stable cash flows, and exhibit low correlation to the economic cycle.

Unlisted infrastructure funds, as shown in Table 6, offer investors the opportunity to engage in large infrastructure projects with the potential for long-term returns and stable cash flow. Although these funds are less liquid than publicly traded investments, their risk diversification and attractive return potential make them a popular choice among institutional investors.

Table 6. Examples of Unlisted Infrastructure Funds²⁸

Funds	Investor	Vintage	Target Fund Size	Status	Focus
EQT Infra V	EQT	2021	EUR12.5	First close	Europe
ISQ Infra III	I Squared	2020	USD12	First close	N. America
KKR Infra IV	KKR	2021	USD12	Raising	N. America
Stonepeak Infra IV	Stonepeak	2020	USD10	Third close	N. America
Copenhagen Infra IV	Copenhagen partners	2020	EUR5.5	Second close	Europe

²⁷ Smith et al. 2020

²⁸ Gatti, op.cit

Unregistered infrastructure funds are investment vehicles that raise capital to invest in major infrastructure projects such as toll roads, airports, ports, power plants, and utility networks. These funds are not traded on public markets and usually have the following characteristics: they are designed for long-term investments, often exceeding ten years, not publicly traded which provides them with lower liquidity compared to exchange-traded stocks. Additionally, these funds deliver stable and predictable cash flow derived from income generated by infrastructure assets. Furthermore, they invest in various types of infrastructure projects to reduce risk.

As of 2021, there were 917 project finance investment activities globally, valued at approximately USD 306 billion²⁹. The geographic distribution of these activities included Africa, Europe, and Central Asia, accounting for 48% of the total, followed by the Americas at 31% and Asia-Pacific at 20%. The top three sectors dominating the project finance space were power (over 42%), transportation (14%), and oil and gas (19%).

Box 1. Case Study of Power Purchase Agreement in The Philippines

This case study examines a significant power purchase agreement (PPA) involving Quezon Power, a 440-megawatt generating plant in the Philippines. Constructed in the 1990s without financial support from the national government or supra-national entities, Quezon Power became a key player in the energy market by selling its power to the Manila Electric Company.

The cornerstone of this project is a 25-year PPA between Quezon Power and Manila Electric, structured with a take-or-pay agreement based on a minimum availability factor of 85% over the duration of the contract. The financial details of the PPA include:

- The capacity Payment was USD 0.0295 per kWh, adjusted according to the United States Consumer Price Index.
- The fixed operating fee was USD 0.0015 per kWh plus PHP 0.0323 per kWh, and a variable operating fee of USD 0.0015 per kWh plus PHP 0.0937 per kWh. These fees are subject to adjustments based on changes in US and Philippine CPIs.
- The energy expenses are calculated by multiplying the fuel cost by 1.06575 per million British Thermal Units (BTUs), then multiplying the result by 0.00975 per million BTU per kWh, and finally by the net kWh output. This method provides a detailed calculation of the energy costs incurred.

Should Quezon Power fail to deliver the minimum guaranteed power output, it incurs a penalty of PHP 0.26 for every kWh under-delivered, as stipulated in the PPA.

Bonetti et al. presented a compelling case study on a power purchase agreement for Quezon Power, a 440-megawatt generating plant in the Philippines.³⁰ Constructed in 1990s, this plant was developed without funding support from the national government or any supra-national entities. The electricity produced by Quezon Power was subsequently sold to the Manila Electric Company, a major power distributor in the region.

²⁹ Refinitiv, 2022

³⁰ Bonetti, V., Caselli, S., & Gatti, S, 2009

3.1.3 Key Stakeholders in Infrastructure Project Financing

As depicted in Figure 1, a project finance investment involves multiple key parties, each playing a distinct role and bearing specific responsibilities. Sponsors initiate the project, providing equity financing and often holding a significant stake in its success. They are responsible for developing the project concept, securing necessary permits and approvals, arranging financing, and overseeing the project's implementation. Meanwhile, lenders provide debt financing, typically in the form of bank loans or bonds, assess the project's risks and financial viability, negotiate loan terms, and monitor performance to ensure repayment and profitability.

The project finance transaction typically begins as sponsors initiate the project and secure funding from lenders and the government. A project Special Purpose Vehicle (SPV) is then established to manage the project and enter into contracts with suppliers, off-takers, operators, and construction firms. Suppliers provide the necessary raw materials and services, while construction firms build the project's facilities. Once operational, the operator manages the daily activities, producing the output sold to the off-taker. The revenue from the off-taker is used to repay the lenders and provide returns to the sponsors.

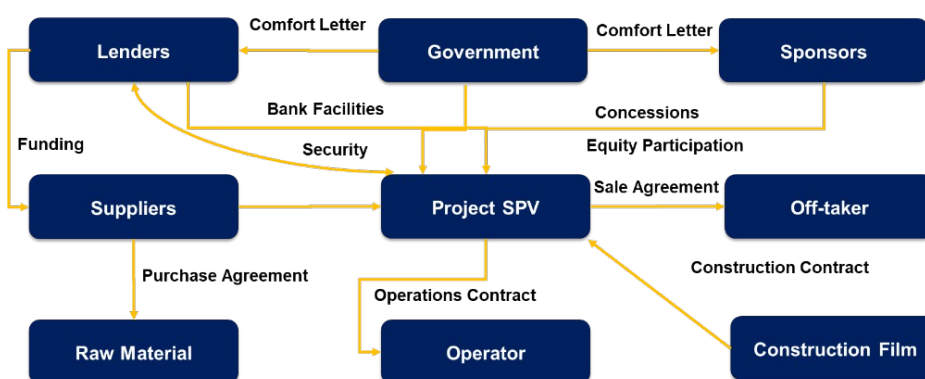


Figure 1. Typical Parties Involved in a Typical Project Finance Deal

Suppliers are crucial for delivering all required goods and services on time and within budget, ensuring quality and adherence to specifications. Government support in the form of comfort letters or guarantees is optional but can be necessary in some cases. This support may include full backing in the event of missed payments, a partial guarantee, or an implicit guarantee if the off-taker is a state-owned enterprise, such as with most electricity generation projects in Indonesia where PLN (the state electric company) is the typical off-taker.

3.1.4 The Critical Need for Project Finance Bonds in Indonesian Infrastructure Development

In Indonesia, project finance is essential to provide adequate financing for projects sponsored by state-owned enterprises (SOEs) in key sectors such as energy (Pertamina, PLN, PGAS), transportation (Pelindo, Pelni, Jasa Marga), and construction (Waskita, Wijaya Karya, etc.), particularly for those with high levels of debt. This financing structure would enable the development of projects despite the high indebtedness of the sponsors, as it allows the project itself to finance its development.

Currently, however, project finance bonds are not being issued. A major regulatory gap is that this type of debt is not yet recognized as a capital market instrument by the Financial Services Authority (OJK). Consequently, these instruments are not included on the list of allowable investments for buyers, nor are they considered eligible assets for mutual funds. Past efforts to issue project finance bonds have not been successful, primarily because investors tend to focus more on the issuer than on the project itself.

Many SOEs and developers have been charged with driving the government's infrastructure agenda. While most projects are completed on time, the involved corporations often face considerable financial strain. For example, Waskita Karya and its subsidiaries have repeatedly defaulted on their bond payment obligations. As depicted in Table 7, there was a notable divergence in performance within the Indonesian construction sector in 2022. While some companies, like PT PP, showed resilience and growth—increasing their EBITDA margin from 7.8% to 10.7%—others, such as Waskita, experienced significant challenges, with their EBITDA margin falling to -1.8% in 2022 from 5.2% in 2021.

This situation has exerted pressure on both the corporate bond market and the mutual fund industry in Indonesia. Many infrastructure bonds are structured as Limited Participation Mutual Funds (*Reksadana Penyertaan Terbatas* or RDPT), which accommodate only a select group of investors. RDPTs are closed-end investment funds in Indonesia with a limited number of participants. These funds typically invest in targeted projects or assets, such as real estate, infrastructure, or private equity, and often include state-owned enterprises, like TASPEN (the civil service pension fund), and other SOE pension funds among their investors.

To support Indonesia's transition towards more environmentally friendly energy sources, it is therefore critical to develop infrastructure financing structures that isolate a project's financial viability from the corporate financial status of its sponsors. This separation allows promising green energy projects to secure funding based on their own merit, regardless of any financial challenges their sponsoring company might face. Such a structure reduces risks for investors and stimulates greater investment in the renewable energy sector, which is crucial for a successful energy transition.

3.1.5 Necessary Regulatory Changes for Successful Implementation of Project Finance Bonds

Several critical features are needed for a successful project finance deal, particularly in terms of how the central government perceives the application of sovereign support. During the New Order period (1966 to 1998), the central government used a two-step loan process, borrowing from multilateral agencies and then on-lending to local governments and infrastructure-developing SOEs.

After the late '90s financial crisis, the central government primarily used bond issuance to finance its budget deficit and rarely provided direct support for infrastructure projects, except for the PLN fast-track program, which aimed to build ten gigawatts of generating capacity. Support from international agencies like the World Bank Group (IBRD, IDA, IFC, MIGA) and the Asian Development Bank (ADB) could be crucial for fostering infrastructure development, especially in clean energy generation. These organizations could not only lend directly but also provide partial risk guarantees to ensure the viability of infrastructure projects, thus enabling global investors to support initiatives in Indonesia.

These institutions can mitigate risks associated with currency fluctuations, contract breaches, and other non-political events typically managed by the central government. Although Indonesia has the Infrastructure Guarantee Fund, its resources are limited. Enacting specific legislation could help alleviate significant political risks.

The regulatory framework needs adaptation to allow institutional investors to participate in project finance debt. This would enable pension funds to invest in these instruments and allow mutual funds to create special funds based on project finance debt as underlying assets. It is also crucial for banks to support project finance transactions by providing facilities and funding for suppliers to ensure an adequate supply of materials during construction and operation. The risks associated with bank support

should be adjusted, considering the project enjoys backing from sponsors and, in some cases, from the government.

Project finance bonds, both mezzanine and senior, should be rated by rating agencies and listed on the stock exchange to enhance liquidity and ensure a transparent flow of information to the public. In cases of illiquidity, the Securities Pricing Agency should produce and provide necessary information.

3.2 Municipal Bonds

3.2.1 Structure of Municipal Bonds

Local government debt, issued by subnational entities such as districts, states, or provinces, plays a pivotal role as a financial instrument. It is predominantly used to fund essential local infrastructure projects like highways, bridges, schools, waste treatment facilities, and systems providing clean drinking water.

Municipal bonds typically offer tax exemptions for residents of the issuing territory from both federal (or national) and local income taxes, making them particularly attractive to individuals in higher income brackets, especially those residing in areas with elevated local income taxes.

There are primarily two types of municipal bonds: general obligation and revenue bonds. General obligation bonds are supported by the tax revenues of the issuing municipality and are not directly tied to any specific project's revenue streams. Some general obligation bonds are secured by specific local government taxes, such as property taxes, enhancing their payment security. In contrast, revenue bonds finance specific infrastructure projects and are repaid from the profits generated by these projects. These bonds may also be bolstered by particular taxes like sales taxes, fuel surcharges, entertainment taxes, or hotel taxes, which ensure their repayment.

Additionally, there are instances where municipal bonds are issued on behalf of a non-profit organization, with the private entity, rather than the local government, responsible for meeting the bond's coupon and principal payments. While the risks associated with municipal bonds generally parallel those of corporate bonds, such as credit risk where the debtor or project may not generate enough cash flow to meet debt obligations, municipal bonds typically show lower default rates compared to corporate debt, according to Moody's research. Tax bracket changes also influence investment decisions, with municipal bonds often providing tax-free income, though at a lower yield than taxable corporate bonds. Moreover, call risk, inherent in most debt instruments, permits issuers to repurchase debt potentially disrupting investors' income streams. Market risk also influences bond prices, especially when interest rates rise, affecting institutions' mark-to-market valuations unless bonds are held to maturity.

3.2.2 Global Perspectives and Lessons Learned

In many developing Asian countries, municipal bond issuance remains scarce, largely due to regulatory and market constraints. Financial market regulations and investor preferences tend to favor highly rated municipal bonds—a status seldom achieved by local governments. Moreover, the development of regional debt markets often correlates with the sophistication of a country's overall debt market. Consequently, while common in developed countries such as the United States, Japan, and China, regional debt markets are less prevalent in other developing Asian countries.

Successful development of municipal bonds typically hinges on several key factors. Foremost among these is the presence of government guarantees, whether express or implied, which play a crucial role in assuring investors about the security of their investments. Additionally, ensuring reliable payments

through mechanisms such as managed project cash flow by a trustee and the establishment of reserve funds to cover potential shortfalls is vital. These measures boost investor confidence and enhance the stability and attractiveness of municipal bond offerings.³¹

In India, local government debt is relatively advanced, with state governments accounting for 31% of public sector debt as of 2021, though municipal bonds represent only 0.03%. The issuers were 11 municipal corporations with a combined debt of USD 532 million. The scarcity of issuances is primarily due to the stringent requirement for a minimum AA rating (on a national scale) as per institutional investor guidelines. Even municipalities that meet this rating face rigorous disclosure requirements set by The Securities and Exchange Board of India, akin to those for corporate issuances, which necessitate revision.

In the Philippines, while decentralization is underway, the ability of local governments to issue and service their debt is legally recognized, yet the risk of diverting local government revenues away from debt servicing remains ambiguous. Many local governments resort to borrowing from central government financial institutions, which offer loans at sovereign rates, rendering municipal bonds uncompetitive.

Local government debt constitutes only 1.3% of the public sector debt, reflecting the generally risk-averse nature of many local governments, which often prefer enduring lower-quality public services over incurring debt.³² There is also a pressing need to enhance the technical capacity at local government levels for infrastructure project preparation, monitoring, and implementation.

In Vietnam, a dynamic Asian economy with many local government units, the central government has delegated significant authority to local governments while maintaining strict oversight, including over the issuance of local government debt. This oversight fosters a perception of an implicit central government guarantee. As of 2022, there were only two local government debt issuers, with a combined worth of approximately USD 486 million, representing just 0.73% of public sector debt.

3.2.3 Indonesia's Experience with Municipal Debt Issuance

Until 2022, the development of municipal debt in Indonesia was sporadic and uncoordinated. However, the enactment of the Financial Relations Law in 2022 brought about a greater coherence in the development of municipal bonds. Despite this, the domestic bond market remains dominated by central government debt, with a burgeoning local corporate market that tends to favor shorter-term bonds, ranging from 3 to 5 years. Although guidelines for issuing municipal bonds have been in place since 2011, no actual issuances have occurred to date. The rating agency *Pefindo* has established guidelines and methodologies for municipal bond ratings but has yet to publish any ratings on its website.

While no local government has yet issued bonds, *PT Sarana Multi Infrastruktur (SMI)*, a government lending platform supported by the Asian Infrastructure Investment Bank and the World Bank, has implemented the Regional Infrastructure Development Fund Project (RDIF). This initiative focuses on financing essential urban infrastructure projects such as clean water, waste management, drainage,

³¹ Sharma, *op.cit.*

³² ADBI, 2019

and local roads. RDIF loans are provided to local governments and, in later stages, to local government corporations, serving as a potential alternative to direct municipal bond issuance. Moreover, RDIF loans are priced competitively—lower than AAA corporate yields but higher than government bonds—making them an attractive financing option for local governments.

Eligibility for RDIF loans requires adherence to several criteria:

- Projects must be crucial and aligned with the local government’s medium-term plan.
- Approval must be secured from the local legislature.
- The local government must not have any outstanding arrears.
- A debt service ratio of at least 2.5 times.
- Loans must not exceed 75% of the revenues from the previous fiscal year.
- The current local government budget deficit must remain within specified limits.
- A record of three years of unqualified audit opinions from the Supreme State Audit Agency (BPK).
- A recommendation from the Home Ministry.

3.2.4 Key Provisions in Law Number 1 of 2022, for Municipal Bond Issuance

The law 1/2022 enacted in 2022 significantly redefines the relationships between regional governments and the central government of Indonesia, introducing more centralized control while aligning with standardized public finance tools.³³ The main provisions related to municipal bond issuance include:

- Article 154 recognizes bonds, including conventional debt and Sukuk, as legitimate forms of borrowing by local governments. However, there is no central government guarantee on local government debt, and any issuance must receive approval from the regional parliament.
- Article 155 requires local government loans from the central government to be approved by the Minister of Finance, following recommendations from the Ministers of Home Affairs and National Development.
- Article 156 specifies that loans intended for cash management must be settled within the same fiscal year. It also covers other types of loans, such as those for local infrastructure financing and equity participation in local government-owned enterprises.
- Article 157 mandates that the issuance of local government bonds must be conducted through the capital market in Rupiah, with Syariah debt issuance requiring compliance statements from experts in the Syariah capital market.
- Article 159 assigns the head of the region the responsibility for debt management.
- Article 160 prohibits local governments from guaranteeing the debt of others or using local government assets as collateral for loans.
- Article 161 requires that debt payments be included in the regional budget for the duration of the debt.
- Article 162 states that any failure to service loans to the central government could lead to deductions from unassigned transfer payments.
- Article 172 of sets significant fiscal boundaries for Indonesia by capping the combined deficit of the central and regional governments at 3% of GDP, while limiting the total debt of both levels of government to no more than 60% of GDP for the fiscal year.

This law is pivotal as it redefines the fiscal autonomy and capabilities of regional governments across the country. It is structured around several key objectives aimed at enhancing the financial governance of regions. Firstly, it strengthens fiscal decentralization by empowering regional governments with greater authority over their financial resources. This includes increased allocations of General Allocation Funds

³³ Lewis, 2023

(DAU) and Special Allocation Funds (DAK), which are critical for supporting various local initiatives. Secondly, the law enhances transparency and accountability in regional financial management. It tightens supervision and mandates clearer reporting, ensuring the management of local revenue (PAD) is conducted transparently, thus improving the efficiency and integrity of financial operations.

Additionally, the law promotes financial independence among regional governments by encouraging them to seek alternative funding sources, such as the issuance of regional bonds. This initiative allows regions to manage their revenues and resources more effectively without over-reliance on central government transfers. Furthermore, the law regulates regional debt management by introducing detailed mechanisms and clear procedures for issuing and managing regional bonds, enhancing both accountability and transparency in their management.

The impact of Law Number 1 of 2022 on the issuance of regional bonds cannot be overstated. It significantly increases the financing capacity of local governments, allowing them to access capital markets more readily to fund infrastructure and other development projects. By providing a clear regulatory framework that outlines the necessary requirements and procedures for bond issuance, the law aims to boost investor confidence. This is achieved through measures that ensure regional bonds are issued and managed transparently, thereby enhancing the investment appeal.

Moreover, the law's emphasis on transparency and accountability in managing regional finances is expected to bolster investor confidence in bonds issued by regional governments. By enabling local governments to explore alternative funding sources, the law fosters financial independence, reducing dependence on central government transfers and promoting sustainable regional development. Ultimately, with improved access to bond funding, local governments can enhance the quality of infrastructure projects and public services, benefiting communities and contributing to the country's overall growth.

3.2.5 Regions Favorable for Municipal Bond Issuance

The Indonesian government has introduced a new reporting system known as the *Sistem Akuntabilitas Kinerja Instansi Pemerintahan* (SAKIP) to assess the institutional capacity of regional governments to manage debt. Under this system, regions scoring above 70 are deemed to have adequate financial accountability and are considered eligible for municipal bond issuance.

Eligibility for bond issuance is also determined by the specific funding needs of a region, which may include projects in education, health, poverty alleviation, and gender equality. These needs are assessed against the targets set out in the *Rencana Pembangunan Jangka Menengah Nasional* (RPJMN), or the Medium-Term National Economic Plan. Additionally, environmental considerations are factored into the funding equation. The Ministry of Environment and Forestry provides indices for water, air, and land cover quality at the subnational level, and regions with indices below the national average are given priority for projects financed through municipal bonds.

Economic performance indicators such as regional growth and financial depth are also critical in determining eligibility for bond issuance. Regions are subjected to a limit where the debt load must not exceed 75% of the region's budget from the previous year. Furthermore, they must demonstrate a capacity to repay the debt, maintain no arrears, and secure an unqualified audit opinion from the Supreme Audit Agency (BPK).

Based on these criteria, there are five regions that stand out as particularly favorable for municipal bond issuance: DKI Jakarta, West Java, East Java, Central Java, and South Sumatra. These regions not only meet the required financial metrics and governance standards but also have significant infrastructural and developmental needs that can be addressed through the issuance of municipal bonds.

Table 8. Top 5 Regions that Meet the Criteria for Issuing Municipal Bonds³⁴

Provinces	Max loan amount (IDR Trillion)	Debt service ratio (3 years average)	Unqualified audit opinion	No loan arrears
DKI Jakarta	10.3	3.2	Yes	Yes
West Java	6.2	2.8	Yes	Yes
East Java	4.7	3.5	Yes	Yes
Central Java	4.0	2.7	Yes	Yes
South Sumatra	1.5	2.8	Yes	Yes

These provinces, identified as favorable for municipal bond issuance, should be the focus of detailed studies, especially regarding investments in public services under a revenue bond scheme. Considering that the central government's debt to GDP ratio is projected to rise to only 40% by 2025, there is considerable scope to support local government debt. This fiscal space allows for strategic investments that can be funded through municipal bonds, promoting sustainable development and enhancing public services in these key regions.

3.2.6 Regulatory Reforms to Facilitate Municipal Bond Market Development

Several key regulations must be reviewed to effectively support municipal bond issuance effectively. One major obstacle is the absence of central government support for municipal bonds, outlined in Article 154 of Law 1/2022. Alternative solutions, such as leveraging the Indonesian Infrastructure Guarantee Facility, could be explored to address this challenge. Additionally, there's a prevalent perception that local government debt must be repaid during the administrative head's term. One proposed solution is the establishment of a debt management unit at the regional level to manage these obligations more effectively.

Another critical aspect is the absence of mechanisms to handle regional government defaults, as they cannot be prosecuted in bankruptcy courts. This necessitates a re-interpretation of bankruptcy laws to establish appropriate default mechanisms. Moreover, the high issuance costs, ranging from 1-2% of the issued amount, present a significant barrier. To mitigate this, options such as waiving or covering these costs by the central government could be considered to incentivize issuance.

Implementing Law 1/2022 requires finalized regulations to provide detailed guidance for municipal bond issuance. Clear instructions are needed for the Finance Ministry, the Interior Ministry, and regional governments to ensure regulatory compliance. Additionally, existing regulations like POJK 61/2017, POJK 62/2017, and POJK 63/2017 need updating to align with the current regulatory framework.

Furthermore, incentives such as tax breaks and fee waivers could be offered to encourage municipal bond issuance, including exemptions from listing fees and associated expenses. Engaging with donor institutions is also vital to mitigate credit and liquidity risks associated with municipal bonds. Initiating discussions with these institutions could provide valuable assistance in navigating these challenges and fostering a conducive environment for municipal bond issuance.

3.3 Real Estate Investment Trust (REIT)

Real estate investment trusts (REITs) are special-purpose vehicles that issue units for investors to purchase. These funds are then invested in real estate assets. In Indonesia, this is known as Dana Investasi Real Estat (DIRE). A related type of asset is *Dana Investasi Infrastruktur* (DINFRA), which focuses on infrastructure funds.

³⁴ UNDP, 2023

The main difference between a REIT structure and a regular mutual fund dedicated to the property sector is that the latter invests in shares of listed property companies, whereas the former allows investors to participate directly in the property itself. Another distinction lies in the nature of returns: investments in property shares typically yield returns from dividends and capital gains, while REITs generate income from the rental payments made by tenants to the Special Purpose Vehicle (SPV). This structure is particularly well-suited for commercial properties such as malls and hospitals, which generate consistent income from rentals or usage. By utilizing the REIT structure, property developers can unlock the value of their assets, enabling them to fund the construction of additional similar properties.

3.3.1 Structure of REIT

REIT is a capital market instrument that allows investors to derive income from indirectly owned properties that are rented out to tenants. Notably, a REIT functions similarly to an equity-like instrument. Its appeal to investors lies in the ability to purchase fractional interests in a diverse mix of property types, which helps minimize investment risk. Typically, the bulk of the rental income generated is distributed to the holders of the REIT units. As property values increase, so does the rental income, potentially enhancing the value of the REIT units. This type of investment structure contributes significantly to the broader economy by expanding the range of financial instruments available and unlocking the value of properties for the retail investment sector.

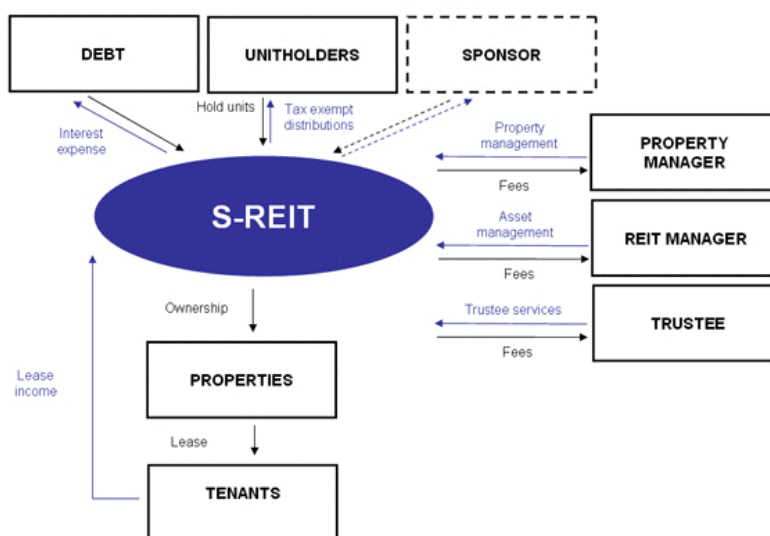


Figure 2: Typical REITS structure³⁵

The process of creating a REIT begins with a sponsor, usually the developer of the property asset, who places this asset under the management of the REIT's Special Purpose Vehicle (SPV) in a beneficiary arrangement. The REIT then appoints a property manager and a trustee to oversee operations. The rental income generated from tenants is channeled through the REIT to its unit holders. Additionally, REITs can incur debt to facilitate the expansion of property ownership.

There are generally three types of REITs: equity-based, which is the most common; debt-based; and hybrid. A property can be structured into a REIT if it generates rental income and is free from creditor claims. Properties included in REITs encompass a wide range, including residential units, office buildings, warehouses, hotels, and healthcare facilities.

³⁵ Securities Investors Association (Singapore)

3.3.2 Global Experiences with REIT

Since their inception in 1960 in the US, REITs have evolved into a pivotal asset class for unlocking value in property developments. Originating from earlier business trust concepts, REITs focus primarily on properties.

Over 40 countries have adopted the US REIT structure, with more than 890 REITs valued at USD 1.9 trillion as of December 2022. These regions represent 83% of global GDP and 64% of the world's population. In the US alone, REITs manage approximately USD 4 trillion in assets, with USD 2.5 trillion publicly listed. The market value of these listed REIT units reached USD 1.3 trillion in 2023.

The REIT subsector encompasses a diverse array of properties including office spaces, gaming facilities (notably casinos), industrial sites (such as warehouses and distribution centers), retail spaces, resorts, hotels, residential properties, timber-producing forests, healthcare facilities, self-storage units, telecommunications infrastructure, data centers, and mortgages.

REITs have consistently delivered competitive returns over long-term investment horizons, outperforming traditional stocks and bonds. As indicated in Table 9, the FTSE Nareit All Equity REITs index shows a steady increase in annualized returns as the investment horizon extends. Over 20 and 30-year periods, REITs have surpassed both large-cap (Russell 1000) and small-cap (Russell 2000) stocks, as well as aggregate bonds (Bloomberg Barclays US Aggregate Bond). The FTSE EPRA/Nareit Developed index demonstrates that international REITs also offer solid returns, particularly over 5 to 10-year periods. This data underscores the appeal of REITs to long-term investors, highlighting their stability and resilience despite potential short-term fluctuations. Such attributes make REITs an attractive option for those seeking reliable long-term returns, especially when compared to the generally lower yields of bonds.

Table 9. Performance of REITs Versus Other Asset Classes³⁶

	1- year	3- year	5- year	10- year	15- year	20- year	25- year	30- year	35- year	40- year
FTSE Nareit All Equity REITs	-1.71	2.68	2.79	6.17	6.11	7.90	8.62	8.64	9.25	10.03
FTSE EPRA/Nareit Developed	2.72	1.53	-0.30	2.97	4.43	6.46	7.42	7.00	N/A	N/A
Russell 1000 (Large-Cap Stocks)	21.19	9.53	9.63	11.63	11.26	9.79	8.08	9.83	10.55	11.81
Russell 2000 (Small-Cap Stocks)	8.93	7.16	2.40	6.65	8.13	8.13	8.00	8.18	8.89	8.68
Bloomberg Barclays US Aggregate Bond	0.64	-5.2	0.10	1.13	2.53	2.85	3.59	4.19	5.19	6.10

Over long periods, REITs have performed well compared to other asset classes, such as large-cap stocks. They have consistently outperformed both small-cap stocks and aggregate bonds. This comparison is crucial, as REITs offer a steady stream of cash flow, similar to bond investments, making them a valuable component in diversified investment portfolios.

36 NAREIT.com, op.cit

3.3.3 Advantages of REIT Investments

REITs offer several key advantages for investors, such as:

- REITs can provide competitive long-term investment returns, similar to those of large-cap stocks, appealing to investors looking for robust growth over time.
- They typically offer more stable dividends than stocks or equity funds, ensuring a reliable income stream which is particularly attractive to income-focused investors.
- The liquidity of REIT units allows investors to easily liquidate their positions, providing flexibility and ease of access to funds when needed.
- Transparency is a hallmark of REITs, as they are regularly assessed by independent auditors, directors, analysts, and the media. This ongoing scrutiny helps maintain trust and ensures adherence to regulatory standards.
- REITs offer diversification by owning various assets with low correlations to each other and to the broader markets of stocks and bonds. This diversification makes REITs less susceptible to economic downturns compared to other asset classes, enhancing their appeal as a resilient investment option.

These advantages make REITs an attractive option for a wide range of investors, combining growth potential with stability and transparency.

Box 2. Case Study: Lippo REITs

Lippo Karawaci, a prominent property developer, manages two specialized REITs namely LMIR Trust (LMIRT) which focused on malls, and First REIT, which is dedicated to hospitals.

Table 10. Lippo Karawaci REITS-LMIRT

Locations	Retailers	Brands
<ul style="list-style-type: none"> • Jakarta • Bandung • Yogyakarta • Medan • Palembang • Bali • Sulawesi 	<ul style="list-style-type: none"> • Hypermart • Matahari • Sogo 	<ul style="list-style-type: none"> • Zara • Uniqlo • H7M • Adidas • Giordano • Starbucks • Timezone • Miniso • Ace hardware

LMIRT oversees assets valued at SGD 1.6 billion as of 2022, encompassing a rental area of 951,000 square meters. In 2022, the occupancy rate stood at 80%, and the average lease was set to expire in three years.

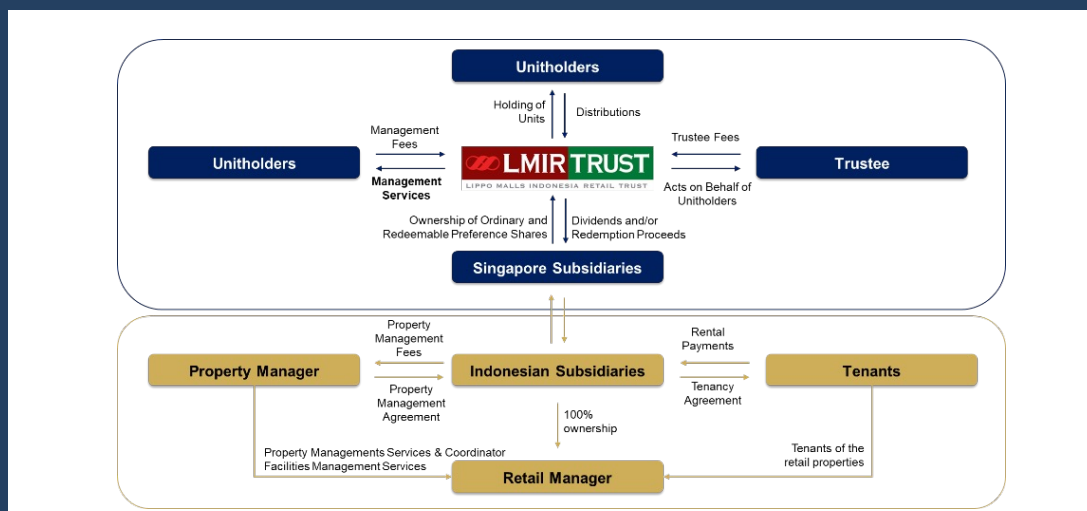


Figure 3. LMIR Trust Structure³⁷

On the other hand, First REIT, manages 32 healthcare facilities across Asia, with a total asset value of SGD 1.1 billion as of December 2023³⁸. This REIT boasts a gross service area of nearly 450,000 square meters, providing 6,500 beds and rooms, with an outstanding average occupancy rate of 100% and an average lease duration of 11.5 years.

Table 11. Lippo Karawaci First REIT Assets³⁹

Type	Location	Number of Units
Hospitals	Greater Jakarta	5
	Jawa and Bali	3
	Outside Jawa	6
Hotels and Resorts	Greater Jakarta	1
Nursing Homes	Japan	14
	Singapore	3

These REITs exemplify how sector-specific real estate investment trusts can successfully manage large portfolios of specialized properties, reflecting their robust management and strategic market positioning.

3.3.4 The Importance of Adopting REIT Structures in Indonesia

As Indonesia continues to advance its infrastructure development, the adoption of REIT structures presents a significant opportunity to unlock the value of existing assets such as hotels, hospitals, residential apartments, warehouses, shopping malls, and other properties. Despite their equity-like structure, REITs promise stable income, making them particularly appealing to income-seeking investors like pension funds and individuals.

REIT units have become an integral part of the stock market in regions like Singapore, where REIT instruments constitute 12% of stock capitalization. Other countries with a significant REIT presence in the stock market include Belgium (6.3%) and Australia (6%). A notable aspect of the REIT market in

37 LMIRT, 2022

38 First Reit

39 First Reit

Singapore is that over 90% of REITs own properties outside the country, allowing local investors to gain exposure to the global property market.

In Indonesia, there remains a wealth of potential property candidates that could be effectively monetized through Real Estate Investment Trusts. These include government, state-owned enterprise (SOE), and privately-owned hospitals, other SOE-owned properties, existing rental office spaces, government and privately-owned industrial parks, and retail spaces. The key advantage of these assets is their existing rental cash flows, which have not yet been fully leveraged. By optimizing these assets through REITs, there is a tremendous potential to enhance their value significantly.

With the abundance of suitable properties that could benefit from REIT structures, it is increasingly important for Indonesia to implement REITs to fully capitalize on this opportunity. This move would not only provide added value to existing assets but also broaden the investment landscape in Indonesia, aligning it with global investment trends.

3.3.5 Regulatory Changes Needed to Develop REITs as a Viable Asset Class

The primary impediment to developing REITs in Indonesia has been a cumbersome tax structure, particularly concerning asset transfer and double income taxation. In 2016, the Ministry of Finance issued a regulation that reduced the income tax rate from REIT SPVs to investors to 0.5%, effectively addressing the issue of double income taxation. However, asset transfers from the original owner to the REIT SPV, and upon the dissolution of the REIT, still incur a property sales tax, although this rate has been reduced to 1% for REITs. Consequently, non-end investors must also pass on these taxes to REITs and property managers in the context of tax revenues.

The newly enacted Law 4/2023 introduces a trustee structure that separates ownership and beneficiary rights. This reform could enable REITs to be structured without incurring property sales tax, thereby lowering the barriers to their formation. However, additional regulations are needed to fully implement the trustee concept for REITs and other capital market arrangements.

Further regulatory details are required in several areas:

- Regulations should specify the procedures for changing investment managers and their key personnel, ensuring transparency and accountability.
- Detailed guidelines are needed on how new REIT offers can be structured, particularly concerning units or asset purchases, and the pre-emptive rights of existing unit holders.
- Further clarification is needed on the rights of minority unit holders, including defining what constitutes controlling unit holders and the limitations on their rights.
- Additional clarity is required on what constitutes affiliated parties and the transactions involving them to prevent conflicts of interest and promote fair practices.
- These enhancements will help streamline the regulatory framework, making REITs a more attractive and viable investment option in Indonesia's capital market.

3.4 Debt Partial Guarantee Schemes

Debt partial guarantee schemes have played a crucial role in facilitating the initial development of municipal bonds and making MSME loans viable across various countries.^{40 41} For instance, in the Philippines, a regulation from the Ministry of the Interior permits central government guarantees, subject to approval by the Secretary of Finance. Additionally, the Local Government Guarantee Corporation, a private entity owned by the Philippines Bankers Association and the Development Bank of the

⁴⁰ Sharma, op.cit.

⁴¹ Figueiredo, op.cit.

Philippines, offers such guarantees. Other significant guarantee institutions include Phil Guarantee, a government entity, and the Bureau of Local Government Finance, which is active in guaranteeing local government units. The European Union acknowledges that while MSMEs constitute a large segment of the economy, many do not have access to financing from banks or the capital market due to their relatively weak financial conditions and lack of sufficient collateral.

In a debt guarantee scheme, the guarantee company assumes the risk of non-payment, which can sometimes overwhelm these institutions. To mitigate this, the partial guarantee scheme distributes the risk between the guarantee institution and the financial services institution, balancing the exposure and making it more manageable. This approach helps in reducing the financial strain on guarantee companies and facilitates broader access to funding for MSMEs and municipal entities.

3.4.1 Framework for MSME Guarantee Scheme

The MSME guarantee scheme can be effectively implemented using a partial guarantee model, which confers various benefits to both MSMEs and banks, enhancing financial access and reducing risk exposure as shown in table 12.

Table 12. Advantages of Partial-Guarantee Scheme

For MSMEs	For Banks
<ul style="list-style-type: none"> • Allowing access to financing for commercially viable projects. • Assessing credit soundness using qualitative factors. • Receiving expert advice to ensure sound business plans. • Benefiting from a non-profit-oriented guarantee scheme. • Accessing various financial facilities, including microloans, leasing, factoring, mezzanine financing, risk capital, and public funding. 	<ul style="list-style-type: none"> • Reducing risk exposure on MSME loans. • Building up an MSME retail portfolio. • Enhancing credibility by participating in the guarantee scheme. • Accessing a sectoral database in addition to conventional financial data.

Meanwhile, the types of guarantee schemes include public guarantees, private guarantees, and mixed models. Public guarantees are initiated by the government, with state capital and a government-appointed board, which can cover 50-80% of credit risk. Private guarantees, on the other hand, are typically started by MSME associations with a private shareholding structure and boards appointed by shareholders, offering coverage for 80-100% of credit risk. The mixed model involves initiatives from government MSME associations with private shareholding, where the government provides a counter-guarantee for a portion of the risk capital, usually up to 80% of credit risk.

Guarantee schemes are broadly categorized into three main types: public guarantees, private guarantees, and mixed models. Public guarantees are initiated by the government, utilizing state capital and overseen by a government-appointed board. These guarantees typically cover between 50-80% of credit risk. Private guarantees, on the other hand, are usually established by MSME associations with a private shareholding structure. Managed by boards appointed by shareholders, they offer coverage for 80-100% of credit risk. Lastly, mixed models represent a collaboration between government and private sectors. These involve government MSME associations with private shareholdings, where the government provides a counter-guarantee for usually up to 80% of the risk capital.

Box 3. Successful Examples of Credit Guarantee Schemes Worldwide

Several countries have effectively implemented credit guarantee schemes that have significantly supported access to finance for MSMEs and reduced credit risk for lenders

I. The FOGAPE Experience in Chile

The Chilean government's establishment of the Partial Credit Guarantee Fund (FOGAPE) in 1980 stands as a significant example of effective credit guarantee schemes. By 2004, FOGAPE's equity reached USD 52 million, with the number of guaranteed loans escalating from 200 in 1998 to over 34,000, covering loans totaling USD 472 million and an average coverage rate of 65%.

The success of FOGAPE can be attributed to several critical factors. A robust supervisory and regulatory framework plays a central role; the program is managed by Banco Estados, a state-owned bank, and is under the strict supervision of the financial sector authority. Transparency is another pivotal element, with guarantees allocated to financial institutions through a sealed bid auction process. The effectiveness of this scheme is further amplified by extensive publicity and educational campaigns orchestrated by the government, which have significantly enhanced the program's visibility and adoption rate.

Empirical studies reinforce the impact of FOGAPE, indicating that its beneficiaries are 14% more likely to secure a loan compared to non-beneficiaries. Additionally, the program has been instrumental in boosting credit volume by 40% and increasing sales turnover by 6% among MSMEs that have acquired loans through the scheme.

II. The KOTEC Experience in Korea

Since its establishment in 1989, KOTEC, a South Korean government initiative, has been pivotal in supporting new technology companies by providing loan guarantees. By 2022, KOTEC had guaranteed over USD 187 billion in loans to more than 300,000 Korean technology MSMEs. Notably, KOTEC has played a significant role in the growth of four unicorn companies—unlisted startups valued at over USD 1 billion each.

A key to KOTEC's success is its sophisticated technology appraisal system, which evaluates the potential of technologies proposed by applicants, going beyond their current financial status. This system not only assesses the commercial viability and risks associated with technology projects but is also recognized as one of the industry's best. Its efficacy has led to its adoption in other Asian countries, including Vietnam, Thailand, Japan, and Singapore, and even by the European Commission.

In addition to its evaluation services, KOTEC offers comprehensive technology advisory services covering financial, legal, and business aspects to MSMEs. These services are instrumental in lowering default rates among loan recipients.^{42 43}

3.4.2 Urgency of Credit Guarantee Schemes for Indonesia

The Indonesian government launched the Kredit Usaha Rakyat (KUR), or People's Business Credit program, in 2007 to boost MSMEs' access to finance through subsidized interest rates and partial credit

42 Jae Won Kang, et.al., 2008

43 Roper, S., 2009

risk guarantees. This initiative is funded by banks designated to distribute KUR, with the government covering the interest subsidies and guarantees. In 2024, Bank BRI, the program's largest distributor, allocated IDR 165 trillion for KUR, followed by Bank Mandiri with IDR 37.5 trillion.

In 2022, the interest rate for KUR borrowers was set at 6%, which was 3% lower than previous rates. The government allocated nearly IDR 48 trillion for these subsidies. However, by November 2023, the non-performing loans (NPLs) for KUR reached 6%, the highest rate among government-subsidized programs and significantly above the general banking sector's NPL rate of 2.5%, and the overall MSME loan NPL rate of 3.91%.

Due to the high non-performing loans (NPLs) within the Kredit Usaha Rakyat (KUR) program, the guarantors, Jamkrindo and Askrindo, have incurred significant costs. As of mid-2022, Jamkrindo has guaranteed KUR loans amounting to IDR 82.6 trillion for 1.8 million MSMEs. Askrindo has guaranteed loans totaling IDR 164 trillion for 4.8 million MSMEs. Both entities receive a fee of 1.175% to cover the credit risk associated with these guarantees, a rate that has proven inadequate, particularly during the pandemic when KUR NPLs increased and required extensive restructuring. This financial strain intensified after the relaxation of OJK credit standards expired in March 2024.

The gearing ratios of these guarantors are considerably high—20.2 for Jamkrindo and 18.9 for Askrindo in 2024—indicating a heavy reliance on debt, which poses significant financial risks. As the volume of KUR continues to grow, the need for capital injections into Jamkrindo and Askrindo becomes increasingly critical. These injections are vital for enabling these companies to continue underwriting credit risks effectively. Therefore, it is essential for the government to provide support in the form of capital injections to maintain the financial stability of these guarantors and help them manage the challenges presented by the high levels of NPLs.

A more effective strategy might involve reallocating some of the funds from KUR to establish a broader and more robust guarantee scheme that supports MSMEs without relying on interest subsidies. Such a scheme should focus on improving the financial stability of MSMEs. Key features of an effective guarantee scheme should include:

- Transition from initial support by a publicly supported scheme to a mixed funding model with private sector and foreign participants.
- Ensure public support is only for initial customers, not repeat ones.
- Develop a re-guarantee and partial guarantee to reduce the risk of MSME credit guarantee.
- Innovate offerings to enrich the guarantee scheme while managing risks.
- Develop a comprehensive credit database that can be shared among guarantee institutions.
- Conduct extensive literacy programs for MSMEs on commercial, financial, and technical knowledge.

3.4.3 Identifying Needed Regulatory Changes

Several POJKs relate to guarantee institutions like Askrindo and Jamkrindo. POJK No. 31/POJK.05/2015 regulates the general principles of credit guarantee, including requirements for guarantee companies such as Askrindo and Jamkrindo. POJK No. 13/POJK.05/2018 provides guidance on infrastructure guarantees conducted by guarantee companies. Additionally, POJK No. 26/POJK.05/2019 further regulates credit guarantees through infrastructure guarantees provided by these companies. Moreover, POJK No. 33/POJK.05/2019 addresses the implementation of export credit insurance programs and export credit guarantee programs, which are managed by Askrindo and Jamkrindo.

These POJKs establish a legal foundation for Askrindo and Jamkrindo to perform their credit guarantee activities and offer guidance on the necessary procedures and provisions that these companies

must adhere to. Consequently, these regulations are anticipated to enhance the role of Askrindo and Jamkrindo in supporting the growth of Indonesia's financial sector and overall economy.

A shift from reliance on KUR to a broader-based guarantee scheme would require several regulatory changes as follows:

- Decrease reliance on KUR to support MSMEs and reallocate a portion of the KUR budget to a partial-guarantee scheme, increasing the amount available for MSME support.
- Use some of the KUR funds to increase the capitalization of Askrindo and Jamkrindo and open the field to competition, including foreign institutions.
- Ensure that distributing banks participate in the credit risk.
- Introduce more robust debtor selection criteria such as reducing the portion of the working capital loan, increasing the percentage of the investment loan, and disallowing the same debtor from borrowing a second time in the publicly supported program.
- Include the private sector in the development of the partial guarantee scheme.
- Require financial institutions to develop a comprehensive database, which is then shared with other lenders.
- Increase the capital requirements of guarantee institutions.
- Improve the legal system to ensure a smooth MSME bankruptcy process, preferably through an out-of-court settlement.



Image credit: Medium

4. Conclusion and Recommendations

There is an urgent need for innovation in financial products to enhance infrastructure funding, promote local development, leverage property value, and expand support for MSMEs. In this context, innovation should be directed toward developing project finance bonds, municipal debt, REITs issuance, and partial guarantee schemes. These measures, if well-designed and implemented, will help reduce the shallowness of financial depth and foster economic growth.

The government should drive innovation in financial products through strategic policy adjustments and regulatory reforms. Some strategic policy changes that can be undertaken include:

4.1 Prepare The Necessary Regulatory Framework for the Issuance of Project Finance Bonds

- Project finance bonds help reduce the pressure on infrastructure developers' credit risk and balance sheets. They also enable participation from various investors, including non-bank financial institutions and foreign investors.
- The regulation should clearly state that investors have first claims on the cash flow generated by the project.
- A robust legal framework should allow investors to take over project cash flow after completion and re-possess the assets if necessary.
- Project sponsors can be contractors who support the construction, financial sponsors seeking returns from their support, or the government (central or local) that provides an additional degree of comfort. The rights of each type of investor should be clearly defined.
- The Financial Services Authorities (OJK) should issue regulations supporting the issuance of project finance bonds. These regulations should allow institutional investors (mutual funds, pension funds, and insurance companies) to invest in such instruments with the appropriate risk assessments.
- These instruments should be credit-rated and listed on the stock exchange to achieve better information disclosure and trading liquidity. In case of illiquidity, the Securities Pricing Agency should estimate prices. These instruments should also be included in the mutual funds' investible assets.
- High-priority sectors for project finance bonds are energy (Pertamina and PLN—especially for the transition to clean energy sources), transportation (Pelindo, Pelni, Jasa Marga), and further toll road development initiated by construction companies (Waskita, Wijaya Karya, and Hutama Karya).

4.2 Enable Issuance of Municipal Bonds Specifically to Achieve SDG Goals

- The government should establish criteria for local government eligibility to issue municipal bonds, preferably at the provincial level. This should be based on existing accrued debt, capacity to pay, unqualified audited finances, and the need to develop a supporting project.
- The Ministry of Finance, the Ministry of Home Affairs, and the targeted region should collaborate to initiate municipal bond issuance.
- The government should issue implementing regulations of Law 1/2022 about municipal bond issuance.
- As direct support from the central government is not allowed by Law 1 / 2022, alternative indirect support could be conceived, possibly with the assistance of PT SMI or PT PII (IIGF).
- A legal mechanism to address cases of regional government default should be established. This may require some modification to the bankruptcy law.
- Alternatively, the municipal bond issuer could be a corporation rather than the local government.
- The government should anticipate overcoming the challenge of synchronizing debt maturity with the

local government's term in office. One solution could be establishing a permanent local committee to manage local debt. There is a perception that various sources of financing exist to achieve public service goals, which may prevent the need to issue municipal bonds.

- Local governments should be encouraged to seek funding sources to achieve SDG goals. The government should further strengthen financial literacy and inclusion programs. This is especially true for regional government levels and local parliaments. There is also a need to increase local community participation in funding regional SDG projects.

4.3 Enable Issuance of Real Estate Investment Trusts (REITs)

- When the REITS SPV is handed property assets, it should be considered a change of beneficial ownership, not legal ownership, to avoid property sales tax. This distinction is crucial because it ensures that the transfer does not trigger the tax implications typically associated with the sale of real estate. Beneficial ownership means that the economic benefits of the property are transferred to the SPV, while the legal title remains with the original owner or another entity within the same corporate structure. In this framework, the SPV essentially controls the property and receives the income generated from it, but since the legal title does not change, the transaction avoids triggering property sales tax, which can be substantial and erode the financial benefits of forming the REIT.
- The OJK ruling that REITs hold at least 80% of their assets in real estate and at least 50% of indirect ownership in the buildings should be revised. The indirect ownership requirement should be raised to 80% to avoid duplication with equity mutual funds. Additionally, a minimum of 90% of net income should be distributed annually. There should be more clarity on the REITS structure, particularly on minority shareholder protection.
- REITS structure could be applied to existing SOEs owned infrastructure, such as operating toll roads and power plants.
- Syariah infrastructure REITS could be launched, as the cashflows from existing infrastructure are transparent and could be used as the base for this instrument.

4.4 Create an MSME Partial Guarantee Scheme

- The government should consider decreasing its reliance on subsidized loan schemes like KUR and reallocating some of its budget to a broader partial MSME guarantee scheme.
- The government should allocate more funding to existing MSME guarantee firms like Askrindo and Jamkrindo.
- However, guarantee scheme should also be open to private and foreign participants.
- The guarantee scheme should remain partial, with distributing banks taking up some credit risk.
- The guarantee scheme should be more robust, with a better selection of debtors.
- Publicly funded guarantee schemes should be limited to first-time borrowers.
- A comprehensive database should be developed and shared among guarantee institutions.
- A more comprehensive legal system should be established to handle failed MSME borrowers, ideally with an out-of-court settlement that still gives lenders legal certainty.

5. Recommendations for Regulatory Adjustments

Each of the four proposed policies has its necessary policy adjustment requirements. A summarized version is provided in the table below. For a more detailed explanation, see appendix.

Table 13. Recommendations for Regulatory Adjustments

Problem	Solution	Existing regulations	Recommended Change in Regulation	Implementation Horizon
1. Limited financing options for funding infrastructure projects	Allow project finance debt instruments to be issued and invested by institutional investors..	Existing regulation in POJK 3/2021 Article 1 regarding types of capital market instruments does not explicitly recognize project finance bonds as a capital market instrument.	OJK should update POJK 3/2021 to include project finance bonds as a capital market instrument.	Short to Mid-Term
	Project finance bonds should be rated and listed on the stock exchange.	Currently, there are no regulations that require project finance bonds to be rated by a rating agency and listed on the stock exchange.	OJK should require these bonds to be rated by a recognized rating agency and listed on the stock exchange.	Short to Mid-Term
	Allow local institutions like PT SMI and PT PII (IIGF) to participate as partial guarantors of project finance debt.	Existing regulation in PMK 100/2009 Article 2 allows PT SMI to provide credit support (credit enhancement), including guarantees for infrastructure financing to support business activities but it does not consider partial guarantors of project finance debt as these institutions' mandate.	The Ministry of Finance should update regulation PMK 100/2009 to include project finance bonds partial guarantee in PT SMI and PT PII (IIGF).	Short-Term
	Allow foreign multilateral institutions to partially guarantee project finance debt.	The existing regulation regarding the participation of private (and foreign) investors in government projects is Minister of National Development Planning Regulation No. 2/2020 is only for infrastructure development.	The Ministry of National Development Planning should amend PPN No. 20/2020 to include private (and foreign) investor participation in providing partially guarantee project finance debt.	Mid to Long-Term

2.	Regions have limited financial capacity	Allow Local government owned companies (BUMD) to issue municipal debt.	Existing regulation in Law 1/2022 changes the approval process for municipal bond issuance. However, there are still no implementations regulation that have been issued, for instance in the form of PP or PMK.	The Government should establish implementation regulation that detailed guidelines on municipal bond issuance, including criteria for eligibility, project types to be funded, debt ceiling, and debt maturity beyond the current term of regional heads.	Mid to Long-Term
			Existing regulation in Law 37/2004 about bankruptcy and postponement of debt payment obligations still does not outline a clear procedure for handling bankruptcy of a defaulted region.	The Government should establish new regulation to deal with defaulted regional debt, providing a clear procedure for bankruptcy for a defaulted region.	Mid to Long-Term
			<ul style="list-style-type: none"> • POJK 61/2017 regarding registration statement document in the public offering of regional bonds and/or regional sukuk. • POJK 62/2017 regarding the form and content of the prospectus and brief offering for the public offering of regional bonds and/or regional sukuk. • POJK 63/2017 regarding reports and announcements of issuers of regional bonds and/or regional sukuk issuers. <p>Existing regulations govern regional bonds. However, they need to be updated to reflect adjustments to the law on central and regional relations in Law 1/2022.</p>	OJK should update POJK 61/2017, POJK 62/2017, and POJK 63/2017 to reflect the latest regulation on regional finance (Law 1/2022).	Short-Term

3.	Vast property assets are not monetized	Increase REITs issuances	<ul style="list-style-type: none"> Existing regulation in Law 4/2023 (Omnibus Finance Law) has established a trust framework but still needs further elaboration. <p>PMK 37/2017 regarding procedures for payment and reporting of income tax on income from the transfer of real estate in certain collective investment contract schemes, states that land tax still applies. However, this land tax law applies to changes in beneficiaries (between previous property owners and SPV REITs)</p> <p>Existing regulation about REITs in POJK 64/2017 has already been issued. However, there are no specific regulations to govern minority shareholder rights.</p>	<ul style="list-style-type: none"> The Government should update the trustee derivative of Omnibus Finance Law to provide further elaboration. The Ministry of Finance should revise PMK 37/2017 (Land Tax Law) to not apply for a change of beneficiary (between previous property owner and REITs SPV) and ensure that income tax is levied only on REIT unit investors. <p>OJK should update POJK 64/2017 or establish a new regulation to provide further clarification on minority shareholder rights.</p>	Short-Term
----	--	--------------------------	---	--	------------

4.	Current MSME financial support is limited	Create a partial-guarantee scheme.	Existing regulation in Permenko Perekonomian 1/2023 has already explained that the KUR is guaranteed by the Guarantee Institution. However, this regulation still does not explicitly state partial guarantee schemes between the Guarantee Institution and the Financial Institution.	The Ministry of Coordinator for Economic Affairs should update Permenko 1/2023 to develop a new institutional regime and regulatory platform for the MSME partial guarantee scheme.	Mid to Long-Term
		Increase the fee for KUR credit insurance.	Existing regulation in PMK 05/2015 Article 14 regarding the amount of Guarantee Services Benefits/Imbalan Jasa Penjaminan (IJP). However the current IJP for KUR coverage is too low at 3% and only leaves very little extra margin.	The Ministry of Finance should amend PMK 05/2015 to increase IJP for insurance companies while improving loan selection, only allowing investment loans and not allowing repeat borrowers.	Short-Term
		Banks should incur some credit risk in MSME credit guarantee.	Existing regulation in Permenko Number 1 of 2023 states the KUR guarantee institutions have to collaborate with financial institutions. However, there are no regulations that suggest that banks also incur some of the burden of KUR risk.	The Ministry of Coordinator for Economic Affairs should update Permenko 1/2023 to add the article about risk sharing between the Bank and credit guarantee institutions in the cases of NPL/NPF.	Short-Term
		Improve legal system to handle MSME default.	Existing regulation in Law 37/2004 about bankruptcy and postponement of debt payment obligations only is suited to low frequency and high-value cases.	The Government should update Law 37/2024 or establish new regulation to provide an alternative default settlement regime for MSME. It should elaborate a special mechanism for MSME bankruptcy, especially for Non-Public MSME. The mechanism should be fast, low-cost, and transparent.	Mid to Long-Term



Image credit: Kabar BUMN

References

- ADB, 2019, "Credit Financing for Local Development: The Subnational Debt in the Philippines," ADB Working Paper Series No. 966.
- AECM.EU, 2023, "Statistical yearbook."
- Ardianto, P. (2021). Pemerintah Akan Kaji Ulang Tingkat IJP KUR Askrindo dan Jamkrindo. Retrieved from Berita Satu: <https://www.beritasatu.com/ekonomi/829961/pemerintah-akan-kaji-ulang-tingkat-ijp-kur-askrindo-dan-jamkrindo>
- Asian Development Bank, 2009, Financial Sector Development, Economic Growth, and Poverty Reduction: A Literature Review.
- Asian Development Bank, 2014, "ADB-OECD study on enhancing financial accessibility for SMEs: Lessons from recent crises."
- Bank Indonesia, 2024, Balance of Payments Indonesia in 2023.
- Beidleman, et.al, 1990, "On allocating risk: the essence of project finance," MIT Sloan Management Review.
- Berita Satu. (2021). Berita Satu. Retrieved from Tembus Rp 93 Triliun, Realisasi Penyaluran KUR 35,96%: <https://www.beritasatu.com/ekonomi/775767/tembus-rp-93-triliun-realisasi-penyaluran-kur-3596>
- Bonetti, V., Caselli, S., & Gatti, S. (2009). Off-taking agreements and how they impact the cost of funding for project finance deals: a clinical case study of the Quezon Power Ltd Co. Review of Financial Economics.
- Hutauruk, D. M., & Waseso, R. (2023). Keuangan Kontan. Retrieved from Jumlah NPL Kredit UMKM Bank BUMN Mencapai Rp 35,2 Triliun: <https://keuangan.kontan.co.id/news/jumlah-npl-kredit-umkm-bank-bumn-mencapai-rp-342-triliun>
- Lee, Allen, 2020, The history of REITs, Money Inc.com
- Lewis, 2023, "Indonesia's new fiscal decentralization law: a critical assessment," Survey of Recent Development, Bulletin of Indonesian Economic Studies, Australian National University
- LMIR TRUST. (2023). LMIR Trust. Retrieved from Company Profile: <https://www.lmir-trust.com/corporate-profile.html>
- Müllner, 2016, "From uncertainty to risk—A risk management framework for market entry," Journal of world business
- Nareit, 2024, Global real estate investment, reit.com
- Nareit. (2024). Nareit. Retrieved from REITs by the Numbers: <https://www.reit.com/data-research/data/reits-numbers>

Rahardyan, A. (2024). *Bisnis Financial*. Retrieved from Riset IdScore: NPL Program KUR Mikro Tembus 6%: <https://finansial.bisnis.com/read/20240308/90/1747662/riset-idscore-npl-program-kur-mikro-tembus-6>

Ramadhani, 2019, "Indonesian real-estate investment trusts (Dana Investasi Real Estat/DIRE) and sufficient protection for investors, *Hukumonline.com*

Refinitiv, 2022, "Global project finance By Geographic Area (in US\$ mil)."

Sharma, et.al., 2023, "Mobilizing resources through municipal bonds: experience from developed and developing countries," *Asian Development Bank*

The Korea Times. (2012). *The Korea Times*. Retrieved from KOTEC supports high-tech SMEs: https://www.koreatimes.co.kr/www/tech/2024/04/419_120717.html

UNDP, 2023, "Assessment on Indonesia's municipal bond landscape."



Image credit: BRI

Appendix 1:

Detailed Explanation of The Required Regulatory Changes for Project Finance, Municipal Bonds, REITs, and MSME Partial Guarantee

- **Regulatory changes required for project finance debt:**
 - Re-open international support for project finance debt, especially in sectors energy transition, major transport, and other large projects. This would allow local, private, and international investors to participate in large-scale projects. Support can come from international agencies like the World Bank Group (IBRD, IDA, IFC, and MIGA) and the ADB. These international institutions could collaborate with the Indonesia Infrastructure Guarantee Fund (IIGF) or PT PII and PT SMI to initiate project finance-based large infrastructure projects.
 - Expand allowable investments for pension funds, mutual funds, and insurance companies to include project finance bonds. Commercial banks should also be allowed to provide short-term funding at the initial stages of project finance-based projects. Banks usually provide funding for vendors and other parties supporting the transactions.
 - Ensure that project finance bonds, both mezzanine and senior, are rated by rating agencies and listed on the stock exchange to guarantee liquidity and facilitate the flow of public information. In cases of illiquidity, the Securities Pricing Agency can provide price information.
- **Regulatory changes required for municipal bonds:**
 - PT PII (IIGF) or PT SMI could partially guarantee municipal bonds, but its resources must be increased.
 - Establish a mechanism to ensure that municipal bonds can mature beyond the current local leadership term, possibly by forming a local government debt management team.
 - Develop an out-of-court resolution mechanism, which requires some re-interpretation of the bankruptcy law.
 - The central government could subsidize part of the issuance cost of municipal bonds, potentially as part of regional transfers to eligible regions.
 - Finalize implementing regulations of Law 1/2022, particularly regarding municipal bond issuance.
 - Update several OJK regulations (POJK 61/2017, POJK 62/2017, and POJK63/2017) to align with the latest regulatory regime.
- **Regulatory changes required for REITS:**
 - Issue implementing regulations on the trust structure as outlined in Law 4/ 2023.
 - Ensure that the REITS SPV, when acquiring and disposing of property assets, is not subjected to property sales tax.
 - Ensure that the REITS SPV is not levied income tax; only the investors should be subject to final income tax.
 - Adjust capital market regulations to ensure transparency and fairness in the management and replacement of REITS SPV managers and their key personnel.
 - Provide more details on offering additional REITS units and clarify the rights of minority shareholders.
 - Clarify who the affiliated parties are and what constitutes transactions between affiliated parties.

- **Regulatory changes required for partial debt guarantee schemes:**
 - Decrease reliance on KUR to support MSMEs, which will likely require changes in budget allocation.
 - Formulate a plan to increase support for MSME financing using a partial guarantee.
 - Increase the capitalization of Askrindo and Jamkrindo, which will require state support for these SOEs.
 - Ensure that distributing banks participate in the credit risk. This will require adjustment in OJK statutory bank capital and Bank Indonesia intermediation ratios.
 - Introduce more robust debtor selection criteria, reduce the proportion of working capital loans, and limit supported lending only to new borrowers in the existing KUR scheme.
 - Open the MSME guarantee scheme to private sector and foreign investors.
 - Increase the capital requirements of guarantee institutions.
 - Improve the legal system to ensure smooth MSME bankruptcy, preferably through an out-of-court settlement.

Appendix 2:

Potential Impact of The Proposed Measures

Instruments / markets	Estimates of quantitative impact of each regulatory adjustments
Project finance debt	Impact will vary based on the scale and number of projects funded through this instrument.
Municipal bonds	Based on UNDP estimates, maximum loan size for Java provinces (excluding Banten) in 2022 was IDR 25.8 trillion. In 2024, regional incomes totaled IDR 172.3 trillion.
REITs units	For illustration, First REIT had 6,522 beds in 2023, generating SGD 26 million in revenues and holding SGD 1.1 billion in assets, with 74% of AUM in Indonesia. Government of Indonesia had 151,000 hospital beds in 2018, potentially generating SGD 602 million in revenues and holding SGD 26.4 billion in assets.
SME partial guarantee scheme	The current KUR interest subsidy budget is IDR 48 trillion. If 3% coverage for SME NPLs is fully funded (average for banking NPLs), the budget could cover up to IDR 1,600 trillion in loans. Potential for even larger loan coverage due to potentially lower insurance costs.

Appendix 3:

Note on Potential Implementations for Project Finance Debt, Municipal Bonds, and REITs

In discussions with former high-level officials experienced in building local government infrastructure, we uncovered interesting findings. These discussions highlight that, at the implementation stage, innovative financing ideas for infrastructure and local government debt require further adjustments to overcome constraints despite the viability of the proposed projects.

For financing large infrastructure projects, investors and lenders typically seek a central government guarantee, often in the form of an undertaking letter from the Minister of Finance. For example, such a guarantee was required for building the 10-gigawatt electricity generation under the first fast-track program during the Yudhoyono administration. Since then, the government has developed new ways to guarantee infrastructure projects, notably through PT SMI and PT PII (IIGF).

Launched in 2009, PT SMI has grown to manage assets worth IDR 115 trillion by 2023. It operates across various sectors, serving as an investor, loan provider, advisory service provider, credit enhancer, and more, in areas such as transport, road infrastructure, irrigation, clean water, telecommunications, electricity, oil, and gas. Historically, PT SMI has also provided credit guarantees for the bond issuance of a private-sector electricity micro-hydro project. It should be able to do the same for project finance debt, if recognized as a capital market instrument.

PT PII (IIGF), also established in 2009, focuses on providing project guarantees. It offers coverage against political risks in public-private financed projects, including delays in approvals, licensing, regulatory changes, and more. Another type of guarantee covers payment failures by state-owned enterprises. PT PII (IIGF) also offers project preparation services and currently guarantees over 50 projects worth close to IDR 500 trillion.

However, these organizations may not be perceived as adequately representing the Indonesian government, and their capital might need to be increased for large-scale projects. One solution, aside from directly providing an explicit government guarantee, could involve issuing regulations that explicitly assign these two institutions to specific projects or categories of projects, along with increasing their capital.

For municipal bonds, obtaining approval from the Ministry of Home Affairs is crucial. Despite financial viability and approval from the Ministry of Finance, early engagement with the Ministry of Home Affairs is essential due to typically lengthy approval processes. Regarding REITs, reducing land sales tax further is challenging since it forms a significant portion of regional government income rather than central government revenue. A compelling case could be made that when a property is sold to a REIT SPV and the proceeds are reinvested locally, it generates employment and potentially higher local tax revenues. Therefore, a mechanism for land sales tax liability or forgiveness could be plausible if coupled with commitments from the REIT arranger for regional investment.



IBC

Indonesian Business Council

Indonesian Business Council (IBC)

Sequis Center 1st Floor
JI Jenderal Sudirman Kav. 71
Jakarta Selatan 12190
Indonesia

 business-council.id

 [businesscouncil.id](https://www.instagram.com/businesscouncil.id)

 [Indonesian Business Council](https://www.linkedin.com/company/Indonesian-Business-Council)

 [businesscouncil_id](https://www.youtube.com/channel/UCbusinesscouncil_id)