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AWQAF LINKED SUKUK TO SUPPORT THE ECONOMIC DEVELOPMENT

Rifki Ismal
Dadang Muljawan
Mega Ramadhanty Chalid
Jhordy Kashoogie
Suminto Sastrosuwito

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Rifki Ismal[1], Dadang Muljawan[2], Mega Ramadhanty Chalid[3], Jhordy Kashoogie[4], and Suminto Sastrosuwito[5]

Abstract

The commercial sector has been dominating the development of the Islamic finance since its emergence. As a matter of fact, Islamic finance has a social sector that is potential to further drive the commercial sector and reciprocally has tremendeous benefits in term of societal welfare to the social sector. This reciprocal relationship could become a potential catalyst for sustainable economic development and also one of Islamic financial deepening efforts. For doing so, project based sukuk with the spirit of real sector development through social sector can be innovated. Particularly, an awqaf linked sukuk with awqaf assets as part of underlying assets is proposed to finance governmental projects and infrastructure development. This paper explores the potential issuance of the awqaf linked sukuk structured through strategic alliance across government institutions and corporates through Public Private Partnership (PPP) to contribute to sustainable economic development and social welfare. It is hoped that the realization of awqaf linked sukuk could become an impetus to the global sukuk issuance within Islamic finance landscape.

Key words : Sukuk, Awqaf, Economic development, Social sector, Governments

JEL Classification: G180

[1] Senior Economic Researcher, Central Bank of Indonesia
[2] Senior Economic Researcher, Central Bank of Indonesia
[3] Economic Researcher, Central Bank of Indonesia
[4] Economic Researcher, Central Bank of Indonesia
[5] Director, Debt Management Office, Ministry of Finance, Indonesia

I. INTRODUCTION

1.1. The Background

The Indonesian Islamic financial system has been developing significantly in the last two decades. The development takes shape in terms of business volume, financial products, and also financial sectors. So far, Islamic banking sector has been the one that takes lead and delivers products and services to the society. The Islamic capital market and takaful industry have also been in their ways to provide customers with variety of products and services. As a matter of fact, Islamic financial system has embedded elements serving low income society to obtain access to financial services that is currently away from sufficient due to the lacks of collaterals and technical capacity. One of such elements is an Islamic social sector comprising of Zakat and Awqaf sectors. According to the latest identification process by the Indonesian Awqaf Board (BWI), Indonesia has a lot of potential in terms of awqaf assets. The BWI records not less than 5 billion m^2 awqaf lands spreaded across the country. Unfortunatelly, those assets are in the state of under utilization due to the lack of proper management to make them economically productive and supportive in many economic initiatives particularly to the low income society.

Fortunately, the government has made its effort to revitalize the national awqaf system by ratifying awqaf Act number 41 of 2004. The enactment was followed by the circulation of the Government Regulation number 42 of 2006 concerning the implementation of the Awqaf Act. Those new regulatory frameworks have opened up the opportunity for managing Awqaf assets in a more productive way as long as the schemes are in compliance to the sharia principles. As a further follow-up to the effort for developing the national awqaf management in a faster and more systematic way, the government has established BWI on July 13th, 2007 standing as an independent government body. Technically, BWI was not established to take over the mandate in handling the awqaf assets from the exsiting awqaf managements (so called nadhir). Instead, the body stands to empower nadhir in many ways, including delivering programs to improve managerial capacity of the nadhirs and taking necessary steps to strengthen legal status of the awqaf lands in which some of them are not in legally secured position. In a wider extent, the mandate could also be enhanced to cover the regulatory and supervisory aspects to ensure that the system could perform on its best to deliver more benefits to the society. Those benefits can be delivered in many ways including educational supports (programs and infrastructures), health services, and lumpsum capital supports. In a more advanced way, those facilities could also be provided in combination with other services by other Islamic financial sectors such as banking and zakat.

In its early stage of development, the awqaf sector needs new thoughts to develop. A constructive collaboration among the stakeholders is worth considering. This paper explores the possibility of structuring a financial contract involving government related institutions (Ministry of Finance and BWI) to issue sukuk based on awqaf land for the underlying asset. Ministry of finance is, in fact, in a pivotal position in promoting the initiative considering its current roles in sovereign sukuk issuance; whilst, BWI has an arm-length to awqaf assets. Lastly, the central bank and the Indonesian financial service authority (OJK) have a role to allow tradability of such a "proposed" sukuk in the secondary market to deepen the Islamic financial market. The arrangement of financial contract proceeds under the following assumptions:

- The government may use *awqaf* land for infrastructural development intended for delivering benefits to the wider society. A minimum legally binding period should be determined to ensure that the objective of the program is well achieved.
- Since the project is intended to provide benefit to the society, it can be considered as a government program classified under the state budget (APBN). In order to attract economic entities (including investors) to deal and invest in this sukuk structure, the monetary and financial regulators may arrange its liquidity, marketability, and tradability in the secondary market. Then, a technically professional team will be dedicated to takecare the mandate to activate the proceeds which starts from the preparation of prospectus to the project operations[6].
- The government, society and BWI will be the beneficiaries of this Awqaf linked sukuk project.

[6] The structure of sukuk can be arranged in combination between commercial (tijari) and non-commercial (tabbaru) schemes.

This collaboration benefits not only the stakeholders of the Islamic financial system but also the society in general.

- BWI – This initiative may trigger a snow ball effect in developing other awqaf assets. Financially, the BWI would get more financial resources to push the development of the Awqaf sector much faster.
- Government – An effective and efficient collaboration in awqaf assets which serve as low-cost assets (no acquisition cost is required) would save a lot of government financial resources whilst keeping the same level of benefits to the public.
- Financial market regulators and players – A lot more of instruments can be created based on the vast amount of awqaf assets. The creation of more instruments could promote financial deepening in the Islamic financial market. With a deeper financial market, the Central Bank could also conduct monetary operation based on the financial instruments available in the market.
- Society – The low-income society would enjoy more facilities in many ways.

1.2. Research Objectives

The research is aiming at achieving the following objectives:

a. To analyze the possibility of altering the usage of awqaf assets based on the mandate stated by the asset provider (waqif) to a more prospective economic arrangement without violating the sharia principles.

b. To analyze the possibility of up-grading the status of awqaf projects to sovereign so that financial resources can be mobilized through government vehicles.

c. To construct possible Islamic financial structure linked to awqaf assets which are applicable to a potential-sovereign sukuk issuance.

d. To explore the potential of utilizing the proposed sukuk structure in deepening the Islamic financial market and in altering the Central Bank monetary instrument.

1.3. Scope of Discussion

This research captures the methods of developing of awqf assets in both terms (fixed and non-fixed assets). The analysis covers the following areas: (i) the properties of awqaf assets (types, terms, and its legal aspects) in relation to government linked sukuk issuance, (ii) the potential structures of sukuk issuance and, (iii) potential use of sovereign sukuk in monetary operation and financial retrenchment.

1.4. Methodologies of Discussion

The research combines qualitative and quantitative analysis. The former uses comparative analysis when developing arguments in the areas of legal framework, relevant financial regulations, effective awqaf management, and financial market (its tradability in the Islamic financial markets and awqaf linked sukuk structure). The arguments are built through series of interview and focus group discussion with relevant stakeholders such as the Indonesian FSA (OJK), the national sharia board, and the Ministry of Development Planning. Whilst, the latter engages with financial simulations which represents the viability of the proposed structures.

II. LITERATURE REVIEW

2.1. The Economics of Awqaf

In literal way, *awqaf* means hold, confinement or prohibition or forbidding movement, transport or exchange of something (Raissouni, 2001:13). Traditionally, awqaf[7] is defined as holding an asset transferred by an asset provider (waqif) and delivering its usufruct to the benefits of the public. A variety of awqaf definition exists in Islamic economics literatures with the samples as follows:

a. "An awqaf known in English also as an 'Islamic trust' or a 'pious foundation' is "an unincorporated trust established under Islamic law by a living man or woman for the provision of a designated social service in perpetuity" (Kuran, 2001: 842).

b. *"Waqf* may be defined as "holding a *Maal* (an asset) and preventing its consumption for the purpose of repeatedly extracting its usufruct for the benefit of an objective representing righteousness and/or philanthropy" (Kahf, 1998: 4).

c. "The definition of *waqf* by Ibn Qudama: *Waqf* means bequeathing the property and dedicating the fruit" (Raissouni, 2001: 14).

The mandate of awqaf management assets is commonly held by the nadhir permanently until the asset lasts or in the perpetuity manner to produce economic benefits to the societal welfare. In the traditional *awqaf* practices dated back to the Ottoman Empire era, cash waqf is commonly practiced as a form of investments whereby the principal funds are continuously invested in potential investment opportunities. In its role as *awqaf* fund investment manager, the *Mutawalli*/*Nazir* on behalf of *awqaf* institution may allocate some *waqf* funds to direct investment, financial portfolio, and finance SMEs' businesses on the basis of the profit-loss sharing system. The larger the investment returns, the more funds that can be allocated to poverty alleviation programmes (Masyita, 2001, 2007).

Within the Islamic socio-economic framework *Cash-Waqf* is a source of social fund that can accumulate and redistribute money. There are any differences between the management of Western foundations, charities or donation funds such

[7] The term of Awqaf was literally derived from Wuquf which means stands still or remains. The term was then absorbed into the financial term to represent the responsibility of an economic agent to maintain the value of the mandated asset.

as Ford, British Trust, Rockefeller, Carnegie and the management of *Cash-Waqf*. *Cash-Waqf* has a principle of perpetuity that makes it different from a western endowment or charitable funds. The perpetuity principle means that the principal of *Waqf* should be preserved and the benefits of *Waqf* portfolios should be available for religious, philanthropic and righteous purposes (Masyita, 2007).

In the current contemporary practices, cash waqf practice is still inherent with a modern awqaf asset management yielded for various investment purposes such as real estate, school buiding, and hospital. An awqaf asset management can be illustrated as in **Exhibit 1** in which an awqaf asset is originated when a waqif transfers his asset that is in his real possession to an awqaf manager (*nadhir*) accompanied with specific prescription to manage the asset.

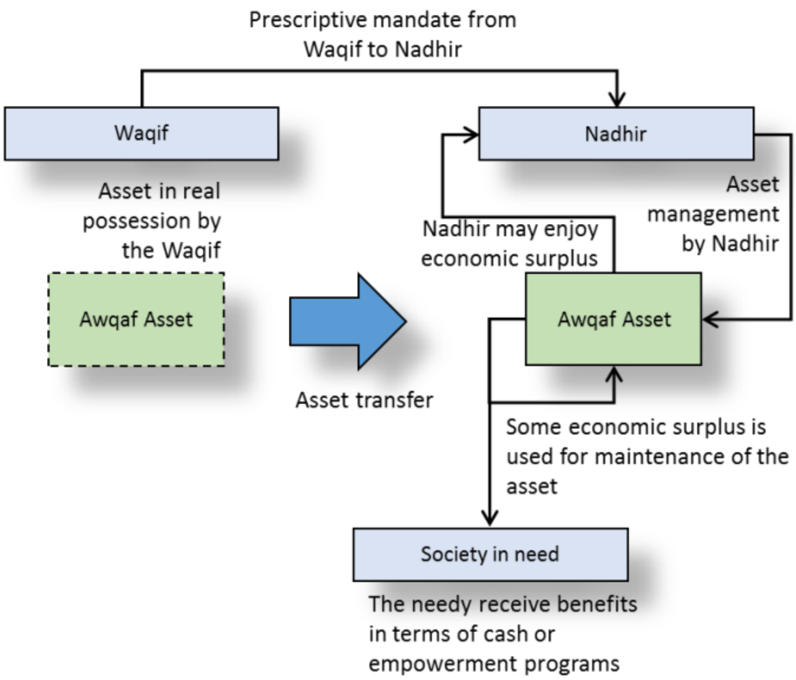


Exhibit 1. Awqaf Arragement

As from *shari'ah* point of view, the intention (*niyyah*) of the waqf contract has to be expressed for charitable purpose (*tabbaru'at*) instead of commercial purpose (*tijari*). Any economic excess generated from the awqaf assets is solely meant for the society welfare[8]. The nadhir should technically be able to maintain

[8] Income generation from the Awqaf asset is also exempted from tax payable income since the financial benefits will be recycled to the benefits of the public. This is similar to the

the value of the assets mandated to them from the waqif in a good trust and manage the awqaf assets to generate economic gain out of the awqaf assets. Thus, as the implication, the waqif is not entitled any return from the gain generated by the Nadhir out of the awqaf asset management and the nadhir is only entitled to certain percentages of management fees. If the awqaf assets generate income, that economic surplus will be distributed to 3 main recepients or objectives (*mauquf alaihi*). Those are the nadhir, payment for the asset maintenance cost, and the society in need as the main recipients. The nadhir may want to determine the terms of benefits to be allocated for the needy. It may be in terms of cash or programs to assist them depending upon what is required most.

In most occasions, the awqaf asset transfer was restrictedly understood and limited to relatively non productive assets such as cemetery and mosque[9]. As a matter of fact, the use of awqaf concept in supporting the education system was a common practice during the periods of caliphs (Cizakca, 1998). Many of lands and school buildings were granted by prominent persons in terms of awqaf assets. This practice had allowed the Islamic schools to provide non-profit oriented education programs.

The attempts to revive this practice in the modern context have started to emerge leaving the opportunities to deliver beneficial programs particularly for low income society. The programs include education program (low-cost schooling), health services (free health program), housing program for the needy (transfer house), and other low-cost social programs. Recent developments in awqaf asset management have also shown significant innovations. Combinations of activities in the Awqaf premises are structured to allow income generation from the awqaf assets without loosing its puspose to perform worshiping activities[10].

treatment of the profit generated from the foundation whose shareholding is owned by the public.

[9] Income received was based on charity by the people who came to the mosque to pray and the fees given by the ones whom the members of their family rest in the Awqaf premises. The fee is made voluntary without concerning about the expenses spent by the caretakers to keep the areas clean and well functional.

[10] The alteration of the activities in the Awqaf assets is processed after getting the approval from the sharia council to assure sharia compliance. The sharia council would normally conduct a thorough analysis to study the impacts resulted from the proposed alteration. If the analysis indicates more benefits to disbenefits, the alteration may proceed. The analysis involves not only the sharia compliance components but also the economic considerations.

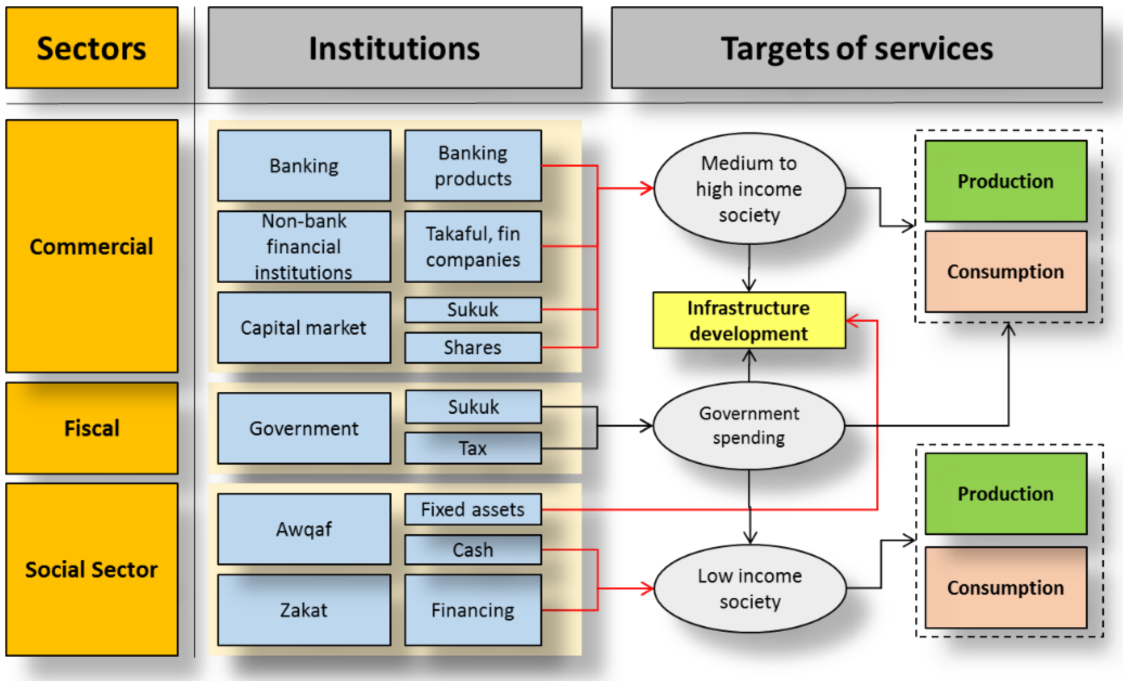


Exhibit 2. Awqaf System in The Islamic Financial Landscape

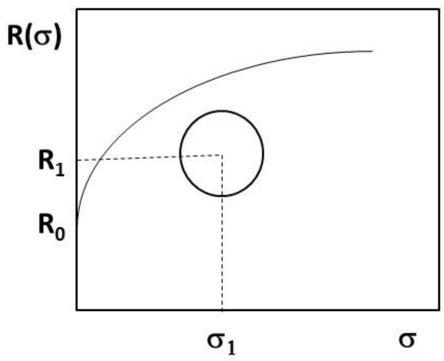
Systemically, awqaf sector is a part of the Islamic financial system that stands to serve all segments in the society as illustrated in **Exhibit 2**. The commercial sectors that ~~consists~~ of Islamic banking, capital market, and takaful ~~exists~~ to entertain high to medium income society by providing fully commercial based financial products and services. The fund mobilized is channeled for various purposes surrounding the production and consumption activities and also infrastructure development. The government, in turn, could also mobilize funds through tax collection and also government sukuk issuance to finance the expenditures (general expenses and infrastructure development). The Islamic social sector which consists of zakat and awqaf exists to serve the low income society by providing them with low-cost economic programs. The programs may cover basic consumption[11], business incubation program, health services, education program[12], and so forth.

From the macroeconomic point of view, the Islamic social sector can be viewed as a vehicle that is suitable to complement the government efforts in poverty alleviation initiatives. The awqaf assets are beneficial in many ways as follows:

[11] Consumption may be provided for ever-green recipients (economically disable persons) and temporary supports to somebody under the economic enhancement program.
[12] The funds may be used for direct consumption program (financial subsidy for paying the expenses of the services or developing the infrastructure that is used to provide the services such as school building and hospitals).

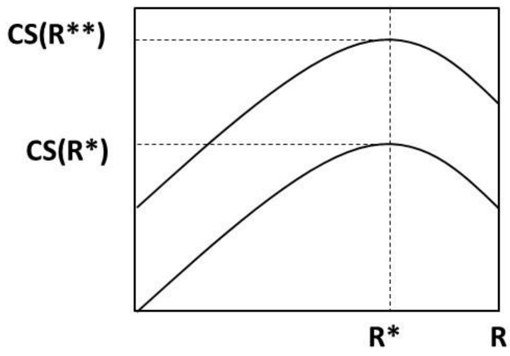
a. Infrastructure – the awqaf assets can be used to support the society in sustaining economic activities of a group of society that has not achieved a critical mass in production. The production cost can be brought to the level of economic competitiveness when it is offered to the market.
b. Low cost funds – the excess returns of the awqaf assets can be used in flexible ways to support the economic develpment of the low-income society.
c. Underlying/basis of Islamic securities – the awqaf assets (particularly lands) can be the financing object or underlying of Islamic securites (particularly sukuk) issuance for the social projects.

The benefits mentioned above are economically beneficial to widen the production base of a country; thus, strengthening the economic stability nationally. **Exhibit 3 (a)** illustrates the role of the Islamic social sector in providing investments to the 'sub-optimal' investment portfolios[13] (R_1, σ_1) to later on standing in the efficient frontier line with higher return (Rσ) and more contribution in the economy.



Sources: Chi Fu Huang (1991,Modified)

Exhibit 3. a) Position of Zakat and Wakaf in efficient frontiers



Sources: Chi Fu Huang (1991,Modified)

Exhibit 3. b) The role of Zakat and Wakaf in credit supply[14]

[13] In the commercial context, the investments take place in the economic efficient frontiers striking the balance between risks and returns that is specific to every financial market. The portfolio selection is then structured based on the principle of profit maximization to entertain the capital holders. In reality, certain groups of people could only offer sub-optimal set of investment portfolio. These groups of people are the recipients of government subsidy in the financial inclusion program.

[14] Stiglitz et.al (1981) conceptually illustrated the backward bending credit supply curve as a result of rational response of credit suppliers to minimize the potential of facing moral hazard. The higher the difference of returns offered by the entrepreneurs to the expected real returns, the higher the banks will face problem loans due to adverse selection problem.

Holding the market economic rate the same (R*), the presence of zakat and awqaf funds is opening the opportunity to increase credit supply to the society (from CS(R*) into CS(R**)) without necessarily increasing the potential of moral hazard since the facility is availed through dedicatedly designed contracts and zero cost of funds (see **Exhibit 3(b)**)[15]. The economic system would then have a chance to thicken the financial cushion to secure the economic production in normal time as well as financial distress.

2.2. Sukuk Development as Sources of Funding

2.2.1. Sukuk Development in Islamic Capital Market

Islamic Capital Market (ICM) has a long term objective to mobilise and allocate resources in an effective and efficient manner. This long term objective can be achieved through a real sector development financing. Within ICM landscape, Sukuk[16] is deemed as a financial instrument to fund specified projects and also liquidity management instrument. Sukuk structure with a variety of Islamic financial contracts as classified by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has evolved from traditional structure through attempts to innovate on sukuk so as to gain popularity in Islamic financial market. Tariq & Dar (2007) gives the exemplary of an attempt for sukuk innovation, which is as follows:

1. **Hybrid/Pooled Certificates**
   These are certificates based on an underlying pool of assets, including *istisna'*, *murabahah* receivables, and *ijarah* with the condition that at least 51 percent of the pool comprises *ijarah* assets. The return on these certificates can only be a pre-determined fixed return.
2. **Variable Rate Redeemable Certificate**
   This type of *sukuk* can be called alternative *sukuk* due to its seniority to issuer's equity, their redeeming nature and their relative stable rate as compared to dividend payouts. The return on these *sukuk* is benchmarked to market references, such as LIBOR.

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[15] The market determines the optimal returns to the corporates based on the best likelihood that the capital holders believe to materialize.
[16] *Sukuk* plural; singular *sak* are defined by the Accounting and Auditing Organisation for Islamic Financial Institutions ('AAOIFI') as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services or (in the ownership of) the assets of particular projects or special investment activity" (AAOIFI 2003, p.298).

3. **Fixed-Rate-Zero-Coupon Certificate**

   These certificates are non-tradable certificates based on an underlying pool of assets, primarily *istisna'* or *salam* that would create debt obligations.

In this regard, *sukuk* are expected to play an important role for smoothing liquidity and resource mobilisation in ICM. Besides, *sukuk* are potential financing instrument for contributing country's economic growth through real sector development initiatives (Nazar, 2015).

2.2.2 Evolution of Sukuk Structure Development: Asset Backed Vs Asset Based Vs Asset Light Sukuk

According to IFSB guidelines (2005) No. 2, *sukuk* are ideally categorised as asset-based and equity-based instruments whereby the former offers fair and predictable return, such as in the case of *salam*, *istisna'*, and *ijarah* whilst the latter the return is derived from profit-loss sharing of joint venture business, which offers unpredictable return, based on *musharakah* or *mudharabah* contracts. Since there is deviation in the actual implementation of *sukuk* from ideal theoretical ground of *sukuk*, there has been concern to categorise *sukuk* in order to differentiate genuine and non-genuine ones, particularly risk factors and sale execution. In this regard, the guidelines of *IFSB 7-Capital Adequacy Requirement for sukuk, Securitisations, and Real Estate Investments* (2009) distinguish three types of *sukuk* structures, which are Asset-Backed *sukuk* ('ABS') and two non-ABS structures, which are pay-through and pass-through structures.

According to these particular guidelines, ABS are "structures that meet the requirement for being an asset-backed structure as assessed by a recognised external credit assessment institution (i.e. rating bodies)" (p.3). Based on this guideline, there are two factors that constitute ABS. Firstly, in the case of any impairment of the *sukuk*'s assets, the *sukuk* holders have to face the loss. Secondly, the risk factor of ABS is the underlying assets of *sukuk*. Therefore, *sukuk* holders derive the risk and return from the cash flows of the *sukuk*'s underlying asset as well as have recourse to the *sukuk* asset, not the issuer, in case of default of *sukuk* issuer. True sale execution is another dimension of ABS in which there is a real transfer of assets from the originators to *sukuk* holders with the effect of releasing assets from the issuer's balance sheet to investors (Ahmed, 2010). Therefore, ABS issuance must be backed by real assets that represent the *sukuk*'s ownership as well as risks attached to the assets.

ABS structure is akin to the concept of securitization in therm of risk assement and management, whereby ABS has an alternative for capital market-based refinancing mechanism to diversify external sources of asset funding instead of intermediated debt finance based with special emphasis on the risk assessment of securitised assets (Jobst, 2006). Effective risk management and capital enhancement are great advantages of asset securitisation, since there are lower costs and risks emanating from asset securitisation than contractual loan relationships (Shaenker & Colletta, 1991; Dvorak, 2002).

In contrast, with asset-based *sukuk*, there is no true sale transaction taking place, rather one sees just transfer of financial rights to the asset and the income is derived from the financial rights to obligations attached to the debt (Aziz & Gintzburger, 2010, p.276). True sale transaction is absent since the *sukuk* holders have recourse to the originator instead of the underlying assets in the event of default. This is based on pay-through and pass-through as defined in IFSB-7 (2009) guidelines, in which the former constitutes recourse to the originator via purchase undertaking whilst the latter constitutes recourse to the issuer via guarantee. Therefore, the risk and return of asset-based *sukuk* are derived from the obligor instead of the *sukuk*'s underlying assets so that in case of default investors have recourse to the obligor and secured creditors cannot claw back the asset.

The risks are measured solely on the issuer/obligor's creditworthiness to pay back the capital. Thus, it is not surprising that investors are mainly focused on sovereign/corporate credit quality and less concerned on the actual underlying asset performance when they buy sovereign *Sukuk* (Hales, 2005). In this regard, *sukuk* holders are guaranteed to get the capital back in the event of bankruptcy. Furthermore, in asset-based *sukuk*, the structures are merely fulfilling the form of a contract with much more complexity, which ultimately leads to Islamic equivalent of unsecured conventional bond (Howladar, 2009).

Even worse, as (Haneef, 2009) argues that there is an emergence of asset light sukuk whereby the features are similar with asset based sukuk structure with less than 30% are the physical asset to fulfill the requirement for asset backed sukuk issuance. This is due to the fact that many corporates in expansion phase are absent with physical assets to fulfill the financing requirement. Hence, such asset based and asset light sukuk issuance, *sukuk* holders would only be able to dispose of the assets to the lessee and be treated as unsecured creditors or ranked *pari passu* with other unsecured creditors. In a nutshell, the difference of asset backed, asset based, and asset light sukuk can be summarised in the **Table 1** below:

Table 1. The Difference of Asset Backed, Asset Based, and Asset Light Sukuk

No.	Sukuk features	Asset backed	Asset based	Asset light
1.	Presence of right to sukuk asset	Present	Absent, as recourse to the guarantor	Absent, as recourse to the guarantor
2.	Risk and return	Deriving from the real asset performance	Based on the guarantor's performance	Based on the guarantor's performance
3.	Presence of true sale transaction	Present	Absent	Absent
4.	Presence of guarantee	Absent	Present	Present
5.	Asset composition	Highly dominated by real assets	Highly dominated by real assets/with mixture of financial assets	Highly dominated by financial assets

Source: Reviewed from Jobst (2006), Howladar (2009), Haneef (2009), Ahmed (2010), Nazar (2015)

2.2.3 Asset Backed Ijarah Sukuk Structure

In spite of the debate regarding the authencity of sukuk structures: asset-backed sukuk vs asset-based sukuk even vs asset-light sukuk, sukuk is on its trajectory to serve its ideal purpose of funding the projects (project-based sukuk). The structure of sukuk that fulfills Shariah requirement is asset backed/project based sukuk that possesses real assets in yielding returns to the sukuk holders. The most common and renowned structure for project-based sukuk prevalent in the market is sale and lease-back (*ijarah muntahia bitamleek*) sukuk with the structure presented in **Exhibit 4** below:

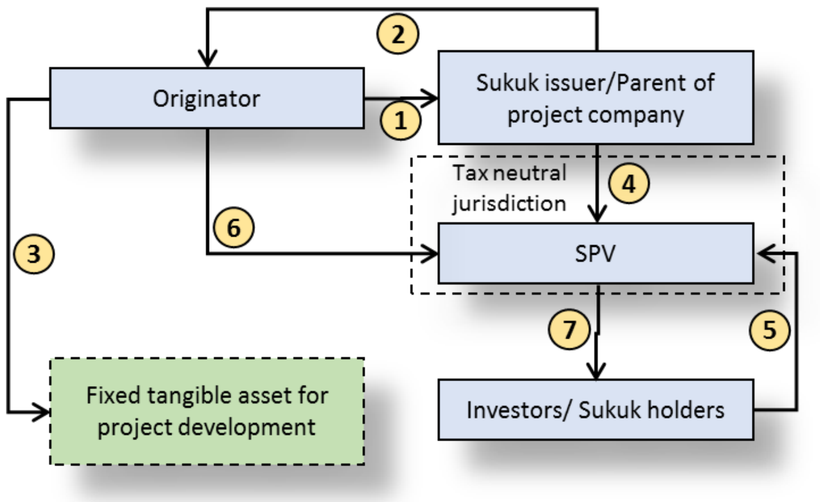

Exhibit 4. Structure of Sukuk: Ijarah Based Sukuk

Originator sells fixed tangible asset aimed for project development worth certain values of money to the sukuk issuer (see **Exhibit 4**);

1. The fixed asset is offered / to be transferred to the parent of project company.
2. The purchase price is paid to the originator based on certain values of money as agreed ex-ante of the contract;
3. The originator initiates the project development with its fixed tangible asset;
4. The SPV, usually established in tax neutral jurisdiction, passes through the beneficial ownership of the fixed tangible asset to the issuer,
5. The investors/lessors secure ownership of the fixed tangible asset represented in the *sukuk*,
6. The originator passes all the proceeds to the SPV,
7. Finally, the SPV distributes all the proceeds to the investors/lessors. By the end of the tenure of contract indicated by the completion of the project, the ownership of fixed tangible asset is transferred back to the originator.

This project-based sukuk based on *ijarah muntahia bitamleek* contract still poses to financial risks (credit risk and market risk) to represent equivalent counter values in Shari'ah (*iwadh*) as well as fiqh maxims in which returns are justified by considerable risks (*al-ghurm bi al-ghunm*). The ideal risk factors of the structure are classified as follows:

1. The sukuk should not be guaranteed by, or, be the responsibility of any entities.
2. The recourse of the secured parties is limited to the assets and rights to which the sukuk holders are entitled.

3. The risks of assets depend on the economic values of the fixed tangible asset.
4. On the enforcement side, the ability of the issuer to repay the sukuk holders is dependent upon the performance of fixed tangible assets and rights to effect the repayment.

2.2.4. Historical Development of Sukuk in Indonesia

Government of Indonesia carefuly develops sukuk as one of the government financing instruments. Starting 2008, when Act No. 21 year 2008 on sukuk was issued and implemented, government initiated the issuance of Fix Rate (IFR) Sukuk and a year later (2009) the issuance of retail Sukuk, Global Sukuk (SNI), and Pilgrimage Sukuk (SDHI) complemeted government sukuk in the domestic Islamic capital market. The latest one was in 2011, when Treasury Notes Sukuk (*Sukuk Perbendaharaan Negara Syariah* or SPN-S) and Project Based Sukuk (PBS) were introduced and transacted in the domestic market. The ongoing ones are the Islamic saving bond and, buy back and switching Sukuk which are about to be released soon. The advantages of the government sukuk (SBSN) are: (i) the sharia compliant Islamic financial markets, (ii) tax incentive for the issuance (tax neutrality) and lower income tax for the investors, (iii) more flexible in managing portfolio investment, (iv) larger potential investors (domestic and overseas), (v) transparant information, and (vi) guaranteed by the government (low and event zero risk). While the disavantages of SBSN are: (i) the volumes, issuances, and variances are still very limited, (ii) it is still limited to fulfill the demand for financing the government projects in the state budget, (iii) there is no pricing benchmark so far in the market and, (iv) limitation for the central bank to invest (purchase) SBSN for the sake of Islamic monetary instruments. **Exhibit 5** illustrates the development of the Indonesian government sukuk in the last 4 years.

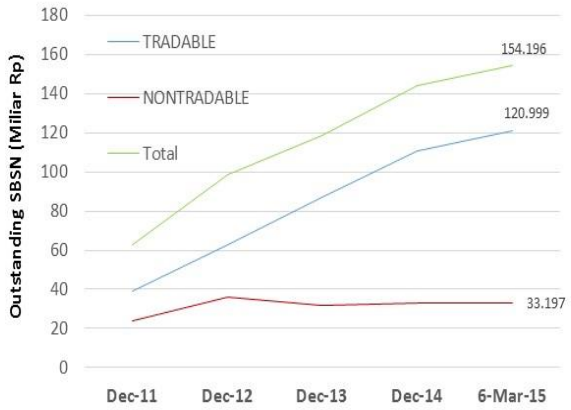

Exhibit 5. The Indonesian Government Sukuk

In relation to the central bank activities, based on Act number 1 year 2004 on the government treasury, government sukuk is the Islamic securities available to be used as the Islamic monetary instrument (for either monetary contraction or expansion) and, to deepen the Islamic financial markets by trading and increasing participation of domestic investors. Practically, the investors can purchase sukuk in the primary or secondary markets and trade it in the secondary market (Islamic capital or money markets) for the purposes of liquidity, switching the ownership of sukuk, or trading for capital gain (profit). As such, more sukuk being issued by the government, corporates including state owned companies, more liquid the Islamic financial markets. Moreover, it assists the liquidity management of Islamic financial institutions, provides fundings (source of funds) for financing various government projects.

Currently, the most active Islamic money market instrument is only the Interbank Mudarabah Investment Certificate (SIMA), hence sukuk in the Islamic money market plays an important role to deepen the market. Besides, available to be traded among banks, sukuk (especially government sukuk) can also be repurchased (repo) to Bank Indonesia and on the other hand, Bank Indonesia is also allowed to utilize government Sukuk (SBSN) for Islamic monetary instrument by applying a reverse repo SBSN transaction.

Based on Act No. 19 year 2008, asset of SBSN can be a financing object of SBSN and/or the state asset having economic value (land and/or building). Thus, the main purpose of SBSN is to finance the government projects (Act No. 19 year 2008) with the issuance coming from the government or the issuer of SBSN certificate. In this case, Ministry of Finance determines composition of the government bond (including Sukuk) in the local or foreign currency and other related procedures. Similar vein in other countries, the development of the Islamic capital market in Indonesia is led by the issuance of government sukuk. Initially, those issuances were aimed at financing the state budget deficit[17]. After a certain series of issuances, the government has started to direct the sukuk issuance to the real project development.

[17] The allocation of funds mobilized from government sukuk issuances to finance state budget deficit has created critics from a number of ulemas. The ulemas are of a view that thoses fund mobilization through sukuk issuance should have clear invesment objectives.

III. APPLICATION OF AWQAF IN MODERN TIME – A NEW VENTURE IN FINANCIAL MARKET

3.1. A Proposed Structure of Sovereign Sukuk Linked to Awqf Assets

A modern interpretation of awqaf allows temporary transfer of assets to attract more Awqaf assets that could be used for charitable and social purposes. A further development also takes place in terms of the types of objects which allow the classification of financial assets as awqaf assets which can be securitised for the issuance of waqf-based sukuk. The spirit of waqf-linked sukuk is similar with project-based sukuk whereby the issuance of sukuk is intended for real economic sector development. The waqf-linked sukuk can be utilised for two purposes as follows:

- The origination of commercial based sukuk (corporate or government) for awqaf land development. This arrangement can serve as a vehicle for resource mobilization.
- The use of awqaf assets as the undelying assets or object of financing in sukuk originations.

Those purposes are based on the paramount priority in the Islamic economic system through upholding real sector development through a spirit of sharing risks and rewards and interaction between the real and financial sectors. In particular, the real sector gives the real resource inputs (land and labour) for investment purposes in the financial sector, and reciprocally the capital generating returns from investment in the financial sector to be contributed towards real sector development. Furthermore, *al bay* (exchange of money for goods or services) counter value exchange is a vital value in the Islamic economy, which promotes healthy economic growth in the economy. Since waqf-linked sukuk is akin to asset-backed *sukuk* which is embedded with real assets in *sukuk* issuance through a true sale transaction, it is expected that waqf-backed *sukuk* can be an ideal form of governmental fiscal financing to stimulate economic growth reflected in GDP growth in the economy through emphasis on the real sector. In this regard, sovereign waqf-linked *sukuk* are structured for extending the financing to various real sectors such as infrastructure development on the waqf land, establishment of education institutions, helping Ministry of Religious Affairs for projects to accelerate societal welfare, and so forth.

In this way, the value of the *sukuk* moves upward in tandem with the goods and services traded in the economy. This would have significant economic implications in the economy, as this sovereign waqf-linked *sukuk* issuance would push unutilised private investment to drop from the shelves, healthy fiscal policy whereby government expenditure is attached with real sector development. Consequently, waqf-linked *sukuk* issuance would stimulate the healthy economic growth associated with balanced capital formation and the special attachment to the real sector. By this approach, sustainable economic development can be realised. Apart from the issuance of sovereign waqf-linked sukuk can be beneficial for healthy economic growth, the development of Awqaf linked financial instruments could provide benefits in the Islamic financial market as follows:

- Awqf based Sukuk can become another investment alternatives (for potential investors) in the Islamic capital markets.
- Awqf based Sukuk can contribute in deepening the Islamic capital markets.

In order to sucessfully realize the idea of Sukuk-linked awqf, the related parties have to consider productive awqaf as the underlying of the instrument. Usually, the awqf assets take a form of unutilized land or building located in strategic areas (center of the city, etc) or productive areas (agriculture lands, etc). These assets, upon valued by the Sukuk asset approval, are very potential and attractive to be underlying of Sukuk asset or object of financing of the government sukuk. In Indonesia, awqaf assets are recorded 4.2 billion meter square in 42,300 locations around the country and amounted Rp350 trillion (USD35 billion). In addition, assuming the modern approach of awqaf, those awqaf assets can be utilized by using Sukuk particularly government sukuk for certain sectors such as education, social infrastructures, health services, etc. Because the awqaf assets are productive, not only can sukuk deepen the Islamic financial market but also give multiplier effects to other aspects. For examples are labor intensive, community development, SMEs and related industrial/manufacturing industries.

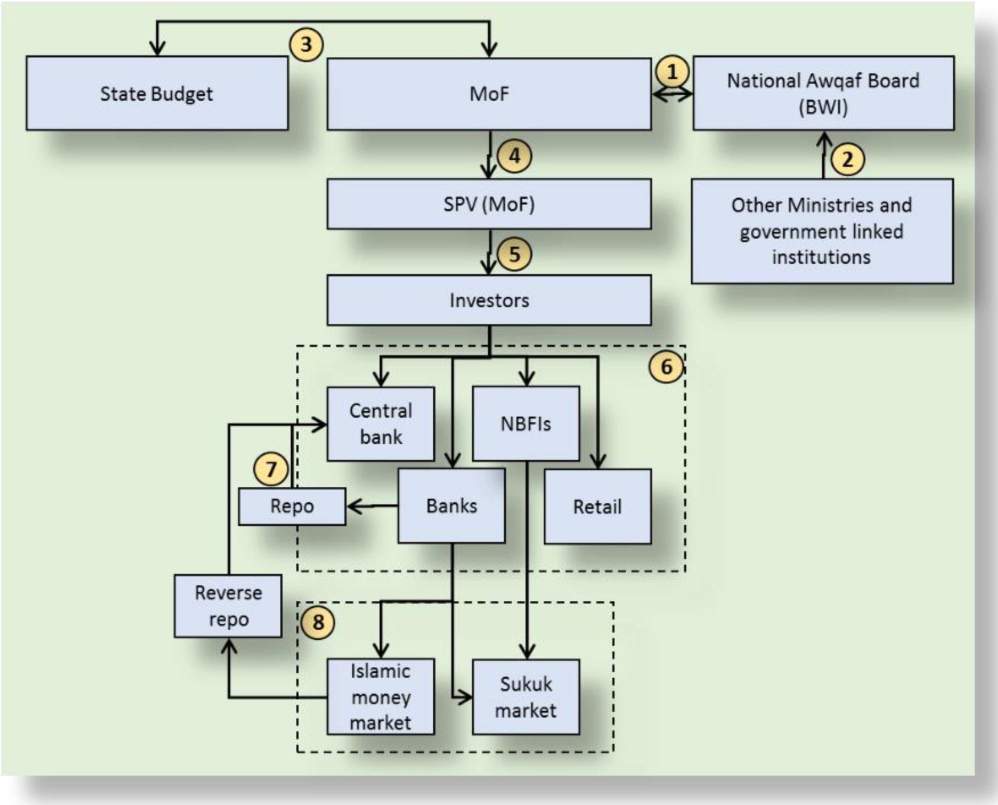

Exhibit 6. Potential Origination of Awqaf Linked Sukuk

Technical preparations need to take place such as:

(i) well-administered awqaf assets (its legality, utilization right and other aspects related to land employment and transfer of ownership from awqaf doner to awqaf management),

(ii) have a well-planned sukuk structure, model/and contracts (aqd) and, funding utilization.

(iii) estimate the marketability and tradability of the sukuk in the primary and secondary markets.

Moreover, above such requirements, coordination among BWI, Ministry of Finance (including related ministries), potential market players (investors) and other regulators (OJK for banking authorities and Islamic capital market regulators and, Bank Indonesia for Islamic money market authorities), should not be ignored as well. When it is related to government sukuk, the Ministry of Finance needs to put in the state agenda, a planning to issue and develop government sukuk-linked on awqaf because it may engage with government budget and allocation, national development agenda, inter ministries committment and coordination and related regulations on the issue. Preparation for secondary market related issues need to be addressed by OJK and BI particularly to assess which potential financial institutions (conventional and/or Islamic banks) as potential investors or any potential investors coming from abroad (foreign investors or foreign banks), the trading mechanism in the secondary market (repo market, inter bank placement, and so forth).

Exhibit 6 illustrates a potential structure for Awqaf asset development through sovereign sukuk issuance. This structure can be pursued by setting the following steps.

1. The Ministry of Finance and National Awqaf Board identify the infrastructure projects that can be done by using suitable awqaf assets. The projects should be supportive to the government economic targets.
2. Other Ministries could also identify their project development programs that can be done by using suitable awqaf assets.
3. The Ministry of Finance would then register those assets in the list of programs to be developed by the state budget. The projects listed would then be scheduled for government sukuk issuance.
4. In order to proceed with sukuk issuance, the Ministry of Finance will establish an SPV to fulfil sharia compliance requirements in the investment structure.
5. For a global sukuk issuance, the SPV will then issue the sukuk in a territory that has tax neutrality regime and capable to accommodate both legal interests of the investors and the issuers[18]. The investment funds received from the investors would then be passed through by the SPV to the Minister of Finance and to the National Awqaf Board to develop such assets.
6. The investors could comprise of central bank, commercial banks, non-bank financial institutions (NBFIs), and retail investors.
7. (i) For the banks, the sukuk issued can be considered as liquid instruments since it has a sovereign class, particularly when the central bank provides an acceptance for repo facility and the bank can trade among themselves under "Islamic repo/repo syariah" transaction. (ii) For the central bank, the sukuk acquired in their inventory could be used as an alternative instrument when conducting monetary policy namely reverse repo transaction in the Islamic money market. The central bank may use the sukuk as the monetary

[18] Luxemberg has been one among the tax-neutral and legally comfortable countries for sukuk issuance.

instruments or retrench the assets through securitization process using the sukuk inventory as the underlying assets.

8. The Islamic banks and the non-bank financial institutions may also use the sukuk acquired for liquidity management purposes (for example, as a secondary reserve requirement) in the inter-Islamic bank money market or with other financial institutions for the same liquidity reasons.

Alternative to the awqaf asset linked sukuk, sukuk issuance can also be conducted by using the existing awqaf assets. The different between the two schemes lies only on the status of the projects that is not directly aimed to develop the undelying awqaf assets. The awqaf assets are used in the sale and lease-back mechanism to create a sharia compliance investment vehicle. The sukuk proceed may use the existing ijarah contract that is commonly used in the existing sovereign sukuk issuance domestically as well as globally.

3.2. Price Competitiveness

The issuance of proposed awqaf linked sukuk carries two different objectives at a time: entertaining the investors with the acceptable rate of returns and providing the low-income society with low-cost financing (or asset finance by low cost funds). In a true project based sukuk, the repayment capacity to the financial obligation depends upon the profit generating capacity as a function of income (I), cost of operations (C), amortization cost (A), and cost of fund (F).

$$\Pi = \mathrm{I} - \mathrm{C} - \mathrm{A} - \mathrm{F} \qquad (1)$$

If the equation (1) is expressed in terms of unit, it becomes

$$\pi = \mathrm{r} - c_O - c_A - c_F \qquad (2)$$

Consider that the probability of default of the sukuk ($K(C_A)$) is represented by the ratio of the financial returns (π) and (c_F)[19]. The equation becomes:

$$K(c_A) = \frac{\pi}{c_F} = \frac{\mathrm{r} - c_0 - c_A}{c_F} - 1, \text{ with } 0<K(C_A)<1$$

[19] It is assumed that a project generating much higher gain (in term of net profit before interest) than its fixed financial obligations would have a greater chance succeed.

If the probability of default is compared between sukuk that has zero land acquisition cost and otherwise, the ratio becomes the following.

$$\frac{K_O}{K(c_A)} = \frac{\mathrm{r} - c_G - c_F}{\mathrm{r} - c_G - c_A - c_F} = I_K$$

The sensitivity of the ratio with respect to c_A is as follow.

$$\frac{dI_K(c_A)}{dc_A} = \frac{-dc_A}{(\mathrm{r} - c_G - c_A - c_F)^2}$$

The mathematical simulation shows that the absence of land acquisition cost would significantly and positively provide positive impact to the repayment capacity; hence, it would be suitable to serve the low-income society that is perceived as having high risk exposures. Moreover, it may also lead to a more competitive pricing and more liquid sukuk linked to *awqaf* asset.

IV. CONCLUSION AND POLICY RECOMMENDATION

4.1 Conclusion

Since commercial sector is dominating within global Islamic financial landscape, there is a need for inter-sector development between financial sector and real economic sector, and even with social sector within Islamic economic system. Zakat and awqaf sectors which are part of social sector are rarely touched for further development within the landscape even though social sectors can actually bring tremendeous benefits to the social welfare and justice, which is in line with the objective of shari'ah (*maqasid al-shari'ah*). Hence, there is urgency interplay between all the sectors through breakthrough development in Islamic finance.

Project based sukuk are deemed to have real sector development impacts as the sukuk are structured to finance governmental projects as well as infrastructure development of corporates with fixed tangible assets for project development as an underlying asset. This project based sukuk can benefit the social welfare by having a cross sector financing to the *awqaf* sector. In a concrete fashion, the project based sukuk is structured as an awqaf linked sukuk with an awqaf land is part of fixed tangible asset for governmental as well as corporate project financing. The sukuk investors are hence *waqif* with the nadhir as an economic agent (*wakeel)* appointed by government institution or corporate institution. The nadhir has the full responsibility to oversee the awqaf asset and an entitlement to certain management fees. The awqaf linked sukuk can serve both commercial and social purposes, depending on the investors' preference, with the former have a sukuk return and latter has no sukuk return.

The *awqaf* linked sukuk is indeed an impetus for global sukuk issuance if it is realized by government or corporate for doing financing with societal impacts. Apart from that, it is one of Islamic financial deepening efforts in the Islamic financial market by adding the innovation structure on sukuk, which is currently driven by commercial purposes. Indonesia that has tremendous waqf assets can be an ideal role model to issue the awqaf linked sukuk. For that reason, a strategic alliance across government institutions in Indonesia is indeed important to realise this important milestone. Ministry of Finance (MoF) that regularly issues a sovereign sukuk for governmental projects should take a lead for the awqaf linked sukuk issuance in coordination with National Planning Ministry which have strategic priority projects and Indonesian Waqf Board which has full information of awqaf assets in a strategic area. Apart from that, Indonesian Financial Services Authority should give full supports to the investors and market players in term of market incentives to push its development. Hence, an awqaf linked sukuk are a pivotal development in Islamic capital market to contribute sustainable economic development that needs full supports from government institutions and relevant stakeholders.

4.2 Policy Recommendation

The *awqaf* linked sukuk has several policy implications, as follows:

1. Islamic financial deepening efforts with product enhancement and innovation on sukuk that has tremendous benefits for social welfare;
2. Zero initial outlay as no acquisition cost and government financial resources cost saving with the impact of quadratic reduction on sukuk pricing
3. Enhancement of Islamic cross-sector financing between financial sector, real sector, and social sector within Islamic economic system to realise the objective of shari'ah (*maqasid al-shari'ah*).

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