Indonesia: Sukuk Make Headway but Banks Lag

By Dr Terry Lacey

The recent issue of US$650 million of dollar-dominated Sukuk by the Indonesian government was oversubscribed seven times, with offers from buyers reaching US$4.7 billion. However, despite the boom in Islamic bonds, Indonesian Islamic banks are performing below expectations.

The combined Islamic banking and finance industry, comprising banking and bonds, financing government debt, consumer and loans to small- and medium-sized enterprises (SMEs), needs to go for volume if it is to impact significantly on the robust Indonesian economy, still growing at 4.5%. Bank lending and bank capitalization are growing despite the global downturn. There lies the dilemma for the Islamic banks. They start from such a small base that they can hardly keep up, let alone make gains in their share of capital growth or lending.

The problem is mathematical as well as about the political will of the government and lack of capacity of the Islamic banking and finance private sector. In order to catch up and start gaining ground, Islamic banking needs growth rates higher than anything achieved in the past.

Earlier euphoria over Islamic banking and finance in Indonesia is therefore giving way to a more cautious approach reflecting several factors. Firstly, Islamic banking and finance remains weak in Indonesia, accounting for only 3% of banking assets and 2.1% of bank lending. Globally, Shariah banking deploys US$250 billion with a 15% growth rate. However, Indonesia, with 15% of the world’s Muslim population, deploys only 2.1% of global Shariah banking assets. With a total population of 235 million, approximately 85% Muslim, and the largest single Muslim population in the world, these figures fall short of targets and expectations.

Secondly, the average rate of growth in Islamic banking (by assets) in Indonesia, according to the central bank, averaged 60% between 1999 and 2004 and fell to an average 46% from 2005 to 2009, compared with a steady average 13% growth in the capital base of conventional banks in the same period. The central bank expects the growth of Islamic banks to perhaps get back into the 50% range, but although this sounds high, it’s not enough. Total Shariah banking assets in Indonesia, excluding Sukuk, only add up to about US$5.2 billion.

Despite the “robust growth” of the Islamic banking sector, it simply cannot reach its target to deploy 5% of national banking capital by 2011 without radical changes. Using present strategies, it would need to deploy 11% of national banking capital by 2011. “Cannot be reached”, said Siti Fadrijah, another central bank deputy governor.

Indonesian Islamic banking will remain an infant industry for at least a decade although Sukuk, both sovereign and corporate, show signs of taking off. It looks like Muliaman had done his sums when he said that without a new strategy, the target for Islamic banking in Indonesia to deploy 5% of banking capital by 2011 “cannot be reached”.

There are also some fears that Islamic banking and finance could slip into the same structural faults and bad practices as conventional Western banking and finance. For the first time we hear of a major default on a Sukuk (Aston Martin Lagonda) and of question marks on strategies, practices and benchmarks as the Islamic banks try to compete on the range and volume of services from conventional banks without falling into the same practices that brought down the Western banks.

Global Shariah banking shows two contradictory trends. It insists on strategies, practices and benchmarks as the Islamic banks try to compete on the range and volume of services from conventional banks without falling into the same practices that brought down the Western banks.

Indonesia Shariah Bank Association chairman Ahmad Riawan said the central bank is confident that Islamic finance could contribute to Indonesian development without inflationary pressures, since it forbids transactions involving derivatives and high leverage. But Indonesia only recently hosted the third Asean annual meeting of Shariah economic

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Indonesia: Sukuk Make Headway but Banks Lag (continued)

experts which discussed Shariah compliant currency exchange swaps and trade support mechanisms.

The discussion topics included derivatives, hedging and collateralization which have caused problems for Western banks, necessitating complex concepts like simultaneous term and reverse back-to-back Murabahah to try to avoid riba (interest), gharar (uncertainty of value of underlying assets) or maysir (speculation).

Whilst Islamic banking and finance is fully integrated into the global banking and financial system, it operates under different rules, based on different values. However, if the Western banking and financial system sneezes, then the Islamic banking and financial system still catches a cold. So Kuwait-based Investment Dar, the owners of half of Aston Martin Lagonda, missed a payment on US$100 million of debt due on the 27th April and became the first major Gulf company to default on a Sukuk.

Also, earnings of some Gulf Shariah banks have dropped by up to 40% while companies like Investment Dar of Kuwait and Tamweel and Amlak Finance of Dubai are trying to restructure. The Islamic bond market ballooned from almost nothing in 2002 to US$90 billion in 2008 as surging oil prices spurred borrowing in the Gulf and Asia. However, Sukuk sales dropped 56% in 2008 from a record US$30.8 billion in 2007.

The chairman of the board of scholars of the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) had shocked markets in 2007 by declaring that 85% of Islamic bonds were not Shariah compliant as they included repurchase undertakings. This remark reportedly contributed to the big drop in Sukuk issuance in 2008. Now AAOIFI says it will launch a global study to see how Islamic financing markets are adhering to benchmarks, with a view to standardizing products.

Consolidation, prudence and strengthening of regulations and enforcement would seem to be the order of the day for Islamic banking and finance. But to travel down which road? Which messages should the relatively weak and under-developed Indonesian Shariah banking sector listen to?

Meanwhile, in Jakarta, the finance ministry launched a new type of Sukuk to tap the Hajj and Ummah funds, managed by the religious affairs ministry. The Indonesian Hajj Funds Sukuk (SDHI) is seen as a way of stopping corruption and imposing transparency via the central bank and Supreme Audit Agency (BPS). Hajj and Ummah Trust funds are pooled into one-year Islamic bonds with a fixed coupon of 8.52% on maturity instead of staying in suspect trust funds where, critics allege, interest has been embezzled by officials and politicians.

SDHI bonds are safer than bank deposits because they are fully guaranteed by the government. The bonds mean higher returns and less risk of mismanagement.

With Finance Minister Sri Mulyani Indrawati saying that the management of Hajj funds “can be better”, her ministry had moved in on the Hajj funds after the success of its dollar denominated retail Sukuk launch in mid-April when it issued US$650 million of government Islamic bonds with a five year maturity and an 8.8% yield, receiving orders totaling US$4.7 billion.

The global Sukuk were ordered by investors from Asia (32%) Middle East (30%) US (19%) Europe (11%) and Indonesia (8%). Orders were made via fund managers (45%), banks (37%), retail investors (14%) and insurance and pension fund companies (4%).

The Sukuk was rated ‘Ba3’ by Moody’s, ‘BB-’ by Standard & Poor’s and ‘BB’ by Fitch. The designated arrangers were Barclays, HSBC Holdings and Standard Chartered. The finance ministry pointed out that it was the largest straight issuance of dollar denominated Sukuk outside of the Gulf Cooperation Council (GCC) and the first benchmark of dollar-denominated Sukuk in Asia since 2007.

Although the Sukuk proceeds will help plug a forecast US$12.8 billion gap in the 2009 state budget, (to help counter the global economic crisis), the success of the issue reflected its good terms, the strength of underlying assets and the outstanding reputation of Indonesia for political and economic stability and sustained growth relative to most countries in Asean and globally.

Given this strong base, it should be possible to construct a broader strategy in support of a higher volume Islamic banking and finance in Indonesia built on four strong pillars:

- A broad individual customer base including on-lending to small lenders.
- Corporate working capital and expansion, especially in high growth and labor-intensive sectors.
- Private sector bonds for company expansion and small infrastructure projects.
- Large volume Islamic bonds to finance state budget deficits and large-scale infrastructure.

For Islamic banking and finance, potential investors from the Middle East, London and Malaysia are deterred by the lack of delivery capacity, the high cost and time involved in building banking outlets, the lack of experience on corporate and project financing and stories of bureaucratic delays and corruption.

The next Indonesian administration, which will assume office in October after the recent general election, will have to address all these issues if the promise of Islamic banking and finance in the country is to become a reality.

Terry Lacey is a development economist who writes from Jakarta on modernization in the Muslim world, investment and trade relations with the European Union and Islamic banking. He can be contacted at terrylacey2003@yahoo.co.uk.