

Indonesia Prepares an Islamic Bonds Industry

Contributed by Lisa Murray
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The world's biggest Muslim nation struggles to build its Islamic finance industry

Bank Indonesia Headquarters, Jakarta

In a bid to drive growth in the fledgling Islamic bonds industry, Indonesia's central bank says it will relax the rules for investors who buy the bonds.

Despite being home to roughly 10 percent of the world's estimated 1.3 billion Muslims, Indonesia has struggled to build up its Islamic finance industry, lagging well behind countries such as Malaysia, Singapore and even Pakistan.

However, the recent introduction of a new law that would allow the government to issue Sukuk, or Islamic bonds, is expected to trigger significant growth in the sector. The government announced this week it has already set aside US\$2 billion in assets to back the bonds, which it expects to sell in two separate issues this August and October. Sukuk bondholders are paid income derived from assets such as rent from property because Islamic law bans lending for interest.

Mulya Siregar, Bank Indonesia's head of Islamic finance, pledged this week that the central bank would change the rules surrounding Sukuk to boost investor interest in the securities.

As the rules stand, investors in Islamic bonds are required to hold them until maturity.

“We will change that regulation,” Siregar told an investment conference Thursday.

“That regulation was made in 2000 or 2002, when Bank Indonesia was still learning about how to develop Islamic finance so it just worried at that time whether the securities of Sukuk were an asset or not. But now, I think we agree they should be an asset so that investors are able to trade them.”

Pushed on the timing of the change and whether it would be before the government’s planned August issue, Siregar said it would be “as soon as possible.”

The move could be a significant boost for Sukuk in Indonesia, which have so far received little interest from traditional investors. In Malaysia, on the other hand, more than 50 per cent of Sukuk issuances are taken up by commercial bond traders.

“A real issue for Indonesia is that conventional investors do not participate in the Sukuk market,” said Badlisyah Ghani, head of CIMB Islamic Bank in Malaysia

“This is a peculiar situation that does not exist in Malaysia. All investors, including conventional banks, chase after Islamic instruments. As a result Islamic bonds in Malaysia are cheaper by 5 to 20 basis points compared to conventional bonds.”

If the Indonesian government and central bank get the regulatory framework right, a sovereign Sukuk would set a benchmark price for corporate bonds and allow the country to capture a significant share of the global market for Islamic bonds, which Moody’s estimates was worth US\$100 billion last year.

“Sukuk is important for Islamic banking development,” says Siregar. “Right now, the problem for Islamic banking in Indonesia is liquidity.”

It would also allow Indonesia to attract investors from the Middle East and provide another funding source for the government, which is struggling to finance its budget deficit as the record-high oil price leaves it saddled with a bulging fuel subsidy bill. The government raised fuel prices by an average of 28.7 percent Saturday in an effort to control its surging subsidy problems.

But experts warn Indonesia still has a long way to go to set up the right

regulatory framework. The new Sukuk law, introduced last April, was restricted to dealing with the government's ability to issue Islamic bonds. It did not deal with the unfavorable tax treatment of the securities or the lack of incentives for companies to issue Islamic bonds.

Most

Islamic bonds involve a sale and purchase, or leaseback, of assets, which attracts Value Added Tax. That generally means they are taxed twice as much as conventional securities.

"The

government is dealing with its own issue first and then with that liquidity, creating the necessary benchmark for industry, it needs to extend the regulatory system to have good laws for corporate issuers," says Ghani.

Still, he

believes demand is already strong, despite the lack of regulatory certainty.

"Even

without those tax incentives, there have already been 17 Sukuk issues in the market worth 2.2 trillion rupiah or about US\$250 million. It's a very exciting market."

There are

only three purely Islamic banks in Indonesia with another 20 mainstream banks offering shariah services. Islamic banking made up just 1.6 per cent of national banking assets in 2006, according to Bank Indonesia and the capital markets regulator Bapepam estimates Sukuk bonds make up about 2.5 per cent of total issuance.

According

to Moody's, the global Islamic finance market has grown by about 15 per cent for each of the past three years and is worth US\$700 billion. Sukuk is the fastest growing part of the market with volumes of US\$97.3 billion last year. New issuance increased 71 per cent to US\$32.65 billion.