

**INDONESIA: Financing Small Scale Urban Infrastructure In the
Era of Decentralization.**

Robert C. G. Varley

Staff Consultant, Asian Development Bank (Manila)
rcgvarley@aol.com

Thursday, March 08, 2001

Policy Background

1. ADB is currently evaluating its lending in Indonesia as the established lending mechanisms and loan preparation processes are not suited to the new era of decentralized responsibilities for urban infrastructure services.¹ In the past, investment planning and fund allocation have been highly centralized. As a result of fiscal decentralization up to 50% of budgetary resources will eventually be transferred as block-grants to the regions. The regions have now become responsible for the provision of a wide range of urban services. Minimum standards have not yet been defined and capacity is acknowledged to be very weak at the LGU level. Hence the immediate priority of GOI policy has been to improve governance and provide support for capacity building, rather than new investments.
2. Some urban services are of a social nature while others are best managed commercially – water supply being a good example. Increased use of fees for urban services would provide a revenue stream to service investment loans. Credit for loans to finance these investments would be enhanced if the project revenues were captured directly and loan installments deducted at source. While fiscal decentralization has been addressed in Law 25, credit and financing policy to complement has yet to be formulated comprehensively. A new policy which takes investment allocation out of the bureaucracy is needed. Placing loan approval decisions with regulated commercial intermediaries will increase objectivity and due diligence.
3. The multilateral development banks (MDBs) wish to continue support of urban services and water sector activities, but have not yet found appropriate lending mechanisms that reflect the new status of regional governments (as defined in Laws 22 and 25.) GOI has indicated it wants a more direct relationship between Lender (MDB) and Borrower (the LGU²/PDAM³), but the MDBs do not have the resources to enter into many separate agreements with up to 370 LGUs. One solution is to use a fund which supports selected intermediaries who make the actual credit approval decisions and bear the risk. Strict limitations on LGU borrowing are being required in the context of Indonesia-IMF relations, which are primarily concerned with short, and medium-term macroeconomic stabilization. The IMF is not opposed to well-designed mechanisms for supplying credit to LGUs and BUMDs, but they are insisting on a moratorium on LGU borrowing until necessary reforms have been implemented and macroeconomic conditions permit. Current lending mechanisms do not work well, but new financial policies, detailed designs for lending mechanisms and supportive institutional frameworks are not yet in place. With no track record and very little financial management capacity most LGUs are very much an unknown quantity. The best use of the time needed for LGUs to acquire these capacities, is in designing sound policies and future financing mechanisms.

¹ A fuller discussion of the problems of past lending mechanisms and potential long and short-term alternatives is contained in "Robert C. G. Varley (Staff Consultant), *Indonesia: The Regional Development Account and Alternatives for Financing Urban Infrastructure*", Main Report: Volume 1 and Annexes Volume-2, Asian Development Bank, January 22, 2001.

² Local Government Unit – the basic unit of local government covering both kabupatens and kotamadya.

³ PDAM – Perusahaan Daerah Air Minum or Regional Water Company. A PDAM is one example of a local government owned enterprise – known generically as BUMD or Badan Usaha Milik Daerah.

4. In November 2000 a high-level multi-agency steering committee was established under the leadership of the Coordinating Minister EKUIN, with responsibility for directing a “Team for Restructuring the PDAMs⁴.” Infrastructure is considered a matter of strategic importance and GOI needs to make the most effective use of donor resources. Because of its unique problems and characteristics and the strength of interests⁵ the water supply sector tends to get special attention and is not treated as just another component of a multi-sectoral urban sector. The major issues for water supply are not just the physical engineering requirements but the urgent need for good governance of the water supply institutions. Financial policies are overarching in this context and the policies relating to banks and other financial intermediaries must be considered carefully in formulating the financial and economic aspects of water supply.
5. The initial mandate of the PDAM Restructuring Team is to develop a basic water supply policy as soon as possible - 6 working groups will be established, including one on capitalization and financing.⁶ ADB’s major policy is now to use the public sector to leverage and facilitate the participation of private sector rather than to compete with it. Privatization itself will generate a demand for debt capital to supplement equity investments and so the role of banking and credit is not likely to decrease in importance. The best way of addressing chronic and intractable deficiencies in PDAM management and governance is privatization, and a sound regulatory framework. Some PDAMs may not, however, be attractive investment prospects and will require investment to repair past neglect prior to privatization. Some may still require ongoing operational subsidies that must be provided by regional or central governments. There will still be a role for the public sector, albeit much reduced and decentralized.
6. Basic water supply policy must address: -
 - the absence of both national and regional regulatory frameworks;
 - the role of grants versus loans from central government to LGUs;
 - unresolved on-lending arrangements for donor-sourced projects;
 - uncertainty about the time horizon for LGUs and BUMDs to establish sound financial management practices and be rated as creditworthy;
 - the constraints on the financial management and governance of BUMD as defined by a forthcoming law (RUU);
 - the sequencing of financial sector reforms;
 - policies for managing existing LGU and central government debt burdens;

⁴ Sometimes this is confusingly referred to as the PDAM Rescue Team – a term deriving from the WB sponsored PDAM Rescue Project.

⁵ E.g. the consulting industry, MDB divisions organized on sector lines, the public works engineering establishment and international water companies.

⁶ The POKJA or working groups are: - Basic Water Policy; Organization Management ;Human Resources; Technical and Production; Capitalization and Finance; Investment and Private Sector Participation.

- reconciliation with the national water resources management policy which is “holistic and comprehensive”⁷

Past Lending for Small Scale Infrastructure

7. The past was characterized by a culture of loan delinquency and corruption - government-sponsored loans were largely seen as “handouts”. The RDA⁸ (Rekening Pembangunan Daerah) was an unsuccessful attempt to develop a speedy and demand-based mechanism for smaller-sized loans to PDAMs (water companies.) To a lesser extent it was used to support investments in other LGU revenue earning projects (LGRGP.) RDA was supposed to be much speedier than the other loan products in use – the RDI⁹ and SLA¹⁰. The RDA was intended to consolidate donor and domestic funds into a single source offering standard terms. Neither ADB nor WB channeling through the account has approached the vast sums channeled through the SLAs. About 80% of the borrowing from RDA was for water supply, the balance for terminals and markets. Overall, the status of RDA borrowers is divided roughly equally between BUMDs and LGUs (the PEMDA or Pemerintah Daerah.) Other LGU infrastructure projects were financed by DIPs¹¹ and INPRES grants, these often being counterpart funding for IUDP/SLA projects. SLA loans were packaged into many smaller projects within an IUIDP¹². The SLA projects have produced very little direct cost-recovery from the LGUs.
8. The MOF managed the RDA account to provide long-term fixed-rate loans directly to final borrowers. In managing the RDA the MOF acted as a “*credit retailer*.” An alternative role, first formulated in 1996 but never adopted¹³, was that the RDA be treated as a fund accessible by qualifying banks making loans to LGUs/PDAMs/BUMD to finance small scale urban infrastructure. This would not have required a new institution at the time proposed but a different way of managing the RDA funds. RDA would have provided “rediscounting facilities” or a “credit line” to individual banks with high prudential ratings, which in turn loaned to the final borrower. Banks were to qualify for access on the basis of transparent criteria of financial health¹⁴ and not the submission of individual projects to the RDA manager for approval. The manager’s role would have been that of a “*credit wholesaler*.” The borrower, an LGU or BUMD would have to initiate the loan application which would be made to the bank. The intermediary, a development or commercial bank would appraise the individual project[s], and then refinance a percentage of the loan or package of loans, by drawing on the RDA for a percentage of investment cost.
9. The performance of the MOF in managing the RDA/RDI and SLA portfolio has been unsatisfactory. The credit system for LGU infrastructure and urban services had all the characteristics of an inefficient, supply-led, bureaucratically managed, central government-directed and subsidized loan program. Most of the borrowers were not creditworthy and the current portfolio of RDA/RDI and SLA loans are at least 50% in arrears.¹⁵ Meanwhile private sector participation has been limited to a few well-publicized metropolises while the private banking market has only provided short term bridging finance to PDAMs and LGUs. Private sector banks are not involved as the potential borrowers are uncreditworthy, government interest rate policy

⁷ Associated with the WB policy adjustment loan or WATSAL. The policy addresses water rights, transfers, pollution fees and conflicts between urban/industrial/commercial and agricultural uses.

undercuts private suppliers of capital, and poor legal protections deter lenders entering what is potentially a strong market for infrastructure lending.

Constraints on a New Mechanisms

10. Multilateral-supported loan programs have used an SLA mechanism – this, however, is a generic term and does not imply that traditional SLA designs from past programs have to be used in the future. The burden of existing debts under past RDA, SLA and RDI lending programs will be a major political constraint on the implementation of any new urban investment financing. The MOF will have little option but to forgive the existing loans or to use commercial banks, paid on a commission basis, to manage collection of the existing portfolio. They lack the capacity to do effective restructuring. Problem-loan handling is a highly specialized yet diverse and complex subject. It is the hardest part of loan administration and involves techniques and solutions that vary with individual loans, marketplaces and institutions. Banks are the only available intermediary institutions with the financial management skills and branch networks needed to negotiate, restructure and supervise loan workouts.
11. A major incentive for the LGUs and PDAMs to restructure existing debt (and institute “loan workouts”), is the promise of future access to credit once they become creditworthy. The RDA/RDI/SLA portfolio has an asset value much lower than the face value of the loans, especially when interest rate distortion and past corruption are factored in (the real value is probably less than 25% of the nominal). Given the additional difficulties the banks faces in dealing with government bureaucracy it might indeed be difficult to give the loans away.
12. PDAMs are being reorganized and consolidated to establish an arms-length relationship with LGU owners, and encourage private sector participation. The timing of a new lending facility should avoid reducing the present incentive to privatize. Offering credit to cash-strapped PDAMs and LGU owners at this stage, lessens the pressure to develop private partnerships. Absence of soft loan finance from central government will increase the incentive to divest PDAM assets or enter concession agreements – a “backs against the wall” strategy to force LGUs to reform and stop treating the PDAMs as cash-cows.
13. At present there is a moratorium on central government loans to LGUs and the IMF is demanding no loans at all. The PP for Law 25 (implementation instructions) will limit credit to projects whose direct revenue streams support repayment. This does

8 Regional Development Account

9 RDI – Rekening Dana Investasi are loans made to local governments through the Onlending Directorate of the Directorate General of Financial Institutions in the Ministry of Finance. They are funded solely from domestic funds.

10 SLA – stands for Subsidiary Loan Agreement. It describes a two stage loan process with agreements between GOI and the international lender, and a separate agreement between GOI and the final borrower, which specifies the obligations of the two parties. In Indonesia SLA s have been adjuncts of large multi-sector urban projects managed by central technical ministries.

¹¹ Daftar Izin Proyek – the term used to describe the budgetary allocations for investment projects that comprised the development budget under the old system of BAPPENAS directed investment.

¹² Integrated Urban Infrastructure Development Project

¹³ See Varley, op cit

¹⁴ Measured in a transparent fashion by Central Bank (BI) prudential regulation indices – such as the CAMEL (Capital, Assets, Management, Earnings, Liquidity).

¹⁵ The latest portfolio status figures from the MOF are for December 1999.

not mean that poverty and social goals cannot be incorporated in future. It does however mean that clear policies be established on entitlement to central government subsidies. These should be given in the form of explicit budgetary allocations¹⁶ rather than concealed commitments implicit in subsidized interest rates.

14. Subsidies to interest rates should be limited to those arising from economies of scale and financing e.g. a long-term ADB loan in dollars is implicitly subsidized by GOI's sovereign guarantee.) Even this subsidy to GOI does not have to be passed on directly to LGUs. Interest subsidies cannot be justified by specious "affordability" arguments. If an LGU cannot currently "afford" a project, it can only do so by supplementing its own resources from the DAU and operating surplus, with additional central government grants (which are likely to be conditional and subject to transparent eligibility criteria.) The grants are outright and appear as line items in the national budget. When a subsidy is delivered in the form of low-interest loans the central government liability is concealed. A web of implicit obligations is created with subsidized credit and it suddenly emerges as explicit budget commitments when financial institutions fail and have to be bailed out by government. Aggravated by devaluation and unrealistic foreign exchange premiums the subsidy ends up being much larger than intended. Below market rates, which do not incorporate such elements as credit risk, full foreign exchange cover, administration costs and a return on capital, will "crowd out" private sector suppliers of capital who must incorporate these elements in loan pricing.
15. The current weakness of the banking sector dictates a medium-term horizon for initial disbursement (probably 2 years at least.) Banks would have to incorporate the new product in long-range strategic and annual business plans. Additional human resources and skills are needed to address the special technical needs of infrastructure lending in general, and water supply in particular. The expertise could come from some combination of consultants, donor-funded TA and recruitment of loan officers with the necessary technical background.
16. A final constraint is imposed by ADB's own lending rules – the counterpart is technically the government (for the sovereign guarantee) but the actual credit relationship is between intermediary and LGU/BUMD. This disconnect between lender and borrower can be addressed by ensuring clear rules for managing the fund and access to it. The management could be done by BI or on a fee basis by any major bank acceptable to both BI and GOI. GOI might want in future to establish a new institution, putting the SIF on an independent basis, rather than just treating it as an administered on-lending mechanism. The disadvantage of premature introduction of a new institution is that it introduces an extra layer of intermediation and potential bureaucratic delay.

Desirable Features of New Financing Mechanisms

17. There are a wide range of LGRGPs that could be financed by a new loan product, with full or partial repayment guaranteed by assignment of revenue streams. Thus the ideal would be that one single mechanism could support not only water supply

¹⁶ conditional matching grants through the Dana Allokasi Khusus or Special Allocation Fund.

but a range of LGRPs. LGRP loans should be secured on the assignment of revenue streams. This differs from general municipal lending such as revenue bond issues, where the security is the LGU's debt capacity not the project's. Most banks would probably also look at the LGU's independent credit rating due to the possible role of a guarantee. The market will eventually mature to permit such general revenue-based borrowing but it cannot be forced. Lending for a broad range of urban activities will require that both GOI and the MDBs get out of narrow sectoral targeting, leaving LGUs to allocate investment resources in the context of their diverse economic requirements.

18. A sample of the types non-water small projects that might be supported by a broader urban loan or smallscale infrastructure fund are: –

- transport terminals;
- markets;
- garbage collection;
- health centers and hospitals;
- industrial estates;
- vocational training;
- schools;
- ports;
- transport services;
- recreational facilities;
- small scale irrigation services (e.g. groundwater sprinklers for high value crops and rehabilitations by Water User Associations) ;
- abbatoirs;
- purchase of heavy equipment to subsequently be charged to other LGU projects or hired out to private sector users (e.g. landfill/excavation.)

19. The borrower must have the incentive to promote only financially viable projects – this is assured by the potential loss of collateral and the need to repay to sustain creditworthiness. From the lender's perspective good loans are made to creditworthy borrowers and require a judgement on the part of the lender that the borrower will not only be able to repay the loan, but is willing to do so as well (a break from past traditions.) The weak link from a development perspective is that the bank may not have sufficient interest in the quality of the project and be satisfied with other security than the net project revenues (such as an intercept on the LGU's block grant.) The DAU intercept has been mandated as the collateral for loans from central government to LGUs (Law 25 only specifies that this guarantee will automatically be given to those loans which are sourced from domestic funds.) For loans to LRGPs funded by the SIF this credit enhancement mechanism would be sub-optimal anyway. LGUs are likely to resist cuts in the DAU using political means. They can exploit regional-center conflicts of interest and refuse to accept

responsibility for financial profligacy. A revenue intercept can be structured as a regular loan installment so the borrower is paying the loan back “as you go.”

20. Experience suggests that the following are all desirable features of a sustainable loan program and loan product: -

- The borrower must be creditworthy and if the project is to benefit the borrower, should also generate a return at least equal to the cost of finance,
- Interest rates should reflect the risk of default;
- The cost of borrowing should be such as to cover all costs - equal to the [cost of funds + foreign exchange risk premium + administrative overhead + risk premium + some return on lender's capital.]
- Grants and Equity - for projects with a social or externality justification, additional assistance should be in the form of a targeted grant to bring down the effective cost of finance, not subsidized interest rates on debt.
- Interest rates on lending should be the result of negotiation between lender and borrower – not administrative dictat. Final interest rates should be regulated by competition between lenders – this can be accomplished by allowing any sound bank access to the SIF.
- The lender and borrower should bear the consequences of a bad credit decision. ADB would have to assume more responsibility for overseeing administration of the SIF.
- The lower the loan size the higher the administrative overhead and hence the necessary interest rate – we should not be surprised if very small loans have high administrative costs.
- Grace periods should be avoided in the interest of establishing the habit of repayment – this may be easier for water supply than many other sectors. Existing inefficiencies and below cost-recovery tariffs make it desirable to move repayments forward – loan repayment can then depend initially on tariff level rather than an immediate increase in water sales.

21. Neither MDB nor GOI agency staffs are in a position to outguess commercial banks assessing project risk or borrower debt capacity. Both ADB and GOI should cease dictating margins, terms, grace periods and interest rates to the final lender (they must of course do so for GOI-ADB and GOI-LB financing agreements.) Final interest rates are best set by intermediaries themselves, and regulated by competition between them. Allowing eligible private, as well state banks, access to the SIF, will enhance competition. The eligibility criteria for accessibility to the “Small Infrastructure Fund” must also be transparent e.g. the bank's audited financial performance, and satisfaction of BI prudent regulations (i.e. independent ADB audit of the LB and the BI CAMEL index.

22. In the past, access to credit involved negotiation of individual projects with the technical ministries, MOF and BAPPENAS. The credit followed automatically once central government and donors had approved. The so-called Blue Book of approved projects has long been the main focus of donor attention. The focus of a new system should be the careful selection of intermediary banks that make the loan approval decision, and bear the associated risk as well as enjoying the potential profit. ADB

must learn to negotiate more directly with the intermediary using GOI as the facilitator as much as guarantor. The presence of the sovereign guarantee need be of no consequence to the borrower if they are convinced they have to repay the central government. In many ways it would be better not to tell LGUs about the central government guarantee.

Proposed Loan Product and Funding Mechanism

23. The product would address a market segment similar to that targeted by the Regional Development Account, but with a completely redesigned and decentralized financing mechanism. Private and state banks with a large branch network would be in a unique position to serve this market in the future, and would want to incorporate the product in strategic plans. Initially ADB is circulating a draft proposal, as material for discussion with the state banks that have large branch networks. This seed of a “product and credit program design” incorporates new ways for ADB and Indonesia to do business. It is not a proposal for yet another traditional project loan to enable lending to continue. The bank/intermediary’s interest in the municipal market is critical and has been addressed first. The program and product designs should be based on lessons-learned from sustainable credit programs in Indonesia and elsewhere – not the failed ones. The final loans would be in the range of Rp. 1-10 billion initially, although discretion might be given to the intermediary to increase the size of subsequent loans, subject to satisfactory LGU/BUMD performance.
24. The loan product and the supporting fund would not be launched until the current restructuring of the water companies (PDAM) has been completed, and sound financial management practices established in the PDAMs and LGUs. The link to privatization strategy should be explicit. Restructuring or settlement of the existing RPD (Regional Development Account), SLA (Subsidiary Loan Agreement), RDI (Rekening Dana Investasi or GOI sourced) loans may be a prior GOI condition for eligibility for the SIF-supported loan product (LP.) Details of the proposed product are: -
- A line of credit/ rediscounting facility for small and medium loans (Rp 1-10 billion), available to LBs for final lending for water/ infrastructure improvement. Project appraisal would be the responsibility of the LB.
 - The line of credit/rediscount facility to the LB would be long-term, at a fixed dollar rate (foreign exchange cover is an issue yet to be resolved.) The fund would be administered by BI or a yet to be determined bank, acceptable to GOI/ADB.
 - The final interest rate to the PDAM borrower should be set by the LB and related to both project risk and the debt capacity of the borrower. The loan margin would be regulated by competition between lenders – not diktat.
 - There would be a limited grace period on the loans and PDAMs would be expected to obtain covenants, if necessary, from the local government owners, to permit raising water tariffs and other fees.
 - The PDAM/ LGU enterprise borrowers would be required to channel their water bill/fee receipts through an account of the LB – hence the collateral would be assignment of the PDAM/ LGU enterprise revenue stream. Under current regulations additional physical collateral is not permitted.

- Access to the facility/discount window would require: - a) satisfaction of BI prudent regulation criteria (CAMEL) and (b) ADB's independent and confirming audit of the LB.
- Individual project loans would not be subject to pre-approval by BI or GOI, although they would be monitored ex-post on a sample basis
- The LB(s) would assume full credit risk and there would be no central government guarantee. At present local governments are not allowed to guarantee a PDAM/LGRP loan, although this might change in the future
- The percentage of the final loan that can be rediscounted has yet to be determined. The PDAM would be required to contribute 10- 20% of project costs.

Advantages and Disadvantages of the proposed financing mechanism

25. The proposal has both advantages and disadvantages – the disadvantages are sometimes called risk factors. The major risks for ADB are (i) the MOF is unwilling to establish an appropriate financing mechanism; (ii) potential LBs are not financially sound and do not have the capability and capacity to act as financial intermediaries; (iii) LGUs and BUMD borrowers are not willing to embrace the necessary institutional, management, financial and tariff reforms; and (iv) beneficiary communities are not willing to pay for the services. One thing is clear is that with a demand-based financing mechanism it is much more difficult to predict future draw down on the loan. Furthermore, slow disbursement may be a demonstration of success of a policy (discouraging investment in low return projects) as of a failure to sell the product (the loan.) Such conflicts have become the staple of MDBs and bilaterals seeking to facilitate reform in client countries.

26. A private sector infrastructure fund may be possible in the future¹⁷ but the only realistic alternatives in the medium-term are:-

- Let LGUs and BUMDs rely on the private capital market, supplemented by operating surplus and central government grants (conditional or unconditional);
- Establish a parastatal intermediary such as a Municipal Development Fund or new development bank – experience suggest these become captive to sectoral ministry and donor interests. Besides which, the conditions for their successful operation are rarely found in developing countries and certainly not present-day Indonesia.¹⁸
- Issuing bonds – which is only likely after the re-establishment of stable financial market conditions and even then, only viable for large rich LGUs. The prior conditions of a bond reference interest rate and credit rating services are not yet satisfied.

The advantages or strengths of the proposed mechanism are: -

¹⁷ See Varley op cit. Chapter 5 and 6.

¹⁸ “These include predictable stable local revenues, and adequate supply of capital, smart demanding borrowers, clear remedies and consequences, good information (accounting data, forecasts, plans) and adequate local government financial management.” , *Subnational Access to Capital Markets*, PREM Learning Week, World Bank, November 14, by E Asturizaga, B Darce and Marcela Huertas.

- National and provincial branch bank networks have the best knowledge of the client and can channel revenues by requiring the borrower use the bank's current account management services. Major banks also provide national coverage and can discriminate between borrowers at regional level;
- Banks already have experience of long-term and project-based lending. (Many projects do not need the long grace and repayment periods which were the standard fare of government programs in the past);
- As long as access to the fund by 3 or more banks is assured then competition should regulate interest rates to the borrower;
- Project-based loans would represent an initial penetration of the municipal credit market by the banks;
- By giving more discretion to the LBs in setting terms it opens avenues for more flexible products including short term credit for still restructuring PDAMs, leasing and other medium term lending.
- It builds on a proposal made in 1996, which was suggested by the MOF but did not gain donor support;
- It could be established relatively quickly
- Donor TA efforts could be targeted at assisting LGUs/BUMDs prepare loan applications and evaluate technical feasibility;
- Donor and government loan funds can be channeled into a consolidated fund and equal terms offered to participating financial institutions;

The disadvantages, weaknesses or risk factors are

- There is an inherent moral hazard in all bank lending – there is an implicit assumption that central government will step in to protect depositors or fail to collect on debts from the bank to the government;
- Many of the banks are in very poor condition and not enough may qualify to make the program effective;
- Transparency in the criteria for access requires reliable prudential regulation by BI;
- While mortgages on physical assets¹⁹ as collateral or a revenue-capture mechanism protects the bank, and lowers the cost of capital, it also lessens the incentive to thoroughly appraise the project;
- The technical skills that were available in the central ministries have yet to be redistributed to local government and consulting services – technical project preparation facilities are very weak;
- Continued pressures from local government officials to pressure banks into supporting particular project loans;
- If a credit lifeline to PDAMs is rushed it may serve to deter them from seeking private participation.

¹⁹ According to Law 25 LGU's cannot pledge such assets. The position for PDAM will depend on the new laws governing BUMD.