# Growth Prospect of Sharia-Based Debt Instrument and Its Rating Perspective

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**Executive Summary**

The potential of sukuk, one form of sharia-based financing, is significant. There is still a wide gap between the issuance of sukuk and conventional bonds, while the demand for sukuk remains high, given that there are institutions which strictly deal only in sharia-based investments. However, there are also still some notable challenges for corporates, including additional processes, costs, and pricing that may not be favorable due to the liquidity premium required by investors. Thus, the number and the names of domestic sukuk issuers have not varied significantly from time to time.

There are efforts to encourage the development of sukuk issuance, which include regulatory adjustments over time and various formats that a sukuk can take in order to be more flexible. From a ratings perspective, the highest priority is given to an issuers' ability to repay the loan in full and in a timely manner. Thus, it does not differentiate significantly between sukuk and conventional bonds. However, sukuk must be sharia-compliant and approved by the sharia oversight board to be legally sound and economically viable. There may be some variations in structure that may affect the rating, but typically these are not exclusive to sukuk. The indirect effect on the rating may come in the form of added financial flexibility as the issuer can tap a wider base of investors, although in whole it should also be done by looking at the overall financial leverage and debt servicing capability.

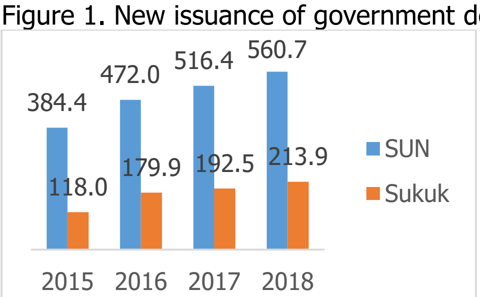
**Substantial growth in global debt market, but domestic presence remains limited**

Total global sukuk issuance in the first five months of 2019 has reached USD67.9 billion, an increase of 17.7% over the same period in 2018 of USD57.7 billion. This was driven by the return of Saudi Arabian and Qatari issuers, Turkey's efforts to extract all available funding sources, and Indonesia's efforts to ramp up liquidity this year. Countries that apply the Islamic financial system have typically been the main drivers for sukuk issuances, but now sukuk has been more attractive to all since it can provide a wider base of investors.

Indonesia's total issuance this year alone has reached USD7.6 billion as of May 2019, after the central bank (Bank Indonesia) started to offer sukuk as a liquidity management instrument for financial institutions. This was a significant increase, since in 2017 the Indonesian government issued USD3 billion in global sukuk, which accounted for 2.6% of total global issuance at that time. In the span of 2001-2017 alone, Indonesia made 45 sukuk issuances, behind only Malaysia, Sudan, Bahrain, and Brunei Darussalam.

In the domestic market, both government-issued and corporate sukuk have recorded positive growth over the years. However, they lagged far behind their conventional counterparts. In full year terms, in 2018, the government issued IDR560.7 trillion in conventional bonds compared to IDR213.9 trillion in sukuk.

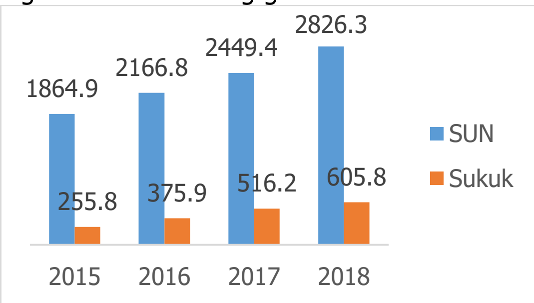
Figure 1. New issuance of government debt instruments (IDR trillion)




Source: KSEI

The difference was even more staggering in terms of outstanding issuances, where conventional government bonds were recorded at IDR2,826.3 trillion compared to government sukuk of IDR605.8 trillion.

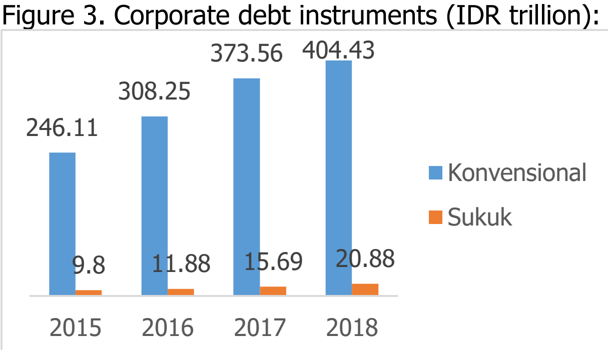
Figure 2. Outstanding government-issued debt instruments (IDR trillion)

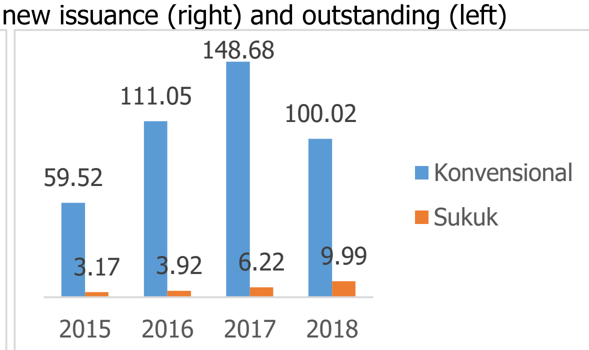



*Source: KSEI*

In the domestic corporate universe, the gap is more prominent as only IDR10.0 trillion of sukuk was issued during 2018, with the outstanding amount only IDR20.9 billion as of that year. As for conventional corporate bonds, the amount issued in 2018 was IDR100 billion and the outstanding amount was IDR404.4 billion.

Figure 3. Corporate debt instruments (IDR trillion): new issuance (right) and outstanding (left)




Source: KSEI

In terms of the number of corporate issuers, the number is somehow flat. There were 8 issuers in 2018, 9 in 2017, 8 in 2016, and 5 in 2015. Moreover, they are dominated by similar corporate issuers, reflecting the relatively lack of appetite from the supply side for issuing sharia-compliant debt instruments.

Table 1. Corporate domestic sukuk issuers in 2015–2018 (*frequent issuers are in bold*)

| No | 2015 | 2016 | 2017 | 2018 | Instrument's latest rating |
|---|---|---|---|---|---|
| 1 | Summarecon Agung Tbk | Bank Nagari | **Adira Dinamika Multi Finance Tbk** | **Permodalan Nasional Madani (Persero)** | idAAA(sy) |
| 2 | Bank BNI Syariah | **Bank Maybank Indonesia Tbk** | **Indosat Tbk** | Perusahaan Listrik Negara (Persero) | idAAA(sy) |
| 3 | **Indosat Tbk** | Bank Sulselbar | Sarana Multigriya Finansial (Persero) | **Adira Dinamika Multi Finance Tbk** | idAAA(sy) |
| 4 | **Adira Dinamika Multi Finance Tbk** | Tiga Pilar Sejahtera Food Tbk | Global Mediacom Tbk | Lembaga Pembiayaan Ekspor Indonesia | idAAA(sy) |
| 5 | **HK Realtindo** | **Adira Dinamika Multi Finance Tbk** | Perusahaan Listrik Negara (Persero) | Medco Power Indonesia | idA(sy) |
| 6 | | **HK Realtindo** | **Bank Maybank Indonesia Tbk** | Sarana Multi Infrastruktur (Persero) | idAAA(sy) |
| 7 | | **Indosat Tbk** | PPEN Rajawali Nusantara Indonesia | Lontar Papyrus Pulp & Paper Industry | idA+(sy) |
| 8 | | Angkasa Pura I (Persero) | **Permodalan Nasional Madani (Persero)** | Bank CIMB Niaga Tbk | idAAA(sy) |
| 9 | | | Timah (Persero) Tbk | | |

Source: KSEI, processed

The unconducive interest rate environment has also played a role in curbing corporate interest in issuing debt instruments. We are of the view that there is a lot of potential for sukuk to gain more growth in the coming years due to its large gap with conventional bonds, and it has the advantage of having the ability to tap a wider investor base as it can serve both the conventional market and those that strictly look for sharia-based investments.

**Features of sukuk, challenges and opportunities**

There are a few differences between sukuk and conventional bonds, with the most essential ones being the requirement of having an underlying asset in sukuk and the definition of investment returns. In conventional bonds, it is common to call returns as coupons or interest, while in sukuk it should be defined as fees, margins, or profit sharing, as any approach to the time value of money is prohibited and investment is seen as a mutual business venture. The underlying asset can be structured to have the whole productive asset be tied to the sukuk, including the rights to use and claim to cash flow arising from that asset, a particular share of that asset, or a claim of income from several productive assets. Any sukuk must have approval that it is sharia-compliant from National Sharia Board at the Indonesia Ulema Council.

Sharia-related financing provides a vast opportunity for both the entity who needs fund and the investors who provides fund. In a Muslim-majority country such as Indonesia, sukuk should have a favorable position. The establishment of Hajj Fund management institution (Badan Pengelola Keuangan Haji or BPKH), which has around IDR110 trillion in funds being managed and can only invest in sharia instruments, should also boost the demand side. Lower supply than demand could lead to more pricing power for issuers, compared to conventional debt, ceteris paribus.

Despite sukuk's potential, in reality the situation is far from ideal. The largest handicap for corporate sukuk growth is still unfavorable pricing — a result of the less liquid market, which in turn leads to investors asking a premium for the instrument. Pricing is also affected by the crowding out effect of the government's sukuk issuance. As for the government, we already saw that the rate of growth of sharia-based instruments has been on the rise compared to the conventional one, although size-wise conventional government bonds are still larger in terms of issuance and outstanding.

The growth of domestic corporate sukuk has also been limited by a more complex issuance process. The proposal must be first approved by the National Sharia Board, and the Company must structure the instrument in relation to its underlying asset in order to be sharia-compliant. Therefore, asset-light companies with no booked receivables (such as business service companies) may be less suitable to issuing sukuk. In short, the issuer should have and select assets that can be used as the base of a sukuk transaction, which will limit flexibility to a certain extent compared to conventional bonds. However, from another perspective, the requirement itself can prevent an economic bubble.

While there are some incentives to boost sukuk issuance — such as a more lenient requirement by allowing a shelf registration sukuk to be done after only a one-year track record in issuing debt instruments, compared to two years for conventional shelf registration bond — the impact is still limited. In contrast, Malaysia, which has the most vibrant sukuk market, offers an advantageous tax treatment. Currently, sukuk issuers in Malaysia enjoy a tax deduction on issuance cost as well as stamp-duty exemption. Likewise, Malaysian sukuk investors receive a tax exemption on income received. The country's tax-neutral framework and tax deductions for sukuk issuance expenses further enhance the competitive advantage of sharia-compliant fixed income securities versus conventional bonds. However, we note that the flexibility of national budget usually dictates tax rates, and may not be directly comparable.

**Regulatory environment**

The country's regulations in regard to sukuk date back to the early 2000s and, in our view, are adequate to support future development. They were initially set by Indonesia Ulema Council's Fatwa No. 32/2002 on sharia debt instruments with contracts (or aqd) that cover mudharabah, musyarakah, murabahah, salam, istishna, and ijarah. It was later reinforced by Bapepam LK regulation No. IX.A.13 and IX.A.14 about the issuance of such instruments. With the transformation of the financial industry regulator, the regulation was updated to OJK regulation No. 18/POJK.04/2015, which states that sukuk must have equal value and represent an undivided share of the tangible assets, the present and future economic value from the assets, and/or a particular investment activity. For sharia asset-backed securitization, OJK has also provided POJK No. 20/POJK.04/2015, which was approved by the National Sharia Board at the Indonesia Ulema Council.

**Types of sukuk**

Out of the many contracts/aqd that sukuk could have, three are commonly used because of the familiarity of investors with them, as well as the type of assets that are readily available and can be used by issuers. These are mudharabah (investor as fund provider and issuer as operator), ijarah (issuer as lessor that leases the rights to use a particular asset to a customer, with lease income being shared to the investor), and wakalah (the issuer acts as an investment manager on behalf of investors, and plows the issue proceeds to profit-making activities).

The choice among these types will depend on the purpose of the issuance, and which type of asset on issuer's balance sheet is most suitable.

- For the real sector, ijarah is the most used contract, since the issuer typically has a real productive asset such as a communications tower, oil tanker, etc.
- For financial institutions, mudharabah is most commonly used because the issuer provides expertise in financing activities.
- Lately, the wakalah scheme has gained momentum because of its flexibility in using a mix of assets as base.

Several recent government and corporate sukuk, such as by Medco Power, have been issued using wakalah contracts. Out of 39 series of sukuk issued in 2018, 18 of them used ijarah, 18 mudharabah, and 3 wakalah.

Table 1. Types of outstanding sukuk

| | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|
| Ijarah | 12 | 7 | 30 | 18 |
| Mudharabah | 3 | 8 | 11 | 18 |
| Wakalah | - | - | - | 3 |

Source: KSEI

In addition to scheme or aqd, there are two ways to use assets in relation to sukuk. The first and the most common way is in an asset-based sukuk, where the assets only act as the underlying asset of the sukuk transaction, but the there is no specific structure to secure the cash flow from that particular asset as the source of repayment for the sukuk issuance.

The second way is an asset-backed sukuk, which is similar to other securitization products where the asset is pooled and sold to a special purpose entity, and the legal right to the cash inflow produced by that asset is transferred to the investor.

**Rating approach**

The rating of a sukuk will act as a measure of the instrument's creditworthiness, reflecting the ability and willingness of the sukuk issuer to meet financial obligations in a full and timely manner. When rating a sukuk, PEFINDO does not express an opinion on the transaction's compliance with sharia, and primarily focuses on the credit aspects of the instrument. Rating a sukuk is the same as a rating a company, where the sukuk is ranked *paripassu* with other senior unsecured financial obligations of the company.

We also take note of several variations that may result in the sukuk not having the same rating as the company. For an asset-backed sukuk, the rating is de-linked from the issuer rating and we apply a similar rating assessment to the securitization rating, where the underlying asset pool is separated from the issuer and credit enhancement can be applied. Given the isolated asset being pledged to the sukuk, the asset claim should also be more superior than other paripassu lenders.

Here we apply the same approach as in a common debt rating, by looking at the business and financial aspects, with detailing factors varying with the characteristics of the business/industry the company is in, or the asset pool it is created from. We provide the rating approach to these industries in our website. If the instrument is structured in a similar way or takes the form of securitization, we look at the strength of available credit enhancements, which come in several forms, such as guarantees (which must come in a highly liquid form such as cash collateral, bank or corporate guarantee), overcollateralization (by posting more collateral or reducing proceeds), or tranching (structuring cash waterfall, with varying cash protection for different tranches). Lastly, we conclude the analysis by assessing the adequacy and robustness of structural protection and the impact of any key legal issues on the sukuk structure.

*DISCLAIMER*

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