

Shari'a Banking and Finance: A Research Agenda on Islam and Democracy in Indonesia

A Discussion Note for Research Collaboration
GSPIA-Pittsburgh and MAP-UGM

Wahyudi Kumorotomo
Pittsburgh, 10 October 2011

Topics

1. Unlike in Arab countries, why Islam and democracy can go along in Indonesia? What happens on the ground?
2. How have been Islamic ideas being implemented? Case: Shari'a banking and finance.
3. What areas of research that have not been explored?

Topics of Research on Islam in Indonesia (Ref: Sera Linardi)

1. What are the signs that a country is truly undergoing an ideological change (Can Afghanistan, Iran, Palestine, Syria and Egypt serve as a comparison to Indonesia?)
2. Religion as a market force.
3. Islam and networking.
4. How far religion has influence public policies?
5. Islam and nationalism in Indonesia.
6. Islam and multiculturalism.

Note: How Islamic ideas being implemented?

→ Islamic Banking and Finance

Tarek Masoud:

1. Democratic transitions have not yet happened in the Arab world.
2. Getting to democracy will require managing several difficult short-term political challenges.
3. Arab countries can learn from the Indonesian experience in building and maintaining democracy.
4. Unfortunately, so far they are ignoring the lessons of Indonesia.

Islamic Finance as an Alternative ?



World Bulletin / News Desk

The Vatican offered Islamic finance principles to Western banks as a solution for worldwide economic crisis.

4. Islamic finance as the alternative

Advocates and the opponents of both schools of thought (market economies) thus far have not provided a solution to the crisis. Most economists, including the late Maurice Allais, believe that the crisis has developed through structural

Updating: 15:10, 06 March 2009 Friday

the tax cut 2%

core elements of Islamic economics

University of New Orleans March 29, 2011

the Future hold?

Shaikh Haitham is currently reading his PhD in Islamic Law at SOAS in London and is qualified to deliver religious verdicts regarding Islamic finance. He is also a member of Zest Advisory LLP (Islamic Finance).

Dr Humayon Dar completed an MPhil and PhD from Cambridge University where he conducted research on Islamic economics, banking and finance.

Date: 3rd June 2009

Time: 6:15pm - 7:40pm

Location: Langwith L/N/028

University of York Islamic Society

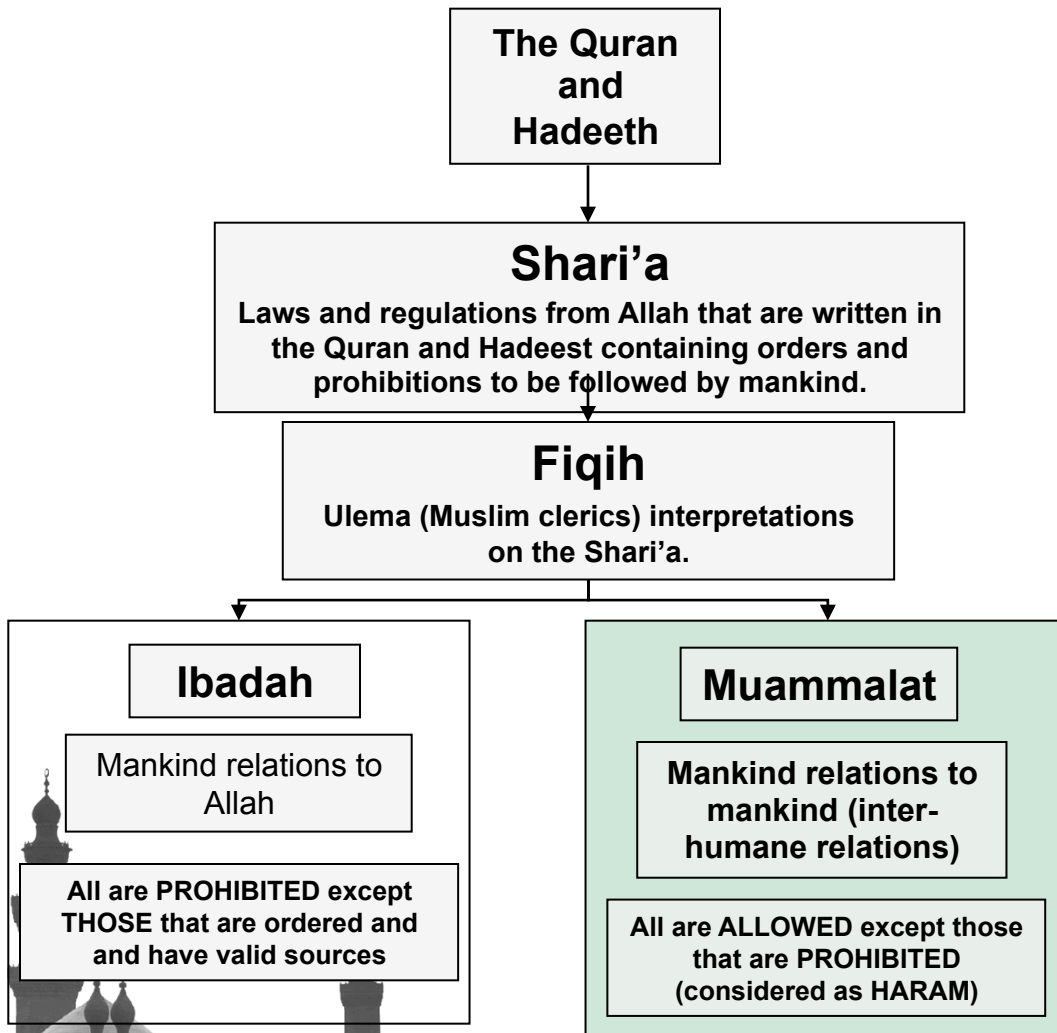
www.yorkisoc.wordpress.com

CAPITALISM FREE-MARKET SYSTEM AND THE NEED FOR ISLAMIC ECONOMIC SYSTEM



University of International Business, October 2010

Basic Concepts of Shari'a Finance



1. The principle prohibits:

- ▶ Riba (*usury*)
- ▶ Gharar (*ambiguity*)
- ▶ Maisir (*gambling*)

2. Investments to be avoided:

- Negative sectors (e.g. alcohol, armaments, financial services, gambling, pork, pornography, tobacco)
- Instruments (e.g. no forward transactions, limited option use, no derivatives & short-selling)

3. Asset-backed transactions.

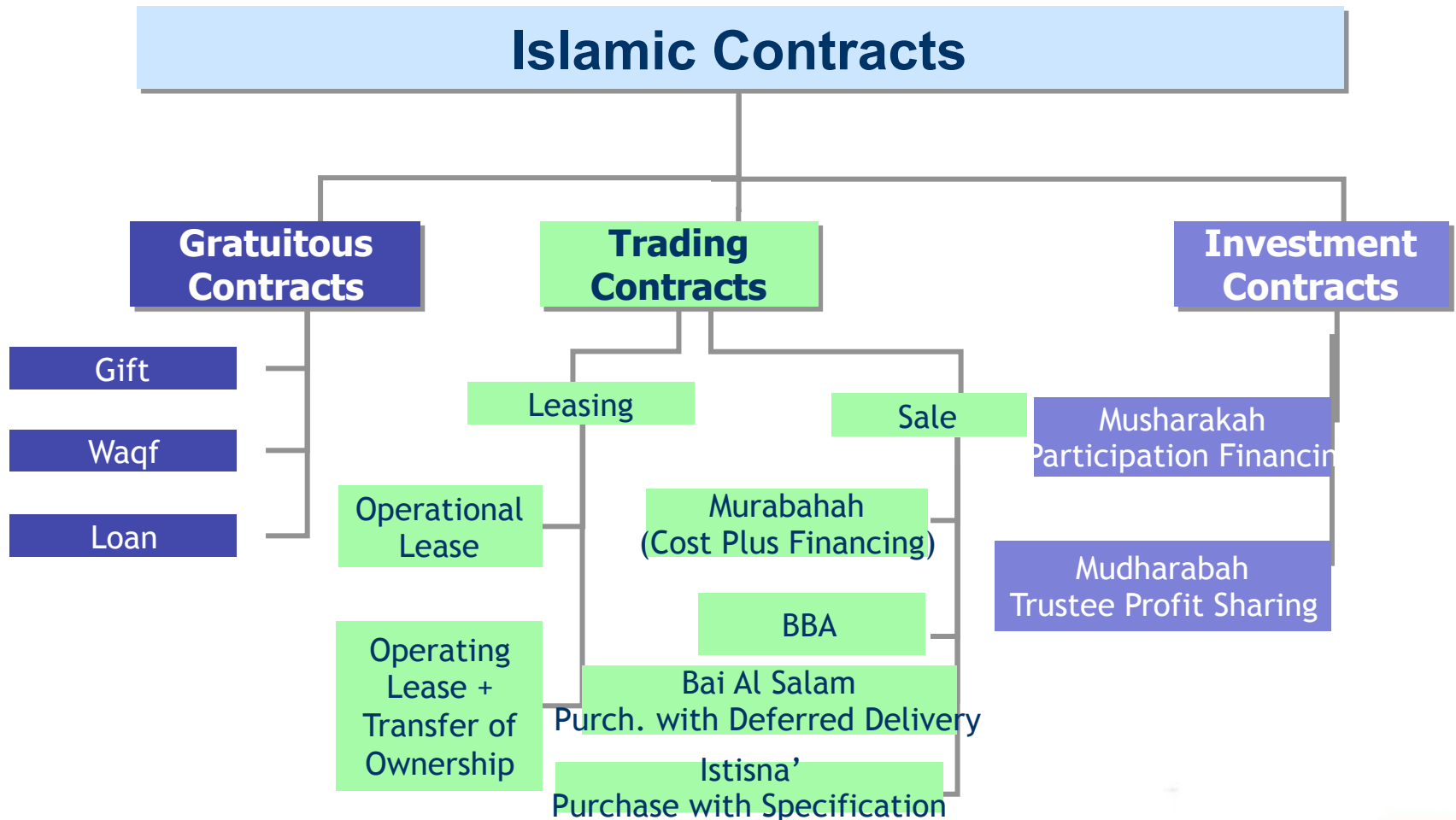
4. The principle of profit and loss sharing in any forms of investments.

Shari'a Filter

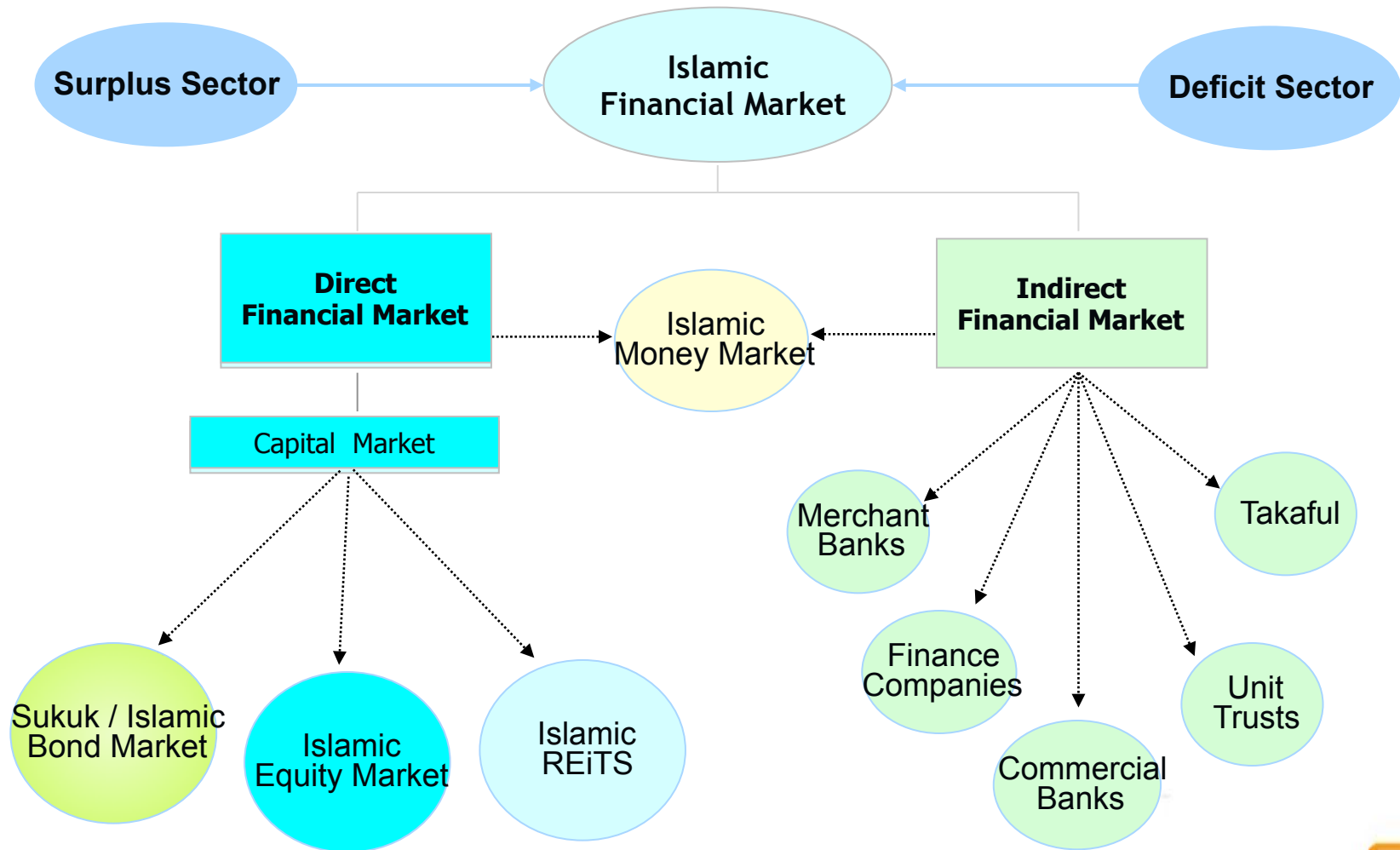
Shari'a Principles in Finance and Commerce

1. Markets are kept fair and fair pricing is achieved without deception (*gharar*).
2. Money cannot be rented by paying a price for using it. The payment of a price or the use of money was called *riba* (usury) and is called an *interest rate*.
3. Buy-sell contract must be fully documented, free from any deceptions or undefined parameters and risks, and should be transparent.
4. In a joint venture, a predefined profit is not allowed. However, the percentage participation in profit and loss, the rent for the use of the property, or the service between parties can be agreed upon between them.
5. One cannot sell what one does not own. One should not profit from another's uncertainty. Hadeeth: We should not buy "fish in the sea" or "dates that are still on the tree".
6. Laws and regulations are designed to supervise, identify, and discover abusers of the system and to examine the safety and soundness of the institutions entrusted with people's hard-earned deposits, investments, and assets.

Contracts According Shari'a Finance



Shari'a Financial Systems

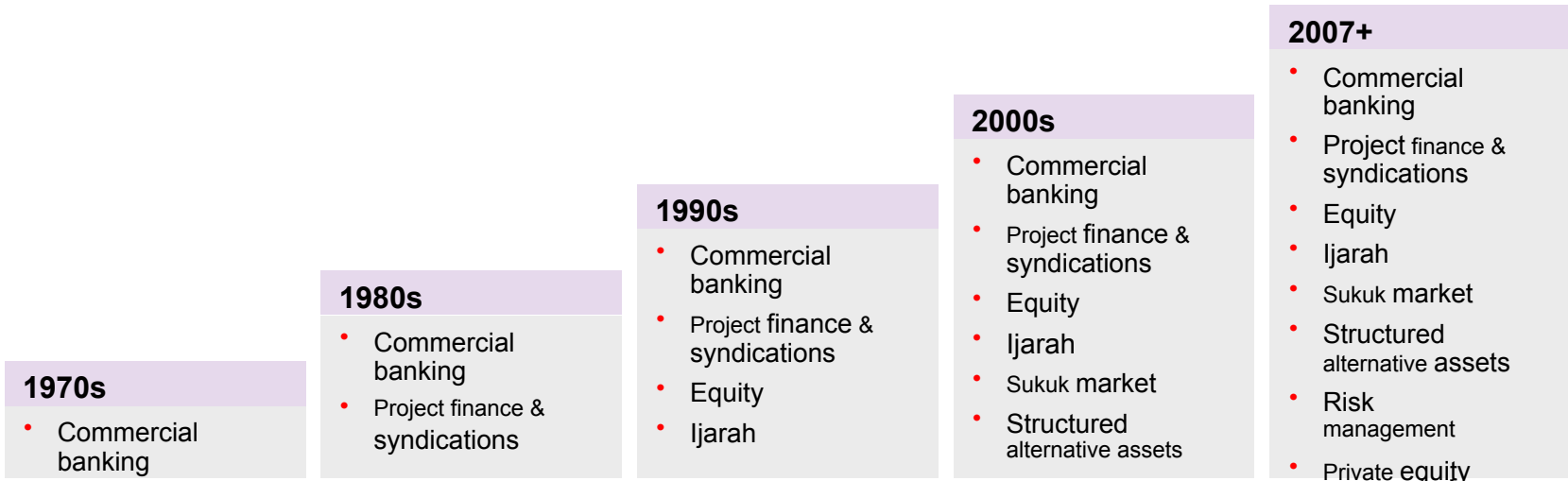


Milestones of Shari'a Finance Development

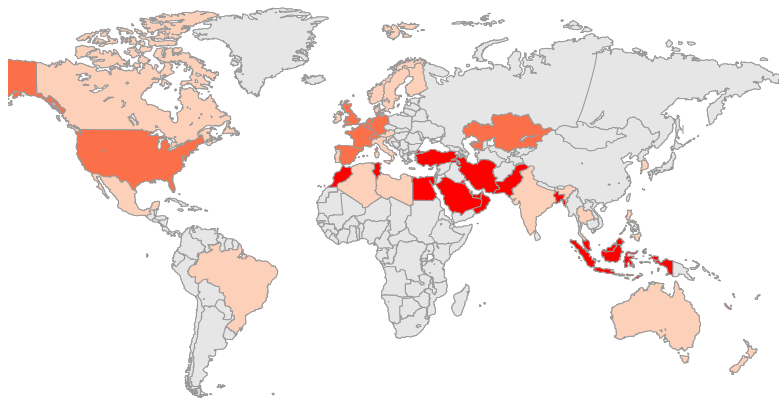
- ❑ Pioneers of Shari'a Banking:
 - The first shari'a bank: Mit Ghamr Local Saving Bank (1963) and Nasir Social Bank (1971) in Egypt.
 - Philippines Amanah Bank (1973).
 - Middle East Timur Islamic Development Bank (1974), Dubai Islamic Bank (1975), Faisal Islamic Bank of Sudan (1977).
 - Islamic International Bank of Denmark (The first shari'a bank in Europe, 1983).
- ❑ The total of shari'a global finance is ±USD 1,7 trillion (per Feb 2011).
- ❑ Around 810 shari'a finance institutions are operating in more than 50 countries.
- ❑ Annual asset growth of 15% – 29%.

(Source: Adapted from Bank Indonesia, IFIS, HSBC, Dealogic)

Global Shari'a Finance Industry Evolution

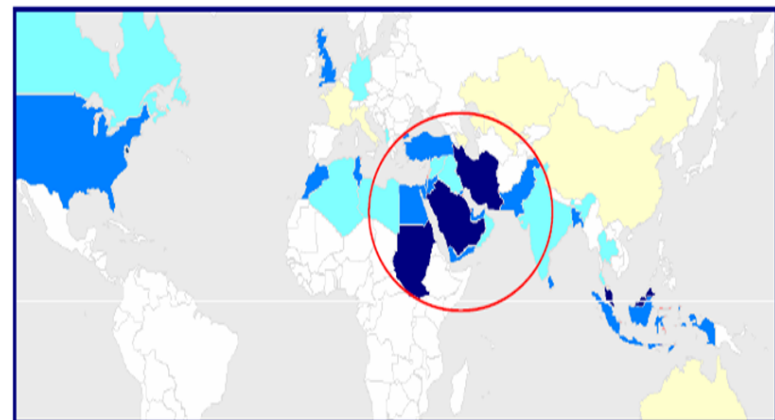


Islamic Issuers & Investors



■ Growing Islamic Investors
 ■ Key Islamic Investors

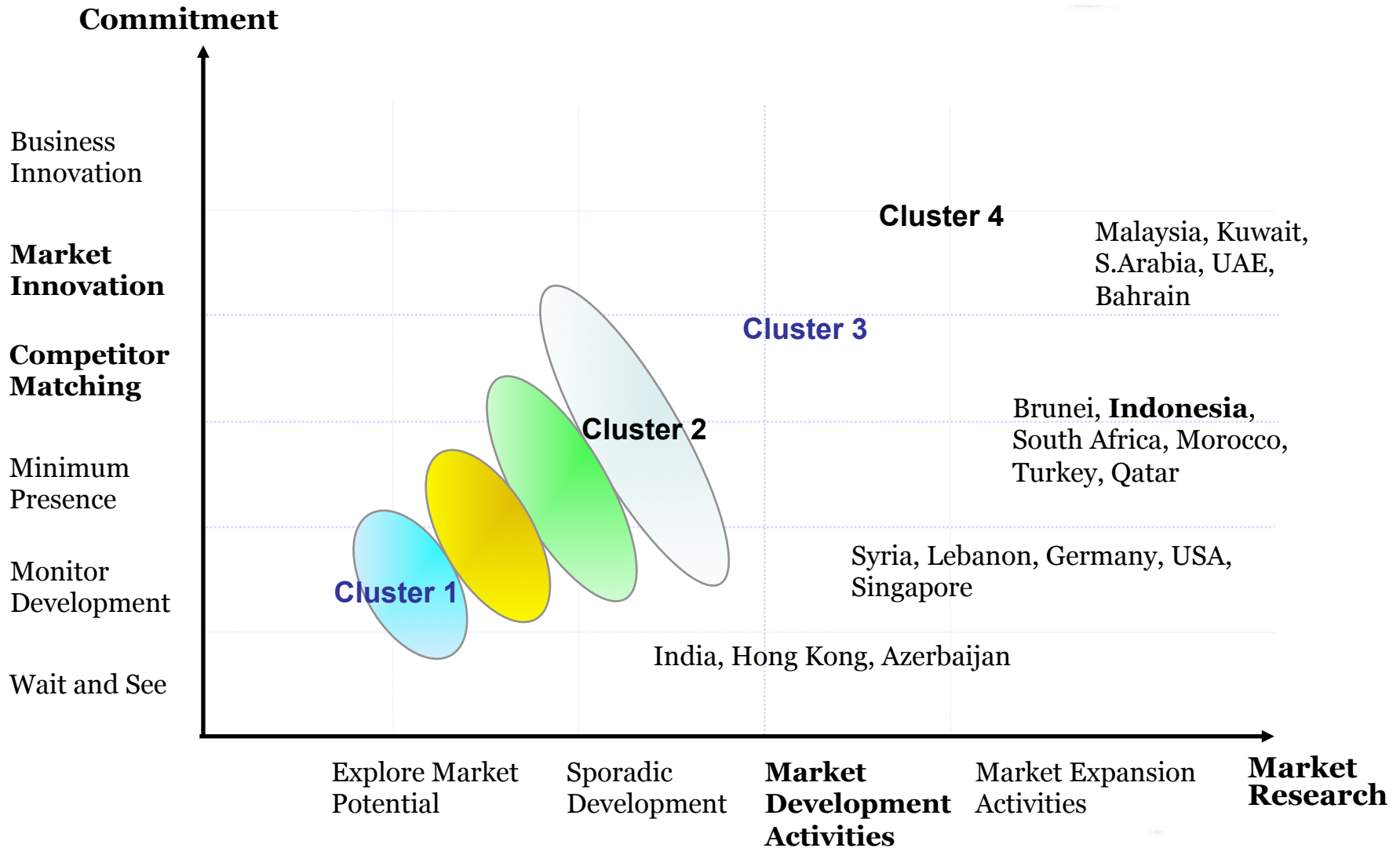
Instrument Distribution



■ Mainstream relevance
 ■ Engaging with regulators
■ Niche presence
 ■ Conceptual exploration

*Source: Bloomberg, HSBC Analysis & Kuwait Finance House.

Shari'a Finance Development Patterns



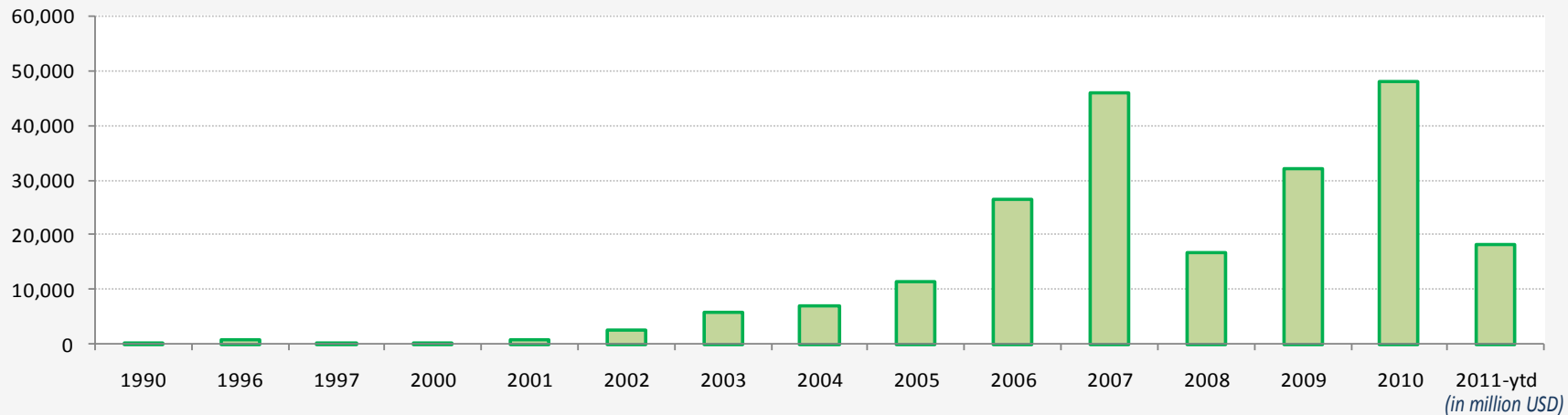
Source: Aseambankers

Sukuk (Islamic Bonds)

- The term “sukuk” stems from “sakk” (cheque), which originally means documents or contractual sheets.
- Along its development, the concept of Sukuk is very much closed to the conventional securities, in which the ownership of the underlying assets are transferred to the investors with a certificate that shows certain proportion of the assets.
- Therefore, Sukuk is asset-based securities that are based on shari’a compliance.
- Today, Sukuk is known as Islamic Bond; it uses profit-sharing mechanisms as opposed to the interest rates, requires underlying transaction in the form of assets for the basis of issuance, requires *akad* (contractual agreement) based on shari’a principles, and it has to be free from *riba* (usury), *gharar* (ambiguity, deception), and *maisir* (gambling).

Global Sukuk Issuance

(in million USD)










(in million USD)

| 1990 | 1996 | 1997 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011-ytd |
|------|------|------|------|------|-------|-------|-------|--------|--------|--------|--------|--------|--------|----------|
| 30 | 860 | 47 | 336 | 813 | 2,504 | 5,745 | 6,985 | 11,504 | 26,370 | 46,023 | 16,698 | 31,961 | 48,181 | 18,249 |

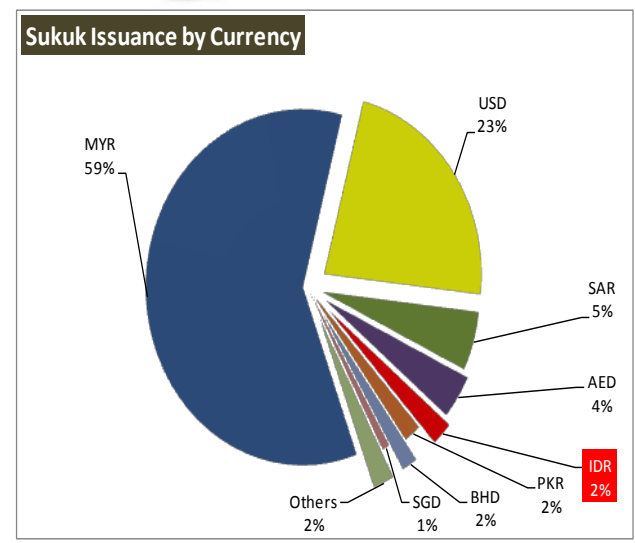
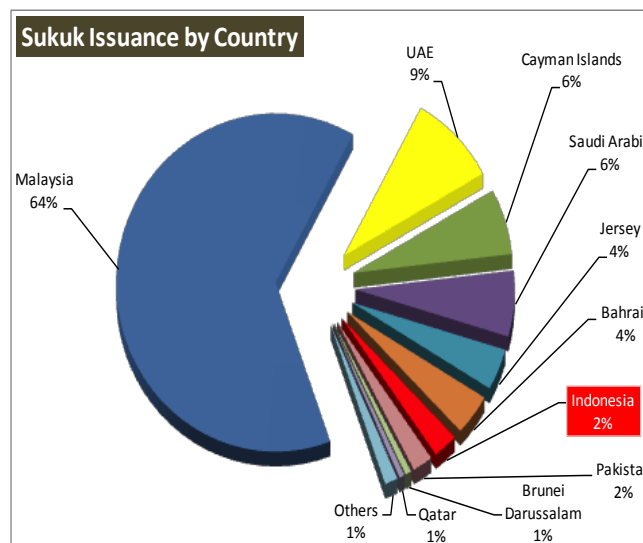
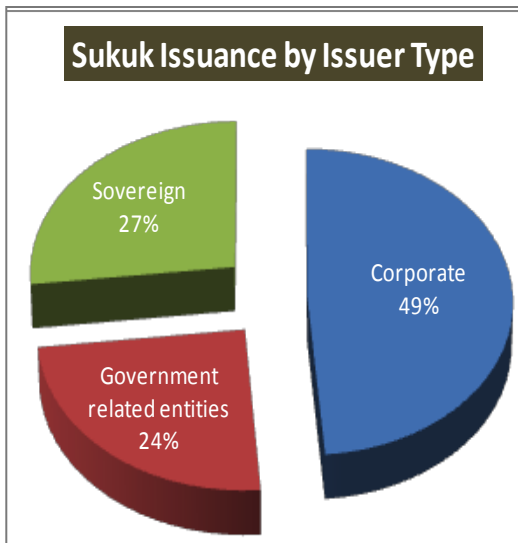
Source: IFIS, Zawya

- The total of international Sukuk in various currencies (per April 2011) is **US\$ 216.31 b**, total outstanding is **US\$ 140.41 b**.
- Countries have been regularly issuing sovereign Sukuk: Indonesia, Malaysia, Bahrain, Saudi Arabia, Emirates Arab Union, and Iran.
- Non-Muslim countries issuing Sukuk:
 - *Germany* : Sachsen-Anhalt €100m [2004].
 - *USA* : East Cameron USD165m [2006].
 - *Japan* : Nomura USD100m [2010].
 - *China* : Chinese Power USD250m [2006].
 - *UK* : Aston Martin £225m [2007], British Health Care Unit £77m (2010)
 - *Canada* : Trustee Societe Montagne USD380m (2010).
 - *Russia* : VTB Bank USD200m (2010)

International Sovereign Sukuk

| |  |  |  |  |  |  |  |
|--------------------------|---|---|---|--|---|---|---|
| Issuer | Malaysia Global Sukuk Inc. | Qatar Global Sukuk QSC | Malaysia Sukuk Global Berhad | Pakistan Intl Sukuk Co. Ltd. | Stichting Sachsen Anhalt Trust | Sukuk (Brunei) Inc. | Perusahaan Penerbit SBSN Indonesia 1 |
| Custodian | Malaysian Govt | Qatar Govt | Malaysian Govt | Pakistan Govt | German Govt Sachsen Anhalt Germany | Brunei Govt | Indonesian Govt |
| Structure | Ijarah | Ijarah | Ijarah | Ijarah | Ijarah | Ijarah | Ijarah |
| Volume | US\$600 mil | US\$700 mil | US\$1,25 bil | US\$600 mil | US\$ 100 mil | BN\$500 mil (max US\$ 1 bil) | US\$650 mil |
| Issued / Maturity | 2002/2007 | 2003/2010 | 2010/2015 | 2005/2010 | 2004/2009 | 2006/2007 (365 days) | 2009/2014 |
| Coupon | 6-mo Libor +95bps | 6-mo Libor +40bps | 3.93% fixed rate | 6-mo Libor +220bps | 6m Euribor +1.00% | Zero Coupon/ - | 8,8% p.a |
| Remarks | First int'l sovereign Sukuk in the world | First sovereign Sukuk Ijarah in Reg-S | Int'l sovereign Sukuk | First Sukuk <i>non-investment grade</i> | First sovereign Sukuk in Europe | First short-term Sukuk In the world | First int'l sovereign Sukuk in Indonesia |

Global Sukuk Issuance



- Corporate Sukuk dominates global shari'a finance with the share of 49%; Followed by *Sovereign Sukuk* (27%), and *Quasi-Sovereign Sukuk (Government Related Entities)* with the share of 24%.
- Sukuk in the world is mostly issued by the Malaysian government. Sukuk's share in Indonesia is only 2% of the total global shari'a finance. But Indonesian share is rapidly increasing.

Sumber: Adapted from IFIS, 2010

Islamic Market Update

- In Jordan, the first Sukuk was issued on 19 April 2011 by Al-Rajhi Cement. Its has a nominal value of JD 85 mil with a tenure of 7 years. It has been purchased by local banks, both conventional and shari'a banks.
- In Pakistan, a domestic Sukuk was issued in May 2011. Its nominal value is PKR 45 b under the Ijarah contract and a tenure of 3 years.

International Sovereign Sukuk Pipeline

| Issuer | Structure | Currency | Subsc. Date | Issue Size (US\$m) |
|------------------------|-----------|----------|-----------------|--------------------|
| Govt. of Pakistan | Ijarah | PKR | 9 - 11 May 2011 | 534.10 |
| Govt. of Hong Kong | Ijarah | - | 2011 | - |
| Govt. of Kazakhstan | - | - | 2011 | - |
| Federation of Malaysia | - | USD | 2011 | 2,500.00 |
| Govt. of Palestine | - | - | 2011 | 50.00 |
| Govt. of Senegal | Ijarah | - | 2011 | 200.00 |
| Govt. of Singapore | Ijarah | USD | 2011 | 134.30 |
| Republic of Tatarstan | - | - | 2011 | 100.00 - 200.00 |

Shari'a Financial Industry in Indonesia

- The shari'a financial systems were initiated in 1990s. It was started with the shari'a banking, bonds, and then insurance.

1991

- First shari'a bank was established.

1994

- Shari'a insurance (Takaful) system was initiated.

2000

- First Wadi'ah Certificate was issued by the Central Bank.

2002

- First corporate Sukuk was issued.
- Jakarta Islamic Index was started.

2007

- The formation of shari'a finance enterprise.
- The list of corporates Shari'a Stock Exchange is published by the Coordinating Borad for Invesments. (Bapepam).

2008

- First Sukuk issuance.
- SBI (Bank Indonesia Bills) Shari'a was issued.

2009

- The issuance of Sukuk retails, Sukuk Global, and Pilgrimage Sukuk.
- First SBSN auctions.

Shari'a Finance Expansion

SHARI'A BANKING

Total assets Dec 2010 +Rp 97.52 trillion
• *Total volume of transactions Rp 76.036 trillion*

SHARI'A INSURANCE

• *Total Asset Sep 2010 +Rp 4.1 trillion*

SHARI'A BONDS

• *Dec 2010: Rp 5,17 trillion*

SHARI'A PENSION FUND

FINANCE, BANKING GUARANTEE, & MORTGAGE

11 Shari'a Banks

23 Shari'a Ventures

3 Life insurance

1 Loss insurance

17 Branches for life insurance

20 Branches for loss insurance

3 Reassurance companies

50 Shari'a bonds

1 Shari'a pension fund

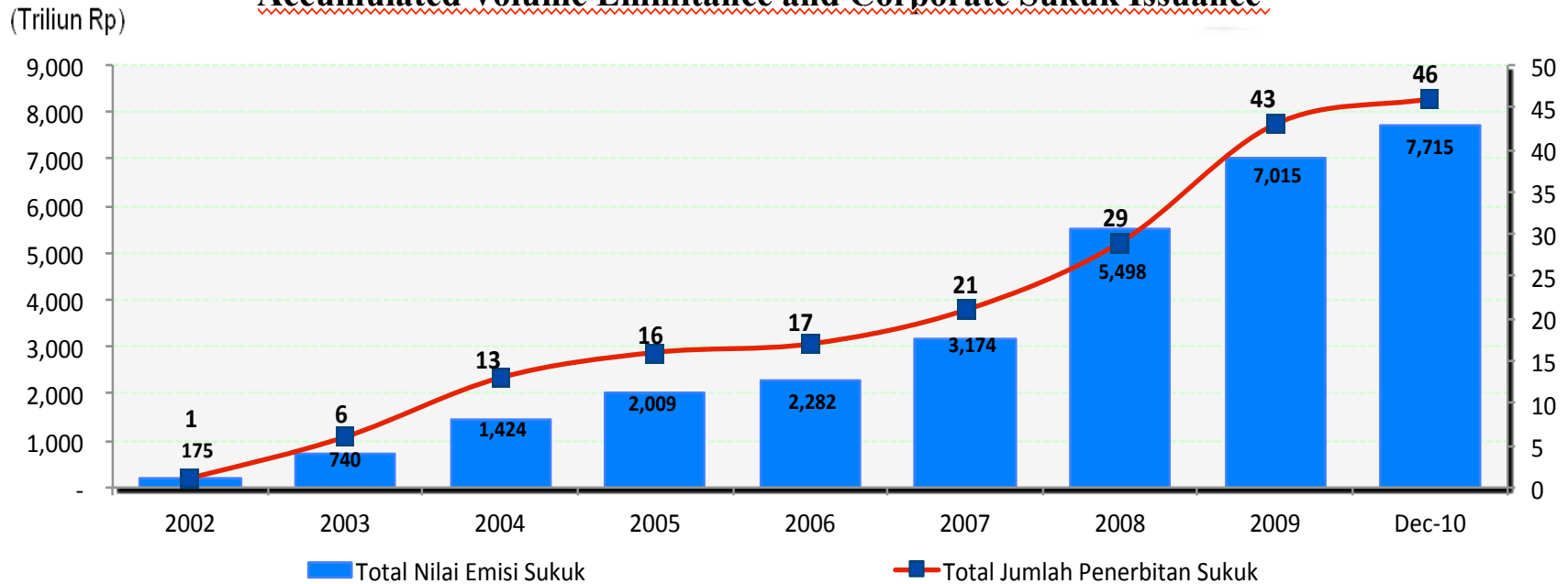
15 Shari'a Finance Companies

1 Guarantee Company

1 Mortgage Company

Indonesian Sukuk Issuance

Accumulated Volume Emittance and Corporate Sukuk Issuance

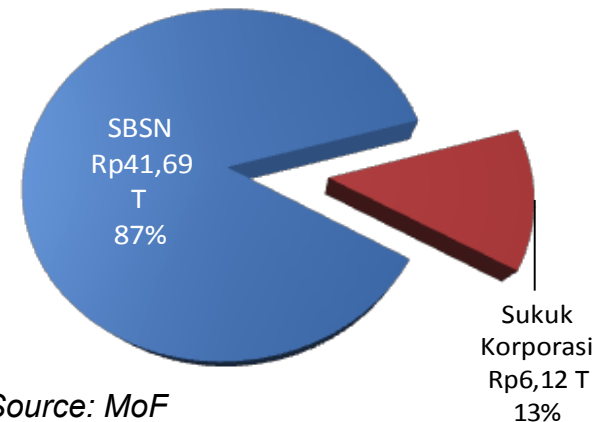


As of December 2010:

- Nominal volume of Corporate Sukuk: ± Rp7.71 triliun.
- Outstanding funds of Corporate Sukuk Rp 6.12 triliun.
- Corporate Sukuk has been paid back / reached its maturity Rp 1.694 triliun.

Source: Bapepam-LK

Outstanding SBSN Tradable & Sukuk Korporasi (per 14/4/11)



National Shari'a Finance

First Domestic
Sukuk
August 2008

- IFR-001 and IFR-002 Series.
- Oversubscribed 1.6 times from the target.
- International awards.

National
Retailed Sukuk
February 2009

- Oversubscribed 3 times from target.
- New investment alternative for individual investors.
- As of mid-2011, National Retailed Sukuk has been issued three times.

Global Sukuk
April 2009

- Oversubscribed 7 times from total issuance.
- An opportunity for the govt to diversify its investment basis and tap investments from Middle East and Shari'a investors; Middle East investors account for 30% of the total.

Sukuk *Private
Placement*
May 2009

- The first Sukuk issued with the "*private placement*" method.
- It is an innovative services using Layanan Haji (Pilgrimage Service) as the underlying assets; giving an alternative for the Dana Haji scheme undertaken by Ministry of Religious Affairs.
- Per 11 April 2011, Sukuk Layanan Haji has been issued 8 times.

Sukuk with
Auctions
October 2009

- Starting from October 2009, the govt has regularly issued Sukuk with an auction method.
- As of April 2011, the govt has issued 7 series of Sukuk under the auction method: SBSN seri IFR0003, IFR0004, IFR0005, IFR0006, IFR0007, IFR0008 dan IFR0010

Retailed Sukuk

| General Principles: | |
|----------------------|--|
| Issuer | The Indonesian government; c.q. Perusahaan Penerbit SBSN |
| Contract (akad) | Ijarah sale and lease back and others. |
| Underlying Asset | State-owned goods, government project. |
| Price Per-unit | At Par (100%) |
| Nominal | Rp 1 million |
| Tenure | 3 to 5 years |
| Buying units | Rp 5 million and its multiplication. |
| Yield | Fixed Coupon and is paid monthly. |
| Trading floor | Indonesia Stock Exchange |
| Administrative Agent | Bank Indonesia |
| Selling Agent | Selected / appointed by the government every year. |
| Characteristics | Tradable |
| Investor Target | Indonesian citizens |

Retailed Sukuk Buyers

A. Region

| No. | Description | Volume (%) | | | Investor (%) | | |
|-------|-------------------------------|------------|--------|--------|--------------|--------|--------|
| | | SR-001 | SR-002 | SR-003 | SR-001 | SR-002 | SR-003 |
| 1. | Jakarta Capital (DKI) | 53.41 | 52.32 | 41.17 | 41.53 | 41.58 | 55.40 |
| 2. | Western Indonesia Outside DKI | 42.84 | 44.19 | 52.32 | 51.65 | 52.41 | 40.33 |
| 3. | Central Indonesia | 2.55 | 2.43 | 4.62 | 4.41 | 4.40 | 2.97 |
| 4. | Eastern Indonesia | 1.11 | 1.06 | 1.89 | 2.41 | 1.61 | 1.30 |
| Total | | 100 | 100 | 100 | 100 | 100 | 100 |

B. According to occupations

| No. | Description | Volume (%) | | | Investor (%) | | |
|-------|-------------------|------------|--------|--------|--------------|--------|--------|
| | | SR-001 | SR-002 | SR-003 | SR-001 | SR-002 | SR-003 |
| 1. | Public officials | 24.61 | 11.81 | 12.77 | 11.33 | 22.06 | 22.94 |
| 2. | Private employees | 21.54 | 34.07 | 31.05 | 39.02 | 23.79 | 23.74 |
| 3. | House wives | 17.01 | 15.46 | 15.24 | 10.91 | 19.89 | 18.38 |
| 4. | Entrepreneurs | 13.88 | 23.69 | 22.91 | 16.93 | 19.00 | 19.09 |
| 5. | Army/policemen | 0.42 | 0.22 | 0.33 | 0.28 | 0.46 | 0.41 |
| 6. | Others | 22.54 | 14.76 | 17.70 | 21.53 | 14.80 | 15.44 |
| Total | | 100 | 100 | 100 | 100 | 100 | 100 |

Sukuk Negara Agents of SR-003

| SELLING AGENTS SR-003 IN 2011 | |
|-------------------------------|-------------------------------------|
| BANKS | LISTED COMPANIES |
| 1 Citibank N.A | 1 Andalan Artha Advisindo Sekuritas |
| 2 Bank CIMB Niaga | 2 Bahana Securities |
| 3 BII | 3 Ciptadana Securities |
| 4 Bank Mandiri | 4 Danareksa Sekuritas |
| 5 Bank Negara Indonesia | 5 Kresna Graha Sekurindo, Tbk |
| 6 Bank OCBC NISP | 6 Mega Capital Indonesia |
| 7 Bank Permata | 7 Reliance Securities |
| 8 Bank Rakyat Indonesia | 8 Sucorinvest Central Gani |
| 9 Bank Syariah Mandiri | 9 Trimegah Securities |
| 10 Standard Chartered Bank | |
| 11 HSBC | |

The Significance of Sukuk in Financial Market

Investment diversification, the use of new pool of funds.

- New access of global shari'a investors.
- Strategic finance with double platforms (conventional and Shari'a).

Creating Price Tension

- 80% of Sukuk is bought by conventional investors.
- The influx of Shari'a investors will create price tension between conventional and Shari'a investors. This will result in better price.

A market introduction to Middle East

- Indonesia is able to create a new profile in Middle East financial market and anywhere places in which capital moves based on Shari'a finance
- Capital market in Middle East will be an important liquidity sources for financial needs.
- It opens for various finance and investments.

Create alternative instruments for domestic market investments.

- Shari'a finance will be an important alternative instruments for domestic markets, especially, shari'a banking, shari'a bonds, and shari'a insurance (Takaful)
- Other conventional banking investors will be able to participate in the Shari'a scheme.
- It will support the success of conventional bonds, treasury bills, ORI, etc. and shari'a finance will be more interesting for retail investors.

Shari'a Finance Potentials

- It is growing fast
- Its market share has not been explored
- High demands, even from muslim minority countries
- More conventional investors are interested in Shari'a finance
- The Indonesian credit rating is gradually improved.

Challenges of Shari'a Finance Expansion

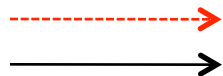
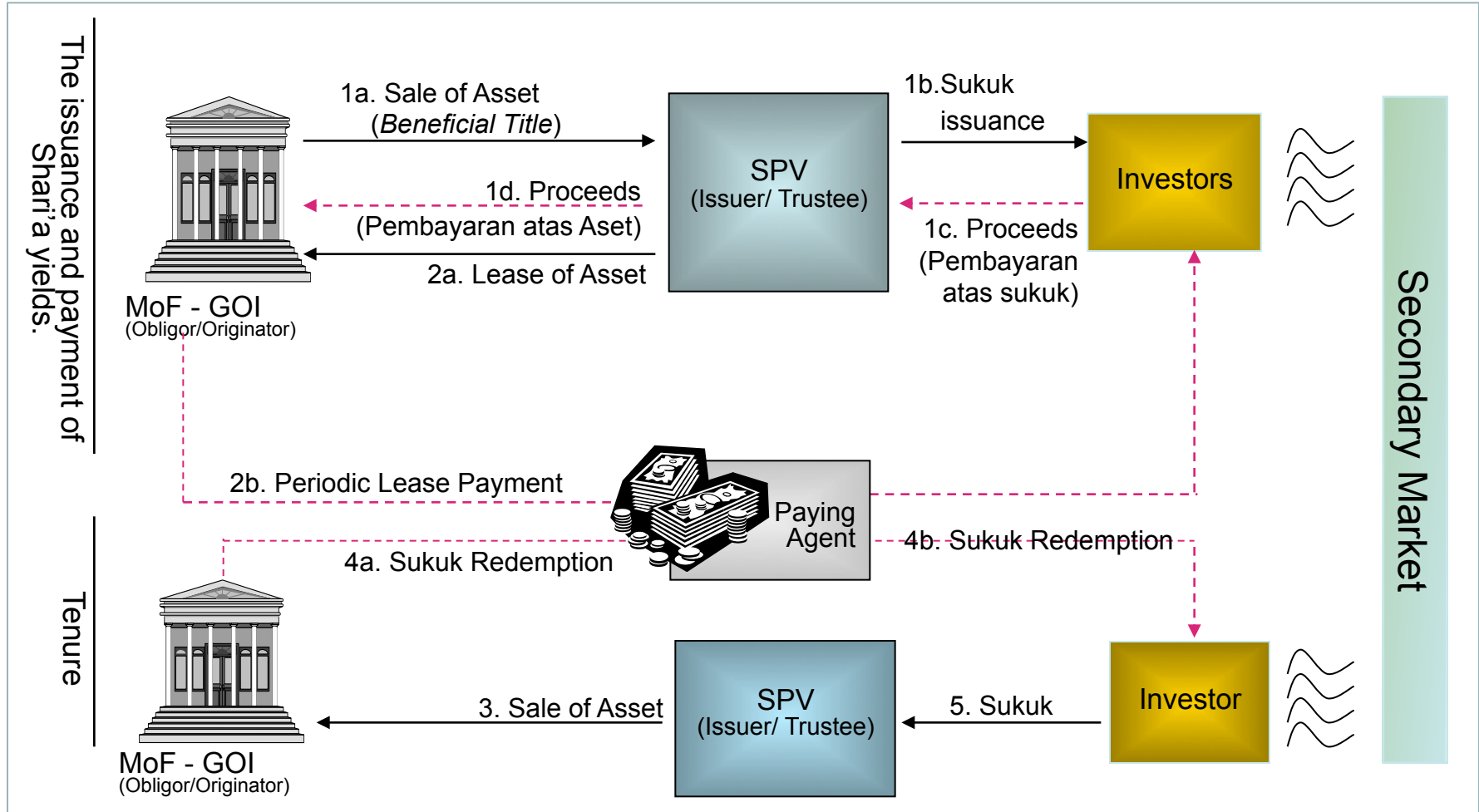
- ❑ It is relatively more complex than conventional financial systems
- ❑ Lack of public understanding about Shari'a system
- ❑ Many regulations are inconsistent and unsynchronized
- ❑ Relatively lack of shari'a investors' participation
- ❑ Unequal spread of investors throughout the country
- ❑ Requires *underlying assets*
- ❑ Under-developed market:
 - Shari'a banking liquidity in secondary market remains low
 - Habits of "*buy & hold*"
 - Islamic benchmark on finance is non-exist
 - Market infrastructure is imperfect, including those relate with transparent price discovery.

Implementing Regulations of Law No.19/2008

Ministry of Finance regulations on:

| No. | Area / Topic |
|------------------------------------|--|
| 118/PMK.08/2008 | The issuance and selling of Shari'a bonds under the method of <i>Bookbuilding</i> . |
| 152/PMK.08/2008 129/PMK.08/2009 | The issuance of Shari'a bonds in foreign currencies. Some amendments of earlier Ministerial regulation. |
| 218/PMK.08/2008 | The issuance and selling of retailed domestic Shari'a bonds. |
| 04/PMK.08/2009 | The management of Shari'a bonds for public assets. |
| 11/PMK.08/2009 | The issuance and selling of Shari'a bonds under the method of <i>Actions</i> . |
| 75/PMK.08/2009 | The issuance and selling of Shari'a bonds under the method of <i>Private Placement</i> . |

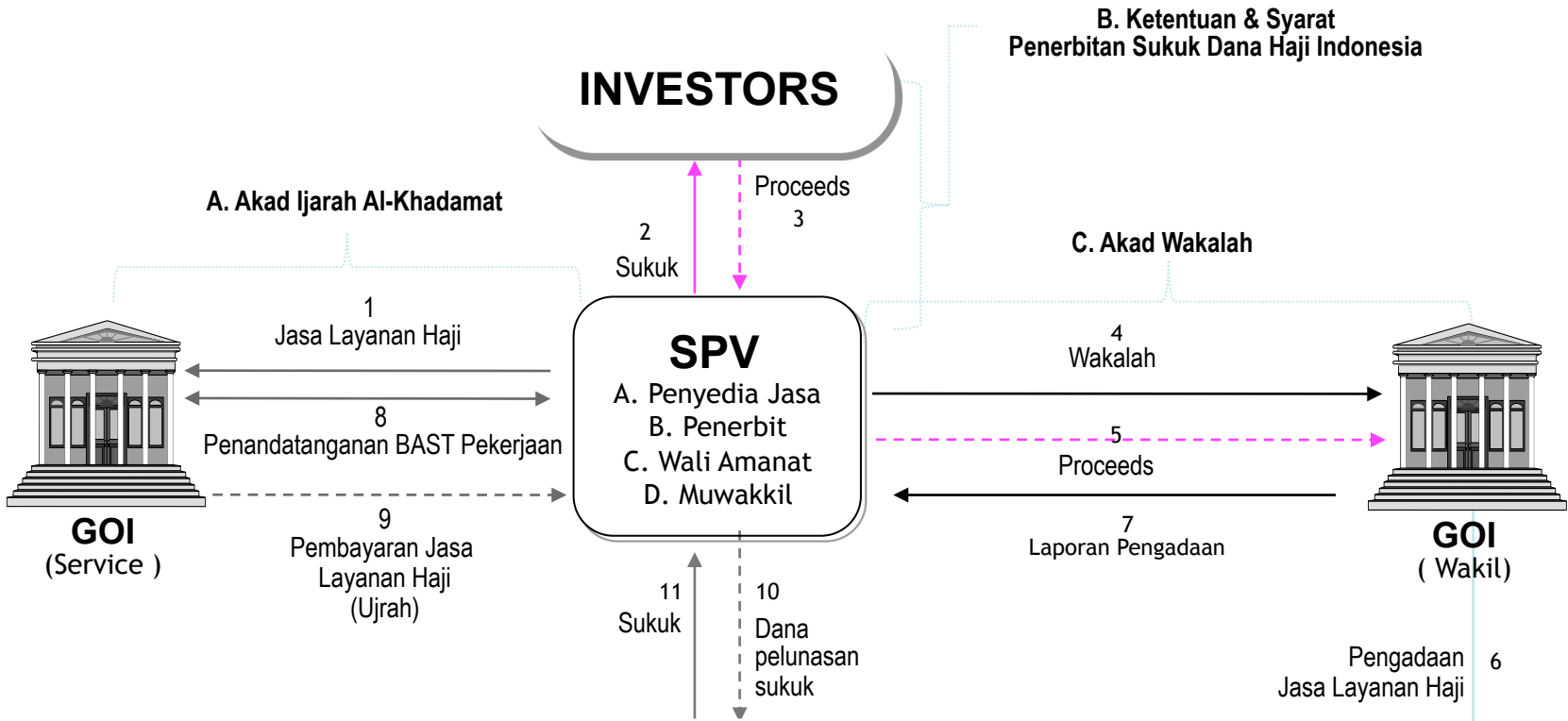
The Ijarah - Sale & Lease Back



Aliran Dana
Aliran Sekuritas /dokumen

- Ijarah Sale & Lease Back adalah Jual beli suatu aset yang kemudian pembeli menyewakan aset tersebut kepada penjual.
- Akad yang digunakan adalah akad *bai'* (jual beli) dan akad *ijarah* (sewa) yang dilaksanakan secara terpisah

The Structure of Ijarah Al Khadamat



- Ijarah al-Khadamat is a contract for services
- The *underlying assets* of Ijarah al-Khadamat is pilgrimage services, which includes air services, catering, and lodging.

Policy Issues in Indonesian Islamic Finance

1. **Moral hazard and the risk of fraud**; underreporting of profits earned by firm, moral hazard caused by risk-return sharing.
2. **Delays in payment and insolvency**; as Islamic banks do not charge interest, there will be delays in due payments.
3. **Problems with future contracts**; speculators are illegitimate, hedging might be allowed depending on contracts.
4. **Shortage of skilled advisors in Shari'a-compliance and modern banking, finance, and economics.**
5. **Problems of double taxation.** Ex: Mudaraba regulates the bank is the seller and the customer is the buyer; VAT was imposed on transactions of Mudaraba. New regulation came into force in April 2010, but some problems remain.
6. **Its effective implementation depends on trustworthy and efficient legal environment**; While the government's political will is strong, its full benefits depend on policy environment and global economic factors.

Does the “clash of civilization” hypotheses have a valid basis?

Samuel Huntington, 2008:

“Islam [...] rejects any distinction between the religious community and the political community. [...] Fundamentalist Islam demands that in a Muslim country the political rulers should be practicing Muslims, shari'a should be the basic law, and ulema should have a decisive vote in articulating, or at least reviewing and ratifying, all governmental policy. To the extent that governmental legitimacy and policy flow from religious doctrine and religious expertise, Islamic concepts of politics differ from and contradict the premises of democratic politics.”

Agenda for Joint Research?

1. How far religion (i.e. Islam) has influenced public policies in Indonesia? What policies are relevant to Islamic values (e.g. Shari'a banking & finance)?
2. Islamic values and democracy; Apart from the ideological difference between the West and Muslim countries, how do Islamic values can go along with democracy? (Case: Indonesia, Turkey)
3. Networking among Islamic countries; There's no such a thing like "Islamic world", but what are the shared values among Muslim countries?
4. Islam, nationalism and multiculturalism in Indonesia; What can we learnt and how can we assist the Islamic countries?

Thank You