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CIMB ISLAMIC

INDONESIA ISLAMIC FINANCE REPORT

PROSPECTS FOR EXPONENTIAL GROWTH

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ISLAMIC RESEARCH AND TRAINING INSTITUTE
A MEMBER OF THE ISLAMIC DEVELOPMENT BANK GROUP

CIBAFI
المجلس العام للبنوك
والمؤسسات المالية الإسلامية
General Council for Islamic Banks And Financial Institutions

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ISLAMIC FINANCE GATEWAY

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President of Islamic Development Bank (IDB) Group Ahmed Muhamed Ali speaks during the "Third IDB 1440H Vision Commission Meeting" in Kuala Lumpur March 23, 2006. REUTERS/Zainal Abd Halim

ABOUT THE ISLAMIC RESEARCH AND TRAINING INSTITUTE

The Islamic Research and Training Institute (IRTI), a member of the Islamic Development Bank Group (IDBG), was established in 1401H (1981). The principal aim of IRTI is to undertake research, training and advisory activities in Islamic Economics and Islamic Finance to facilitate the economic, financial and banking activities in IDB member countries to conform to Shari'ah. A knowledge-based organization, IRTI, is considered to be one of the pioneers and key centres of excellence around the world in promoting and supporting the development and sustenance of a dynamic and comprehensive Islamic Financial Services Industry (IFSI), which supports the socio-economic development of IDB member countries and Muslim communities across the globe.

VISION To be the global knowledge centre for Islamic Economics and Finance by 1440H (2020)

MISSION To inspire and deliver cutting edge research, capacity building, advisory and information services in the area of Islamic Economics and Finance

IRTI SERVICES

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IRTI provides comprehensive advisory and consultancy services in the fields of Islamic Finance and Economics with global outreach to the public and private sectors. Backed by over three decades of industry experience, IRTI's advisory and consultancy services add real value to the clients' businesses.
In addition to IRTI's renowned experts, IRTI utilizes industry experts, affiliate partners and IDB Group members entities' experts to provide advisory and consultancy services to clients. IRTI's consultancy services include (but not limited to): setting up regulatory framework, developing new Islamic financial products and services to cater to the market needs, Shari'ah research, Shari'ah toolkits, Shari'ah guidelines, introduction of Islamic banking windows in conventional banks, conversion to Islamic banking, Shari'ah auditing exercises, Shari'ah advisory and technical support for sukuk issuance etc.

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IRTI is a catalyst in the advancement of the Islamic Economics and Islamic Finance fields. Currently IRTI's research agenda is focused on five clusters, namely: Islamic Financial Institutions and Financial Sector Development, Islamic financial products development, Financial Stability and Risk Management, Economic development in OIC member countries, and Human development in light of Maqasid Al Shari'ah.

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ISLAMIC FINANCIAL INDUSTRY INFORMATION CENTER (IFIIC)

IFIIC is a portfolio of online applications and databases with relevant data about the Islamic Financial Industry. Components of the IFIIC are the following: Islamic Banking Information System (IBIS, www.ibisonline.net), Shariah and Who's Who Databases.

Islamic Research and Training Institute | P.O. Box 9201, Jeddah 21413, Kingdom of Saudi Arabia | Tel: +966-12-636-1400
Fax: +966-12-637-8927 or +966-12-636-6871 | http://www.irti.org | Email: irti@isdb.org

General Council for Islamic Banks and Financial Institutions

المجلس العام للبنوك والمؤسسات المالية الإسلامية

CIBAFI

15 ANNIVERSARY 2001 - 2016

About CIBAFI

General Council for Islamic Banks and Financial Institutions (CIBAFI) is a nonprofit institution that represents Islamic financial institutions (IFIs) worldwide. It was founded by the Islamic Development Bank (IDB) and a number of leading Islamic financial institutions. CIBAFI is affiliated with the Organisation of Islamic Cooperation (OIC). Established on 16 May 2001 by an Emiri special decree, in the Kingdom of Bahrain, today with nearly 120 members from over 30 jurisdictions, CIBAFI is recognized as a key component of the international architecture of the Islamic finance industry.

Its mission is to support the Islamic financial services industry in the form of a leading industry voice in advocating regulatory, financial and economic policies which are in the broad interest of CIBAFI's members and which foster the development of the Islamic financial services industry and sound industry practices.

CIBAFI's members vary from Islamic banks, multilateral banks, international standard setting organizations, regulators and other professional service firms.

Policy, Regulatory Advocacy

- Balanced dialog with the International standard setting organisations
- Establishing a dialog with the Financial Regulators and Supervisors
- Create working relationships with other Stakeholders such as multilateral banks

Research and Publications

- Develop & publish periodical newsletter
- Publication of specific reports
- Develop technical market related research

Awareness and Information Sharing

- Organise periodic regional events
- Create arena for dialog - Roundtables
- Establish discussion platform

Professional Development

- Executive Programme
- Technical Workshops
- Professional Certifications

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General Council for Islamic Banks
and Financial Institutions (CIBAFI)

Manama, Kingdom of Bahrain.
P.O. Box No. 24456

Email: cibafi@cibafi.org
Telephone No.: +973 1735 7300
Fax No.: +973 1732 4902

Foreword

The seventh in our series of Islamic Finance Country Reports (IFCR), the Indonesia Islamic Finance Report is designed to provide detailed analysis and key insights on the unique development of the Islamic finance industry in Indonesia and the great potential for growth that the country has to offer.

Dr. Mohamed Azmi Omar

Mustafa Adil

Abdelilah Belatik

Indonesia, with a total population base of 220 million people (95% of whom are Muslim), vast natural resources and a strategic geographic location, offers great potential for economic growth, and great opportunities for the Islamic finance industry. Unlike other countries, the Islamic finance industry in Indonesia has largely been built up on community based initiatives. This has led to the development of unique features such as the presence of rural Islamic banks, retail sukuk, Hajj funds and various innovative social finance initiatives.

Now with the government making the development of the Islamic finance industry a key pillar in their overall economic growth strategy, we can expect the industry to grow into a strong and sustainable sector of the financial services industry, while still maintaining many of its unique products and services. The government is expecting this to drive up the market share of Islamic banking from 3% today 11% by 2020.

The Indonesian Islamic finance sector is also one of the leading sectors on the radar of many foreign investors. The attractive economic factors, demographics and government support are expected to position Islamic finance as one of the fastest growing segments in the country, and one of the most attract for foreign investors.

With the support of CIMB Islamic Bank, our Exclusive Strategic Partner, it gives us great pleasure to present the Indonesia Islamic Finance Country Report. We hope this report will provide you with the information and analysis required to better understand and capture the opportunities that Indonesia presents in the Islamic finance space.

We have no doubt that in the coming decade, we will see Indonesia become a leading market and a key pillar for the growth of the global Islamic finance industry.

Dr. Mohamed Azmi Omar
Director General
IRTI

Mustafa Adil
Head of Islamic Finance
Thomson Reuters

Abdelilah Belatik
Secretary General
CIBAFI

Executive Summary

Indonesia has vast potential to grow economically, with its abundant natural resources, geographic location and expanding internal demographics, all of which make it a lucrative destination for investment. It is the sixteenth largest economy in the world, and its economy focuses on several major industries that contribute over 50 percent to its GDP: manufacturing and trade; tourism and hospitality; and agriculture.

Until now, Indonesia has lagged behind its regional peers in attracting investments, as measured by such global benchmarks as Ease of Doing Business. Indonesia's government is now focusing on improving its environment to attract investors — it streamlined Indonesia's investment process in early 2015 and is currently developing its human capital and disaster risk-management systems.

Developing its finance industry is also important if Indonesia is to improve its economic climate and attract investors. According to the ICD-Thomson Reuters Islamic Finance Development Report 2015, the global Islamic finance industry grew by 9.4 percent to US $1.8 trillion in 2014, and Indonesia is considered among the top ten developed pioneers in the Islamic financial world. The report details the progress and growth opportunities for Indonesia's local Islamic finance industry, which took its first steps in the 1990s.

Indonesia's Key Islamic Finance Insights

In 2014, the local Islamic finance industry grew to Rp 559 trillion, which constitutes 3 percent of Indonesia's total overall finance industry assets (Rp 16,380 trillion). Also, the total Indonesian Islamic finance assets grew 10%, reaching to Rp 617 trillion in 2015 according to the latest data reported. Its Islamic finance growth rate since 2010 surpassed that of the conventional sector (139 percent and 42 percent, respectively) and with the introduction of the new Islamic financial services roadmap, certain sectors of Islamic finance, such as Islamic banking, are expected to drive the take-up rate for this industry.

The report highlights that there are opportunities for Islamic finance in Indonesia for both the retail and corporate sectors, as detailed below.

RETAIL

ISLAMIC BANKING

The Islamic retail business is less competitive than its conventional peers, and its financing constitutes only 7.86 percent of total retail commercial banking loans.

Our retail banking consumer survey reveals that awareness campaigns are necessary to increase Islamic financial inclusion, as there is an untapped Islamic banking potential in Indonesia, especially relating to local young professionals.

Islamic rural banks represent only 7 percent of total loans by all rural banks in the country, and innovative, affordable products like micro-savings should be offered to attract rural and urban low- to middle-income earners, according to the survey.

TAKAFUL

Direct family takaful has a promising growth momentum that could boost Islamic investments, as many demand unit-linked products.

New regulations that require takaful business windows to be spun off by stand-alone operators may strengthen the takaful sector, as mergers and acquisitions may be on the horizon, especially within the general takaful and retakaful areas, given their low contribution to the insurance sector.

Our retail insurance survey reveals that there is immense untapped potential for takaful, as more than 50 percent of survey respondents do not use insurance services, particularly the micro-takaful that covers natural disasters and education.

Investing in a digital infrastructure and front-line staff training to improve customer satisfaction should be a top priority for insurance companies in Indonesia.

WEALTH MANAGEMENT

Banks need to educate the rural populations on banking fundamentals before introducing them to retail investment opportunities, whether Islamic or conventional.

Hajj funds, which could boost both liquidity and transparency within the Indonesian economy, are expected to increase in line with income growth.

SUKUK

Indonesia's retail sukuk, which presents a more secure investment opportunity than a bank deposit, is important for increasing the country's financial inclusion, diversifying its investor base and also possibly decreasing government exposure to foreign debt.

Devaluation of the Indonesian Rupiah presents an additional expense for government retail sukuk.

ISLAMIC SOCIAL FINANCE

The current Zakat Management Acts No. 23/2011 and No. 41/2004 on Waqf present a comprehensive regulatory environment for zakat and awqaf in Indonesia. For zakat, these acts have resulted in deeper government involvement in zakat management, as the National Board of Zakat (BAZNAS) now plays a bigger role than private zakat organisers (LAZ) when it comes to zakat.

Economic empowerment programmes account for a small percentage of the zakat distributed, and regulatory support is needed to utilise zakat as part of Indonesia's national economic policy.

The baitul-mal-wal-tamweels (Islamic micro-finance institutions) are making impressive progress in Indonesia as a result of the supportive regulatory environment and policies and the growing fervour for micro-finance among Indonesia's Muslim population.

CORPORATE

ISLAMIC BANKING

Corporate financing has grown at a faster pace since 2010 compared with corporate loans but remains less competitive. Conventional and Islamic banks serve different sectors.

There are opportunities for Islamic corporate banking in Indonesia in the form of syndicated financing and sukuk for infrastructure development, collaborating with other ASEAN nations, or benefiting from the easing of foreign ownership rules for Islamic banks.

TAKAFUL

Family takaful operators need to gain a competitive advantage by offering greater benefits, additional coverage, competitive fees and customised sum-covered arrangements invested in a Shariah-compliant manner for group policies, especially for term and personal accident insurance.

In terms of general insurance, property insurance attracts the highest premium/contribution income, so introducing a new tariff for property insurance could be beneficial to takaful operators.

Corporate takaful opportunities lie in offering attractive pricing and product offerings under commercial contracts for infrastructure projects, as well as in the emergence of new retakaful companies as a result of three factors: the windows spinoff rule, the rise in demand for group health insurance that covers employees under private healthcare, and the expected increase in insurance agents and brokers.

ASSET MANAGEMENT

The Indonesian market has a high concentration of institutional investors for its mutual funds, most of whom prefer to invest in equities. This causes many of these funds to be undiversified, as other asset classes are less attractive.

Indonesian mutual fund industry performance is inhibited by the rigid regulatory environment indicated by the smaller role foreign asset management companies play and that no more than 15 percent of the net asset value (NAV) sold in the country can actually be invested in stocks traded on an offshore stock exchange.

Institutional Islamic funds in Indonesia are expected to grow further as a result of the demand for Islamic pension funds by many companies and innovation through Islamic venture capital.

SUKUK

The corporate sukuk market in Indonesia is domestically focused and dominated by sukuk issued by three big corporate players holding 54 percent of the market share or RP 5,206 billion.

There is potential for growth, especially in the transportation, oil and gas, and constructions sectors, using different sukuk structures.

Indonesia's Islamic Economy

Aside from Islamic finance, the demand for halal food and the halal lifestyle in Indonesia is growing, especially given that Indonesia has the largest Muslim population in the world and currently ranks tenth according to the State of the Global Islamic Economy Report 2015 – 2016 produced by Thomson Reuters. Investment opportunities are plentiful for such Islamic economy sectors as halal/Muslim-focused tourism, halal food, Islamic/modest fashion and their sub-sectors, along with their surrounding infrastructure. Sub-sector opportunities could present in the form of Muslim-focused hotels and wellness tourism for halal travel, food manufacturing, export and retail outlets for halal food, and/or textile and e-commerce for modest fashion.

1 Macroeconomic Overview

Cityscape of Indonesia capital city Jakarta at sunset.

INSIDE THIS CHAPTER

INTERNATIONAL DIALING CODE
+62

PRESIDENT
Joko Widodo

GDP
(IMF, OCTOBER 2015, IN CURRENT PRICES)
US$ 872.615 Bn

GDP PER CAPITA
(IMF, OCTOBER 2015, IN CURRENT PRICES)
US$ 3,415.834

INTERNET DOMAIN
.id

FULL NAME
Republic of Indonesia

CAPITAL
Jakarta

LIFE EXPECTANCY
69 years
Male (UN)

73 years
Female (UN)

AREA
1,904,569 km²

MAIN RELIGIONS
Islam
Protestantism
Catholicism
Hinduism
Buddhism
Confucianism

MONETARY UNIT
Indonesian Rupiah

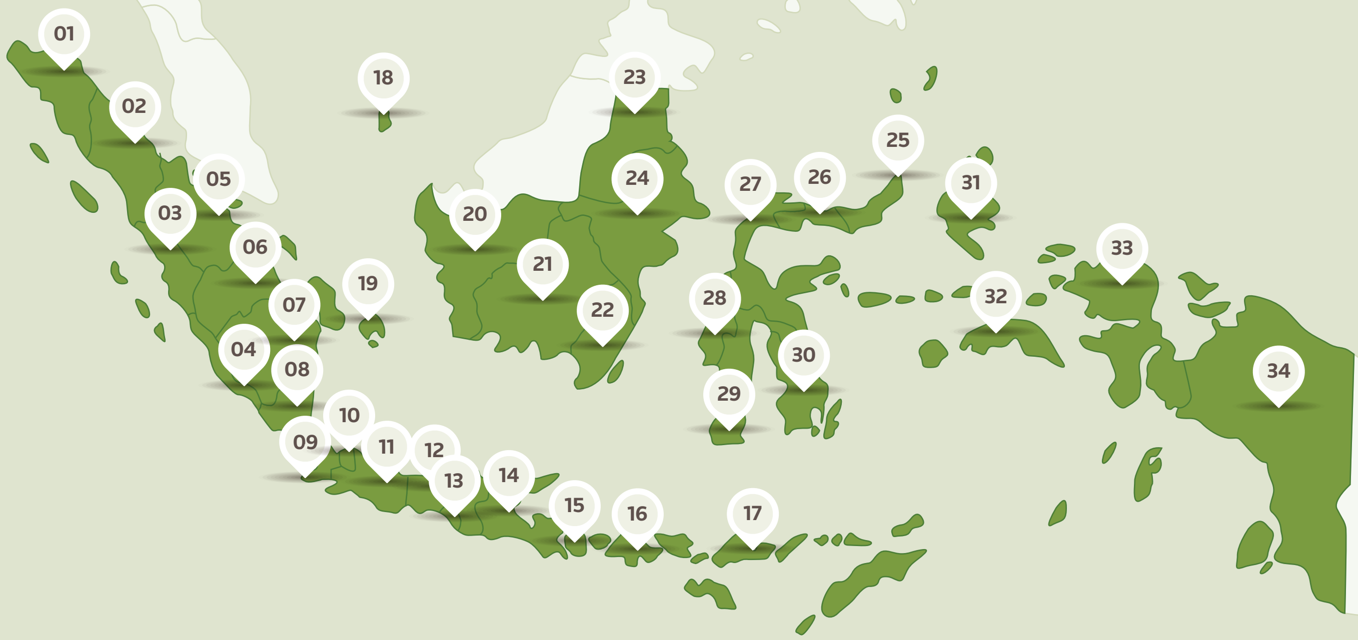
MAIN EXPORTS
Oil
Gas
Electrical appliances
Plywood
Rubber
Textiles

MAJOR LANGUAGE
Indonesian

LARGEST CITY
Jakarta

POPULATION (Central Bureau of statistic 2015)
255,182,144

01.
ACEH
Population: 4,993,385
—
02.
SUMATERA UTARA [NORTH SUMATRA]
Population: 13,923,262
—
03.
SUMATERA BARAT [WEST SUMATRA]
Population: 5, 190,577
—
04.
BENGKULU
Population: 1,872,136
—
05.
RIAU
Population: 6,330,941
—
06.
JAMBI
Population: 3,397,164
—
07.
SUMATERA SELATAN [SOUTH SUMATRA]
Population: 8,043,042
—
08.
LAMPUNG
Population: 8,109,601
—
09.
BANTEN
Population: 11,934,373
—
10.
JAKARTA
Population: 10,154,134
—
11.
JAWA BARAT [WEST JAVA]
Population: 46,668,214
—
12.
JAWA TENGAH [CENTRAL JAVA]
Population: 33,753,023
—
13.
YOGYAKARTA
Population: 3,675,768
—
14.
JAWA TIMUR [EAST JAVA]
Population: 38,828,061
—
15.
BALI
Population: 4,148,588
—
16.
NUSA TENGGARA BARAT [WESTERN LESSER SUNDA ISLANDS]
Population: 4,830,118
—
17.
NUSA TENGGARA TIMUR [EASTERN LESSER SUNDA ISLANDS]
Population: 5,112,760
—



18.
KEPULAUAN RIAU [RIAU ISLANDS]
Population: 1,968,313
—
19.
KEPULAUAN BANGKA BELITUNG [BANGKA BELITUNG ISLANDS]
Population: 1,370,331
—
20.
KALIMANTAN BARAT [WEST BORNEO]
Population: 4,783,209
—
21.
KALIMANTAN TENGAH [CENTRAL BORENEO]
Population: 2,490,178
—
22.
KALIMANTAN SELATAN [SOUTH BORNEO]
Population: 3,984,315
—
23.
KALIMANTAN UTARA [NORTH BORNEO]
Population: 639,639
—
24.
KALIMANTAN TIMUR [EAST BORNEO]
Population: 3,422,676
—
25.
SULAWESI UTARA [NORTH SULAWESI]
Population: 2,409,921
—
26.
GORONTALO
Population: 1,131,670
—
27.
SULAWESI TENGAH [CENTRAL SULAWESI]
Population: 2,872,857
—
28.
SULAWESI BARAT (SULBAR) [WEST SULAWESI]
Population: 1,279,994
—
29.
SULAWESI SELATAN [SOUTH SULAWESI]
Population: 8,512,608
—
30.
SULAWESI TENGGARA [SOUTHEAST SULAWESI]
Population: 2,495,248
—
31.
MALUKU UTARA [NORTHERN MOLUCCAS]
Population: 1,160,275
—
32.
MALUKU [MOLUCCAS]
Population: 1,683,856
—
33.
PAPUA BARAT (IRIAN JAYA BARAT) [WEST PAPUA]
Population: 868,819
—
34.
PAPUA (IRIAN JAYA)
Population: 3,143,088
—

Growth

	Average Annual GDP Growth (%)	Main impact	
1965–1997	7	Under President Soeharto's "New Order Government" country moved from low income to middle income status	
1998–1999	- 6.65	Asian financial crisis shrank the country's GDP 13.6% in 1998	
2000–2004	4.60	Recovery post-Asian financial crisis	
2005–2009	5.64	1.2007/2008 – hit by global financial crisis 2. 2009 – 3rd highest GDP growth among G20 despite falling commodity prices, falling stock market, higher domestic and international bond yields and a depreciating exchange rate	2009 growth attributed to relatively limited importance of Indonesian exports to the national economy, high market confidence, and sustained robust domestic consumption
2010–2014	6.02	Recovery post-global financial crisis	Contribution of private consumption to the country's national economic growth accounts for approximately two-thirds of total economic growth, which demonstrates its significant impact. A big chunk of middle class economy constitutes an additional seven million people; this has been considered the force driving the economy and has substantially triggered increased domestic and foreign investments from 2010 onwards
2015, 2016 and beyond	4.73 for 2015 5.2 - 5.6 for 2016	High inflation and interest rate along with declining purchasing power	Slow growth in China's economy resulting in decreasing export demand, low commodity prices and the recent appreciation of the USD

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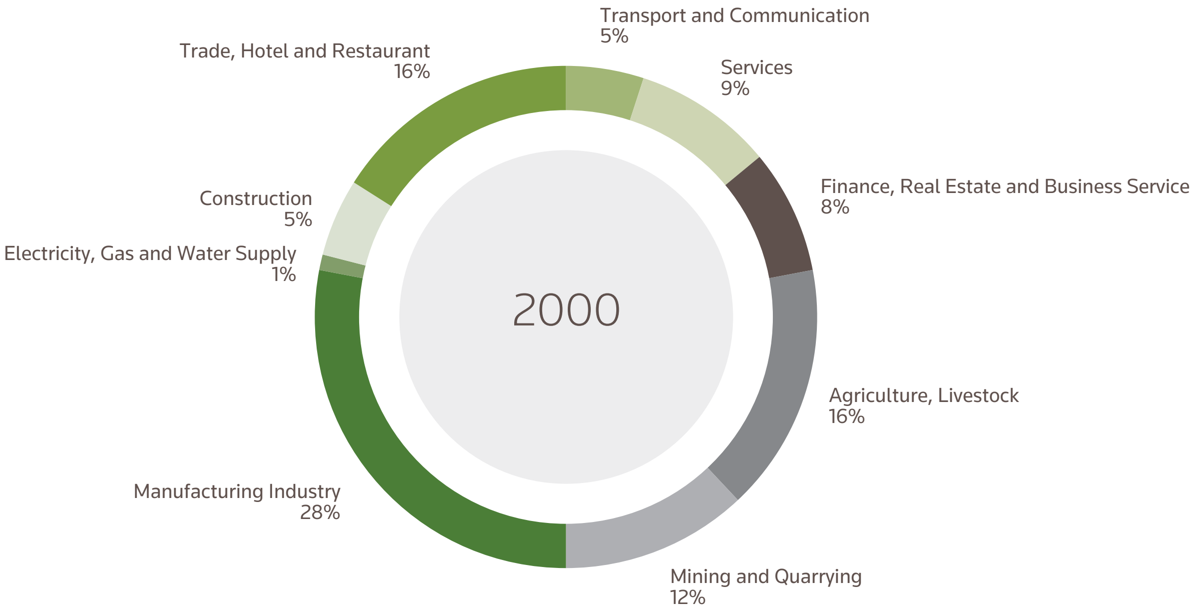
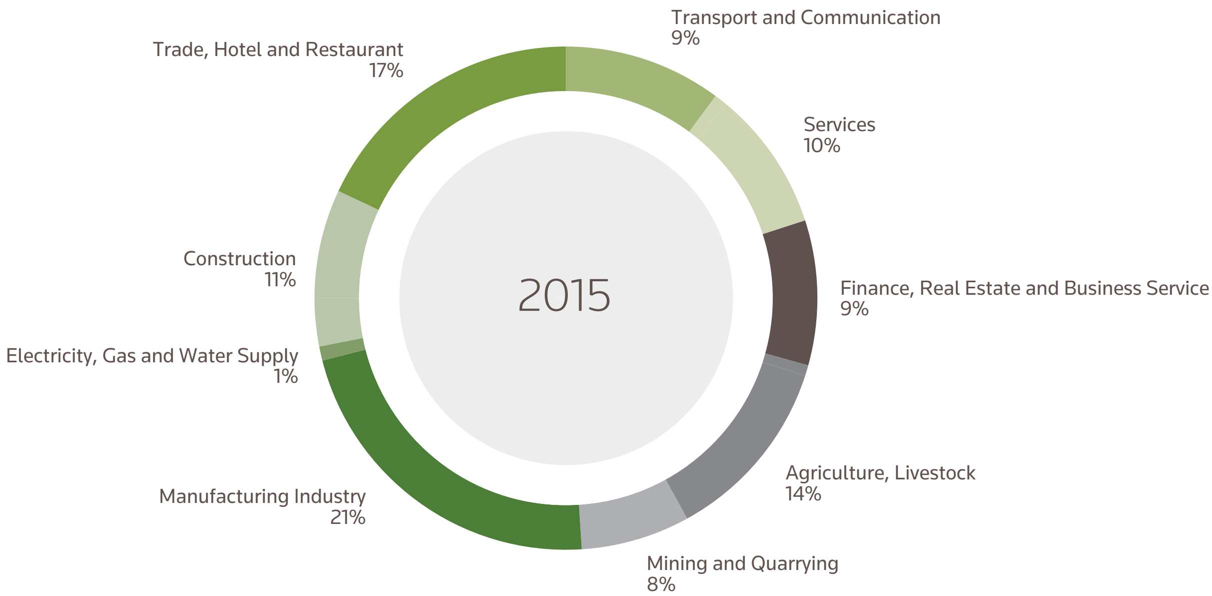
Indonesian Trade Minister Tom Lembong chats with members of the media during a visit to Rangkasbitung, Banten province, near Jakarta. REUTERS/Darren Whiteside

Sectorial Contribution

The Indonesian economy is broadly diversified with the manufacturing (food and beverages, machinery, transport equipment and tobacco) sector constituting the largest share of GDP followed by agriculture, trade and hotel. The figure below shows contribution to GDP by sectors.

CONTRIBUTION TO GDP BY SECTORS





Source: World Bank, IMF, and Bank of Indonesia

In 2015, the contribution of the manufacturing industry to GDP was 21 percent, followed by trade, hotel and restaurant, and agriculture and livestock. The top three major sectors that contribute to the Indonesian economy have remained unchanged over the years, although their levels of contribution have changed slightly due to the Asian financial crisis and the more recent global financial crisis.

Between 2000 and 2015, the trade, hotel and restaurant sector increased its contribution to GDP from 16 to 17 percent while manufacturing, and agriculture and livestock dipped from 28 to 21 percent and from 16 to 14 percent, respectively.

Indonesia's main exports are commodities, which account for 65 percent of total exports. Its current account therefore has suffered from low commodity prices, shifting global demand for commodities and high oil prices from the first quarter of 2012 onwards.

While the share of Indonesia's exports to the U.S. and the EU declined to 10 percent and 12 percent of total exports, respectively, by 2011, growth in exports to major emerging economies has continued to grow and minimises the decline in traditional trading partners, led particularly by exports to China, India and, increasingly, albeit low from a low base, the Middle East and Africa.

> THE TOP THREE MAJOR SECTORS THAT CONTRIBUTE TO THE INDONESIAN ECONOMY HAVE REMAINED UNCHANGED OVER THE YEARS, ALTHOUGH THEIR LEVELS OF CONTRIBUTION HAVE CHANGED SLIGHTLY DUE TO THE ASIAN FINANCIAL CRISIS AND THE MORE RECENT GLOBAL FINANCIAL CRISIS.

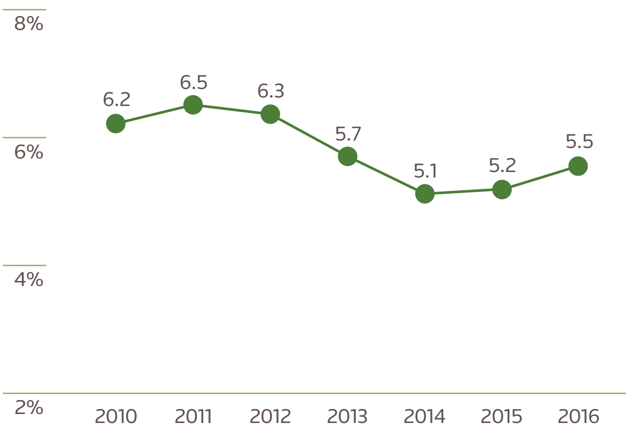
Inflation and Monetary Policy

Although the rate of inflation is in the single digits, it stayed relatively high and out of Bank of Indonesia's target band of 3 – 5 percent in 2010, 2013, and 2014. However, with effective monetary stance and low fuel prices, the inflation rate is expected to remain within the target band. For 2015 and 2016, end period inflation is projected at 4.5 and 4.8 percent, respectively.

Monetary policy provides a strong anchor to inflation expectations and facilitates external adjustment. The exchange rate regime serves well in absorbing external shock.

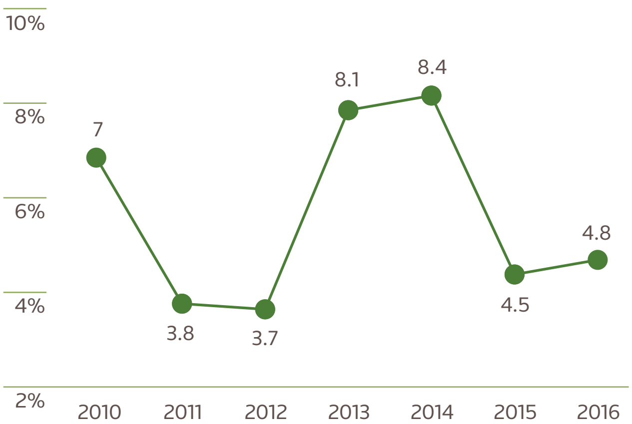
However, the Indonesian rupiah continued to depreciate against the U.S. dollar year on year. The highest depreciation rate was registered in 2013 where the rupiah depreciated by 26 percent against the U.S. dollar. This period coincided with low commodity prices and high oil prices which adversely impacted the current account balance.

REAL GDP GROWTH



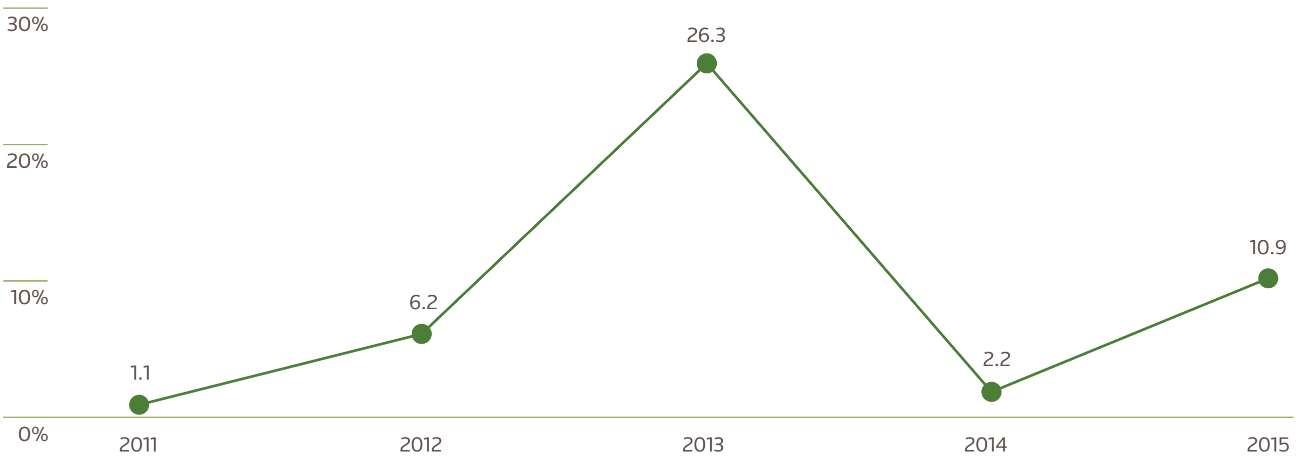
Source: IMF, 2014 AIV

INFLATION (END PERIOD)



Source: IMF, 2014 AIV

RUPIAH PER US DOLLAR (DEPRECIATION[+], APPRECIATION [-])



Source: IMF, 2014 AIV

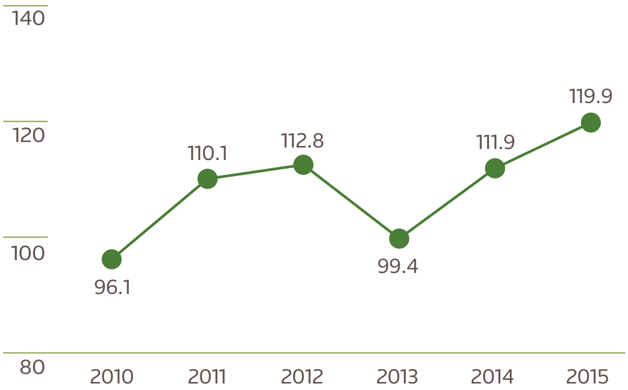
International Reserve Position

Reserves continue to remain strong and at comfortable levels. Average months of import cover was above 6 months between 2010 and 2013. In addition, months of reserve cover continue to increase in subsequent years averaging above in 2014 going forward.

RESERVES (MONTHS OF IMPORT COVER)

Source: IMF, 2014 AIV

GROSS RESERVES IN BILLIONS OF US$

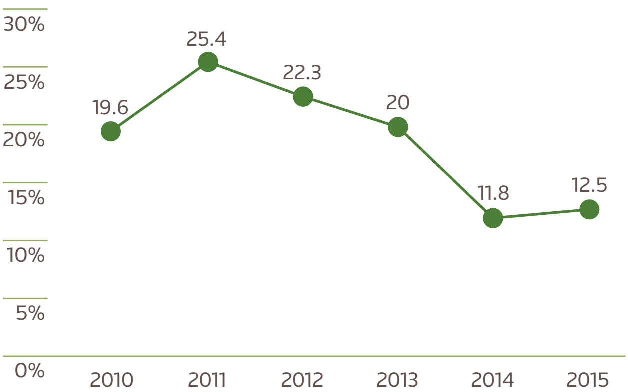


Source: IMF, 2014 AIV

Credit

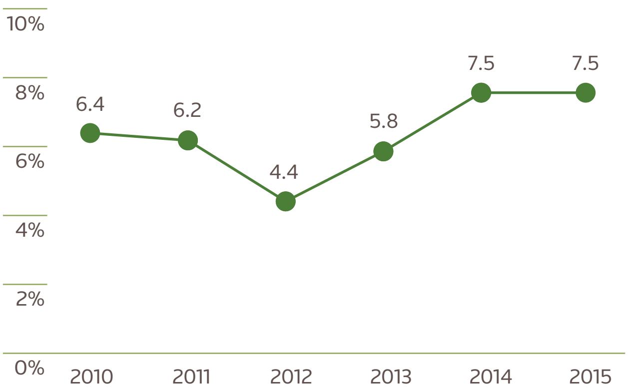
Private sector credit continues to be in the double digits although it decelerated moderately in recent years due to tight monetary stance. Credit declined from 22 to 20 percent in 2012 and 2013, respectively. It deteriorated further to 12 percent in 2014. However, it is projected to increase to 13 percent in 2015. This development could be a reflection of an increase in the one-month interbank rate which increased from 6 percent in 2013 to 8 percent in 2015.

PRIVATE SECTOR CREDIT



Source: IMF, 2014 AIV

ONE-MONTH INTERBANK RATE (PERIOD AVERAGE)



Source: IMF, 2014 AIV

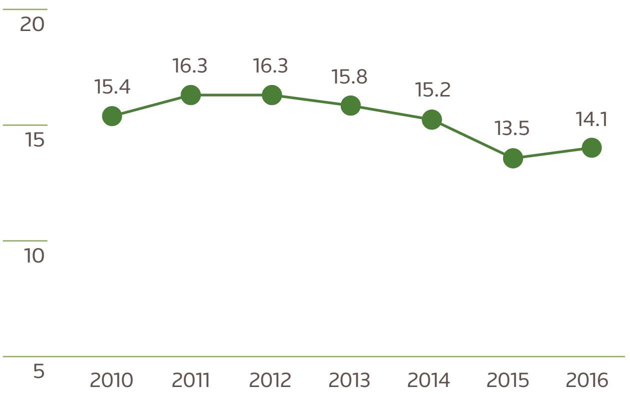
Fiscal Position

On the fiscal front, revenue collection remained relatively strong but a lot still needs to be done to increase non-oil tax revenue to strengthen tax administration taking into account the revenue loss on energy subsidies.

Fiscal policy actions taken in 2014 to control spending on energy subsidies will create fiscal space for spending in priority areas and increase government spending in social and infrastructure areas. However, Indonesian authorities should continue to protect the most vulnerable households. To further address expenditure controls, state-owned enterprises and public-private partnerships must be closely monitored to avoid any excessive reliance on the national budget.

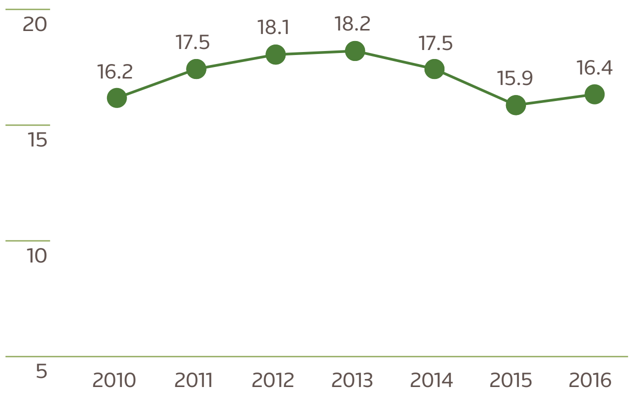
Although the Indonesian economy has registered robust growth over the years, it faces challenges in maintaining high, inclusive growth, macro-financial stability and strengthening its external position. Hence, there is a need for structural policies to deepen financial markets and create a more business friendly climate in order to increase exports and create jobs.

CENTRAL GOVERNMENT REVENUE (% OF GDP)



Source: IMF, 2014 AIV

CENTRAL GOVERNMENT EXPENDITURE (% OF GDP)



Source: IMF, 2014 AIV

CENTRAL GOVERNMENT EXPENDITURE OF WHICH ENERGY SUBSIDIES (% OF GDP)

Source: IMF, 2014 AIV

CENTRAL GOVERNMENT BALANCE (% OF GDP)

Source: IMF, 2014 AIV

Outlook

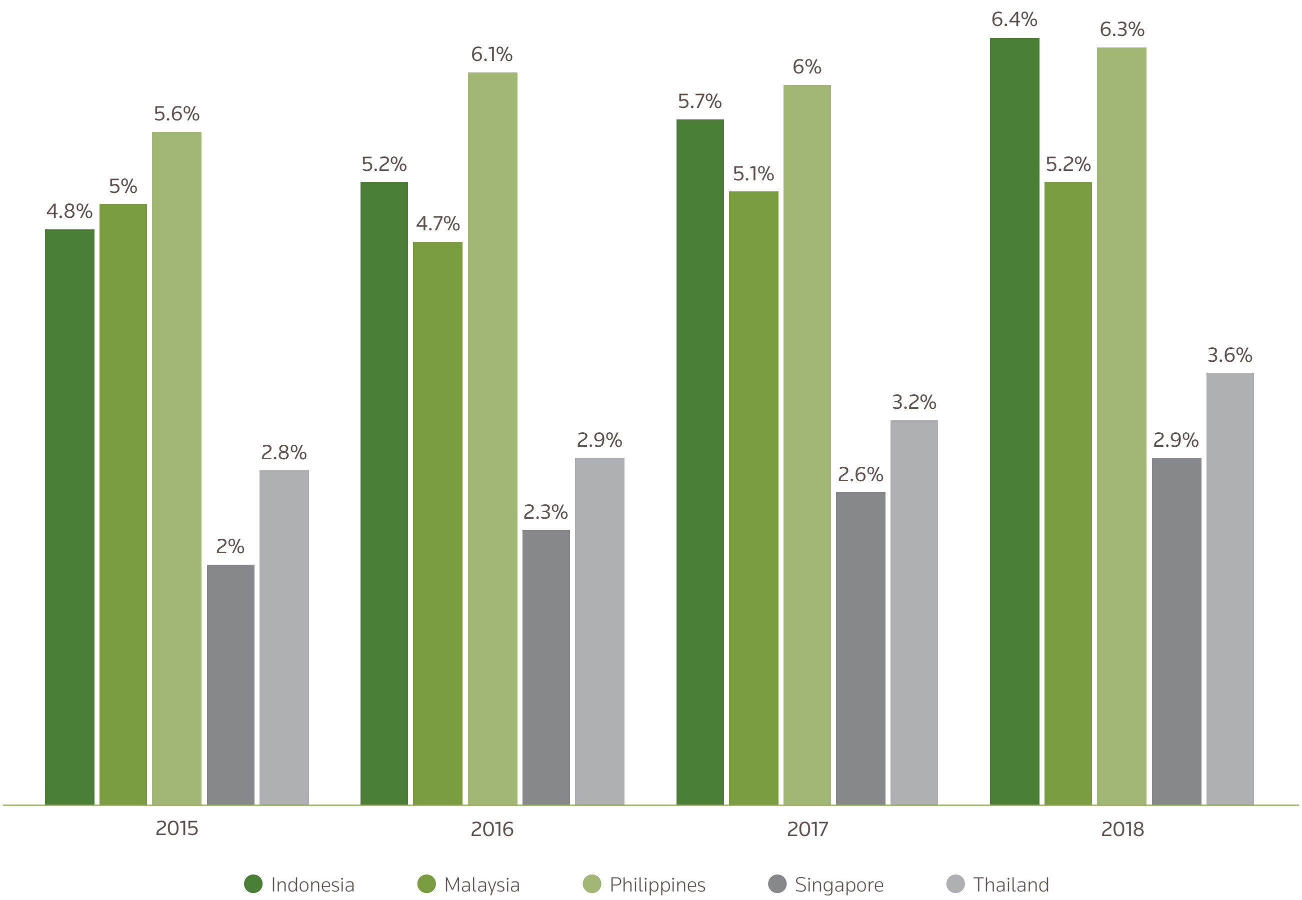
It is often said that the Indonesian economy has huge growth potential. Indonesia is the 16th largest economy in the world and is forecasted to grow to become one of the big seven globally by 2030 (McKinsey Global Institute, 2011). However, since 2013, Southeast Asia's largest economy and the "sleeping giant of Southeast Asia" has been suffering from a slowing economy due to both external and internal factors.

In the second quarter of 2015 Indonesia's annual economic growth dropped to 4.67 percent, its slowest pace since 2009. In an attempt to steer growth back on track, from the third quarter of 2015, the Indonesian government started announcing stimulus packages and incentives to draw in investments, boost consumer spending and support a rupiah that had weakened to 17-year lows.

The weak growth in 2015 is mainly due to low export demand from slow growth in China's economy, stagnant growth in Europe and Japan, low commodity prices, the recent appreciation of the USD[1].

Growth in Indonesia is expected to be above 5 percent in the medium term and increase gradually to be above its comparator countries namely Malaysia, Singapore and Thailand. According to Prof. Suahasil. Nazara, head of fiscal policy agency, Ministry of Finance, Indonesia current growth trajectory is expected to be driven by growth in Java Island which contributed about 63 percent of Indonesia's GDP growth.

GDP GROWTH



Source: Consensus Economics, Goldman Sachs Global Investment Research

However, current account is expected to narrow partly due to the current low oil prices. Inflation have picked-up in 2014 above Bank of Indonesia target as a results of hikes in fuel prices but with the current low oil prices, it is expected to ease to 4.7 percent in 2016.

The near-term Outlook will be challenged by current global economy affecting developed countries and commodity prices. Although growth could be impacted by current low commodity prices, prospects should improve, as there are ongoing reforms particularly in the area of infrastructure with greater Public Private Partnership (PPP). This is demonstrated in the country's master plan where contribution from PPP constitutes a significant percent towards financing infrastructure developments. In addition, the establishment of PPP unit at the Ministry of Finance is a good initiative towards achieving this objective[2]. Domestic prices will continue to ease downward due to the lower oil prices which will dampen inflationary pressures.

Inflation is expected to decelerate from 8.4 percent in 2014 to below 5 percent in 2016 year-on-year going forward due to low oil prices, which translates to low retail gasoline prices. The low prices coupled with preservation of tight monetary stance by Bank of Indonesia will result to bring inflation to meet BI's inflation target.

The Current account deficit is projected to narrow in 2016 going forward mainly due to reduction in the oil import bill resulting from low oil prices. This reduction could be partly offset by lower commodities prices and weak external demand due to slow growth in China and Europe. Therefore, the Balance of payments (BOP) which recorded a surplus in 2014 will continue to be in surplus though with smaller magnitude. In addition, level of reserves as of 2015 is above 7 months of imports cover in goods and service which demonstrates a significant comfort level. This trend is expected to continue in the medium term going forward. Since Indonesia is on a flexible exchange rate regime, this level of reserves is relatively sufficient to weather most of shocks that confronts the economy.

Downside Risks

The main downside risks confronting the Indonesian economy is mostly from external factors which could impact negatively the banking and corporate sectors. Out of these risks, the one risk that stands out the most is the slow growth in the trading partners' countries and sluggish growth outlook in major global economies (US, China, Japan and Europe). This weakens external demand and commodity prices. An unexpected high frequency in the global financial market volatility could exert pressures on BOP and bank funding pressures and high foreign investors' participation in government securities particularly bond market could increase vulnerability as a result of such global volatility. The recent strengthening of the US dollar could negatively impact corporate balance sheets where debt servicing is mainly carried out in US dollar.

In addition, in 2014 debt servicing as a percent of GDP stood at 22 percent. A sharp US rate normalization could have an impact on capital outflows, which could exert pressure on the local currency. On the domestic front, the extremely underdeveloped quality of the port infrastructure compared to comparator countries such as Singapore, Malaysia, and Thailand could diminish Indonesia's competiveness as a re-export hub. Indonesia continues to be challenged with infrastructure needs where the public sector support is about 70 percent of the total infrastructure needs which corresponds to 4.2 and 6.2 percent of GDP in 2015 and 2019 respectively. The growth in infrastructure needs during this period corresponds with Indonesia government's ambitious National Medium Term Plan (RPJMN 2015-2019) that includes infrastructure policy. Indonesia registered the highest gap in terms of infrastructure needs versus spending in the ASEAN economies. In order to meet this need, it could seriously challenge the fiscal situation of the country.

A worker unloads oil palm fruits to a local palm oil factory in the Serdang Bedagai district of Indonesia's North Sumatra province. REUTERS/Y.T Haryono

2 Islamic Finance in Indonesia

Great Mosque of Central Java,
Semarang, Central Java.

INSIDE THIS CHAPTER

Development of Islamic finance in Indonesia

Indonesia was slow to take to Islamic finance and only established its first Islamic bank, Bank Muamalat, in 1991. This late adoption, relative to neighbours Malaysia and other major Muslim-majority countries such as Pakistan and those in the Middle East, was not for want of a lack of understanding or desire from various factions on the ground. Resistance came from the government of President Soeharto, who was in power from 1967 to 1998, against what it perceived as Islamic movements underlined by a brand of political Islam that could threaten the stability of the government and the state.

President Soeharto started softening his stance towards Muslim groups in the late 1980s and in 1990 opened the first meeting of the Ikatan Cendekiawan Muslim Indonesia (ICMI), or the Association of Indonesian Muslim Intellectuals, whose influence was growing politically. This was a significant symbol of his opening up to increasingly loud calls for what was frequently called Indonesia's 'Islamic economy movement'. The path to the establishment of the country's first Islamic bank then became a smooth one.

Customers are seen at a counter inside a bank complex in Jakarta, Indonesia. REUTERS/Darren Whiteside

1970s – 1991

Grassroots movements asking for Shariah compliant financial services in Indonesia had its roots in the 1970s, much in line with the blossom of thought to establish Islamic banking and finance in major Muslim countries like Malaysia, Pakistan and those of the Arabian Gulf and the Middle East, which had earlier set up the Jeddah-based Organisation of Islamic Conference (now Organisation of Islamic Cooperation) in 1969.

In 1975, in a bid to accommodate the needs of Muslim and Islamic parties and factions, President Soeharto established the Majelis Ulama Indonesia (MUI), or the Indonesian Council of Religious Scholars, largely to present the government's development policies as being fatwa-supported.

In the 1980s the momentum for establishing Islamic financial institutions was primarily sustained by student and university groups. In 1983 a national symposium on Islamic economics was held at Bandung Islamic University and this was followed by a group of students establishing Baitut-Tamwil Teknosa in Bandung two years later. Another group brought Shariah cooperatives into Jakarta named "Ridho Gusti". However, these institutions did not take root.

This was followed by banking sector reforms in 1983 as result of declining oil prices and this involved deregulation of deposit and loans interest rates, removal of credit ceilings and phasing out funding state-owned banks by government. As a result, the banking system became less controlled and more market-based and this had a number of positive outcomes as indicated by the rise of time deposit funds held and the increasing levels of competition in the banking sector.

More reforms were enacted in 1988 by PAKTO '88, a liberalisation policy package that encouraged alternative banking with more private and foreign banks involvement. (These reforms later led to the study of establishing Islamic banking and introduction of Islamic rural banks in several regions in 1991.)

After President Soeharto opened the first meeting of the ICMI in 1990, in the same year the MUI started exploring the idea of Islamic banking in a workshop, which ended with a recommendation to establish a working group (MUI banking team) to explore the idea with the backing of President Soeharto, as well as the ICMI. Hence, Indonesia's first Islamic commercial bank was swiftly established in 1991 but without a legislative basis for non-interest banking which was only introduced a year later.

1991 – 2014

1990

AUGUST
Study of establishing Islamic commercial bank by national religious scholars

1991

AUGUST
The first three Islamic rural banks (BPRS) were licensed and opened in two areas

NOVEMBER
Bank Muamalat Indonesia, Indonesia's first Islamic bank was established

1992

MARCH
Banking Act No.7/1992 initiated the legislative basis for Islamic banking in Indonesia

Indonesia's first official Baitul Mal Wa Tamwil (BMT) was established

MAY
Bank Muamalat began operating

OCTOBER
Government Regulation No. 72/1992 on profit-sharing banks was issued

1994

FEBRUARY
Indonesia's first Islamic insurance company, Syarikat Takaful started operations

1996

Baitul Tamwil Muhamadiyah (BTM) was established by Muhammadyah Foundation

1997

JULY
Issuance of Islamic mutual funds by PT Danareksa Investment Management

1998

Establishment of Indonesia's National Shariah Board (DSN) under Majelis Ulama Indonesia (UI)

NOVEMBER
Recognition of dual system of banking, conventional and Islamic, as part of a new banking act (Act No.10) as well as Unit Usaha Syariah or Islamic business unit (UUS)

1999

MAY
Law no. 23/1999 allowed central bank to provide all Shariah measures for monetary policies and liquidity instruments for Islamic banks as well law no. 38 on Zakat

SEPTEMBER
Bank Syariah Mandiri, Indonesia's second bank, was established along with the first Islamic banking unit (UUS) of a conventional bank (Bank IFI)

2000

JULY
Launch of Jakarta Islamic Index (JII)

Introduction of Shariah Interbank Money Market (PUAS)

2001

APRIL
National Shariah Board issued Guidelines for Implementation of Shariah Mutual Funds

2002

MAY
First Shariah Banking Accounting Standard introduced by Indonesian Accounting Standard Board

SEPTEMBER
First corporate sukuk (mudaraba sukuk) issuance by PT Indosat Tbk

SEPTEMBER
Blueprint for Islamic Banking Development in Indonesia to 2012

2003

HSBC Amanah, the first Shariah compliant banking unit of a foreign bank started operating

MARCH
MoU between Bapepam-LK and DSN-MUI to establish Islamic capital market regulation

2004

JANUARY
ReINDO Syariah established as Indonesia's first ReTakaful operator

2005

Amanah Finance was established as Indonesia's first non-bank financing company

2006

NOVEMBER
Bapepam-LK issued rules regarding Islamic Capital Markets

2007

SEPTEMBER
Launch of the first Shariah Securities List by Bapepam-LK

2008

MAY
Passing of Sovereign Sukuk Law

AUGUST
Government of Indonesia issued Sovereign Sukuk for the first time

2009

FEBRUARY
Indonesia's first retail sukuk issued

2011

MAY
Launch of Indonesia Shariah Stock Index (ISSI)

2013

MAY
First Shariah ETF by Premier ETF

OCTOBER
Launch of Grand Design Development of Microinsurance Indonesia which covers microtakaful as well by OJK and a number of insurance associations

2014

MARCH
Issuance of Shariah guarantee regulation by OJK

SEPTEMBER
OJK starts drafting regulations for Islamic pension funds

OCTOBER
New takaful law requiring conventional insurance firms to spin-off Islamic units

2016

JANUARY
New committee: National Committee for Islamic Finance

H.E. AGUS D.W. MARTOWARDOJO

Governor of Bank Indonesia

AGUS D.W. MARTOWARDOJO is a graduate of economics at the University of Indonesia and he was part of various programs at the State University of New York, Harvard Business School, Stanford University, and Wharton Executive Education.

Agus D.W. Martowardojo's career began in the banking industry at the Bank of America and then Bank Niaga in 1986. In 1995, he was appointed Managing Director of Bank Bumiputera and in 1998 as the Managing Director of Bank Ekspor Impor Indonesia. From 1999-2002, he served as the Managing Director of Bank Mandiri. In October 2002, after working as an advisor to the Chairman of IBRA (The Indonesian Bank Restructuring Agency), he was elected as the Managing Director of Bank Permata. From May 2005 until May 2010 Agus D.W. Martowardojo led Bank Mandiri as its Managing Director.

Prior to his selection as the Governor of Bank Indonesia, Agus D.W. Martowardojo was the Minister of Finance of the Republic of Indonesia as of 20th May 2010.

1. What is the current state of Islamic financial Institutions in Indonesia?

The Indonesian Islamic financial industry is currently in the development stage with OJK acting as the regulatory authority, formulating and publishing a strategic plan for development of the industry since December 2013. Bank Indonesia (BI), previously acting as the regulatory authority still has a prominent role in promoting the Islamic finance industry through a number of Islamic economic and finance initiatives in line with the government policy package as well as the national economic development plan. The Islamic finance initiatives in Indonesia embrace the principles of market-driven, prudential management, financial efficiency and robustness, service excellence as well as conformity to Shariah principles. The vision of the development program is to establish a robust and sound Islamic banking system which is consistent with the implementation of Shariah principles to assure ethical based investment and real economic based financial transactions. OJK has formulated short-, medium-, and long-term initiatives to support the development of the Islamic banking sector which are also in line with the National Banking Architecture. Being at the development stage, commercial sector and social sector within the Islamic financial landscape continue to increase in terms of asset size and product innovation.

SUPPORTING DATA (2015)

- Indonesian Islamic banking industry has 13 MILLION SAVING ACCOUNTS
- Office networks: 3000 SPREAD ACROSS INDONESIA
- Islamic banking share within banking industry: 4.8%
- Islamic mutual funds share: 4.5%
- Islamic capital market/sukuk share: 3.2%
- Shariah Non-Banking Financial Institutions share: 3.1%

2. Which sector(s) are the potential demands for Islamic finance? What percentage of the current business clients will opt for Islamic finance once the Islamic finance becomes more mainstreamed?

Islamic banking sector is still dominating the Islamic financial system although the Islamic capital markets show a promising future as supported by regular issuance of government sukuk. With this development, we foresee growing potential clients as more product innovation is taking place in the Islamic financial industry. However, the percentage of which current business clients will opt for Islamic finance will be most likely driven by customers' rationale. In this case, incentive benefits in terms of higher return for Shariah deposit and cheaper financing are the main pull factors in which a high percentage of business clients will occur.

3. What do you see as the regulatory road-map to facilitate the development of a level playing field for Islamic finance? What are the possible scenarios?

Development of the Islamic banking, capital market, and non-bank Islamic financial institutions roadmaps are under the purview of OJK. However, BI has the commitment to support and contribute fully in the development of Islamic finance in line with its mandate. Hereby, BI commitments to Islamic finance development focus on the context of the macroprudential policy framework and financial deepening initiatives through development of Islamic money market instruments. Furthermore, BI also provides advancement support to other financial sectors such as the Islamic social sector that requires assistance to develop better regulatory governance framework. All kinds of initiatives undertaken by BI and OJK are preserved to maintain the Islamic financial stability.

4. How would you describe the current banking industry in Indonesia before and after the financial crisis, paying particular attention on the evaluation of Islamic bank?

The global financial crisis had limited impact to Islamic banks in Indonesia as they had no exposure to derivative transactions (prohibited under Indonesian Shariah regulatory framework). However, in the

"ISLAMIC BANKING SECTOR IS STILL DOMINATING THE ISLAMIC FINANCIAL SYSTEM ALTHOUGH THE ISLAMIC CAPITAL MARKETS SHOW A PROMISING FUTURE AS SUPPORTED BY REGULAR ISSUANCE OF GOVERNMENT SUKUK.

> IN THE NEXT 5 YEARS (2020),
> UNLESS THE STRUCTURAL PROBLEMS REMAIN UNRESOLVED,
> WE FORESEE THE ISLAMIC BANKING SHARE
> TO BE IN THE RANGE OF 6% – 8%.

aftermath of financial crisis which led to the economic slowdown internationally, the performance of Islamic banks was slightly impacted in terms of lower asset growth and profitability. Nevertheless, Islamic banks still remain sound as supported by strong capital and they continue to show improvements.

5. How do you see Islamic banking share of Indonesia to the total banking sector in 2020, taking into account the current growth in Islamic banking?

Despite the seasonal economic challenges that hinder the potential of Islamic banks from its potential growth currently, Islamic banks are still in the growing phase. In the next 5 years (2020), unless the structural problems remain unresolved, we foresee the Islamic banking share to be in the range of 6% – 8%. Potential structural problems include as follows:

a. Higher financing pricing as compared to conventional counterparts;

b. Retail and commercial orientation;

c. The needs to have more innovative product development.

6. From the perspective of a regulator, how would you observe the role of BI, OJK and Shariah National Council in creating awareness on Islamic finance services and products to the public?

BI, OJK, and Shariah National Council have their own distinctive roles in nurturing Islamic finance services according to their mandate. While OJK focuses on the supervision of Islamic financial institutions and implementing microprudential regulation, BI commits to undertake initiatives that are in line with its macroprudential objectives, Islamic financial deepening, liquidity support, and advancement support for the social sector. On the other hand, Shariah National Council acts as the reference/guiding authority for BI and OJK to ensure that the Islamic Finance initiatives comply with Shariah principles. In this case, the Shariah National Council is responsible for the issuance of fatwa. Given the importance and also the differences in the role and responsibilities of each institution, coordination becomes important in ensuring success of developing the Islamic finance Industry. Therefore, it is in our greatest interest that the collaboration and coordination that is now already well-established can be upheld.

7. Are Islamic banks posting any constraints on Central Bank of Indonesia in its monetary policy implementation?

Islamic banks pose no constraints in relation to the effectiveness of our monetary policy implementation. BI continues to incorporate and develop Shariah monetary instruments as part of our monetary operation strategy. BI also acts as the Lender of Last Resort (LOLR) for Islamic Banks. Furthermore, BI, Indonesia's FSA (OJK), and Ministry of Finance have cooperatively work together to deepen the Indonesian Islamic financial markets especially sukuk and Islamic money markets through an Islamic financial market development framework.

8. What are the current innovations in Islamic liquidity management in Indonesia?

One of the innovations in Islamic liquidity management is the repurchase facilities provided by Bank Indonesia for Islamic money market instruments. The repurchase facilities include repo of SBIS (Central Bank Islamic Certificate) and reverse repo of SBSN (government sukuk). Furthermore, Bank Indonesia has recently introduced Shariah term deposit FX for liquidity management in the domestic market. In due course, Bank Indonesia will also issue a regulation on Shariah compliant repurchase agreement whilst other Islamic financial instruments are also in the pipeline to be developed.

9. Who do you think is the main driver behind Islamic financial innovation in Indonesia?

Market players are definitely the main driver with the support and coordination of BI, OJK, and National Shariah Council. This is because market players have the capacity and expertise to broaden the market as well as the understanding of customers' risk appetite to innovate Islamic financial products in Indonesia.

10. What are the current major constraints confronting Islamic Banks?

In our opinion, there are four major challenges ahead to be addressed in order to make Islamic financial industry more competitive and continuously flourish within the right trajectory that are as follows:

a. **Regulatory clarity and legal certainty whereby the standards for Islamic finance, especially for Islamic banking, are relatively fragmented across jurisdictions due to different fatwas interpretation and legal enforcement in each respective jurisdiction.** For that reason, there is a need for harmonisation of perception as well as unison of standards and regulations across jurisdictions, which can be achieved by cross border collaboration between key players, regulators, and international standard setting bodies.

b. **Human capacity development in the Islamic financial industry across all sectors.** The central issue in this particular challenge is the significant gap between Shariah and finance skills. People who are well versed in Shariah skills do not necessarily possess finance skill, and vice versa. In light of that issue, academic institutions and Islamic financial institutions are critical to work hand-in-hand in order to pursue initiatives in fostering a set of skilful Islamic finance talent in the industry.

c. **Missing gaps between Islamic finance theory and actual practices as reflected by the gaps between academicians and practitioners.** These gaps should be bridged by more practical and pragmatic research conducted by academicians in collaboration with practitioners, with an objective of bringing feasible solutions to address inherent gaps in Islamic financial industry and also build Shariah awareness for market participants.

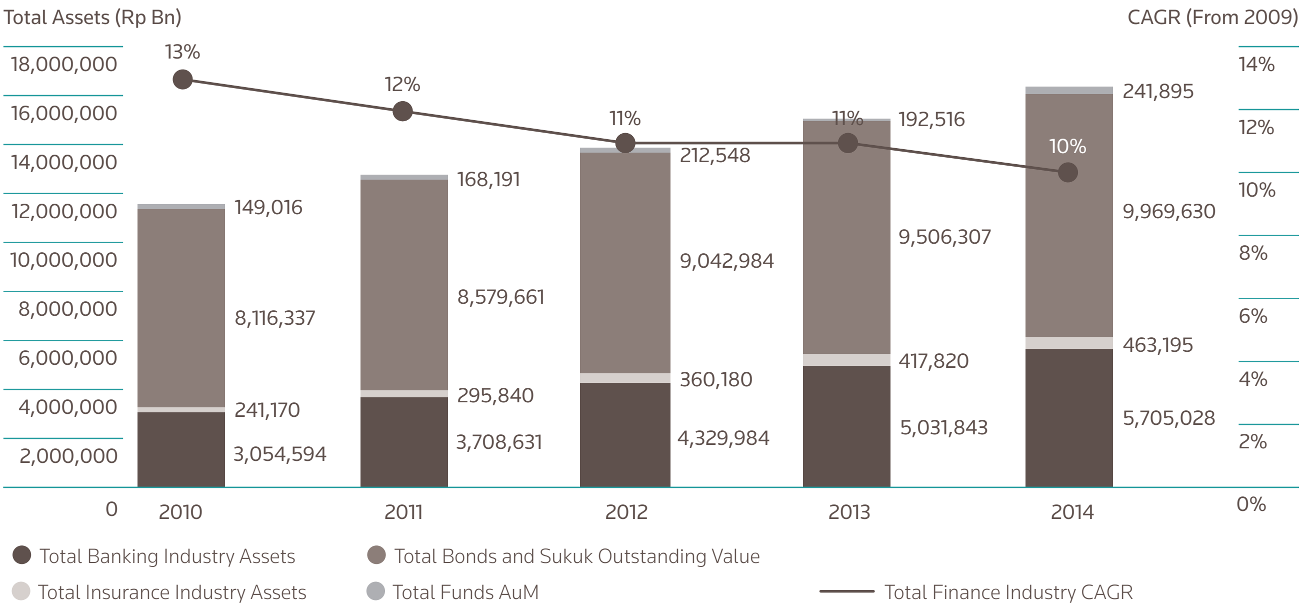
d. **Low technological diffusion in Islamic financial market development.** To accelerate Islamic financial market, the development should incorporate technology advancements such as digital mobile banking technology, big data management, IT interfaces with a third party, in order to be more competitive and to anticipate disruptive megatrends in the future.

11. How do you want the world to recognize Islamic financial industry in Indonesia? What do you think is the most distinct feature of Islamic financial services industry in Indonesia?

We aspire to be the best Islamic financial services provider in the region which plays a significant role in financial stability and sustainable and equitable economic development program. The high performance of the system is supported by high professionalism and stronger governance. The most distinct feature of Islamic financial services industry in Indonesia lies on the vision to incorporate all potentials into a comprehensive development program which involves all relevant institutions and economic segments.

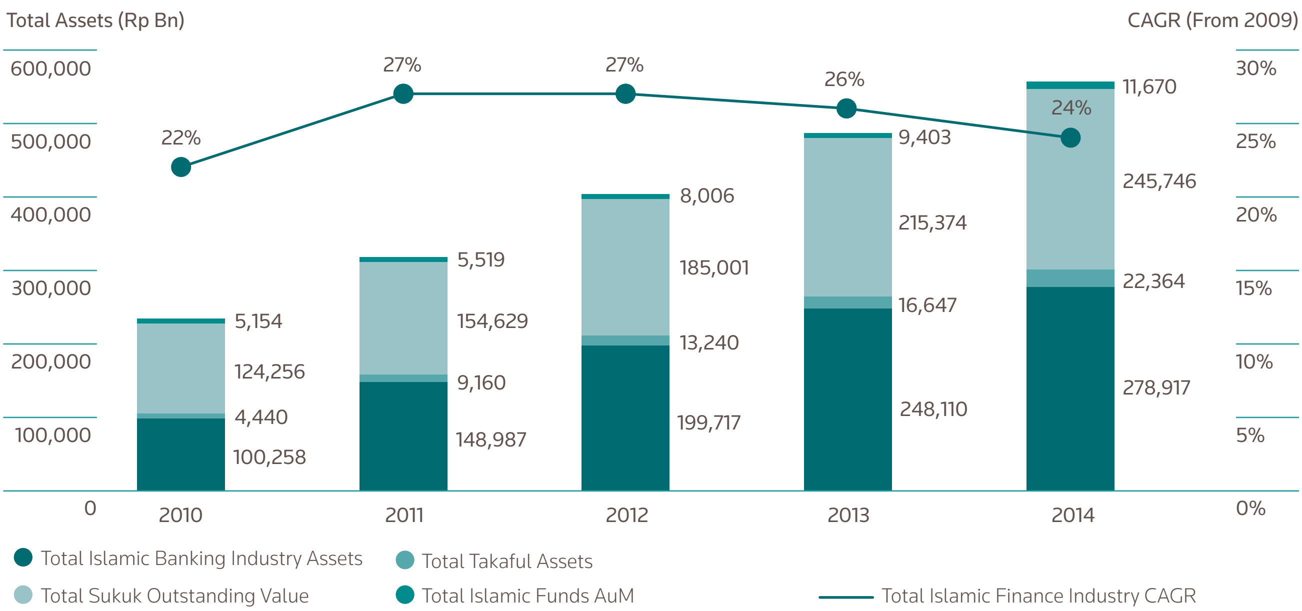
Islamic Finance Landscape

INDONESIAN FINANCE INDUSTRY LANDSCAPE



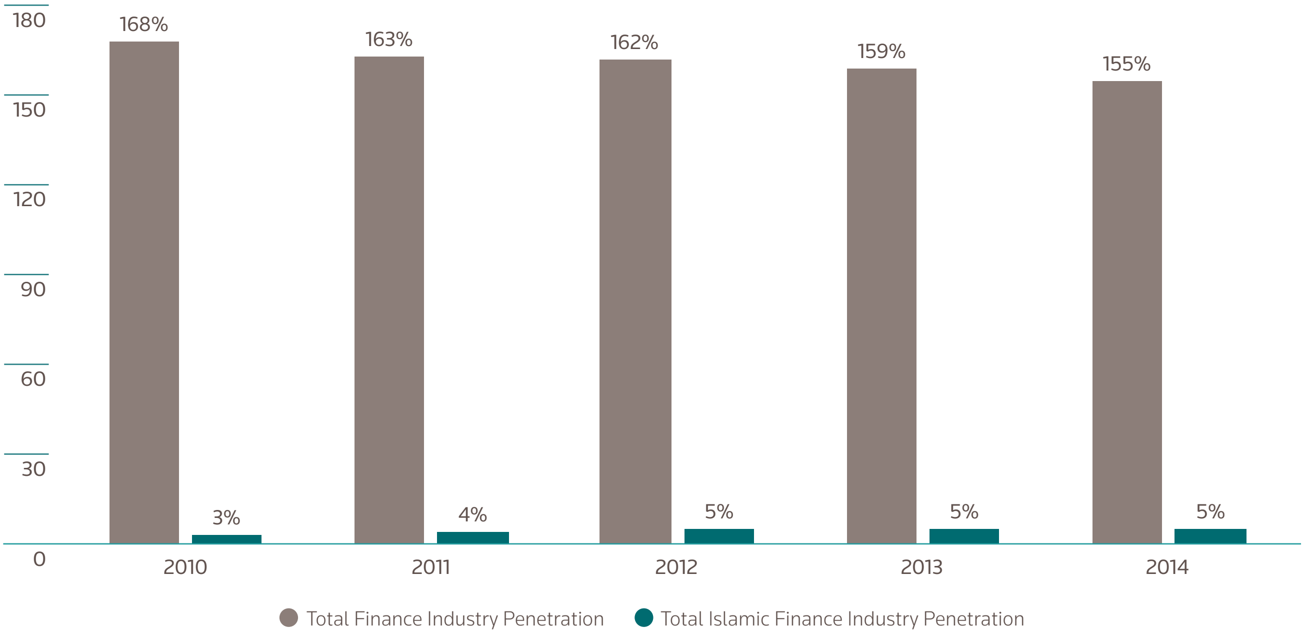
Source: Bank Indonesia, Financial Services Authority (OJK), Thomson Reuter's Eikon and Lipper

INDONESIAN ISLAMIC FINANCE INDUSTRY LANDSCAPE



Source: Bank Indonesia, Financial Services Authority (OJK), Thomson Reuter's Eikon and Lipper

INDONESIAN FINANCE AND ISLAMIC FINANCE INDUSTRY PENETRATION (TOTAL ASSETS AS % OF GDP)



Source: Bank Indonesia, Financial Services Authority (OJK), Thomson Reuter's Eikon and Lipper

Islamic finance enjoying higher growth than conventional sector

In 2014, Indonesia's overall finance industry held Rp 16,380 trillion in assets with Islamic finance constituting only 3 percent of this total (Rp 559 trillion). The overall financial industry grew at 42 percent from 2010 (8 percent since 2013) and 7 percent CAGR since 2010 while the Islamic finance industry surpassed that growth with 139 percent YTY growth since 2010 (14 percent since 2013) and 19 percent CAGR-wise.

Islamic banking is the biggest contributor to Islamic finance (50 percent) followed by sukuk (44 percent). For the whole financial industry, bonds dominate (61 percent) followed by banking (35 percent). Insurance and funds both do not contribute significantly to the financial sector with a total of 6 percent for the whole finance industry and 4 percent for the Islamic equivalent.

There is a huge gap between the take-up rate for Islamic finance compared to the whole industry; Islamic finance is 31 times smaller than the whole financial industry. The take-up rate for Shariah-compliant finance stayed at 5 percent over the last 3 years.

DR. MULYA E. SIREGAR

Deputy Commissioner of Banking Supervision,
Indonesia Financial Services Authority (IFSA) / Otoritas Jasa Keuangan (OJK)

DR. MULYA E. SIREGAR is the Deputy Commissioner of Banking Supervision, Indonesia Financial Services Authority (IFSA)/ Otoritas Jasa Keuangan (OJK) in January 2014. Prior to his assignment in IFSA/OJK, he was Assistant Governor in Bank Indonesia since May 2013. Before that, he headed the Department of Banking Research and Regulation as a Executive Director since 2012. In Bank Indonesia, Dr. Mulya Siregar spent most of his professional career in Shariah banking and his past position is Director of Department of Shariah Banking. Dr. Mulya Siregar is a member of Advisory Council to Indonesian Waqf Board (BWI) from 2008 to 2010, a member of Postgraduate Board of Studies in International Center for Education in Islamic Finance (INCEIF) KL-Malaysia from 2006 to 2009. Dr. Mulya Siregar holds a PhD and MSc in consumer economics from Ohio State University, USA and a Bachelor of Agricultural Economics from Bogor Institute of Agriculture, Indonesia.

1. How would you describe the current progress of Islamic Finance in Indonesia?

Indonesian Islamic banking during the last ten years experienced relatively high growth, but in the last two years experienced a slowdown; the main reasons, among others, are related to a slowdown in the national economy and the internal consolidation of the industry in addressing the conditions and the situation, in order to rediscover the momentum of new business growth.

In addition, Islamic banking activities support growth investment, as seen from the allocation of financing for investment purposes that experience the greatest growth in year 2014 (23.3%, yoy) compare to consumer financing's growth (1.2% , yoy) and working capital financing's growth (8.9%, yoy). Although in terms of market share, consumer financing is still the largest share of assets of around 40% (2014), but its growth has slowed compared to the previous year (2013) where the consumer financing's share reach around 43%.

The performance of the Islamic commercial bank industry, particularly from the capital side, has also improved, as indicated by the CAR increase from the previous year (2013) which is 14.4% to 15.7%, among others due to the capital increase and Initial Public Offering.

2. What impact does the change from BI to OJK make on the development of IFSI in Indonesia? Will it potentially alter the shape of the development? If so, in what manner?

The establishment of OJK has marked a new era in the regulation and supervision of Indonesia's financial sector. Since December 2013 OJK had assumed the supervisory roles on the financial sector (including IFSI) previously conducted by Bank Indonesia and the Ministry of Finance. Based on its mandate, OJK is required to develop an integrated approach of regulation and supervision for the financial sector. This specific OJK role could potentially change the development of IFSI, as we may improve, and thus leverage the benefit of interconnectedness between industries (i.e. bank, insurance and NBFI, Microfinance Inst., and capital market), while minimising inconsistent regulations and potential arbitrage across the system.

Furthermore, OJK is also mandated to enhance the protection of interests of consumers and the public. A key to achieve this mandate is financial literacy and financial education programs. In this regard, we may expect that OJK will promote more systematic and effective financial education programs to a wider range of potential customers, thus creating more demand for Islamic financial services. This integrated approach will also enhance efficiency and effectiveness of the programs to develop supporting institutions and infrastructure for Islamic finance that covers the interest of all types of IFSI, e.g. : enhancing the fatwa authority, human capital development for many function in IFSI, religious court judges, notary, Shariah experts, trainings for lectures and teachers.

3. What do you see as the regulatory road-map to facilitate Islamic Finance to have a level playing field? What are the possible scenarios?

In order to develop Islamic banking further, we have identified a wide range of strategic issues, as mentioned in the Islamic banking roadmap 2015 – 2019, as well as policy directions for managing these issues, to achieve our vision for the industry where "Islamic banking \contributes significantly to sustainable economic growth, equitable development and the stability of the financial system and highly competitive."

There are seven directions in the Islamic banking roadmap 2015 – 2019, namely (i) Strengthening policy synergies among government, authorities and other stakeholders, (ii) Strengthening of capital and the scale of their operations and improve efficiency, (iii) Improving the structure of the fund to support expansion of financing segment, (iv) Improving the quality of service and diversity of products, (v) Improving the quantity and quality of human resources and Information technology and other infrastructure, (vi) Improving literacy and community preferences and (vii) Strengthening and harmonization of regulation and supervision.

The possible scenarios, among others, are: (i) make policies in order to optimize synergies among business groups that have an Islamic bank / Islamic business units, so it is expected to achieve

> "THE ESTABLISHMENT OF OJK HAS MARKED A NEW ERA IN THE REGULATION AND SUPERVISION OF INDONESIA'S FINANCIAL SECTOR.

the share of larger Islamic banks by utilizing conventional networks and infrastructure, (ii) while also encouraging the structure of Shariah compliant banking funds, which is more efficient through the optimization of the use of long-term stable funding in Islamic banking such as Hajj funds, Zakat funds / infaq / shodaqoh, (iii) encouraging the involvement of government in supporting the Islamic banking growth, by the establishment big Islamic banks and optimizing of Islamic banking in serving government activities.

4. How would you describe the distinguishing feature of IFSI in Indonesia as compared to other countries?

The needs for Shariah compliant financial services were rooted for a century or even longer in Indonesian society, as Islamic values continue to assimilate into and re-shape our culture. Therefore, initiatives to set up the Islamic financial institutions (IFIs) in Indonesia were mostly coming from communities, instead of a top-down approach involving government or any political agenda. This explains why Indonesia now has a rich structure of its Islamic financial industry. As of 2014, the Islamic financial industry consists of 34 Islamic banks and windows, 163 Islamic rural banks, 49 takafuls and 51 other non-bank Islamic financial institutions (i-NBFI), apart from about 5500 Islamic cooperatives or bait al maal wal tamwil (BMT). It also explains why our Islamic financial industry has strong retail-orientation, unlike many other countries which rely more on corporate and investment banking. Indonesian IFIs may have small scale of assets under management, but our IFIs have developed their distinct capacity of serving millions of customers. For example, just the Islamic banking sectors customers have reached 18 million accounts (both financing and deposit/ investment sides). The mass and community based development of Islamic finance is also a determinant of the success of the retail sukuk market in Indonesia.

With the features of iB clients in Indonesia, most are judicious and critical of IFSIs on the Shariah compliance of their products and how these institutions conduct their business. It is a reason why, in applying the iB network enlargement strategy, we use a gradual approach, from a full-pledge iB, then introduce dual system banking (Islamic banking windows operated by conventional bank), then introducing iB office channelling concept, and then delivery channel and leveraging programs between conventional and Islamic banks for delivering iB products and services. In Indonesia, the regulators, fatwa authority and Islamic bankers have a serious concern on Shariah-compliance. We do not progressively follow the mazhab that allows transactions which are doubtful in Shariah such as bai' al dayn and tawaruq.

5. How do you see Islamic banking share of Indonesia's total banking sector in 2020?

The market share of Islamic banking in 2020 is expected to reach around 11% (based by assumption that the growth of the national banking system is around 15% per year and the growth of Islamic banking around 28% per year). However, if some conditions, as specified in the Islamic banking roadmap and national master plan for Islamic finance, are put in place such as a national committee for Islamic finance under leadership of the country's leader which can coordinate and monitor the various policies and their implementation, such as the establishment of large Islamic banks which will drive the growth for Islamic banking and finance, and government support for the use of Islamic banking in various activities such as fund management of national budget (APBN) and Hajj fund, we expect the market share of Islamic banking could become higher.

6. What is the main driver of IFSI development in Indonesia?

Unlike the main drivers in some countries for the Islamic financial services industry (IFSI), such as the abundance of natural wealth fund / oil-rich countries such as in the middle east, or the government policies such as in Malaysia (in addition to awareness as Muslim countries for using and developing the Islamic financial services industry), Indonesia's financial services industry in the initial stage depended on community initiatives (bottom — up policy). After that, the development continued through certain main stakeholders who focused on the development of Islamic finance, such as Bank Indonesia, the Ministry of Finance and now Indonesia's Financial Services Authority or OJK. But in the future, there needs to be more synergies among stakeholders and authorities in the development of Islamic finance, where this can be done under a shared vision and in line with policy direction, in the context of developing Islamic Finance national wide. This can be done through the establishment of a national committee for Islamic

> INITIATIVES TO SET UP THE ISLAMIC FINANCIAL INSTITUTIONS (IFIS) IN INDONESIA WERE MOSTLY COMING FROM COMMUNITIES, INSTEAD OF A TOP-DOWN APPROACH INVOLVING GOVERNMENT OR ANY POLITICAL AGENDA.

finance development, under the leadership of the country's leader.

7. Would the presence of foreign Islamic banks affect the level of competition in IFSI? If so, to what extent?

As the world's 16th biggest economy and home to about 240 million people, of which the majority are Muslim (88%), Indonesia still has a lot of room in the development of the IFSI, even for foreign Islamic banks. As a regulator, we expect any foreign entry to raise the level of competition in the industry, however even in the retail segments there is still substantial growth potential for any IFI, as Indonesian middle class income is grow strongly, while large parts of population are still considered under banked.

Nevertheless, we expect any foreign entry to the Indonesian IFSI to have a clear positive contribution to our national economy. The foreign Islamic banks, with strong talents, good international networks and special advantages — i.e. in area of corporate finance, project/infrastructure finance, international trade, or investment — are favoured to take a part in the Indonesian IFSI. Those international banks are also required having good intentions to conduct know-how and expertise transfer to local bankers. Furthermore, we expect foreign institutions that enter the Indonesian market to also accompany corporates from their home countries that have economic interest in Indonesia to foster trade and other economic relationship between Indonesia and their home countries.

8. What are the initiatives to ensure that other sectors (other than Islamic banking; such as non-bank Islamic financial institutions, Islamic capital markets, and social finance sector) are also well developed?

Our intention is to integrate Islamic finance national development, by involving more non-banking Islamic finance development in the development of Islamic banking and to develop the two together in a more integrated way. OJK has initiated this, by forming a committee of development for Islamic finance services (KPJKS) within OJK, whose members include the chief executives of banking supervisors, chief executive of capital market supervisor and chief executive of the non-bank financial industry supervisors (IKNB) in OJK.

It also can be done in a more integrated manner by: (i) promoting and educating Islamic finance (Islamic banking, Islamic capital market and Islamic non-bank financial services) to the public through seminar/expo/training, so that all sectors of the Islamic financial services industry have the same perception and development stage, then (ii) making a roadmap of Islamic financial services such as the roadmap for Islamic banking and the roadmap for Islamic capital markets that contains programs / initiatives to develop inter-connectedness between Islamic banking with Islamic capital market and/or Islamic non-bank financial services industry (vice versa) to encourage and linked each other in their respective development stage, and (iii) composition of

A teller prepares Indonesian rupiah for a customer at a money changer in Jakarta, Indonesia. REUTERS/ Nyimas Laula

Islamic financial services industry master plan/roadmap.

9. Would you agree to the perception that the global Islamic finance community doesn't know much about the development of IFSI in Indonesia? If so, why is it the case?

As explained before, the Indonesian Islamic finance industry has risen from grass-root levels. As such, perhaps one would hardly find an Indonesian IFI listed in various 'top charts' available in international media, despite the fact that it has a much sounder foundation (i.e. customer base) at home. Given a miniscule of operation of some of our IFIs, transparency to public may not be a priority in our regulatory framework and oversight for some of the IFIs. However, there are fully fledge Islamic banks, Takaful and NBIFI that are required to apply governance and transparency standards similar to international IFIs. These segments of IFIs are basically 'open' for public and international exposures. Yet, it seems that they have only limited international news coverage, perhaps due to their relatively small scale (compared to international IFIs) and limited overseas operations. Moreover, as they have strong domestic orientation, perhaps they have found no incentives to have international exposures, or at minimum, to provide English translated publication materials.

In the scene of global Islamic finance, Indonesia is tending to use an "inward-looking" strategy, which means that its focus is to serve the local market, which is has big market potential for Islamic finance. So the existence of Indonesian IFIs in the global platform is not currently a priority. But the upcoming liberalisation of ASEAN Economic Community and rapid development of Islamic finance now make the regulator and market players in Indonesia aware of the need to enhance the Indonesian position and flagship in the global market. We are now more actively involved in the global forum of Islamic finance and are actively conducting seminars and conferences to present our achievements and potentials.

10. What will be the quick wins from Islamic banking industry in the coming 5 years?

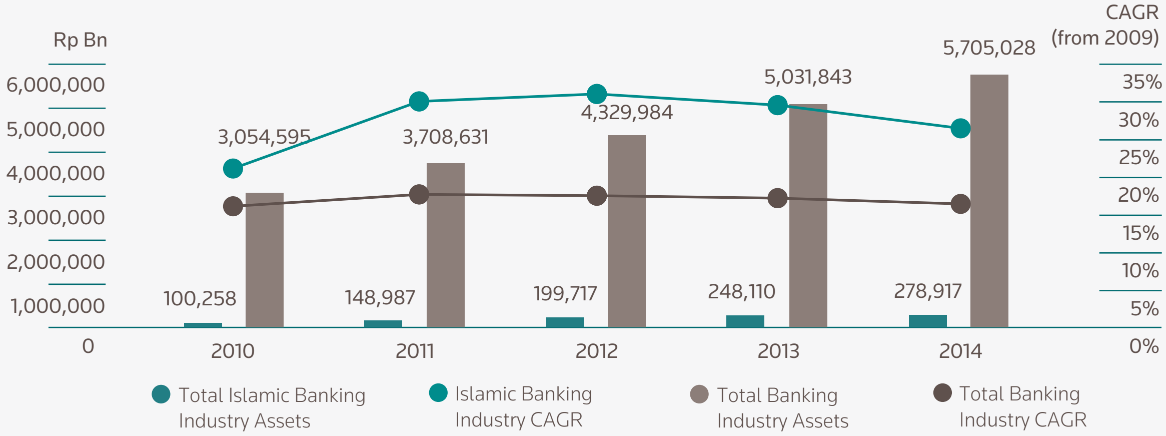
Some quick wins in the Islamic banking roadmap 2015 – 2019, among others, are: (i) The establishment of national committees for Islamic finance and the inclusion of the development of Islamic finance in the national medium term development plan (RPJMN) year 2015-2019, (ii) optimization of the role and increasing the commitment of bank's parent / conventional group in the development of Islamic banking, to achieve and Islamic banking share of at least 10% compared to the parent / group, (iii) encourage the establishment of big Islamic banks that can became a catalyst for the growth of national Islamic banking and finance.

11. How do you envisage the document of 10Y Framework and Strategies published by IDB and IFSB? Do you think countries hosting Islamic financial services industry should take the document's recommendations into consideration in the development of IFSI in their respective jurisdiction?

The 10 Y Framework and Strategies consist of 2 big initiatives, firstly an international initiative to develop and strengthen the global infrastructure for IFIs, and secondly frameworks and strategies for domestic authorities and stakeholders to develop IFIs in their own jurisdiction. We benefit from these frameworks and strategies; even though the level of development, socio-culture and history, and complexity of the Islamic finance industry in every country is different, and we have our own roadmap and framework to develop Islamic banking and finance in Indonesia.

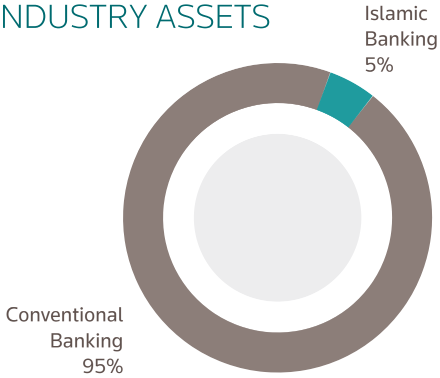
Banking Industry Landscape

INDONESIAN BANKING INDUSTRY TOTAL ASSETS



Source: Indonesian and Islamic Banking Statistics December 2014, Bank Indonesia / *Includes Shariah Business Units

INDONESIAN BANKING INDUSTRY ASSETS



BANKING INDUSTRY HIGHLIGHTS – 2014

Indonesian Banking Network

All Commercial Banks*:
119

Islamic Commercial Bank:
12

Dual System Bank (conventional bank with Islamic banking Unit):
22

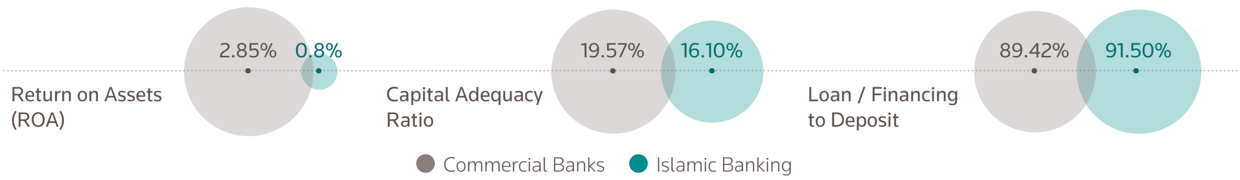
Conventional Bank:
85

All Rural Banks:
1,643

Islamic Rural Bank:
163

Conventional Rural Bank:
1,480

Source: Indonesian Banking Statistics December 2014, Bank Indonesia



Rp 5,705,028 bn
Commercial Banking Industry Assets (US$ 426 billion)

Rp 3,706,501 bn
Commercial Banking Industry Loans (US$ 277 billion)

Rp 4,114,420 bn
Commercial Banking Industry 3rd party Funds (US$ 308 billion)

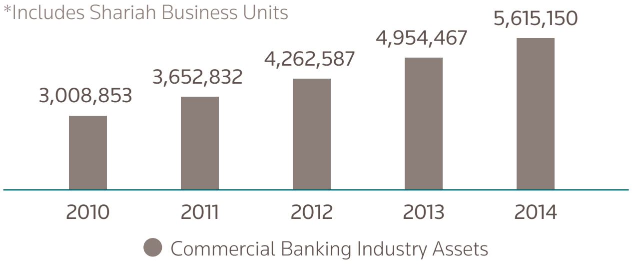
Rp 278,917 bn
Islamic Banking Assets (US$ 20 billion)

Rp 199,330 bn
Islamic Banking Financing (US$ 14 billion)

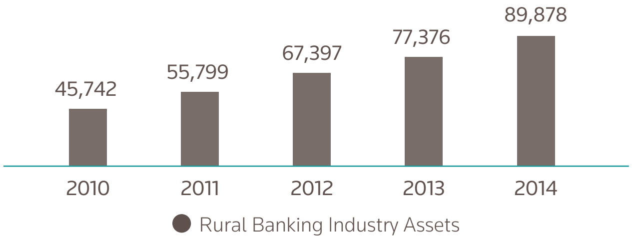
Rp 217,858 bn
Islamic Banking Depositor Funds (US$ 16 billion)

INDONESIAN COMMERCIAL BANKING INDUSTRY ASSETS (Rp Billion)

*Includes Shariah Business Units



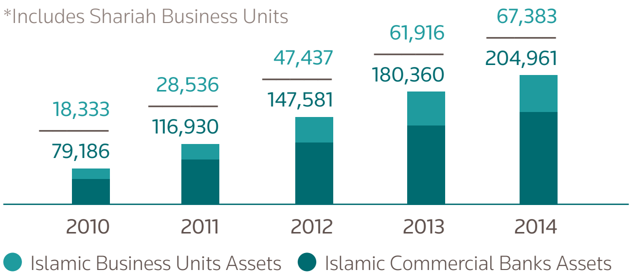
INDONESIAN RURAL BANKING INDUSTRY ASSETS (Rp Billion)



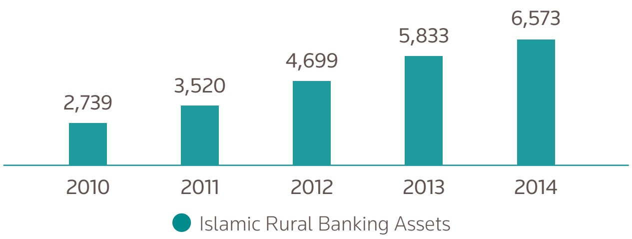
Source: Indonesian Banking Statistics December 2014, Bank Indonesia

INDONESIAN ISLAMIC COMMERCIAL BANKING ASSETS (Rp Billion)

*Includes Shariah Business Units



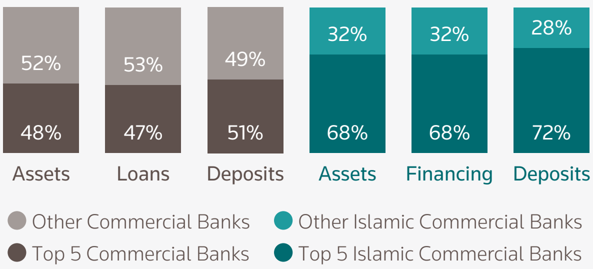
INDONESIAN ISLAMIC RURAL BANKING ASSETS (Rp Billion)



Source: Islamic Banking Statistics December 2014, Bank Indonesia

CONCENTRATION & COMPETITIVENESS of Commercial Banking in Indonesia (2014)

*Includes Shariah Business Units

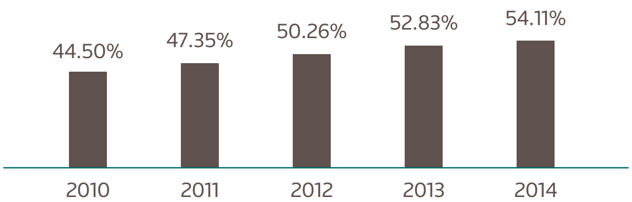


Source: IFG Database, Indonesian Banking Statistics December 2014, Bank Indonesia

	TOP 5 Commercial Banks	TOP 5 Islamic Commercial Banks
1°	PT Bank Rakyat Indonesia Tbk (BRI)	PT. Bank Syariah Mandiri
2°	PT Bank Mandiri Tbk	PT. Bank Muamalat Indonesia
3°	PT Bank Central Asia Tbk (BCA)	Bank BRI Syariah
4°	PT Bank Negara Indonesia Tbk (BNI)	Bank BNI Syariah
5°	PT Bank CIMB Niaga Tbk	Islamic Banking Unit of PT Bank Permata Tbk

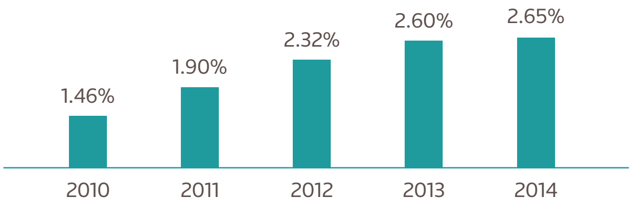
INDONESIAN BANKING INDUSTRY PENETRATION (Total Assets as % of GDP)

*Including commercial and rural banking, conventional and Islamic



INDONESIAN ISLAMIC BANKING INDUSTRY PENETRATION (Total Assets as % of GDP)

*Including rural Islamic banking



Source: Indonesian Banking Statistics December 2014, Indonesian Financial Statistics, Bank Indonesia / *Includes Shariah Business Units

Indonesia's banking sector[3] shines in terms of profitability but remains significantly under-penetrated and the market is inefficient

The banking sector remains the key growth driver of Indonesia's financial services industry. The sector posted the highest profit worldwide on account of high net interest margins (NIM)[4]. It still holds significant potential for growth as banking penetration is still very low.

The industry's penetration growth rate is moving at a slower pace; it stands at approximately 54 percent with almost 150 commercial banks operating within the industry. Conventional banking penetration (as a proportion of GDP) is 20 times higher than that of Islamic banking, which enjoys just 2.65 percent of GDP (2014). With the introduction of the new Islamic financial services roadmap and the new economic vision by current president Joko Widodo to promote Islamic finance, Islamic banking is expected to transform the industry and drive the take-up rate for Islamic finance overall. Further, a new policy to ease foreign ownership in the Islamic banking sector may attract foreign investors and institutions.

A money changer counts Indonesian rupiah for a customer in Jakarta, Indonesia. REUTERS/ Nyimas Laula

PT Bank CIMB Niaga Tbk is registered at and supervised by Otoritas Jasa Keuangan

INDONESIA'S NEXT STEPS IN ISLAMIC FINANCE

Jonathan Lawrence, Partner, K&L Gates
Lian Yok Tan, Partner, K&L Gates
Matthew Mullarkey, Associate, Singapore Office, K&L Gates

JONATHAN LAWRENCE is a partner at K&L Gates and is co-head of the firm's Islamic Finance practice. He has a broad finance practice with specific experience of advising financial institutions, lenders, funds, investors, trust companies and concession companies. *Chambers UK 2015* says: "Recognised in the market as an Islamic finance specialist, Jonathan Lawrence of K&L Gates continues to represent a broad spread of market players. He is also adept at handling international deals with real estate or project finance elements." Jonathan is also listed for Islamic Finance in *Euromoney's 2014 Banking, Finance and Transactional Law Expert Guide.*

LIAN YOK TAN is a partner at K&L Gates and co-ordinates the firm's Indonesia group that comprises lawyers across the Asia Pacific region and globally who have decades of experience advising Indonesian companies, and clients doing business in Indonesia. Lian has more than 20 years' experience specialising in a broad spectrum of energy, mining, LNG and oil and gas matters.

MATTHEW MULLARKEY is an associate in the Singapore office of K&L Gates. He focuses on project finance, project development, commercial finance and acquisitions in energy and infrastructure transactions. Matthew has advised government investment authorities, export credit agencies and commercial lenders on all aspects of cross-border corporate and project financing transactions. He has a broad spectrum of professional experience in both the private and public sectors.

Indonesia, the world's most populous Muslim nation, has announced plans to distinguish the country in the global Islamic finance markets. Locally, the government has unveiled policies to introduce regulatory changes to promote Shariah-compliant financial tools and establish a state-run Islamic bank to develop the country's potential as an Islamic financing hub in Southeast Asia. Internationally, Indonesia is taking steps to partner with China, the Middle East and Turkey to establish multilateral development financing institutions that will serve the purposes of (i) solidifying its relationships with key global Islamic-compliant players and investors and (ii) meeting its demand for infrastructure financing over the next five years. If this dual strategy unfolds as currently proposed, Indonesia may find itself playing a more prominent role in global Islamic finance, potentially attracting investors looking to fund future projects.

Local Initiatives in Indonesia

Indonesia's Islamic finance industry currently lags behind other Muslim nations; most notably, its neighbour, Malaysia. Nevertheless, Indonesia may be in a position to claim a larger share of the global Islamic finance market, given its large Muslim population, emerging economic strength in Southeast Asia and recent growth in Islamic banking assets. Joko "Jokowi" Widodo, president of Indonesia, announced the "I Love Shariah Finance Program" (ILSFP) in June 2015 to encourage the use and promote awareness of Islamic finance. The ILSFP aims to increase the Islamic finance industry's current 4.88% share of Indonesia's total banking and finance market to 15% by 2023. Initiatives include reducing fees on Shariah-based banking products and developing an institutional framework and nationwide training programmes.

The country has already seen some success in major transactions using Shariah-compliant financial tools. In 2014, the government raised US$1.5 billion from a ten-year *sukuk* issuance.[5] The initial bidding for the issuance attracted close to US$10 billion of interest from foreign investors. Additionally, Garuda Indonesia, the national flag carrier, raised US$500 million from a *sukuk* issuance in May 2015. The airline has already received over US$1.8 billion in bids, the majority of which have come from investors in the Middle East.

Indonesian State-Owned Islamic "Megabank"

In June 2015, Indonesia also announced plans to create a state-run Islamic finance "megabank". The "megabank" would be the result of combining the Islamic financing arms of four state-owned banks: PT Bank Rakyat Indonesia, PT Bank Mandiri, PT Bank Negara Indonesia and PT Bank Tabungan Negara. It is expected that the combined Shariah-based assets of the "megabank" would total over US$8 billion, nearly half the total assets of all the Islamic banks in Indonesia. While agreed in theory, actual implementation of the "megabank" will depend on agreement of a shareholding arrangement amongst the banks and the Indonesian government providing additional financial support.

The Indonesian government hopes that the "megabank" will, in addition to creating a local platform for global Islamic finance, enhance cost efficiency and allow for increased underwriting of Shariah-based bonds and notes.

> "THE RESULTING ISLAMIC FINANCE SECTOR GROWTH IS ALSO EXPECTED TO EXPAND INDONESIA'S FINANCIAL DIVERSITY, THEREBY MAKING INDONESIA LESS SUSCEPTIBLE TO THE EFFECTS OF GLOBAL ECONOMIC TRENDS AND DECLINES.

The resulting Islamic finance sector growth is also expected to expand Indonesia's financial diversity, thereby making Indonesia less susceptible to the effects of global economic trends and declines.

In conjunction with the establishment of the "megabank", Indonesia's Financial Services Authority (*Otoritas Jasa Keuangan*) (OJK) has indicated the possibility of easing foreign ownership restrictions for Islamic banks (currently set at 40%). Abu Dhabi Islamic Bank, Dubai Islamic Bank and Bahrain's Al Baraka Banking Group have expressed interest in expanding their presence in Indonesia. It is expected that the extent of these plans from Gulf Cooperation Council state-backed banks will be the determining factor in the OJK's decision to relax the current foreign ownership restrictions.

Partnering with China, the Middle East and Turkey

In addition to its efforts at home, Indonesia also intends to partner with other nations to establish new multilateral institutions in the Asia Pacific region and the Middle East. It also appears that Indonesia will be one of the first countries lining up for financial assistance from those same bodies.

Indonesia has committed to investing US$672 million in the China-led Asian Infrastructure Investment Bank (AIIB), which was established in June 2015 to finance infrastructure development projects throughout the Asia Pacific region. It is speculated that China is driving the AIIB in an effort to challenge Western-led financing institutions like the World Bank and the Asian Development Bank (ADB).[6] Indonesia, with Southeast Asia's largest population and consequent demand for electricity, has already expressed its intention to seek AIIB financing for a series of coal-fuelled power plants. Such financial assistance from the AIIB will be imperative, given the general reluctance Indonesia has faced from the World Bank and ADB with respect to financing its power projects.[7]

Given that Indonesia will need an estimated US$455 billion over the next five years for infrastructure projects, it is likely that Indonesia will have to seek financial assistance from additional sources. To that end, Indonesia has agreed to partner with Turkey and the Jeddah-based Islamic Development Bank (IDB) to form a new Islamic financing institution with a focus on infrastructure development, the World Islamic Infrastructure Bank (WIIB). The IDB will stake US$1 billion as starting capital for the WIIB, while Turkey and Indonesia have each pledged to contribute US$300 million. The WIIB would operate similarly to other multilateral institutions, except that it would exclusively use Shariah compliant financing and *sukuk* bonds to fund infrastructure projects in Muslim-majority countries.

The IDB is also in talks with China to use the WIIB as an Islamic-financing arm to the AIIB, which would allow more capital to be available for nations in need of infrastructure development, such as Indonesia. Additionally, the partnership could also serve as a breakthrough in the use of Islamic financing in project finance, which still has not found the same popularity as conventional finance, by allowing borrowers to take advantage of China's foreign exchange reserves and the Middle East's interest in Shariah-based investments. This potential tie-up would also give the AIIB exposure to borrowers and governments (such as those who only accept Shariah-compliant financing) with whom it might not otherwise engage.

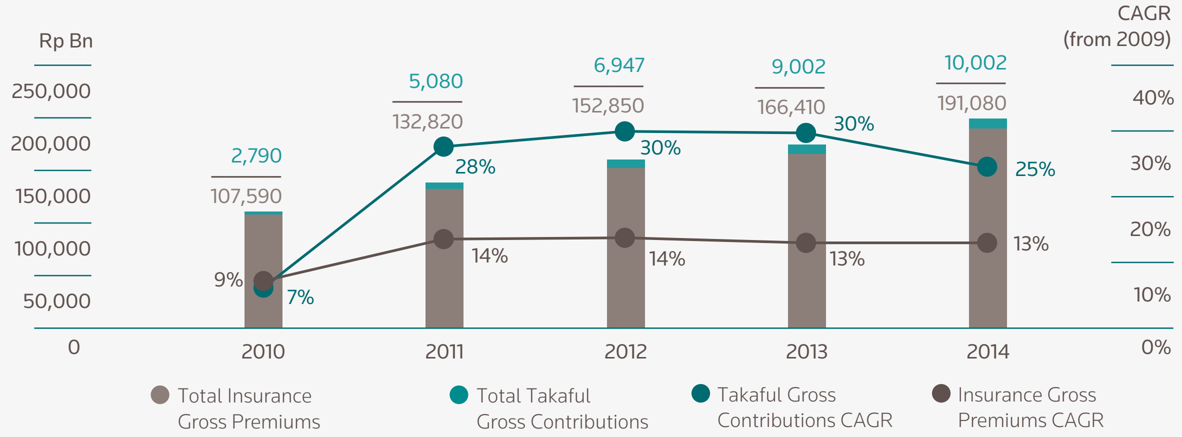
Indonesia has also bid to be the host country for the WIIB, which, it is expected, would essentially act as the IDB's arm for infrastructure investments. Hosting a major unit of the IDB's operations may assist Indonesia consolidate its relations with the development institution's largest shareholders (which include Saudi Arabia, Iran, the United Arab Emirates and Qatar) and lay the groundwork for further Shariah-compliant foreign investment.

Conclusion

Between potentially playing host to the WIIB, the probable investment from the AIIB and increased Islamic-financing capabilities under the proposed state-run Islamic "megabank", Indonesia appears to be positioning itself to attract foreign investment to meet its demand for infrastructure financing and to increase the adoption of Islamic finance by domestic consumers. However, there are several contingencies upon which the success of these plans will depend. There also remains a large funding gap between the amount Indonesia will likely receive from foreign investors and what is actually required for its infrastructure projects. At the very least, these initiatives are considered a more concerted attempt by Indonesia to obtain a larger share of Southeast Asia's Islamic finance market from Malaysia and to put itself on the map with Shariah-compliant investors.

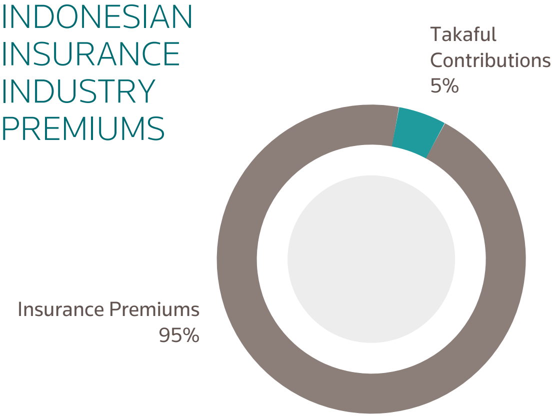
Insurance Industry Landscape

INSURANCE AND TAKAFUL GROSS PREMIUMS/CONTRIBUTIONS



Source: Indonesia Financial Services Authority Insurance Statistics

INDONESIAN INSURANCE INDUSTRY PREMIUMS



Source: Indonesia Financial Services Authority Insurance Statistics

INSURANCE INDUSTRY HIGHLIGHTS – 2014 (NUMBER OF OPERATORS)

Indonesian Insurance Network

	Insurance	Takaful	Islamic Unit
General	80	2	23
Life	49	3	18
Reinsurance	5	N/A	3

Source: Indonesia Financial Services Authority, March 2015 Islamic IKNB Financial Highlights, Insurance Directory 2014

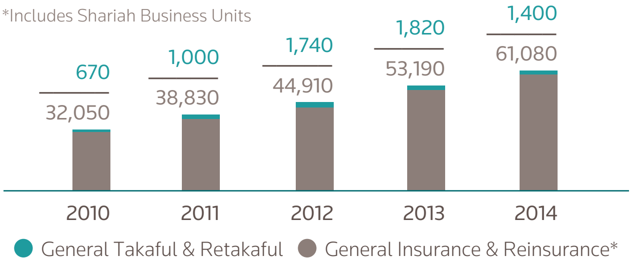
Gross Premiums:	Rp 61,080 bn **General Insurance & Reinsurance** (US$ 4.6 billion)	Rp 1,400 bn **General Takaful & Retakaful** (US$ 105 million)	Rp 130,00 bn **Life Insurance** (US$ 9.7 billion)	Rp 7,881 bn **Family Takaful** (US$ 589 million)
Assets	Rp 117,680 bn **General Insurance & Reinsurance** (US$ 8.8 billion)	Rp 4,313 bn **General Takaful & Retakaful** (US$ 322 million)	Rp 323,151 bn **Life Insurance** (US$ 24.2 billion)	Rp 18,052 bn **Family Takaful** (US$ 1.3 billion)

Source: Indonesia Financial Services Authority, March 2015 Islamic IKNB Financial Highlights, Insurance Directory 2014

GENERAL INSURANCE AND TAKAFUL GROSS PREMIUMS/CONTRIBUTIONS

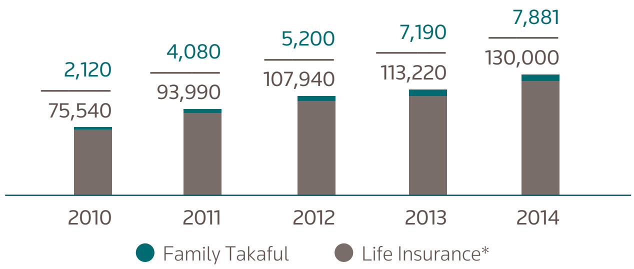
(Rp Billion)

*Includes Shariah Business Units



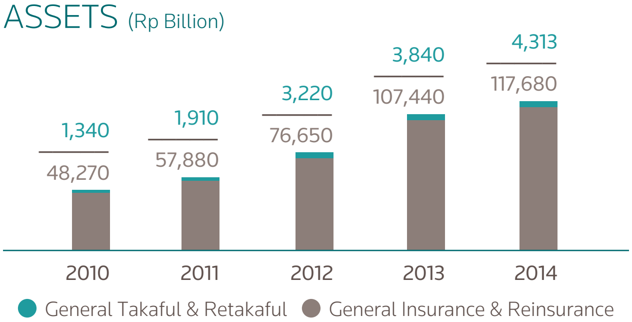
LIFE INSURANCE AND FAMILY TAKAFUL GROSS PREMIUMS/CONTRIBUTIONS

(Rp Billion)

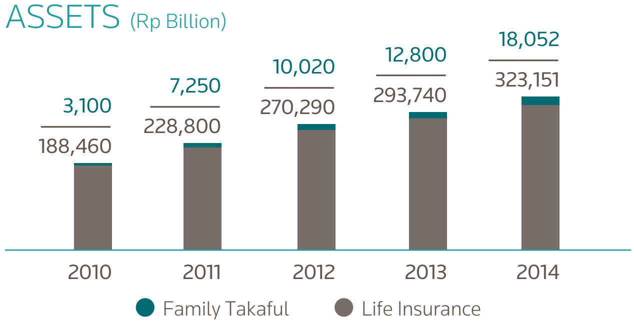


Source: Indonesia Financial Services Authority Insurance Statistics

GENERAL INSURANCE AND TAKAFUL ASSETS (Rp Billion)



LIFE INSURANCE AND FAMILY TAKAFUL ASSETS (Rp Billion)



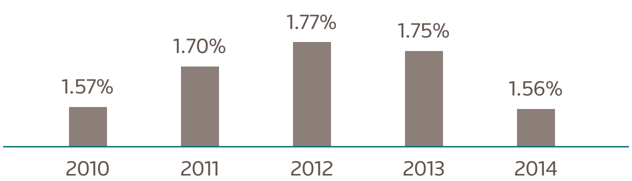
Source: Indonesia Financial Services Authority Insurance Statistics

*Islamic business unit of conventional insurance /** Fully fledged takaful company

	TOP 5 General Insurance Companies	TOP 5 Life Insurance Companies	TOP 5 General Takaful Companies	TOP 5 Family Takaful Companies
1°				
2°	Panin Insurance	PT AIA Financial	Asuransi Adira Dinamika*	PT Prudential Life Assurance
	Tugu Pratama Indonesia*	PT AIA Financial	Astra Buana*	PT Asuransi Jiwa Manulife Indonesia
3°	Asuransi Central Asia	Takaful Kelugara	Takaful Umum**	PT AIA Financial
4°	Astra Buana	Bumiputera 1912	Sinar Mas*	Bumiputera 1912
5°	Jasa Indonesia	PT Asuransi Allianz Life Indonesia	Asuransi Central Asia*	PT Asuransi Allianz Life Indonesia

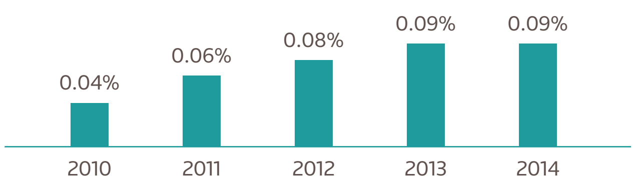
INDONESIAN INSURANCE PENETRATION

(Total Premiums As % Of GDP)



INDONESIAN TAKAFUL PENETRATION

(Total Contribution as % of GDP)



Takaful: Small in terms of contribution to the overall industry, but growing

The overall insurance and takaful penetration rate is very low and both sectors suffered in 2014 from slower growth. Conventional insurance is 17 times larger than takaful in terms of premiums/contribution penetration as percentage of GDP.

Although takaful contributes only 5 percent to total insurance industry premiums, it is growing at a faster rate than conventional insurance. Since 2010, takaful grew at a CAGR of 27 percent while conventional insurance grew at a much lower 12 percent. The biggest growth contributor for the takaful industry is family takaful (30 percent CAGR) while general takaful had a CAGR of 16 percent (family and general with retakaful make up 85 percent and 15 percent of total takaful sector contributions, respectively).

Comparatively, life (68 percent of total conventional insurance premiums) and general insurance with reinsurance (32 percent of total premiums) CAGR were 14 percent and 11 percent, respectively.

Takaful's biggest growth was in 2010 but growth has since declined; growth in 2014 was unfortunately slower compared to conventional insurance due to a 23 percent drop in general takaful and retakaful contributions.

<
Muslims from a nearby neighbourhood arrive by boat to attend Eid al-Fitr prayers at Sunda Kelapa port in Jakarta, Indonesia. REUTERS/Darren Whiteside

EDDY BELMANS

President Director, PT Sun Life Financial Indonesia
Country Manager, Sun Life Financial Group in Indonesia

EDDY BELMANS is responsible for setting the strategic direction of the business and managing the growth and profitability of Sun Life Financial Indonesia.

Eddy has extensive insurance and leadership experience as well as significant understanding of the industry in Asia. A native of Belgium, Eddy has been living and working in Asia since 1996. He spent 19 years working in four different locations in Asia during his 30-year career with Dutch financial conglomerate ING. His most recent role was as CEO of ING's Life Insurance business in Japan from 2009 to 2013.

Eddy holds a "License" (equiv. M.A.) in Applied Economics from University of Antwerp, Belgium.

1. Total insurance penetration in Indonesia is under 3% and hence there remains a very large untapped market for conventional insurance and takaful. How will the takaful sector compete with the conventional insurance sector to win over the growing base of affluent and middle-class Indonesians?

To tap the full potential of the takaful market for the affluent and middle class in large cities as well as rural areas across Indonesia, we require a marketing and sales strategy that is focused on increasing market penetration and market expansion. This includes bringing innovative and unique takaful products that fit the needs of the Muslim community to help them meet Shariah obligations and other financial needs in the future, such as saving and protection for hajj, umrah, charity, education, health and pension.

We can reach the target market by increasing the number and quality of the sales force through quality recruitment, training and development in order to deliver our products and services in a way that exactly meets our customers' needs. Also, education and socialization of takaful to the community is very important so that all can understand the benefits of takaful products to meet their protection requirements in a way that is compatible with their religion.

As an example, recently Sun Life launched a new takaful product called Asuransi Brilliance Amanah for the Muslim community to help them with the financial planning for hajj and umrah funding.

2. Beyond affluent and middle-class Indonesians, how could insurance and takaful reach and benefit the rural poor?

Micro-takaful products with small contributions (premium) can be offered to poor people in rural areas and small cities.

Micro-insurance is an emerging sector, not dissimilar from the microcredit movement that proved so successful in Bangladesh. Despite the extensive reach of microcredit in South Asia, micro-insurance is still a nascent sector, with approximately 37 million lives in South Asia now covered by some form of micro-insurance.

Micro-insurance is designed generally to address economic suffering in the case of death, ill-health, or other adverse life-events. Micro-insurance for health is also designed to rectify exclusion from health services for groups in society that are marginalized for economic, cultural or other reasons. It can open up access to health services for women, rural people, and the poor. As such, micro-insurance for health and/or its tools and methods can be an important part of a country's public health strategy. These schemes contribute to reducing poverty and improving the health status of the poor.

3. How would you evaluate the performance of Sun Life Financial Indonesia compared to its Shariah unit?

Shariah premiums (contributions) contributed 12% of total premium for Agency distribution in the first half of 2015. We have a strong commitment and focus on developing the takaful business. Since it was launched in 2010, our Shariah unit has continued to develop products that vary according to the needs of the community and that were initially marketed through our existing conventional insurance agency. In 2014, we launched our first dedicated Shariah agency and Shariah marketing offices specializing in Shariah insurance products in the Palembang area, marking a new chapter for the company in developing a Shariah business unit in Indonesia. By now, we already have 41 Shariah marketing offices with 47 agency directors and more than 1,000 agents across Indonesia.

4. Indonesia's takaful network is dominated by its Shariah-compliant units and not full-fledged takaful companies. How will the introduction of the new law, which requires Shariah units to be spun off within the next few years, affect Sun Life Financial Indonesia specifically and how will it affect the industry in general?

According to insurance act No. 40/2014 Companies that operate a Shariah "window" such as Sun Life are required to spin off this window into a separate Company within 10 years or when Shariah assets reach 50% of the total assets of the Company. As a prominent insurance company, SLFI will obviously comply with this regulation. As explained, SLFI has started to develop and grow a special distribution unit to market takaful products. This is an excellent preparatory step to carry out a successful spin-off at a later stage.

5. Distribution (delivery) channels are important within the insurance industry value chain and the growth of the sector is highly dependent on the success of its distribution channels. What are the available distribution channels in Indonesia's insurance/takaful industry, and which are Sun Life Financial's preferred channels for its conventional insurance and takaful business units?

The available distribution channels in Indonesia's insurance/takaful industry span across agency distribution, bancassurance and direct marketing. At Sun Life, our main focus is on agency distribution to market our takaful products, with a gradually growing reach into bancassurance.

6. President Joko Widodo has placed a priority on promoting and expanding Islamic finance. Indonesia's new Islamic financial services roadmap highlights stricter corporate and Shariah governance, pricing reduction and a focus on increasing awareness. How will Sun Life Financial respond to the new rules and guidelines as outlined in the new roadmap?

At Sun Life we're fully focused on growing our takaful business. We will undoubtedly contribute to increasing the takaful market share in Indonesia by meeting regulations and Shariah principles.

7. Does Sun Life Financial see any other areas and issues that would need to be addressed, outside of the government's Islamic finance roadmap, in order to boost takaful penetration?

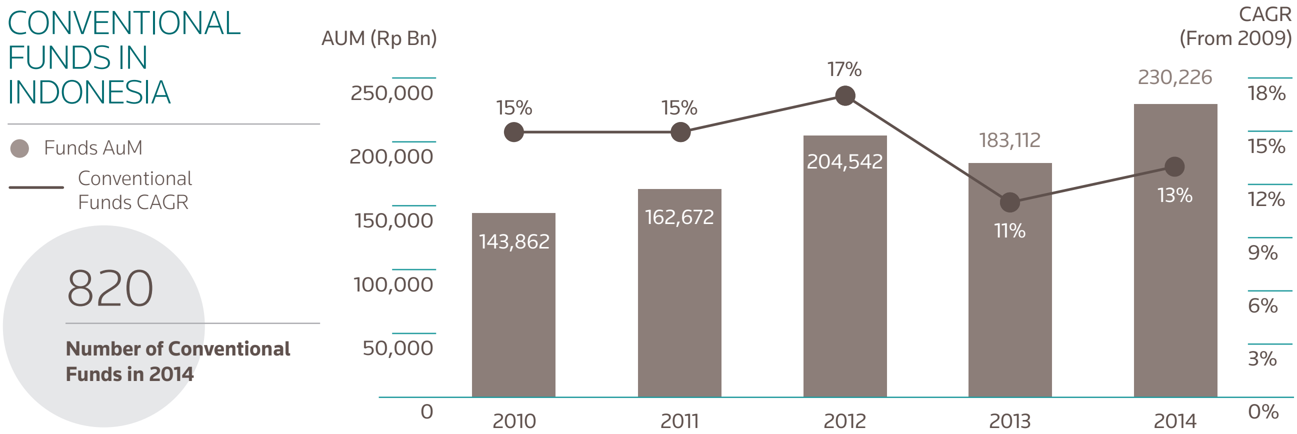
Educating the public on the importance and the benefits of having takaful insurance coverage and on the various product offerings that are available is really key. Therefore we're doing our bit to help increase financial literacy to educate and increase public awareness regarding Islamic finance. The Regulator is also proactively working to increase awareness and thus help market penetration.

8. Where are the growth opportunities for business/corporate insurance/takaful sum insured, and which lines of business will Sun Life be most keen on in the next 2 to 5 years?

You'll see us increase market penetration, notably by increasing our sales force number and quality, as well as by launching innovative and unique products to meet our customers' needs through multi-distribution channels.

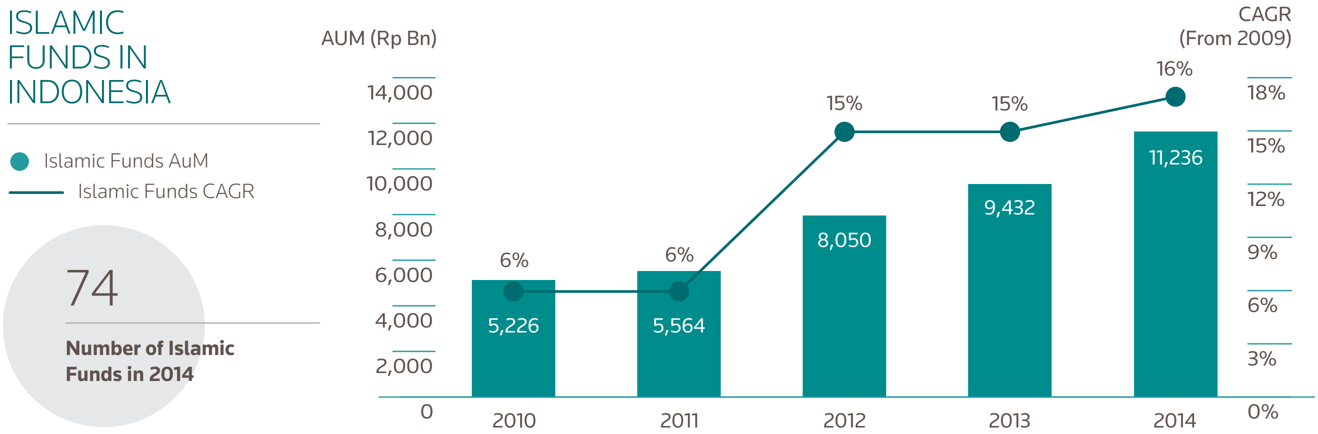
Capital Market — Funds Landscape

CONVENTIONAL FUNDS IN INDONESIA



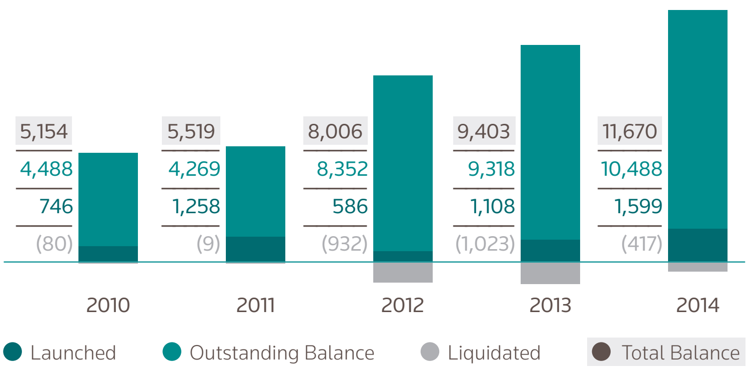
Source: Financial Services Authority (OJK) Funds Statistics.

ISLAMIC FUNDS IN INDONESIA



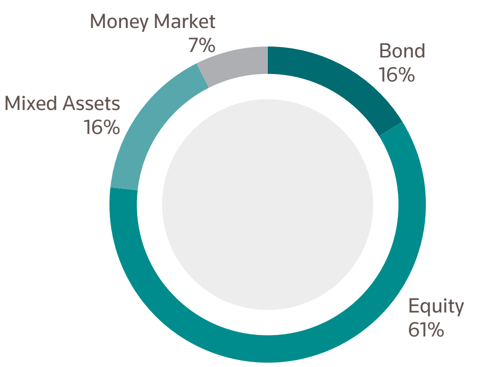
Source: Financial Services Authority (OJK) Funds Statistics.

AUM OF INDONESIAN ISLAMIC FUNDS (RP BILLION)



Source: Lipper Data.

AUM OF INDONESIAN ISLAMIC FUNDS OUTSTANDING BY TYPE



Source: Lipper Data.

Investors are becoming bullish

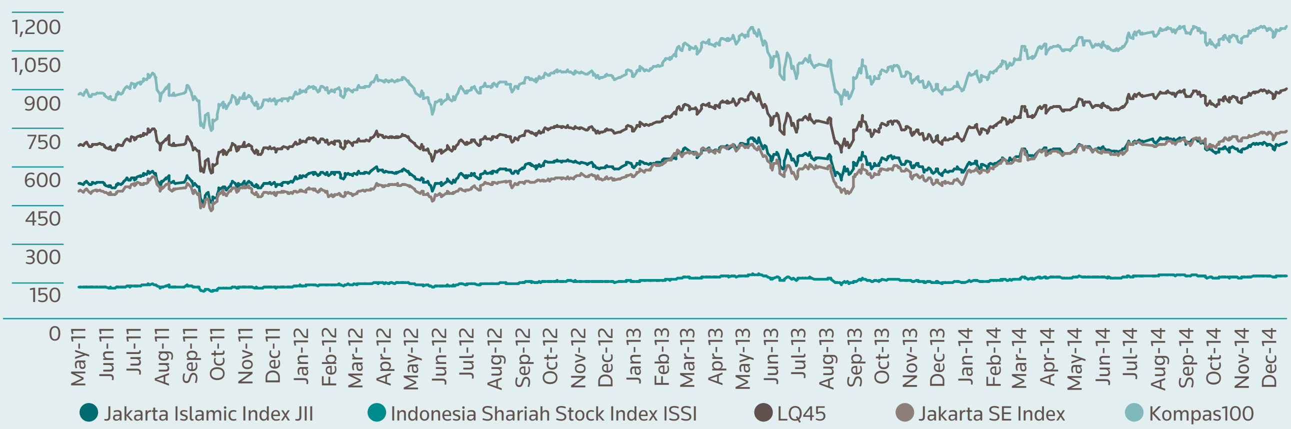
The market capitalisation of Indonesian equities has been on the rise reaching RP 5,228 trillion by end of 2014, well above 2013's market capitalisation of RP 4,219 trillion, thanks to buoyant performance in the equity market in recent years as companies started increasing their profitability.

The number of listed companies as a result has also increased to 506 in 2014 from 483 in 2013. The top five companies based on market capitalisation make up 28.6 percent of total market capitalisation.

The Indonesian stock exchange (IDX) consists of 25 indices, out of which two are Shariah-compliant — the Jakarta Islamic Index (JII) and Indonesia Shariah Stock Index (ISSI). The performance of the two Islamic indices was no different than their conventional peers. The performance of the JII has been in line with the overall economic performance of the stock exchange. The index bounced back from its low of 452.2 points in Oct 2011 to end 2014 on 691.0 points. The other Islamic Index, ISSI, has relatively been more stable given it is only about four years old, and has only 30 companies. The performance of ISSI has been on the rise, but not in any substantial volumes. The index was launched at 122.7 points in May 2011 to end 2014 on 168.6 points.

Listed Stock	# of Listed Shares	Market Capitalization (Million RP)	% of Total
Bank Central Asia, Tbk	24,408,459,120	320,361,026	6.13%
HM Sampoerna Tbk	4,383,000,000	300,892,950	5.76%
Astra International Tbk	40,483,553,140	300,590,382	5.75%
Telekomunikasi Indonesia (Persero)	100,799,996,400	288,791,990	5.52%
Bank Rakyat Indonesia (Persero)	24,422,470,380	284,521,780	5.44%

INDONESIAN INDICES PERFORMANCE COMPARISON



Shariah Screening Methodologies

The Jakarta Islamic Index (JII), which consists of 30 selected companies, was established on July 3, 2000. However, to have more historical data, the IDX assigned the base date to Jan 2, 1995 with index base number of 100. The JII index constitutes the largest and most liquid 30 Shariah-compliant companies. Initially, the IDX selected 60 top companies based on their previous year's market capitalisation and then filtered this number down to the 30 top companies based on their level of liquidity from the previous year.

The Indonesia Sharia Stock Index (ISSI) was launched on May 12, 2011, with the purpose of listing all Shariah-compliant companies in the country. As of November 2013 (the latest available data to date on the IDX website) ISSI lists 311 companies and uses December 2007 as a base value (index value 100).

The selection process is based on Islamic principles and the methodology screens out companies that are involved in non-Shariah-compliant activities such as gambling, interest-based banking and financing, transactions involving speculation (gharar). Other selection consideration pertain to financial ratios: the ratio of interest-based liabilities to total assets cannot be more than 45 percent, and the ratio of interest income and other non-Shariah income to total revenue cannot be more than 10 percent.

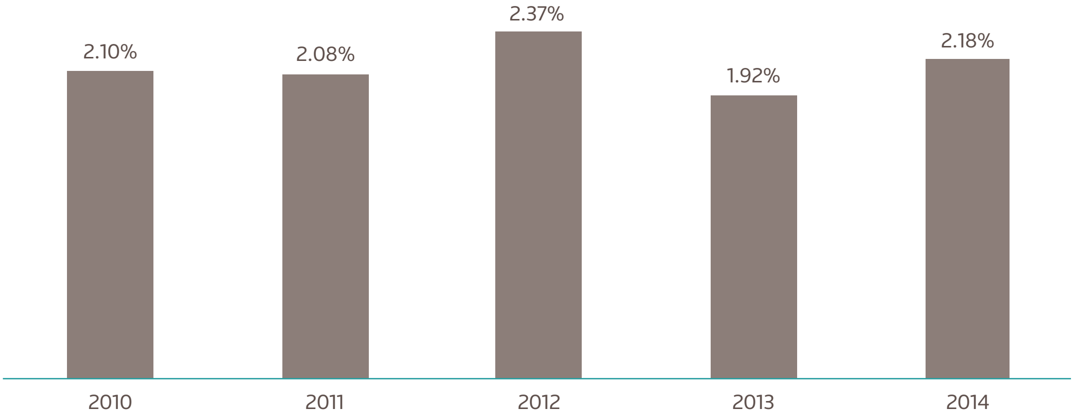
People stand near the stock price movement board during the first day of stock trading at the Indonesia Stock Exchange in Jakarta. REUTERS/ Puspa Perwitasari/ Antara Foto

10 LARGEST INVESTMENT MANAGERS IN INDONESIA AS OF MAY 2015

Fund Manager	Funds Value
1. Schroder Investment Management Indonesia	IDR 46.2 trillion
2. BNP Paribas Investment Partners	IDR 26.7 trillion
3. Mandiri Manajemen Investasi	IDR 21.9 trillion
4. Bahana TCW Investment Management	IDR 18.4 trillion
5. Batavia Prosperindo Aset Manajemen	IDR 14.2 trillion
6. Manulife Aset Manajemen Indonesia	IDR 13.2 trillion
7. Panin Asset Management	IDR 12.6 trillion
8. Danareksa Investment Management	IDR 8.8 trillion
9. BNI Asset Management	IDR 8.2 trillion
10. Trimegah Asset Management	IDR 6.3 trillion

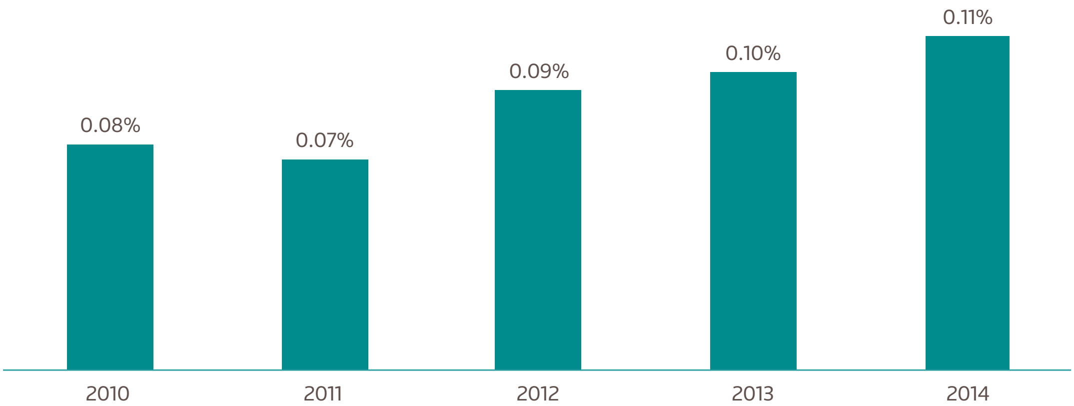
Source: Financial Services Authority (OJK)

CONVENTIONAL INDONESIAN FUNDS PENETRATION (AUM AS % OF GDP)



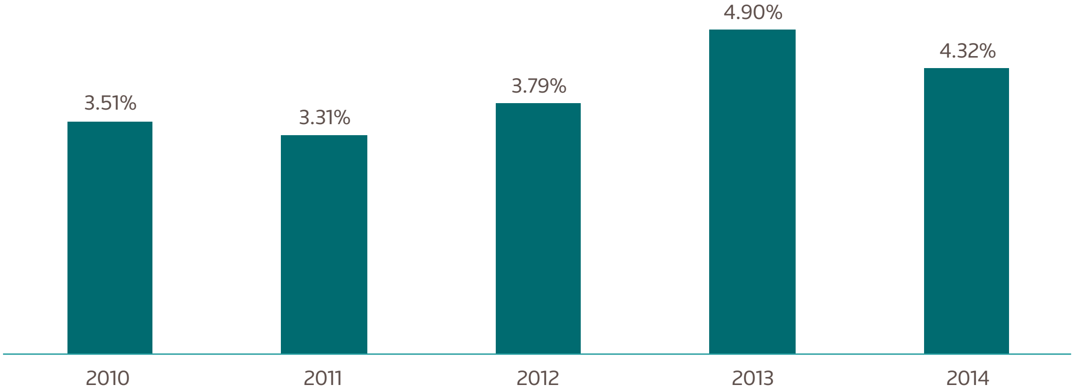
Source: Bank Indonesia, Indonesian Financial Statistics. Financial Services Authority (OJK) Funds Statistics.

INDONESIAN ISLAMIC FUNDS PENETRATION (AUM AS % OF GDP)



Source: Bank Indonesia, Indonesian Financial Statistics. Lipper data.

ISLAMIC FUNDS AS % OF TOTAL MUTUAL FUNDS



Source: Financial Services Authority (OJK) Funds Statistics and Lipper data

Underpenetrated funds market, with plenty of room to grow

The Islamic asset management industry is fairly young and small, with only 74 Islamic active funds as of December 2014. The 74 funds are all mutual funds, giving investors a variety of asset classes to invest in. The number of funds, although small, has been on the rise.

The total Islamic asset under management (AUM) increased to $937 million in 2014 from $581 million in 2010, registering a CAGR of 12.7 percent. While growth has been good, Islamic funds still make up just 4.32 percent of the total asset management industry in Indonesia. The Indonesian Islamic asset management industry is completely domestic, with no geographical focus other than Indonesia. This doesn't come as a surprise especially as there are only a few foreign asset management companies which have tapped into the country.

The Islamic funds are heavily biased towards equity at 61 percent, followed by sukuk, mixed assets and money market at 16 percent, 16 percent and 7 percent, respectively. The concentration in equity funds is also part of the government's plan to attract more foreign direct investment (FDI) and enhance business funding given a number of planned infrastructure projects.

The equity market had a weak performance in 2013, as some foreign investors sold off their Indonesian stocks and bonds to repatriate funds. It was a move following the weakening in the macro-economy resulting in devaluation of the rupiah and rising inflation, making investments more expensive. Nevertheless, the outlook for fresh FDI is positive, especially with the depreciation of the rupiah, which means that foreign investors get more for their hard currencies.

Despite the significant growth in personal income which is measured through GDP per capita — $1,274 in 2005 to $3,475 in 2013 — there are very few investors. Most would prefer to deposit their funds in saving accounts or invest in their own homes.

The size of the asset management industry is a result of a number of challenges, mainly, unfavourable regulations and lack of confidence following the Asian financial crisis in 1997, which had a negative impact on the Indonesian economy as a whole, especially with the collapse of a number of banks. However, Bank Indonesia, the central bank, has started to restore confidence in the capital markets by stabilising the financial market. From 2009 to 2013, FDI in the country increased 4.8 times from RP 45,945 billion to RP 283,867 billion, which indicates that the regulators are on the right track to restoring confidence.

As is the case with most emerging economies, FDI plays a major role in developing the Indonesian economy. However some countries are more open to foreign investments while some are more cautious and depend internally to build their economies. Indonesia falls somewhere in between. The country is in transition and is setting the blueprint for future growth. The potential is significant for the country given its young and growing population of about 240 million people, positive annual GDP growth and low debt to GDP ratio of 25 percent (Malaysia's is at 57 percent).

RUDIYANTO

Head of Operation and Business Development, PT. Panin Asset Management

RUDIYANTO is head of operation and business development of PT. Panin Asset Management, one of Indonesia leading mutual fund company. After graduation from Tarumanagara University in 2006, he joined www.infovesta.com, a research company that data and consulting services to institutional investor. During his 5 year services, Rudiyanto also appointed as Oversight Committee of PT. Askes (Persero) now BPJS Kesehatan (Indonesia Health Social Security Provider) to give advice regarding company fund management in 2011 – 2012.

Rudiyanto has writes numerous articles about investment and financial planning in his personal blog rudiyanto.blog.kontan.co.id and also published two books about investing in mutual fund.

1. In your opinion, is the regulatory environment supportive of the sustainable growth of the mutual funds sector in Indonesia? What new measures would you like to see that would benefit both fund managers and investors? Have there been any recent developments or initiatives that have benefited your business in the Islamic funds industry?

The Financial Services Authority or Otoritas Jasa Keuangan (OJK) is very supportive. Its rule-making process involves industry players and associations. Although not all of our demands or aspirations are accommodated, at least they understand the needs of the industry.

In the last year, there were 2 new regulations that support the mutual fund industry growth:

- Mutual Fund Selling Agent Rules, that allow more companies apart from traditional agents such as bank and securities companies to be able to market mutual funds;
- Know Your Customer Rules, that relaxed face-to-face procedures for low-risk investors (i.e. have investments < Rp 100 million = USD 7,700).

OJK also recently declared 2015 as the Year of Shariah Capital Market (Tahun Pasar Modal Syariah) and held an event called People Market Shariah (Pasar Rakyat Syariah) inaugurated by the Indonesian President Joko Widodo.

2. Malaysia, Thailand and Singapore are now part of the ASEAN passporting funds scheme that allows theses countries to invest in one another. What could have Indonesia benefited from passporting should it have joined the scheme?

I think it is a very different playing field.

For example it requires the asset management company to have 500 Million USD to participate and @

5-YEAR EQUITY FUND COMPARISON

1 USD = Rp 13.000, only 9 out of 73 Asset Management companies in Indonesia qualify. Some of those — including Schroders, BNP Paribas, and Manulife — already have presence in either Malaysia, Thailand or Singapore.

In Indonesia, out of our 250 million population, the approximate number of mutual fund investors is maybe only 250, 000. So the domestic market itself is still a big one to penetrate.

If Indonesia joined the ASEAN passporting scheme right now, Indonesia only will become market. I think it is more appropriate to focus on our domestic market and build capacity for domestic players.

3. How can the industry increase the diversity of institutional investors? What is the biggest constraint for Islamic fund managers in attracting institutional capital?

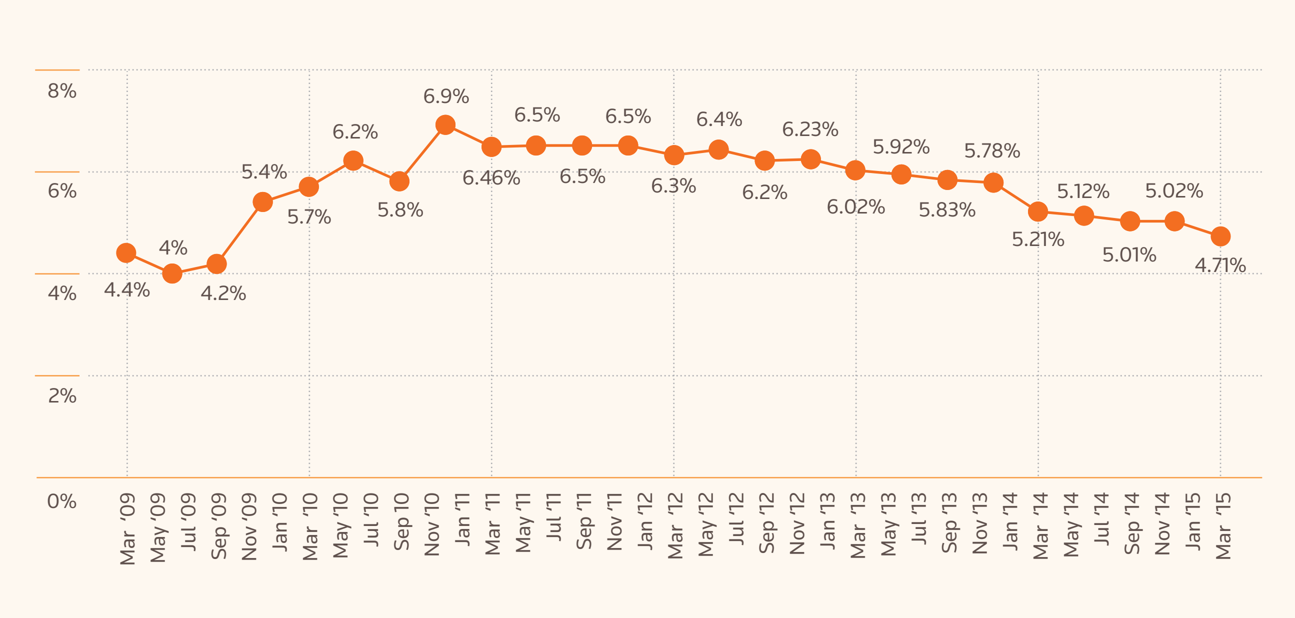
Most institutional funds come from insurance and pension funds. Currently there are no Islamic Pension funds or Pension funds that only focus on Islamic products. They see Islamic funds as alternative to investment and focus on risk and return. So to be able to attract institutional investors, Islamic funds have to produce superior risk and return. Sadly, they have not. There are also a limited number of Islamic insurance companies. Some of them already have internal fund managers. However, Islamic Insurance companies are relatively new in Indonesia so their Assets under Management are at a very early stage.

4. Indonesia went through the Asian financial crisis in the late 1990s and the more recent collapse and exit of many foreign investors amid valuations that started to appear more expensive. How much has the Indonesian market recovered from these crises and has confidence returned to the market?

Money comes and goes. I believe that eventually money will always flow from countries with lower

> OJK ALSO RECENTLY DECLARED 2015 AS THE YEAR OF SHARIAH CAPITAL MARKET (TAHUN PASAR MODAL SYARIAH) AND HELD AN EVENT CALLED PEOPLE MARKET SHARIAH (PASAR RAKYAT SYARIAH) INAUGURATED BY THE INDONESIAN PRESIDENT JOKO WIDODO.

INDONESIA GDP GROWTH



ACCUMULATION OF FOREIGN FUND FLOW TO INDONESIA STOCK (IN BILLION IDR)

> INVESTING IN MUTUAL FUNDS IS RELATIVELY NEW FOR MUSLIMS AND NON-MUSLIMS, AND IT IS PERCEIVED AS HIGH-RISK. THIS IS DUE TO A LACK OF INVESTMENT EDUCATION AS WELL AS A LOT OF INVESTMENT FRAUD SCHEME.

economic growth to those with higher economic growth. If the current pace continues and Indonesia can achieve investment grade status from credit rating economic growth to those with higher economic growth. If the current pace continues and Indonesia can achieve investment grade status from credit rating agencies, I believe that in the long run funds will keep flowing into Indonesia.

5. With favourable demographics and a young Muslim population, what is challenging the growth of retail investments in Indonesia?

Investing in mutual funds is relatively new for Muslims and non-Muslims, and it is perceived as high-risk. This is due to a lack of investment education as well as a lot of investment fraud scheme. There is also a lack of human capital with relevant experience and license in the capital market.

6. We know that there is a relatively huge population who live in rural areas with lower incomes; do you think there is an opportunity in rural areas especially as the rural population is estimated to be over 100 million people? How can the rural population and the rural areas of Indonesia be included in the growth story of the funds sector?

I think it will take some time for the industry and OJK to educate the rural markets. It could take several years before yielding any results. For the industry, I think it is better to focus on big cities such as Jakarta, Bandung, Surabaya, Medan and Makassar. These urban populations are more receptive to investment products and the infrastructure is ready.

7. In your opinion, what are the main challenges you face that prevent you from growing and expanding? And what are the opportunities that could be seized?

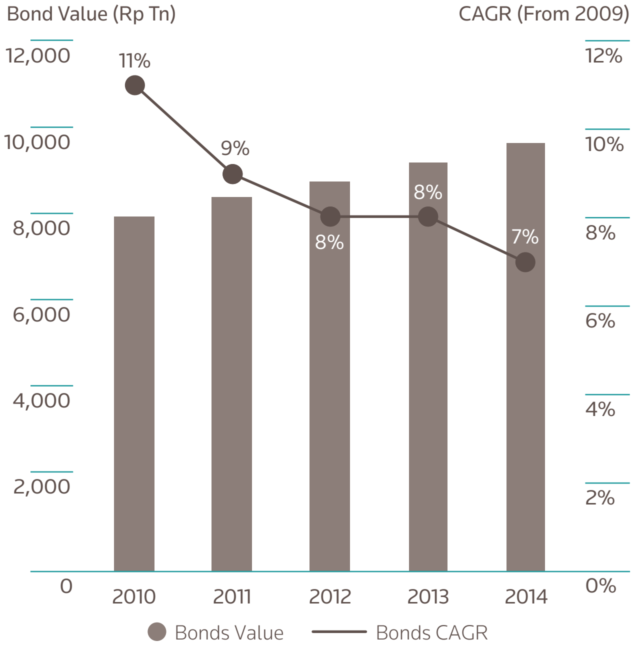
Because the potential market is still very large, I think the main challenge is how fast we want to grow. The faster we grow, the more human capital we will need, and managing that human capital is not an easy task. The second challenge is the economic condition. Right now, investment performance is bad due to the macroeconomic condition. If this continues, marketing mutual funds will become harder. Plunging stock and bond prices offer the right timing to buy at low prices. If marketing gets it right, the customer will keep investing and the industry will be able to attract new clients. However, we are not getting more talented and capable human capital to keep on growing the industry.

8. What is your outlook for the Indonesian Islamic funds sector for the next 3-5 years?

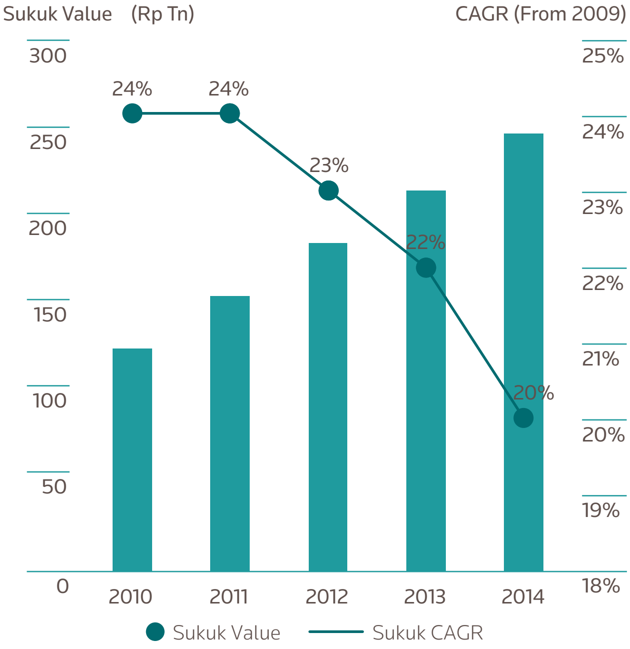
I think it is still hard to compete with conventional funds. The Islamic sector will grow but I don't think the growth rate will grow any much higher. Unless there is a new big Islamic insurance company and new Islamic bank that can invest and distribute Islamic funds, I think Islamic funds will not become the main focus for Asset Management companies.

Capital Market — Sukuk Landscape

INDONESIAN BONDS VALUE OUTSTANDING

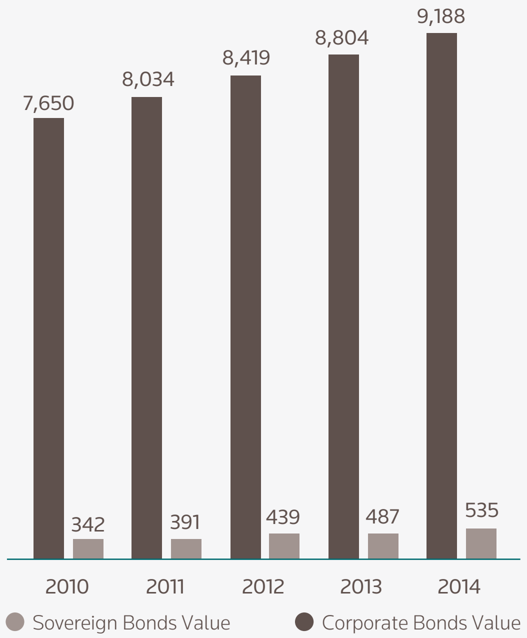


INDONESIAN SUKUK VALUE OUTSTANDING

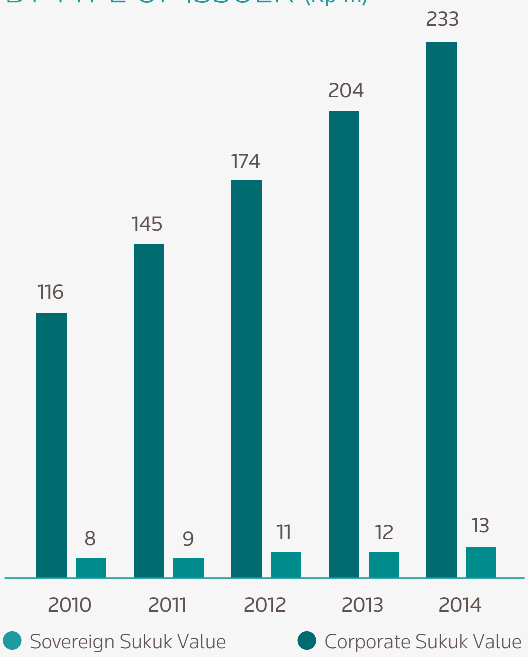


Source: Thomson Reuters Eikon

INDONESIAN BONDS BY TYPE OF ISSUER (Rp Tn)



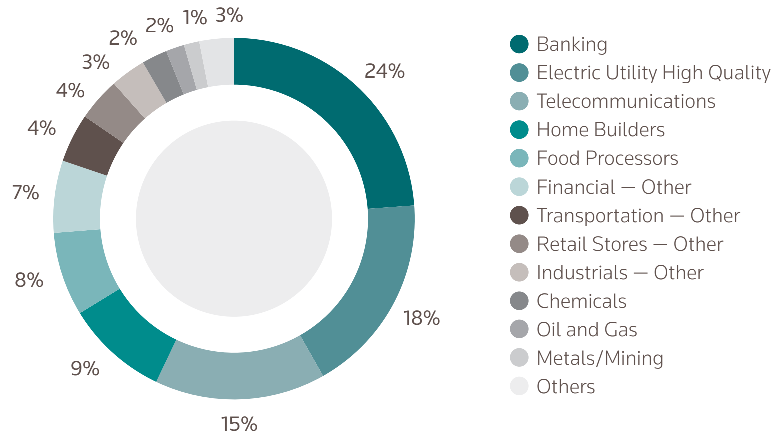
INDONESIAN SUKUK BY TYPE OF ISSUER (Rp Tn)



Source: Thomson Reuters Eikon

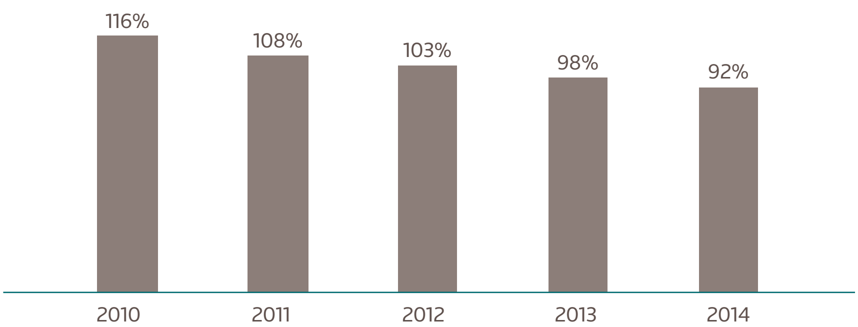
	TOP 5 **Largest 5 Indonesian Bonds**	TOP 5 **Largest 5 Indonesian Sukuk**
1°	Indonesia Government	Perusahaan Penerbit Surat Berharga Syariah Negara Indonesia
2°	Bank Indonesia	Bank Indonesia
3°	Trimata Benua PT	Bank Muamalat Indonesia Tbk PT
4°	Bank Mandiri (Persero) Tbk PT	Bank BNI Syariah PT
5°	Lembaga Pembiayaan Ekspor Indonesia	Indosat Tbk PT

SUKUK OUTSTANDING BY SECTOR (2014)



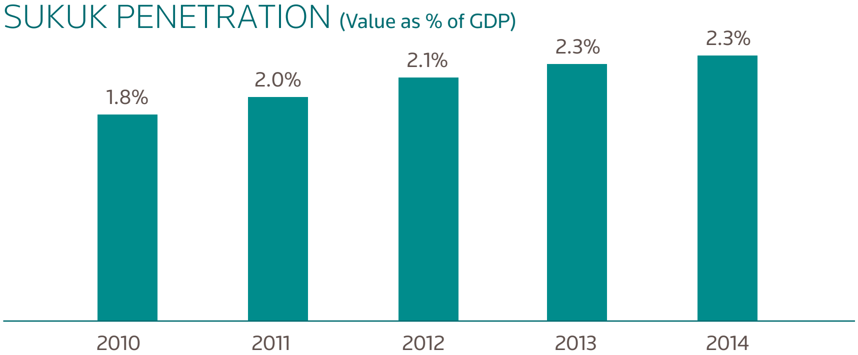
Source: Thomson Reuters Eikon

BOND PENETRATION (Value as % of GDP)



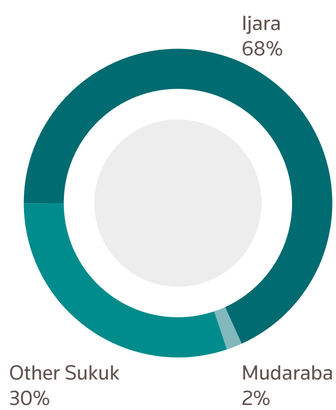
Source: Bank Indonesia, Indonesian Financial Statistics. Eikon Data

SUKUK PENETRATION (Value as % of GDP)



Source: Bank Indonesia, Indonesian Financial Statistics. Eikon Data

SUKUK OUTSTANDING BY STRUCTURE (2014)



Source: Thomson Reuters Eikon
Other Sukuk include hybrid and other structures

Corporate sukuk falling behind, international sukuk on the rise

Sukuk continues to play a major role in many developed and emerging economies as a source of funding for infrastructure projects. The case is no different for Indonesia where sukuk remains a prime asset class, and is expected to grow. Indonesia has many planned infrastructure projects which could potentially be financed by sukuk, as banks generally would not lend at longer maturities.

The sukuk market in Indonesia started in 2002 through a corporate local currency issue by local telco Indosat but it was only in 2008 that a sukuk law was passed. However, issuers did not lag behind significantly (although the pace was slow), as they continued issuing without a defined sukuk law in place. Indonesia's sukuk market is small; the country has a 4.6 percent market share of the global sukuk market, which is far behind the likes of Malaysia, UAE, Saudi Arabia and Bahrain.

The market is heavily driven by quasi sovereign issues at 52 percent followed by sovereign issues at 25 percent and corporate issues at 23 percent. Indonesia mainly issues ijara sukuk (compared to neighbour Malaysia which mainly uses murabaha) which is more widely favoured by investors in different regions, especially GCC investors which are mainly Islamic banks considered anchor investors for sukuk given the limited investment options available to them. By sector, apart from government, there are a few sukuk from financial services, power and utilities, and telecommunication.

More recently, Indonesia has become active in the international markets; the country has an annual programme to issue international sukuk. This started in 2009 and is ongoing. Since 2009, the government of Indonesia has raised $5.650 billion.

Indonesia is also home to the biggest retail sukuk ($1.67 billion), a segment that remains highly untapped with a huge investor base. Retail sukuk works well for a country like Indonesia where investors mainly deposit their cash in saving accounts, a scheme that has been followed by a majority of investors after the Asian financial crisis which hit investor confidence. This lack of confidence has caused investors to become more risk averse; however, sukuk, unlike bonds, are considered safe investments as they are backed by assets.

<
A 100,000 Indonesian rupiah note is seen through a magnifying glass among other Southeast Asian currency note in this photo illustration taken in Singapore. REUTERS/Edgar Su

INDONESIA SOVEREIGN SUKUK ISSUANCE 2014 & 2015

Mohamad Safri Shahul Hamid
Senior Managing Director/Deputy Chief Executive Officer, CIMB Islamic Bank

MOHAMAD SAFRI SHAHUL HAMID first joined CIMB Islamic Bank as one of its pioneer members in 2003 and was credited for a number of ground-breaking, "world's first" and award-winning transactions.

Safri is in charge of the CIMB Group Islamic Wholesale banking business comprising debt and equity capital markets, corporate financing, asset management, treasury and securities services.

Safri holds a Bachelor's degree in Accounting from the International Islamic University Malaysia and an MBA (Globalization) from Maastricht School of Management, The Netherlands. He is a Chartered Accountant with the Malaysian Institute of Accountants MIA).

Traditionally, the definition of real assets in the sphere of Islamic finance, particularly Islamic bonds or Sukuk, has been confined to the realm of the physically tangible, be it land, buildings, or even office furniture. As the Sukuk market evolves to meet the future needs of the issuers and investors, the definition of what can be considered (Sukuk) assets has widened significantly.

Assets which are non-physical in nature, for example those that have certain rights to or claims on certain services and future income flows, can be considered as assets for the purpose of issuing Sukuk. They are effectively a source of wealth (*tamawwul*) that generates future benefits and can be compensated for and exchanged; hence, certain non-physical assets are deemed tangible and may be used as Sukuk assets. There are issues relating to the use of non-physical assets: the excessive uncertainty in the identification and determination of the non-physical assets, due to the non-existence of its physical substance and the probability of its future benefits.

In recent years, the Sukuk market has witnessed new asset classes, namely (mobile telecommunications) airtime vouchers, airlines' rights to travel, provision of transportation services and even under-construction and to-be-constructed project infrastructure assets ("Project Assets"). The use of Project Assets has been further expanded with the foresight and vision of the Republic of Indonesia.

Innovation Case Study: Republic of Indonesia Sovereign Sukuk

The Republic of Indonesia ("ROI") is the world's most active and prolific sovereign Sukuk issuer, with a total of six issuances to-date, between 2009 and 2015:

Month/ Year	Sukuk Structure	Amount (US$)
Apr/2009	Ijara	650 million
Nov/2011	Ijara	1.0 billion
Nov/2012	Ijara	1.0 billion
Sep/2013	Ijara	1.5 billion
Sep/2014	Wakala	1.5 billion
May/2015	Wakala	2.0 billion

Source: Bloomberg

The inaugural global sukuk issuance of USD650 million in 2009 took place a year after the enactment of the historic Law No. 19 of 2008 on Sovereign Sukuk (*Surat Berharga Syariah Negara*). The first four issuances were structured based on an Islamic principle of Ijara or leasing, a common principle adopted by many other sovereigns. As part of

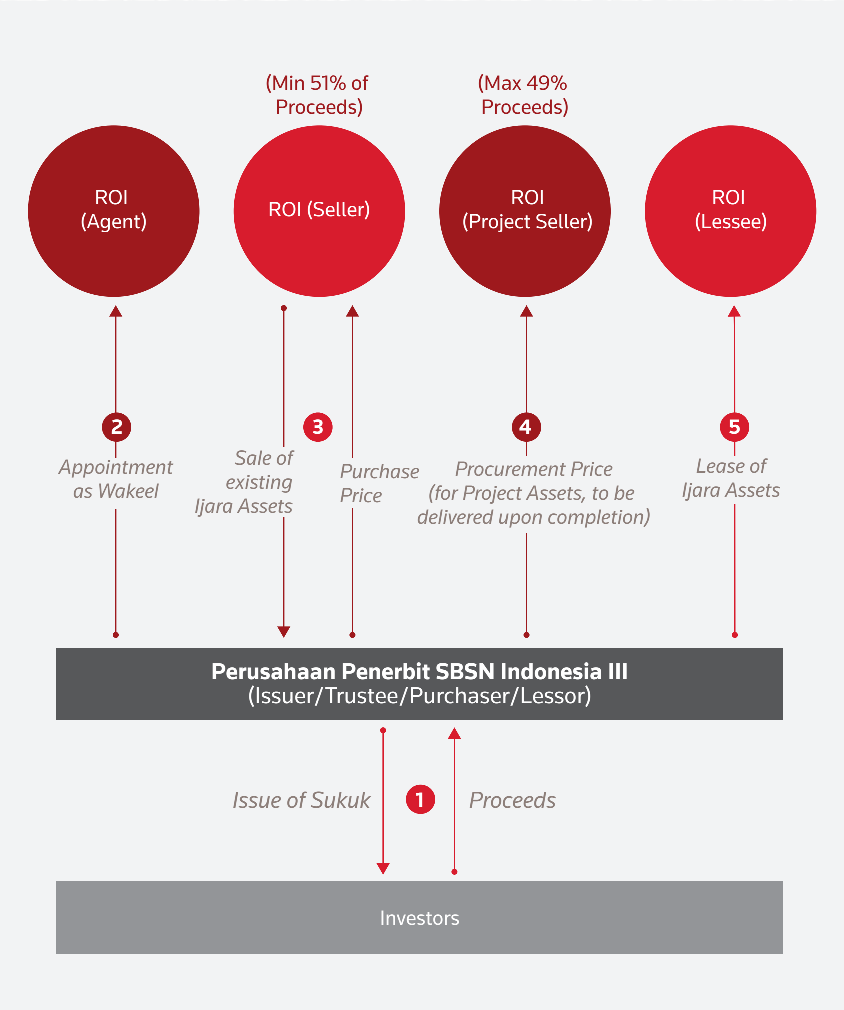
ROI's efforts to innovate and lead in the development of Islamic finance globally, it decided to embark on a new structure for its fifth sukuk issuance in 2014 that was based on a principle of Wakala or Agency. The Wakala structure enabled ROI to raise Sukuk in an asset-efficient manner by combining existing Ijara assets ("Ijara Assets") with Project Assets (under construction or to-be-constructed) to be completed within the tenure of the Sukuk. The success of the 2014 issuance was followed through by another Sukuk transaction in 2015, also based on the same Wakala principle.

The initial challenge was to ascertain whether the proposed structure using Ijara Assets and non-completed Project Assets was doable from a Shariah standpoint. The legal and accounting perspectives had to be incorporated and reconciled to ensure that the proposed structure would (i) work from an Indonesian law perspective, (ii) be Shariah-compliant, and (iii) garner positive response from the market.

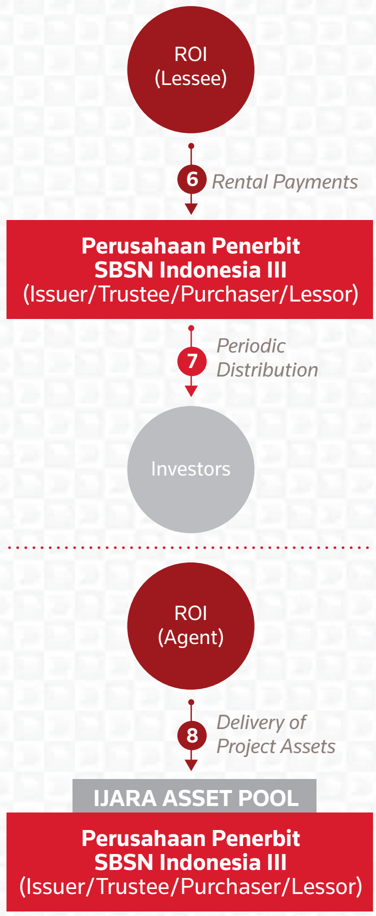
How did one make concrete the value of things that were in the process of being built or constructed? The solution was to develop a procurement agreement which detailed the individual projects and their respective values.

On the issue date, the investors paid the Sukuk proceeds to Perusahaan Penerbit SBSN Indonesia III (the "Issuer"). No more than 49% of the Sukuk proceeds were utilised to procure Project Assets which must be completed within the tenure of the Sukuk. (Existing) Ijara Assets accounted for the balance 51% of the proceeds, as opposed to 100% Ijara Assets utilised in the first four issuances.

At Inception



Ongoing



On a periodic basis, actual rental payments (by ROI) from the Ijara Assets would be sufficient to cover periodic distribution amounts payable by the Issuer to investors.

Upon completion, Project Assets listed in the procurement agreement would be added to the pool of Ijara Assets and leased back to ROI.

Dissolution/Maturity

At maturity i.e. the scheduled dissolution date, the Issuer, pursuant to a purchase undertaking, would require ROI (the sole obligor) to purchase all of the former's rights, title, benefits and entitlements in, to and under the Ijara Assets (which include the completed Project Assets). The exercise price payable by ROI pursuant to the purchase undertaking is intended to fund the redemption amount under the Sukuk.

Market Reception

September 2014. Following a successful roadshow which spanned six cities across three continents, covering key financial markets in Asia and the Middle-East as well as London, the Government of Indonesia launched a 10-year Wakala Sukuk transaction on 2 September 2014 with a target amount of USD1.0 billion to USD1.5 billion. Initial price guidance was set at 4.625% area.

Orders were in excess of USD10 billion which allowed pricing to tighten to 4.35%. The transaction was well received globally and generated a large order book with almost 400 investors placing orders resulting in a 6x book oversubscription.

A diverse group of international investors participated, with over a third from the Middle Eastern and Islamic investors, 10% from Indonesia, 20% from Asia (ex-Indonesia), 20% from the USA and 15% from Europe. By investor type, the Sukuk were allocated to a broad investor base including 57% to funds, 28% to banks, 13% to central banks and sovereign wealth funds and 2% to other investors.

May 2015. Following the success of the inaugural Wakala sukuk transaction in 2014, the Government of Indonesia launched the largest

> ASIA'S INFRASTRUCTURE MARKET ALONE IS FORECASTED TO GROW BY BETWEEN 7% AND 8% ANNUALLY OVER THE NEXT DECADE, NEARING USD5.3 TRILLION BY 2025.

ever single-tranche USD sukuk issuance globally of USD2 billion on 21 May 2015. It garnered an overwhelming response which resulted in a demand totalling USD6.8 billion for the 10-year offering. The transaction was 3.45 times oversubscribed, demonstrating global investors' confidence in the Government of Indonesia's credit story as well as the proven transaction structure.

The 10-year offering was well-distributed with participation via Middle-East investors (27%), USA investors (21%), Europe investors (16%), Malaysia investors (14%), Asia ex-Malaysia and Indonesia investors (12%), and Indonesia investors (10%).

Conclusion

The groundwork was laid in 2008 when ROI started its tremendous debut in Islamic finance industry through the enactment of Law No. 19 of 2008 on Sovereign Sukuk. One year later, ROI issued its maiden global sukuk and has tapped the market five times since. With the success of its two most recent issuances in 2014 and 2015, ROI has set a precedent and proven itself to be an innovator with foresight. The quasi-project finance global sukuk structure pioneered by ROI in 2014 has helped bring the Sukuk market to the next level — it is an asset-efficient or asset-light structure which could be applied for typically sovereign and corporate sukuk issuances as well as project finance transactions.

The Sukuk market has been growing leaps and bounds over the past decade, dominated by Asia and the Middle East. Asia's infrastructure market alone is forecasted to grow by between 7% and 8% annually over the next decade, nearing USD5.3 trillion by 2025. The Middle East meanwhile, requires an estimated funding of USD2 trillion for infrastructure projects by 2020. Thanks to ROI, we now have a viable and proven Sukuk structure for project and infrastructure development activities — further enabling the Sukuk market to play a vital role in plugging funding gaps.

Islamic Finance Development in 2015 and Outlook

2015: Indonesia's Islamic finance industry grew as much as 10% to reach Rp 617 trillion in 2015 from Rp 559 trillion in 2014. A well rounded performance has been witnessed across almost all sectors and asset classes. The only asset class that slightly declined by 3.5% is the Islamic mutual funds. The sukuk market has noticeably increased the most, an asset class that the government has been quite active in issuing. In addition to its yearly programme to issue retail sukuk, offering investment opportunities for its population.

INDONESIA'S ISLAMIC FINANCE DEVELOPMENT IN 2015

Sector / Asset Class	Item	Total	Growth from 2014	Source and Latest Date
Islamic Banking	Islamic Commercial Banking Assets (Commercial Islamic Banks & Islamic Business Units)	Rp 273,494 billion	0.4%	OJK Islamic Banking Statistics June 2015
	Islamic Commercial Banking Financing (Commercial Islamic Banks & Islamic Business Units)	Rp 206,056 billion	3.7%	
	Number of Islamic Banks (Commercial Islamic Banks & Islamic Business Units)	34	0%	
	Islamic Rural Banking Assets	Rp 7,418 billion	12.9%	OJK Indonesian Banking Statistics November 2015
	Islamic Rural Banking Financing	Rp 5,741 billion	14.7%	
Takaful	Takaful Assets	Rp 26,519 billion	18.6%	OJK Shariah Insurance Statistics December 2015
	General Takaful & Retakaful Assets	Rp 4,905 billion	13.7%	
	Family Takaful Assets	Rp 21,614 billion	19.7%	
	Number of Takaful Operators	53	8.2%	
	Total Takaful Contributions	Rp 10,489 billion	13.0%	
	Total General Takaful & Retakaful Contributions	Rp 1,676 billion	19.7%	
	Total Family Takaful Contributions	Rp 8,813 billion	11.8%	
Islamic Funds	AuM of Islamic Mutual Funds Outstanding	Rp 10,771 billion	-3.5%	OJK Shariah Mutual Funds Statistics November 2015
	Number of Islamic Mutual Funds Outstanding	86	16.2%	
Sukuk	Sukuk Value Outstanding	Rp 298,724 billion	22%	Thomson Reuters Eikon
Total Islamic Finance Assets		**Rp 617 trillion**	**10.4%**	

According to the ICD - Thomson Reuters Islamic Finance Development Report 2015, Indonesia is ranked among the top performers globally in 2014 (out of 108 countries) as indicated by several findings from the report, both in terms of assets and indicator values. Given the latest reported developments in 2015, Indonesia is more likely to remain within the top performers, with high potential to moving further upward against other countries' ranking.

BEYOND 2015: Global Islamic finance assets are expected to reach a total of US$ 3.2 trillion by 2020 from US$ 1.8 trillion in 2014. Islamic banks are expected to be the biggest growth drivers of such growth with a projected growth between 11 and 12% per year.

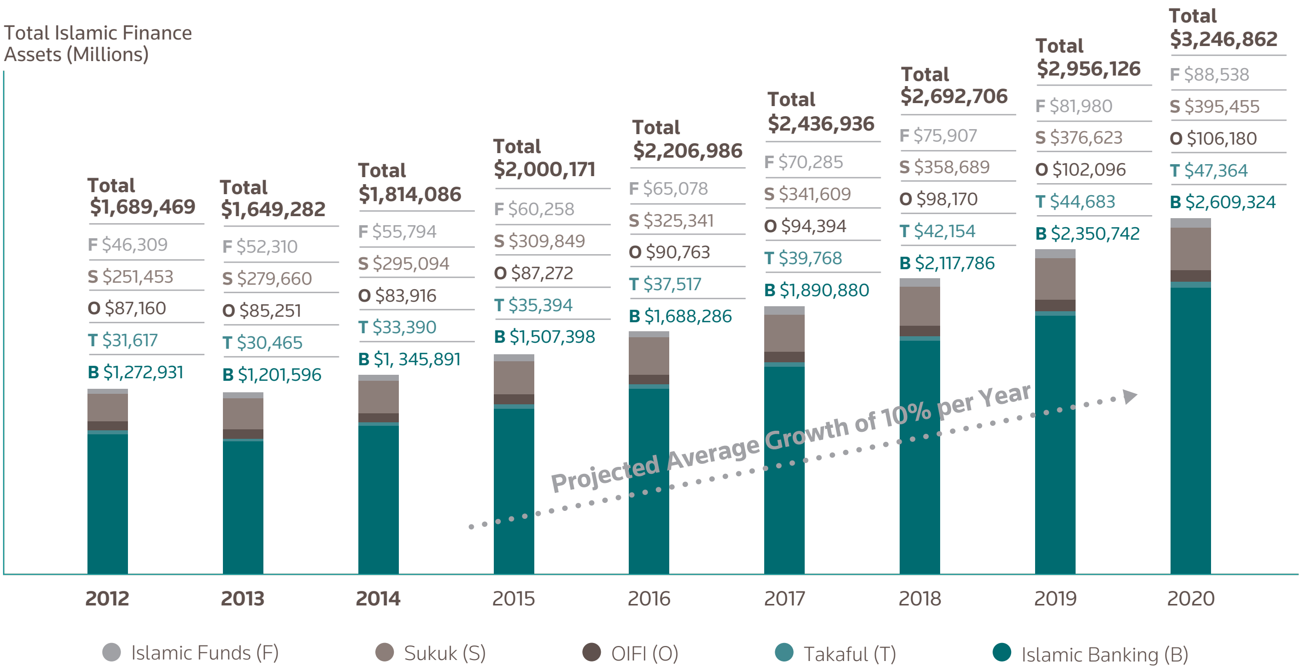
Like other top performers, Indonesia will contribute significantly to the global growth especially given that its government has prepared Market Roadmaps (2015 – 2019) for Islamic Banking, INKB and Islamic Capital Markets aiming to increase financial inclusion for different Islamic finance sectors and triple Indonesia's Islamic banking market share to 15% by 2023.

Retail and corporate investment opportunities for different Islamic finance sectors, which will be highlighted in later chapters of this report, support this notion as well. The government's ambitious infrastructure investment decision is considered the biggest enabler of such growth by creating a pathway for Indonesia's Islamic finance and opening door for Islamic finance tools like sukuk and syndicated financing to flourish.

ICD – THOMSON REUTERS ISLAMIC FINANCE DEVELOPMENT REPORT FINDINGS ON INDONESIA:

- **Ranked 10th for Islamic Finance Development Indicator and 9th for Quantitative Development Indicator**
- **9th in terms of Islamic finance assets and Islamic funds outstanding**
- **10th in Islamic banking assets and other Islamic financial institutions assets**
- **5th in takaful assets**
- **4th in sukuk outstanding**

GLOBAL ISLAMIC FINANCE ASSETS PROJECTED GROWTH UP TO 2020



Source: ICD – Thomson Reuter Islamic Finance Development Report 2015

3 Regulation and Market Infrastructure

People are reflected in a screen showing the share prices in a securities company in Jakarta.
REUTERS/Crack Palinggi

INSIDE THIS CHAPTER

History has shown that an enabling Islamic finance regulatory framework can often be the trigger for growth of the industry in a country. Regulators must be able to address the regulatory issues that affect operations and the institutional development of Islamic finance.

However, there are variations with regard to the approaches taken by different regulators in different jurisdictions and the degree of success of regulations to spur industry growth also varies. For Indonesia, the question arises as to how to produce an effective regulatory approach especially in the presence of many Islamic financial institutions that might affect the Islamic finance business. In this section we detail who the regulators are and what the key regulatory issues.

Key agencies

The system of regulations governing Islamic finance today remains complex. This is not exclusive to Indonesia. The system in Indonesia relies on three agencies: Bank Indonesia (BI), the central bank; Otoritas Jasa Keuangan (OJK), the Financial Services Authority; and The National Shariah Board (DSN). In addition other government bodies are also involved in regulating specific element of Islamic financial system that including Deposit Insurance Company, National Zakat Board (Badan Amil Zakat Nasional/ BAZNAS), and Indonesian Awqaf Board (Badan Wakaf Indonesia)

Laws governing Islamic financial institutions and Islamic banking: 1992, 1998, 2008, 2011

The development of modern Islamic banking in Indonesia was formally initiated in 1992, in line with the enactment of Banking Act No. 7 Year 1992 which includes provisions that provide an opportunity to establish interest-free banks in Indonesia. In same year, the first Islamic bank — Bank Muamalat — was established and some rural Islamic banks were also established in some rural regions in Java. Bank Muamalat — as the only Islamic bank in the country — faced some obstacles during the early years of its operations, especially due to lack of market instruments and alternatives for liquidity management problems.

In addition, the central banks also did not provide special central bank facilities (e.g. instruments for open market operations, discount windows or central bank credit facilities) that comply to Shariah principles. To overcome these problems and to encourage network enlargement, in 1998 the government amended the Banking Act with a new Banking Act No. 10 Year 1998, which provides a wide opportunity and a stronger legal foundation for Islamic banking operations. A notable change in this act was the opportunity of conventional banks to open Islamic banking units (UUS) by recognizing dual system banking and a provision to convert conventional banks to Islamic banks. In addition, in 1999 through amendment of Central Banking Act with Act No. 23 Year 1999 concerning Bank Indonesia, the central bank is allowed to conduct monetary policy through Islamic banks with instruments that comply with Shariah principles. Since 1999, new players came into the industry and it has made steady progress. Non-bank financial companies have also emerged, offering Islamic insurance (takaful), mutual fund, venture capital, pawning (rahn), and ijara financing; while Jakarta Stock Exchange also has introduced Jakarta Islamic Stock Index in June 2000.

Islamic banking grew steadily from 1999 to become part of the mainstream financial sector and in 2008 was given a further boost with a specific law on Islamic banking: [Law No 21 of 2008 on Islamic Banking]. In the same year the House of Representatives also passed the Sovereign Sukuk Law (UU No.19 Tahun 2008 tentang Surat Berharga Syariah Negara) which was considered necessary to flourish the development of islamic liquidity market instrument to enhance liquidity management in Islamic finance industry.

Legal and functional definitions of an Islamic bank

Legal Definition **[Law No 21 of 2008 on Islamic Banking]**	**Functional Definition** **[Abdul Ghafar Ismail (2010) Money, Islamic Banking and Real Economy. Singapore: Cengage Learning Asia Pte. Ltd.]**
Shariah (Islamic) Banking is all matters concerning Shariah (Islamic) Bank and the Shariah (Islamic) Business Unit, including institution, business operation, and means and process in the implementation of its business operation	The means of payment; smooth support payments mechanism; community savings funds; supports smooth international transaction; storage of valuable goods; provision of other services such as paying for electricity, sending money via ATM, paying employee salaries

After long years of discussions, the Financial Services Authority (Otoritas Jasa Keuangan/OJK) bill was passed by the House of representative in 27 October 2011. This enactment has born a new era in the regulation and supervision of Indonesia's financial sector. Supervisory roles on all financial sectors, including Islamic financial services, previously conducted by Bank Indonesia, the Capital Market and Financial Institutions Supervisory Agency (Ministry of Finance), are to be held by the OJK in an integrated manner.

OJK's power also includes the regulation, inspection, and investigation of the capital market and financial institutions, as well as the protection of consumers. The aims are to make sure that the activities within the financial services sector are in order, are fair, transparent, and accountable; and able to create a financial system that grows continuously and in a stable manner; and able to protect the interests of consumers and the society. Bank Indonesia as the central bank continues its main roles and functions to maintain monetary stability, the integrity of payment system and financial system stability.

Shariah oversight: Dewan Syariah Nasional and Shariah Supervisory Boards of Islamic financial institutions

The National Shariah Board (Dewan Syariah Nasional Majelis Ulama Indonesia or DSN-MUI) is the supreme authority in the country to issue the fatwa and opinions on products, services and operation of all Islamic financial services. DSN-MUI is completely independent of all government entities and part of the Indonesian Council of Scholars (Majelis Ulama Indonesia/MUI). In addition, DSN also have an important role in the process of fit and proper test to license a person elected as a member of Shariah supervisory board (SSB) which according to company law must exist in all Islamic business entities. The DNS also has an important role in screening the Shariah Securities List (Daftar Efek Syariah). The DSN-MUI is currently composed of 46 senior Islamic scholars from different regions of the country, representing different religious groups in Indonesia and with different academic background. It is supported with the DSN Executive Committees that consist of 40 members which divided into 4 sub-committee on Islamic banking, capital markets, non-bank financial services and other Islamic business. The DSN's existence and power recognised in the Islamic banking law No 21 Year 2008.

Shariah Supervisory Board (SSB) is an important organ for Shariah governance which shall be established in any business entities that declare themselves to be a Shariah business entity. In an Islamic bank the role, duties and composition of the SSB is clearly set in the regulation. SSB members are appointed by the Board with the approval by OJK after considering recommendations from DSN. The SSB provide the check and balance to ensure Shariah compliance in every Islamic financial institution, with the main duties to advise the board and management on Shariah matters on Islamic finance operations, endorse Shariah compliance manuals and products documentations with regard to the fatwa issued by the DSN, provide Shariah opinion (but do not entitle to issue a fatwa) and advise related parties within the financial institutions on Shariah matters. SSB is obliged to submit SSB Shariah Supervisory Report every semester to OJK and DSN.

Until mid 2015, DSN has issued 96 fatwa on every aspect of Islamic financial services, including the generic products such wadia, mudaraba and musharaka contracts, instruments for liquidity market, hybrid products, treatment of non-halal revenues, penalties, takaful and Islamic capital market operation, and hedging instruments. The fatwa issued by DSN have been put into power by Bank Indonesia and the Financial Services Authority (OJK) regulation, which obliges all Islamic financial services entities to comply with the DSN fatwas.

Practices of national-level Shariah oversight bodies in different jurisdictions

Matters considered by oversight bodies	Bahrain	Indonesia	Malaysia	Pakistan	Sudan
Independent Body:					
Appointment	Yes*	Yes	Yes	Yes	Yes
Budget	n.a	Yes	n.a	Yes	Yes
Remuneration	n.a	Yes	Yes	Yes	Yes
Function:					
Issuing fatwa on Islamic finance products	Yes	Yes	Yes	Yes	Yes
Approval for new Islamic products	Yes	Yes	Yes	Yes	Yes
Final authorisation of new products	Yes	No	No	No	No
Come up with standard guidelines for contracts	No	Yes	Yes	Yes	No
Members with backgrounds in different disciplines (i.e. not just fiqh or Shariah-related disciplines)	n.a	Yes	Yes	Yes	Yes
Meetings (frequency/month)	n a	Yes	Yes	Yes	Yes
Decisions (binding)	n.a	Yes	Yes	Yes	Yes
Legislated body	n.a	Yes	Yes	Yes	Yes
Governance arrangement	Yes	Yes	Yes	Yes	Yes
Disclosure	n.a	Yes	Yes	Yes	Yes

* Multiple appointment

Policy issues related to regulation

Business of Islamic banking

Law No 21 of 2008 on Islamic Banking allows Islamic banks to carry out normal banking operations as long as they comply with Shariah principles. In addition, Islamic banks are also allowed to operate or carry out their social functions. Islamic banks and Islamic banking windows (or Unit Usaha Syariah, UUS) have the obligation to execute the following functions:

- To mobilise and distribute private and public funds;
- Islamic bank and Islamic banking window may conduct social functions in the form of *baitul mal* institution, receiving funds from zakat, infaq, sadaqat, grant, or other social funds and distribute them to a zakat managing organisation;

Islamic banks and UUS may raise social funds originating from waqf money and distribute it to waqf management (*nazhir*) according to the will of the waqf donor (*wakif*). However, the social function execution as considered in item (2) shall follow the provision of laws and regulations. This shows that the legal and functional definitions of Islamic banking are lumped together.

Single regulatory power

OJK, in pursuant to Article 6 of the 2008 Bill, has regulatory and supervisory powers over Islamic financial services, such as capital markets, takaful, pension funds, Islamic financial institutions, and others. The regulatory power of the OJK on the Islamic banking system includes regulation and supervision of Islamic banks (licensing, Islamic bank business plans, mergers, consolidations and acquisitions, and articles of association).

OJK also supervises and regulates the financial soundness of Islamic banks (capital ratios, liquidity, reserves, reports, and accounting standards); supervises and regulates prudential aspects of banking (risk management, bank governance, customer principles, and money laundering); and supervises Islamic banks. All these functions were previously assigned to Bank Indonesia.

However, Bank Indonesia still has the power to regulate and supervise the macro-prudential aspects, such as minimum reserve requirement, loan to value ratio, etc. Meanwhile, OJK still has the power to supervise the micro-prudential aspects of the financial system and therefore it's responsible for determining the financial health criteria for Islamic banks should also fall under the OJK and the Indonesian Deposit Insurance Corporation (*Lembaga Penjamin Simpanan,* LPS).

Financial system stability coordination

The monitoring and evaluation of the Islamic financial system's stability included in the role of the Financial System Stability Coordination Forum that formulates and implements policies to prevent and deal with Islamic financial system crises. However, since, the size of Islamic banks and other Islamic financial services entities is considered small, and none of them are included as a systemic important financial institutions (SIFIs), this forum does not have special arrangements for Islamic financial safety net. But according to the Deposit Insurance Company Law, Islamic bank deposit also included in the deposit insurance scheme are guaranteed by the Indonesia Deposit Insurance Corporation (LPS) with special regulation.

Moving forward

Strengthening of the regulatory framework is necessary. The legislation gives the agencies the ability to specify regulatory requirements that promote and also work in parallel with Shariah-based operational frameworks. For example, Islamic banks can specify Shariah principles for financial contracts in consultation with the bank's Shariah Supervisory Board (SSB) and National Shariah Board, and operational standards on Islamic banking matters are issued by the regulators in order to make the implementation of standards effective and in compliance with Shariah principles.

The next action plan must underline the need for the regulators to maintain consistency, push for collaboration between stakeholders and compatibility with the conventional financial sector.

Although the Islamic finance industry has immense potential this must be reinforced by an improved, and investment in, a strong structural framework. Development must be supported by capital investment in IT, human resources and product development, while the retail sector urgently needs investment in information and knowledge dissemination and education to reach the unbanked population.

A centralised Shariah financial authority similar to the Malaysia International Islamic Financial Centre (MIFC) to strategise and plan for a blueprint for Islamic finance development in Indonesia would be beneficial to chart market trends and strategies for the development of the Islamic finance industry and will also highlight opportunities for inward investment, cross-border collaborations, corporate sukuk issuance, and initiatives to advance Shariah-compliant trade finance.

In conclusion, it is not just the responsibility of Bank Indonesia, OJK and other regulatory authorities to drive the industry forward, all stakeholders must commit to greater levels of cooperation. The involvement and the responsibility of all related parties are welcome. Given the increasing exposure to global risk a "cross-sectorial integrated approach" would be useful; this could be an approach with greater international collaboration towards standardisation, such as with the issue of tax neutrality. An integrated and comprehensive regulatory and supervisory approach is required to maintain positive results, financial stability and economic development.

A NEW STAGE OF DEVELOPMENT FOR ISLAMIC ECONOMICS AND FINANCE IN INDONESIA

Dr Dadang Muljawan, Deputy Director at Macroprudential Policy Department, Bank Indonesia
Mr. Jhordy Kashoogie, Analyst at Macroprudential Policy Department, Bank Indonesia

DR DADANG MULJAWAN
is currently a Deputy Director at Macroprudential Policy Department, Bank Indonesia. He holds a BSc degree in Engineering Physics from Bandung Institute of Technology, an MBA from PPM Graduate School of Management, and PhD in Economics from Loughborough University, UK. He has written a number of research publications in international journals and presented papers at international conferences. His areas of interest cover financial supervision and regulations, and financial assessment both in micro level and macro level. He has been exposed to more than 10 years of experience in the Central Bank of Indonesia as an economic researcher, managing a project on involved in the area of prudential database for Financial Soundness Indicators (FSI) at the IFSB, participating in a number of the IFSB Working Groups, and assuming a position as a senior research economist at the IRTI-IDB. Currently, he is in charge in research activities relating to the development of Islamic economics and finance development in Indonesia.

MR. JHORDY KASHOOGIE
Mr. Jhordy Kashoogie is currently an Analyst at Macroprudential Policy Department, Bank Indonesia. He holds a BSc degree in Islamic Economics and Finance from International Islamic University Malaysia and MSc in Islamic finance from Durham University, United Kingdom. He has written several articles and insights relating Islamic finance development in Islamic finance publications worldwide. He has practical exposures in strategy and product development area prior to join Bank Indonesia. In Central Bank of Indonesia, he in activities relating to Islamic economics and finance development and cooperation in Indonesia.

In the midst of global economic slowdown, Islamic economics and finance can offer a way to equip the national economy with alternative vehicles in stimulating growth and opening up financial access in a more equitable way.

This is considered imperative due to imbalances between the financial and real sectors in the economy that causes economic and social injustice. In the Indonesia context, Islamic economics and finance has been developed through a bottom-up approach. Due to this reason, strategic initiatives need to be driven by the government to take the development phase to the next level. Therefore, concrete government actions through strategic initiatives in the development of Islamic economics and finance are important, as part of policy packages to improve economic growth and prosperity. The government of Indonesia has an annual national development and a set of strategies, as defined in Annual Medium Term National Development Plan 2015 – 2019, which translate into 9 key development program priorities ("Nawa Cita"). Amongst these key development priorities, one of key agenda items is to mobilise resource allocation for real sector development in order to be an autonomous independent economy. This agenda is in line with the spirit of development of Islamic economics and finance in the country. Hence, it is critical to develop Islamic economics and finance through a top-down approach, with strategic policies from government aimed at mainstreaming Islamic economic and finance into the national policy.

In order to drive such strategic initiatives, the development program is envisioned to establish a robust and sound Islamic economics and financial system, which is consistent with the implementation of Shariah principles in the spirit of justice, general well-being and balanced living and to promote both material and spiritual social prosperity. In line with the development stage, commercial and social sectors within the Islamic financial landscape are developing in terms of asset size and product innovation. Islamic finance has to be embodied with a value preposition of real sector development and social sector aspects (zakat and awqaf development) for realising socio-economic objectives.

Within the current Islamic economics and finance regulatory landscape in Indonesia, the Indonesian Authority in banking and finance sectors, namely the Bank Indonesia, Indonesian FSA (OJK), and the Ministry of Finance, have to cooperatively undertake efforts to develop further Islamic economics and finance. There are 3 new important strategic initiatives that are underway, besides other initiatives in the Islamic banking, capital market and insurance as follows:

- **Islamic social finance development;** this departs from the urgency of quality of living improvement and equitable economic distribution in Indonesia. Ideally, economic development achieved by a country should be enjoyed equally by the people of that particular country. However, in the case of Indonesia, the gini coefficient has widened from 29 to 38.1 in the past decade (source: United Nations), which means that the income disparity between the 'haves' and the 'haves nots' has increased. Hence, considering a reality divergence from an ideal state, a financial inclusion policy initiative has to be formulated to provide fair opportunity to low income society to contribute in economic development with the implication of a broader production base and sustainability of economic development.

Indonesia has great potential in terms of zakat collection, which amounts to USD 15.5 billion, and spacious waqf land, which amounts to 414,246 hectare (or equivalent to USD 29.5 billion, assuming that the price of waqf land is USD 7/m2). In order to leverage the potential of zakat and waqf in Indonesia, Bank Indonesia is driving an initiate related to zakat and waqf core principles formulation, in coordination with the National Zakat Board (BAZNAS),

> "CONCRETE GOVERNMENT ACTIONS THROUGH STRATEGIC INITIATIVES IN THE DEVELOPMENT OF ISLAMIC ECONOMICS AND FINANCE ARE IMPORTANT, AS PART OF POLICY PACKAGES TO IMPROVE ECONOMIC GROWTH AND PROSPERITY.

> STRATEGIC INITIATIVES FROM THE GOVERNMENT ARE CRITICAL AT THIS MOMENT TO BRING THE DEVELOPMENT STAGE TO THE NEXT LEVEL AND BRING ECONOMIC PROSPERITY TO INDONESIA

the National Waqf Board (BWI), and respective zakat and waqf authorities of Muslim countries. The core principles are expected to improve the governance of zakat and waqf institutions by providing general guidelines for regulators on how to conduct supervisory actions and managers on how to manage zakat and waqf institutions, in the same fashion of Banking Core Principles (BCP) formulated by Basel Committee. With those core principles formulation, it is expected that the third sector development can be used to bring prosperity to society.

- **Project based sukuk development;** in the recent years, the government has issued sovereign sukuk amounting to USD 25.9 billion (source: Ministry of Finance). Project based sukuk has been favoured by the government to fulfil the fiscal needs to fund strategic government projects. However, the corporate sukuk is not growing in Indonesia and its share is only 3% – 4% in the total sukuk issuance. This is due to the fact that corporate sukuk are solely used to fulfil the demand in the market. Given this, there needs to be better collaboration between government and market players to discuss the financing needs that can be structured through sukuk issuance. In order to increase corporate sukuk, the government should collaborate with corporates in the form of Public-Private Partnership (PPP) to fund strategic projects or even potential mega projects in Indonesia. The government should also promote awqaf based sukuk issuance, coordinating with the National Board of Waqf, in order to gain societal welfare through leveraging the great potential of waqf asset in Indonesia.

- **Islamic financial deepening;** the current state of the Islamic financial market is still at the nascent stage. This is based on the fact that the share of interbank Islamic money market is 1% – 5%, on average, of daily trade in the interbank money market. This is because some Islamic banks still leverage on their parent banks for liquidity support and there is limited product availability in the market. Currently, Bank Indonesia has provided repurchase facilities for Islamic money market instruments, particularly with SBIS (Central Bank Islamic Certificate), reverse repo of SBSN (government *sukuk*), deposit FX for liquidity management in domestic market, and recently a Shariah repurchase agreement. In the effort to deepen Islamic financial market, we see innovation in a variety of Islamic money market instruments based on relevant Islamic contracts as well as Islamic hedging instrument in the pipeline.

These strategic initiatives are breakthroughs that will drive Islamic economics and finance development in Indonesia to the next level. Support from the government and relevant stakeholders is important. Hence, strategic initiatives from the government are critical at this moment to bring the development stage to the next level and bring economic prosperity to Indonesia.

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Workers walk along a pathway at the nickel smelter of PT Vale Tbk, near Sorowako, Indonesia's Sulawesi island. REUTERS/ Yusuf Ahmad

4 Retail Sector in Indonesia: Investment Opportunities

An employee holds a gold piece, each weighing 100 grams, at the state-owned mining company PT Antam Tbk metal refinery in Jakarta. REUTERS/Beawiharta

INSIDE THIS CHAPTER

Islamic Banking

Retail banking at a glance

Shariah-compliant retail financing concentrated in hands of top five

The Indonesian banking landscape is vast 119 commercial banks but loans and financing are highly concentrated in the hands of the top five banks in each of the conventional sectors. While in the Islamic banking sector, the industry is dominated by two big banks, Bank Syariah Mandiri and Bank Muamalat.

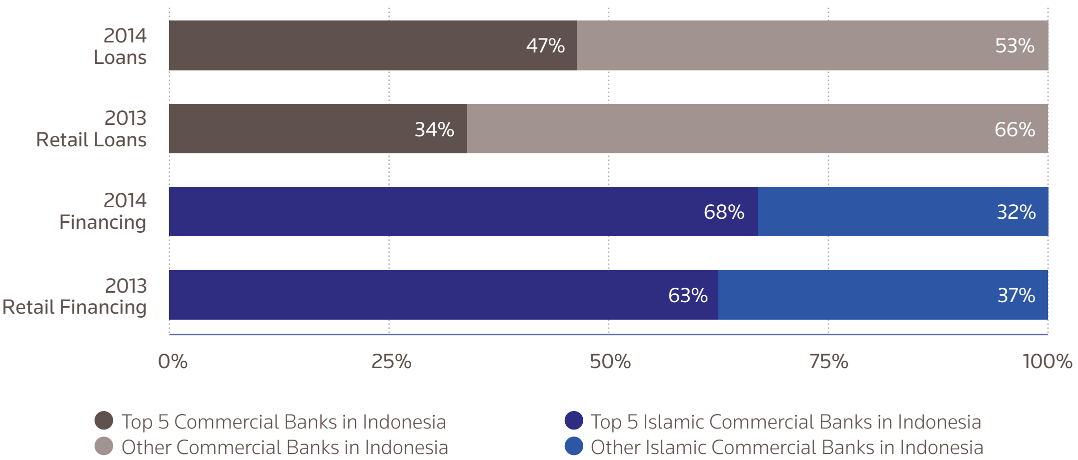
However, the conventional loans business is more competitive than the Islamic financing business. In the conventional sector, the top five banks, which make up only 4 percent of the total number of banks, are the source of 34 percent of all conventional retail loans. In contrast, the top five Islamic banks control almost 70 percent of all Islamic financing.

Islamic banks make up 28 percent of the commercial banking network (34 out of 153 banks) but hold only approximately 5 percent of the country's total banking assets. There is significant room for growth for the Islamic banking sector both in terms of winning over conventional banking customers as well as attracting Indonesians who do not already hold formal bank accounts. There has been a rise in formal bank accounts (for people aged 15 and older) with financial institutions, which reached 36 percent in 2014 from 20 percent in 2011, as measured by the World Bank Global Financial Inclusion Index.

However, progress to win new customers in the last three years has been slower for the Islamic banking sector compared to the whole banking industry. Islamic banking penetration grew by an average 0.25 percent only in the last three years compared to 2.25 percent for the banking industry as a whole. Consumer loans and financing, however, have seen steady growth in recent years. To this end, future profitability of the banking industry will be driven not only by pulling up financing but by maintaining the quality of loans and financing as well.

CONCENTRATION AND COMPETITIVENESS OF RETAIL COMMERCIAL BANKING IN INDONESIA

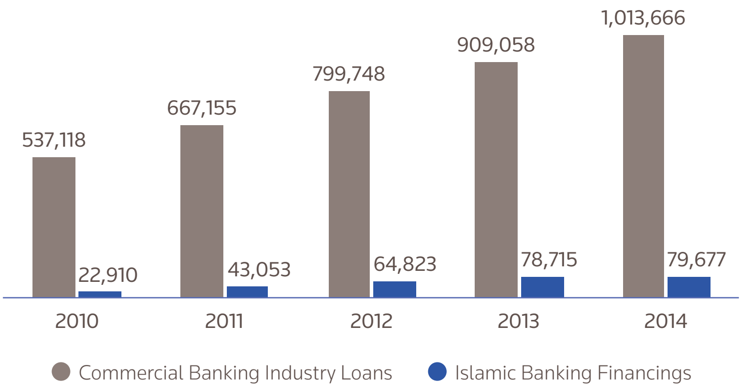
* Total retail loans and financing are represented by consumption loans and financing



Source: IFG Database, Indonesian Banking Statistics December 2014, Bank Indonesia

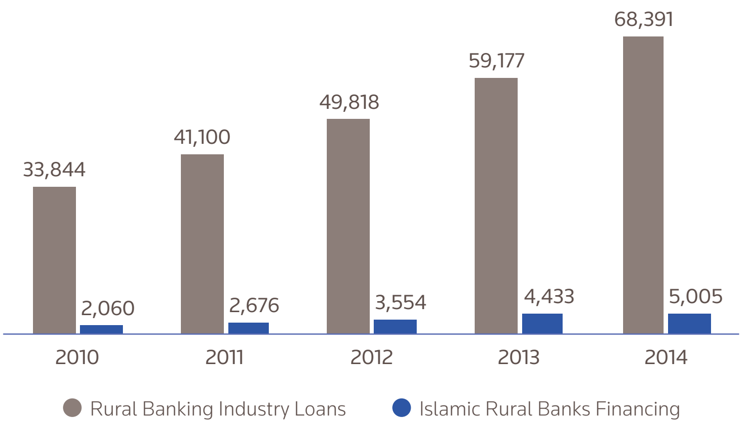
RETAIL CREDIT* BY COMMERCIAL BANKS (RP BN)

* Total retail loans and financing are represented by consumption loans and financing. Includes Shariah Business Units.



Source: Indonesian and Islamic Banking Statistics December 2014, Bank Indonesia

CREDIT BY RURAL BANKS (RP BN)



Source: Indonesian and Islamic Banking Statistics December 2014, Bank Indonesia

Credit and Financing

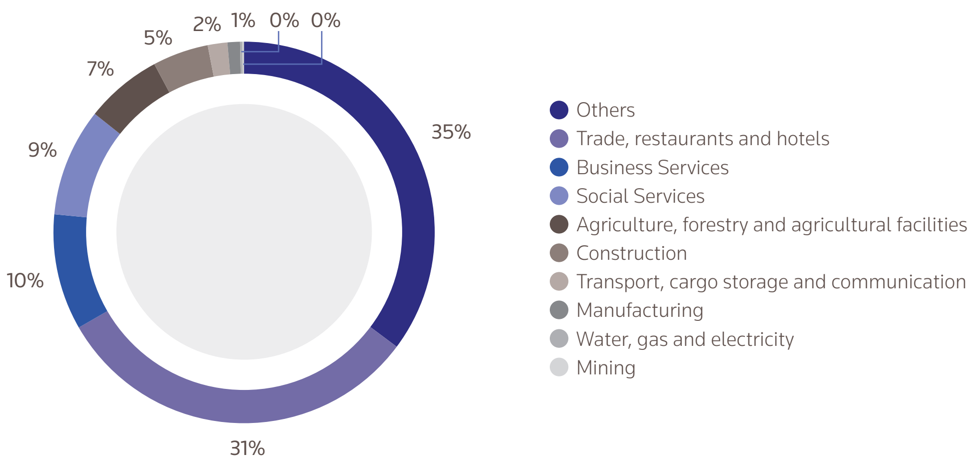
Shariah-compliant financing is growing at a much slower pace compared to conventional loans. Indonesia wants to increase financial inclusion and it is hence time for banks to move beyond just financing/lending and look to also better serve the financially excluded and unbanked within the population.

With increasing purchasing power by a growing middle class, retail consumer financing has gained strategic importance. However, Shariah-compliant financing extended by Islamic commercial banks are still at a low level — they constitute only 7.86 percent of loans in the whole retail commercial banking industry.

In the Republic, the retail banking industry is supported by rural banks. Islamic rural banks account for 10 percent of the 1,643 rural banks, and their financing amounted to only Rp 5,005 billion (representing only 7 percent of total loans/financing of the country's rural banks).

Rural banks provide micro-financing solutions to retail businesses or micro and small enterprises. Financing by Islamic rural banks is extended mostly to the agriculture sector as well as to trade, restaurants and hotels. Given the recent growth within these sectors in Indonesia, it is expected that credit demand in the form of micro-financing from retail businesses, especially in the rural areas, will only increase.

FINANCING BY ISLAMIC RURAL BANKS BASED ON SECTOR (2014)



Source: Indonesian and Islamic Banking Statistics December 2014, Bank Indonesia

Retail Banking Consumer Survey

Our exclusive retail consumer financial services survey reveals a number of growth and investment opportunities for the Islamic banking sector in Indonesia. Our analysis of the survey results reveal strategic insights that point to possible opportunities for the banking sector in general and Islamic banking in particular.

RETAIL BANKING SECTOR HIGHLIGHTS

CUSTOMER AWARENESS

- Awareness campaigns to bank the unbanked
- Islamic banks should reach out to low income customers through offering affordable products such as micro-savings
- Specialised Islamic finance institutions, universities, and public seminars are welcome to boost awareness levels and to raise market professionalism

FINANCIAL INCLUSION

- Young professionals to lead growth of the financial services sector
- Islamic banking perception in Indonesia needs to be enhanced by products that are in line with the needs of young consumers.
- Findings reveal an untapped Islamic banking potential in Indonesia

CUSTOMER EXPERIENCE & PRODUCT PREFERENCES

- Institutional factors matter most when choosing an Islamic bank
- Islamic banks should target consumers through attractive and competitive promotional campaigns
- Are Islamic banks ready to capture retail consumer mortgage demand?

STATE PLANS TO SPUR FINANCIAL INCLUSION

The financial Inclusion strategy comes as part of the economic development and poverty alleviation plans which were implemented successfully in 2012. However the initiatives have remained small-scale.

Despite past efforts devoted to spur micro finance, Indonesia continues to lag behind its peers in term of financial inclusion. But increasing the level of financial inclusion has now become a key goal for President Joko Widodo, who emphasises the implementation of the Financial Inclusion Policy Framework through six main pillars.

FINANCIAL EDUCATION

- TabunganKu
- Financial Education for Society (students, TKI, and public)
- Campaign to increase the culture of saving
- Mini website (specific for customer information and education)

PUBLIC FINANCE FACILITY

- Social assistance, in the form of Family Hope Program (PKH), School Operational assistance
- (BOS), Community Health Insurance (Jamkesmas), and Rice Subsidy (Raskin)
- Empowerment of Micro and Small Enterprises
- National Program for Society Empowerment (PNPM)

MAPPING OF FINANCIAL INFORMATION

- Financial Identity Number
- Credit Rating Agency for MSMEs
- Credit Information Bureau

SUPPORTIVE REGULATION /POLICY

- Branchless Banking Policy (Laku Pandai refers to Branchless Financial Services in the Framework of Inclusive Finance)

INTERMEDIATION /DISTRIBUTION FACILITY

- Mobile Financial Services
- Remittance Operations (KUPU)
- Regional Credit Guarantee Board (LPKD)
- Start up credit
- Linkage Program
- Program of economic clusters
- Financial Consultant Partner Bank Program

CUSTOMER PROTECTION

- Product Transparancy
- Special unit handling customer complaints
- Banking Customer Mediation
- Customer Education

The framework built on the basis of government-led programmes driven primarily by bank participation and accompanied by several innovative technology-based programmes. Under this strategy, the financial inclusion framework partners with state-owned as well as private banks. During 2015, the government implemented key initiatives:

1. Direct-deposit programme for welfare service, with transfers of approximately Rp 8.5 trillion ($600 billion). To increase consumer financial eligibility, unbanked families are incentivised to open accounts to receive direct payment of government benefits under the Welfare Family Savings Program (PSKS).

2. The Laku Pandai programme is another initiative that focuses on increasing financial access through branchless banking, by using agents.

3. The Financial Identification Program allows the unbanked population to easily open accounts and will make it easier to identify new consumers through the Financial Identity Number (FIN). FIN is a lifetime number connected to the existing e-ID card.

4. Rekening Hape program started in April 2015 in collaboration with telecommunication companies to allow the unbanked population to use their mobile number as an e-money account number. Simple text messages will allow them to transfer funds and pay bills, among other functions, through a mobile number-based account.

Moreover, OJK introduced a five year roadmap in 2015 with the objective of increasing Islamic banking contribution to Indonesia's financial inclusion, competitiveness and stability in addition to contribution to its economic growth.

The Roadmap of Indonesian Islamic Banking (2015 – 2019) has seven policy directions as outlined below, which are aligned with the state's Financial Inclusion Policy Framework:

Develop and strengthen synergies between the authorities and other stakeholders in terms of policy development	Enhance efficiency and strengthen capital and business scale	Expand financing segment by improving funding structure

Improve product and service quality and diversity	Improve infrastructure quality and quantity including HR and IT
Enhance public preference and literacy	Harmonize and strengthen supervision and regulations

The policy directions fit within 41 priority programs that intend to increase the Islamic banking assets contribution to 15% market share by 2023. Some of these programs are:

Area	Priority Programs
Policy Development	▪ Establishment of National Committee for Islamic Finance (KNKS) ▪ Establishment of Islamic investment banks with a target to finance government projects ▪ Establishment of research and development centre for Islamic banking
Increase Competeveness	▪ Establishment of State owned or government owned Islamic bank ▪ Incentive framework to increase productive financing in corporate and infrastructure sectors ▪ Hajj fund management through Islamic banks along with zakat, sadaqa, waqf and infaq ▪ Allow Islamic banks to manage government or government owned enterprise funds ▪ Improve service and product quality as well as HR, IT and other infrastructure
Regulation	▪ Improve policies related to Financing to Value (FTV) and institutional regulations ▪ Develop guidelines related to Islamic banks stress test and taxonomic system
Improve Literacy	▪ Islamic Banking campaign program (iB) to increase Islamic banking branding, positioning and segregation ▪ Improve Islamic finance education and socialization

People wait for a commuter train at Manggarai train station in Jakarta. REUTERS/ Beawiharta

Customer Awareness

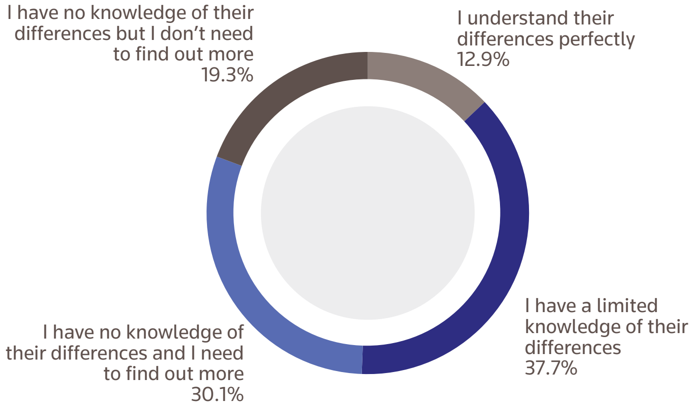
Awareness campaigns to bank the unbanked

The majority of survey respondents — 60 percent — build relationships with conventional banks and a lower proportion — 25 percent — have relationships with Islamic banks (just under half of the 25 percent also bank conventionally). This 25 percent who bank Islamically is a high proportion relative to the whopping 87.1 percent of all survey respondents who say they have no or limited knowledge of Islamic financial products and services. There is a substantial group — 15.1 percent — that is unbanked.

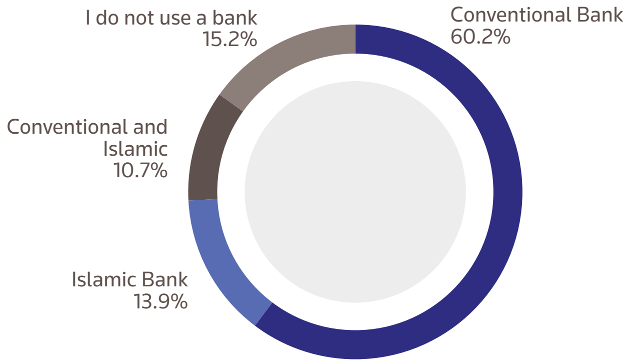
54 percent of the unbanked do not have bank accounts due to low or insufficient income or they feel that bank accounts are not needed. 19 percent of the same addressed the issue of high banking fees in both the conventional and Islamic banking sectors.

To increase financial inclusion among the population (who are mostly low- to middle-income earners), Islamic banks should **offer innovative products at affordable fees to attract the rural and urban** low- to middle-income earners. Additionally, as the majority of the unbanked respondents have low or insufficient income **Islamic banks should reach out to this group of customers through affordable products such as micro-savings.** This would require Islamic banks to strengthen their relationships with development and rural banks.

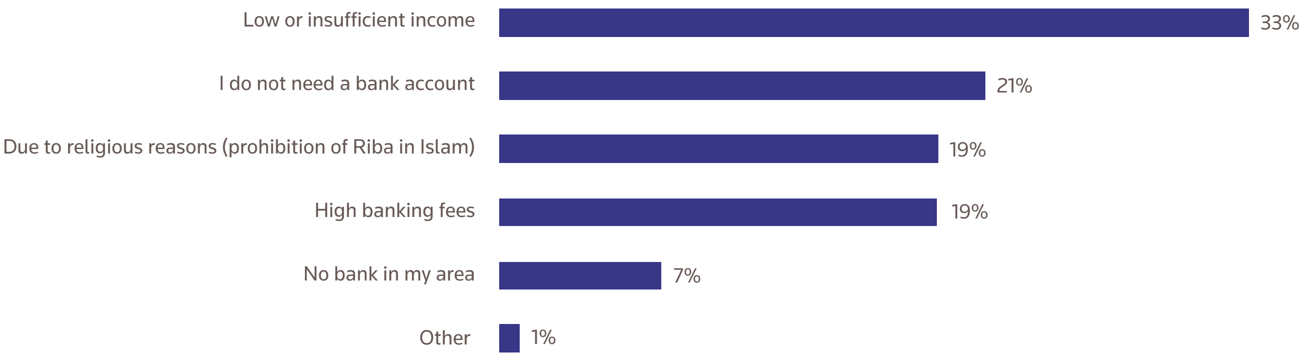
WHAT IS YOUR LEVEL OF UNDERSTANDING OF THE DIFFERENCES BETWEEN ISLAMIC AND CONVENTIONAL FINANCIAL SERVICES AND PRODUCTS?



WHAT TYPE OF BANKING SERVICE PROVIDERS DO YOU CURRENTLY USE?



IF YOU DO NOT HAVE A BANK ACCOUNT, CAN YOU PLEASE EXPLAIN THE REASONS WHY?



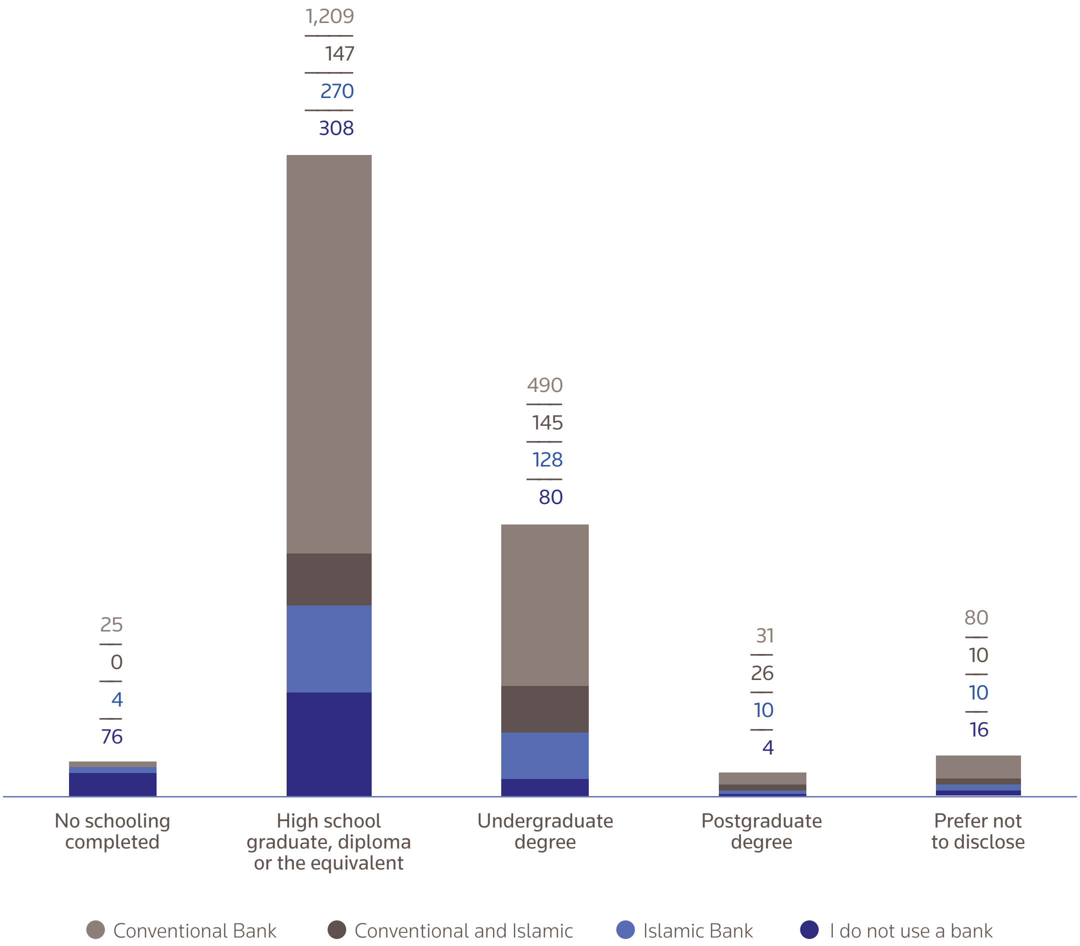
Specialised Islamic finance institutions, universities, and public seminars are welcome to boost awareness levels and to raise market professionalism and increase experts

Despite the growing trend of universities offering new Islamic finance programmes, Islamic finance education, specialised courses and seminars are still lacking in Indonesia, according to the Islamic Finance Development Indicator Report 2014.

Our survey findings reveal that the level of familiarity with Islamic finance concepts, products and services is low across the board. Most of the survey respondents are high school graduates, diploma holders or undergraduate degree holders (these three groups account for 90 percent of total respondents). Most survey respondents, from the high school graduates to postgraduates, (1,730 out of 3,165) use conventional banks and only 13 percent deal with Islamic banks. Only 12.9 percent have knowledge of Islamic finance while 37.7 percent have limited knowledge and 30 percent don't understand the differences between conventional and Islamic banking.

This lack of awareness is not at all lost on the authorities; the government has kick started a national Islamic finance awareness campaign as part of plans to boost the take-up rate for Islamic finance. On the ground, universities and Islamic banks must pick up the gauntlet and start offering courses, degree programmes, workshops, seminars and symposiums in order to raise the overall level of market awareness.

FINANCIAL INCLUSION BY EDUCATION

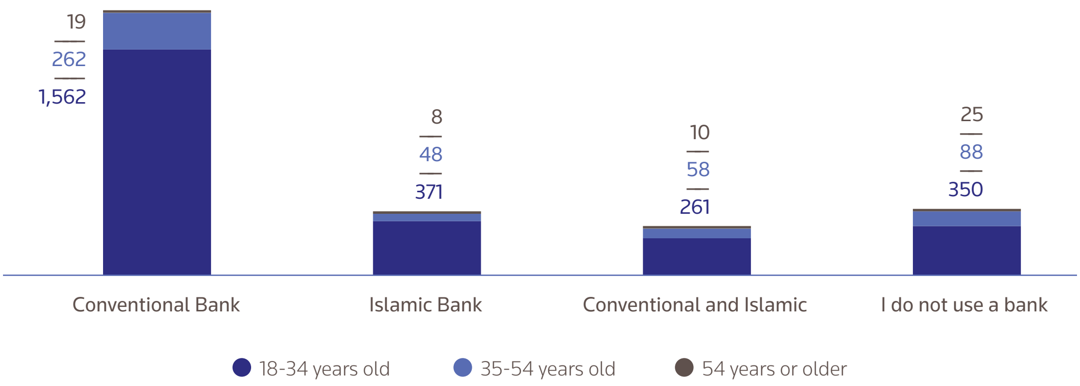


Financial Inclusion

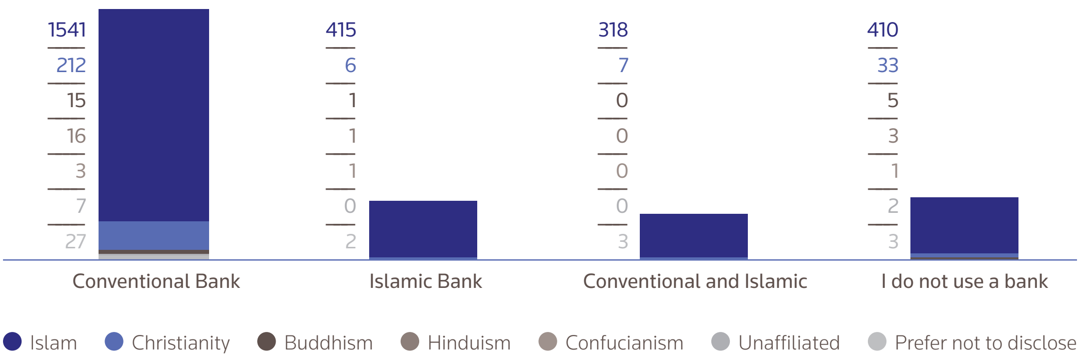
Young professionals to lead growth of the financial services sector

Indonesia has a very young population; citizens in the 15-54 age group account for 59.4 percent of the country's population (Index mundi, July 2014 estimate) and the median age is 29.3 years (CIA World Factbook 2014 estimates). 2,194 respondents out of the total survey sample size of 3,165 are between the ages of 18 and 34. **Islamic banking in Indonesia needs to be enhanced by products that are in line with the needs of young consumers.**

FINANCIAL INCLUSION BY AGE GROUPS



FINANCIAL INCLUSION BY RELIGIOUS AFFILIATION



Findings reveal an untapped Islamic banking potential in Indonesia

Although the majority of the Indonesian population is Muslim the market share of Shariah-compliant banking is extremely low. 60 percent of survey respondents deal with conventional banks and Shariah-compliant banking is used by only 14 percent of respondents. 10.8 percent use both conventional and Islamic banks.

The government hopes that its new five-year roadmap to boost Islamic banking through national-level promotional, educational and awareness programmes will boost the take-up rate for Islamic banking. In addition, Islamic banks should focus on investing in human resources, innovation and technology solutions to attract the 15 percent unbanked population. Foreign investors with Shariah mandates will be welcomed in the Republic to bring new business solutions to attract more consumers.

Customer experience and product preferences

Institutional factors matter most when choosing an Islamic bank

The most important considerations for Indonesia's retail banking consumer when choosing to deal with an Islamic bank are institutional ones: top of their considerations is the financial institution's reputation (12 percent), followed by government endorsement, direct interaction with bank representatives, and transparency of products. Thereafter comes the informal advice of family and friends and self-research. Interestingly, the advice of Shariah scholars is the least important consideration.

83 percent of respondents cite government endorsement as important to help them choose an Islamic bank or takaful service. This bodes well for the government's new Islamic financial services roadmap, which we anticipate will help to make a gradual shift towards Islamic financial services by the mass market.

As part of this roadmap, the government approach is to promote Islamic finance as a viable alternative to conventional finance. Therefore, **Islamic banks should target consumers through attractive and competitive promotional campaigns,** which could start with Islamic business units to gain consumer trust and build up the bank's reputation (which is considered important by 91 percent of survey respondents).

We highlight two considerations that we believe are closely linked — the transparency of products can be improved if the role of the National Shariah Board is enhanced and the overall Shariah governance framework is strengthened.

The survey also reveals that retail consumers' priorities are categorised into three tiers of importance: the top tier outlines the importance of customer services and ATM networks, represented by 92 percent and 91 percent of responses, respectively; the second tier highlights the importance of technology, pricing and the bank's reputation; and the least important tier deals with the proximity of branches (79 percent) and Islamic mandate (77 percent).

Are Islamic banks ready to capture retail consumer mortgage demand?

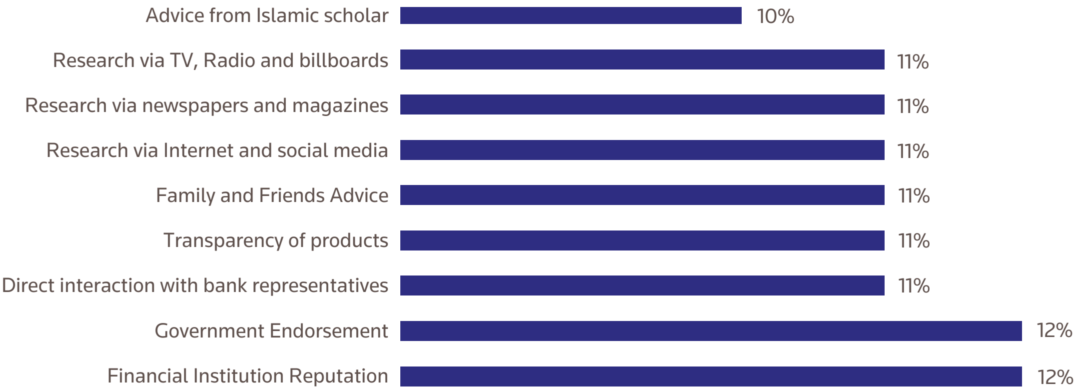
The introduction of new mortgage rules that ease down payment from 30 percent to 20 percent for first-time home buyers will push up the demand for home mortgages.

The level of competitiveness in the banking sector is expected to increase as these changes will only apply to banks that can show a healthy mortgage portfolio with less than 5 percent non-performing loans.

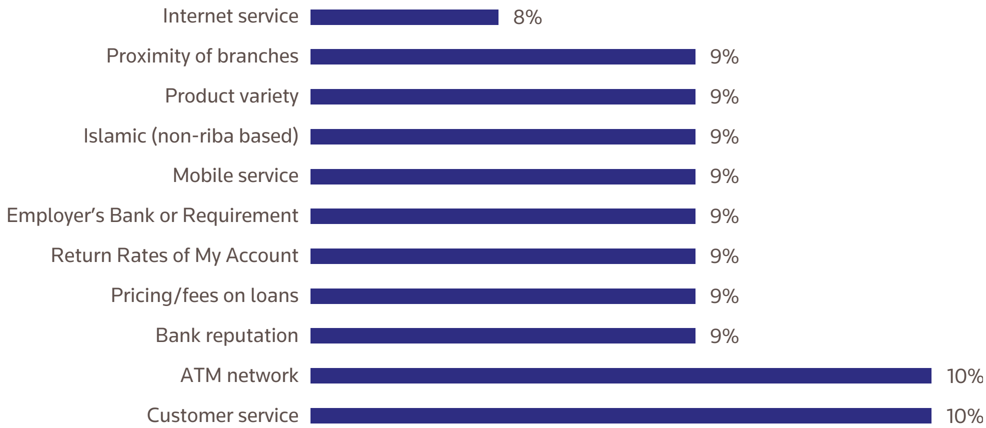
The NPL of Indonesian Islamic banks reached 4.58 percent in August 2014, up from 2.62 percent in December 2013. The situation needs to be watched closely and Islamic banks must devote their efforts to reducing this negative growth to benefit from the new rules in order to gain market share.

Savings accounts may be the least important need for our survey respondents but they are selected as a need by almost 82 percent of respondents. Therefore, easing access to the market through providing savings solutions with lower account opening charges and fees should be introduced to attract the bracket of the population who are poor and low-income earners and who would benefit from formal saving facilities.

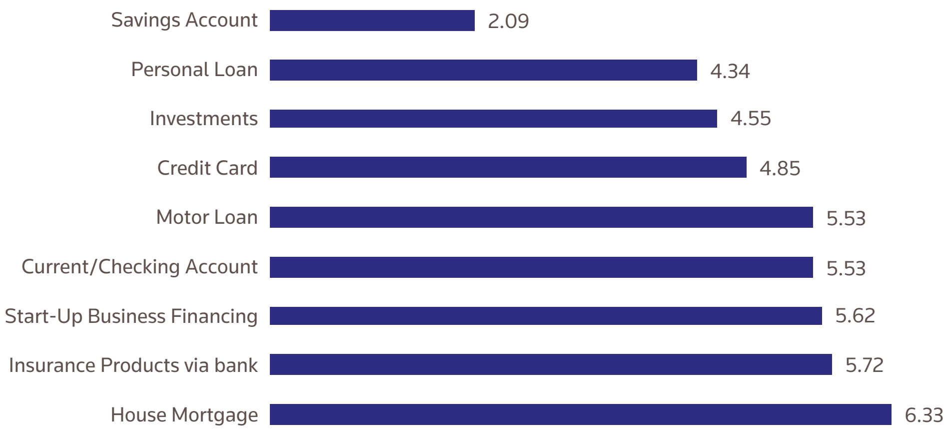
WHAT WOULD BE YOUR MOST IMPORTANT CONSIDERATION WHEN CHOOSING ISLAMIC BANKING OR ISLAMIC INSURANCE SERVICES?



HOW IMPORTANT ARE THE FOLLOWING PRIORITIES TO YOU WHEN DEALING WITH YOUR MAIN BANKING SERVICE PROVIDER?



PLEASE RANK THE FOLLOWING BANKING PRODUCTS AND SERVICES BASED ON YOUR NEEDS



MMQ — PKR IB FLEXI, AS A MARKET BOOSTER: FROM SHARIAH CONSUMER FINANCING PERSPECTIVE

Pandji P. Djajanegara, Chief of Sharia Banking, CIMB Niaga

PANDJI P. DJAJANEGARA is an Indonesian citizen, 51 years old. Appointed Chief of Sharia Banking in 2015, he started his career at CIMB Niaga in 1992 when he joined the bank's Executive Program.

Pandji was Care Taker of Commercial Director and Chief of Commercial Banking & Sharia (2014), and has taken on a variety of senior positions, including Chief Corporate Banking Officer, Head of Corporate Banking and Head of Credit Restructuring & Settlement.

He holds a bachelor's degree in economics from Universitas Trisakti and an MBA from Erasmus Universiteit in Rotterdam, the Netherlands.He has attended various executive training programs at Shanghai CIMB-INSEAD Leadership Program and Treasury Academy 'A New Dawn' Workshop.

CIMB Niaga Syariah created history when it launched the PKR iB Flexi on 19th August 2015, a product which uses musharaka mutanaqisah (syirkatul 'inan) contract known as MMQ. Under this contract with integrating partnership, rental and sale contracts will not only solve the customers' needs but also the bank's concerns as well.

MMQ is not new to the market, though there are only less than 10 banks in Indonesia that have this type of scheme. The features of MMQ could provide answers to some of the needs that other aqad (principle) could not accommodate.

A Shariah home financing which uses MMQ as the principle will have a better product when compared to Shariah home financing based on other principles or conventional home loan products (under the current conditions). For that reason, PKR iB Flexi will be a more appealing alternative product.

PKR iB Flexi also has unique selling propositions:

i. a lower down payment at 15%, currently the best rate among Shariah financing institutions, combined with;

ii. flexibility, as it is a combination of fixed and floating rates and

iii. longer financing period that is up to 20 years.

One of the Indonesian government's goals in 2015 is to provide 1,000,000 houses for the public. There are some challenges in achieving this goal, which includes the capability of the buyers who need the houses but do not have the capacity to buy or to provide the down payment (at least 30% from the housing price) through bank financing. As such, we do believe that the MMQ is one of the solutions to this limitation and MMQ's bank financing is relatively much better when compared to the murabaha or conventional home loan.

For most Shariah banks in Indonesia, to offer and sell murabaha with fixed margin would mean that the bank would not be able to perform the repricing when the trend of margin (profit rate) increases in Indonesia. It needs to be noted that the majority deposit period is less than home financing period; i.e. deposit is a maximum of a 3 year-tenure whilst home financing is more than 3 years. This further strengthens MMQ as one of the solutions as the floating margin feature is available.

Otoritas Jasa Keuangan Indonesia (OJK) has always encouraged Shariah banks in Indonesia to come up with innovative products. With the current conditions, the MMQ could be one of the "killer products" given that MMQ could answer the public's need and the Shariah banks' challenges simultaneously. We do believe that the Shariah banks can play a significant role in Indonesia's home financing industry as this scheme has a better product positioning when compared to conventional home financing products.

> "MMQ [MUSHARAKA MUTANAQISAH] IS NOT NEW TO THE MARKET, THOUGH THERE ARE ONLY LESS THAN 10 BANKS IN INDONESIA THAT HAVE THIS TYPE OF SCHEME.

What's next?

Even though the Bank has launched this scheme, there are still a number of things that needs to be done. *Firstly,* "How to inform the market (market socialisation)"; although Shariah business has been established in Indonesia for more than 20 years, the branding for Shariah banking needs to be improved. This scheme has to be promoted effectively so that potential customers will know that CIMB Niaga Syariah has the solution. *Secondly*, "Pricing"; one of the classical challenges pertaining to Shariah banks in Indonesia is the cost of funds that is less competitive when compared to its conventional counterpart. This is understandable as the industry is less than 25 years old; however Shariah banks have to adopt the correct business model in order to minimise fixed costs. *Thirdly,* "Business Process"; home financing is a mass product and therefore, the bank has to ensure that the right infrastructure is in place in order to meet the consumer's standard requirement. Good pricing and competitive bank financing needs to be supported by an excellent business process and Shariah banks have to have this in order to attract customers from conventional banking.

The target market of PKR iB Flexi is in line with existing PKR iB Murabahah, i.e. employees, professionals and the self-employed, whereas the purpose of PKR iB Flexi is more related to home, home office, and apartment. On the other hand, land, home renovation, housing construction, top up and take over financing can be offered to the customer through PKR iB Murabahah.

CIMB Niaga, known in the industry as one of the best banks for home financing received its latest recognition from Property Indonesia as "The Most Innovative Loan Bank". Since CIMB Niaga adopts the "dual banking leverage model" in doing Shariah business including consumer financing, its management has decided to apply the success of the consumer home financing especially for MMQ scheme to the conventional home loan.

It is fortunate that CIMB Niaga Syariah has timely launched the MMQ for the consumer segment and has proven that it could play a significant role in Indonesia that is also in line with the Government's goal to provide 1,000,000 houses for the public.

Takaful

Direct insurance industry at a glance

Direct Insurance sector dominated by family takaful

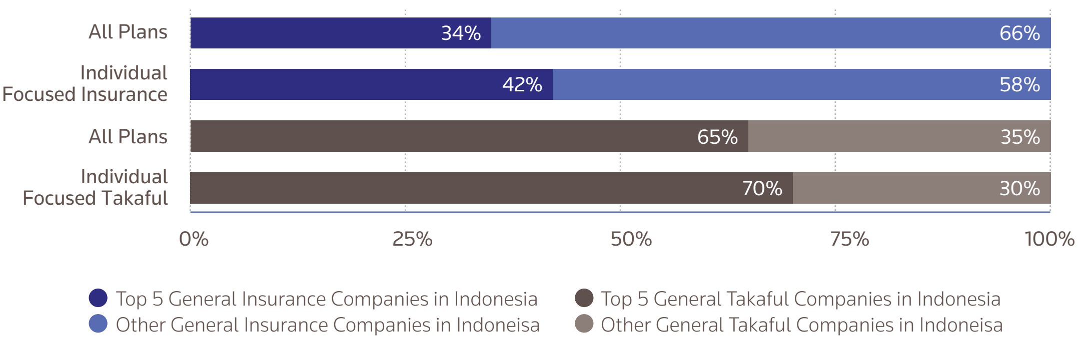
Indonesia's very low insurance penetration rate offers attractive growth opportunities for the financial services sector as a whole.

From the retail consumer perspective, direct insurance premiums are highly concentrated with five companies holding 66 percent of the total sum insured for life insurance and five takaful operators holding 82 percent of total family takaful.

The premium income in the non-life (general) insurance sector shows a lower rate of concentration — five companies hold 42 percent of all general direct insurance premiums. (These are five different companies from the ones that dominate life insurance.)

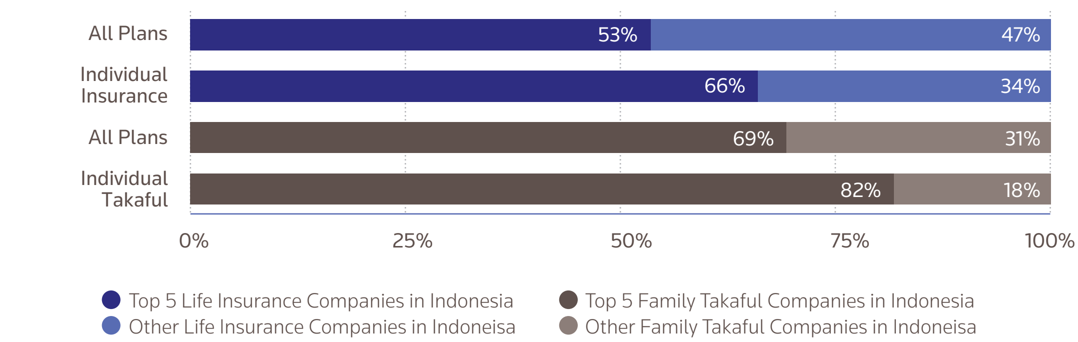
The percentage share of general takaful held with the top five takaful operators is higher than for general insurance in the hands of the top five conventional insurers.

CONCENTRATION AND COMPETITIVENESS OF INDIVIDUAL FOCUSED GENERAL INSURANCE IN INDONESIA (PREMIUM INCOME)



Source: Indonesia Financial Services Authority Insurance Statistics 2013

CONCENTRATION AND COMPETITIVENESS OF INDIVIDUAL LIFE INSURANCE IN INDONESIA (SUM INSURED)



Source: Indonesia Financial Services Authority Insurance Statistics 2013

Life Insurance

Promising growth momentum for family takaful, could boost Shariah-compliant investments

Life insurance is more expensive than non-life insurance, given the nature of the risks associated to each. Hence the premiums generated by life insurance are higher than those generated by non-life policies.

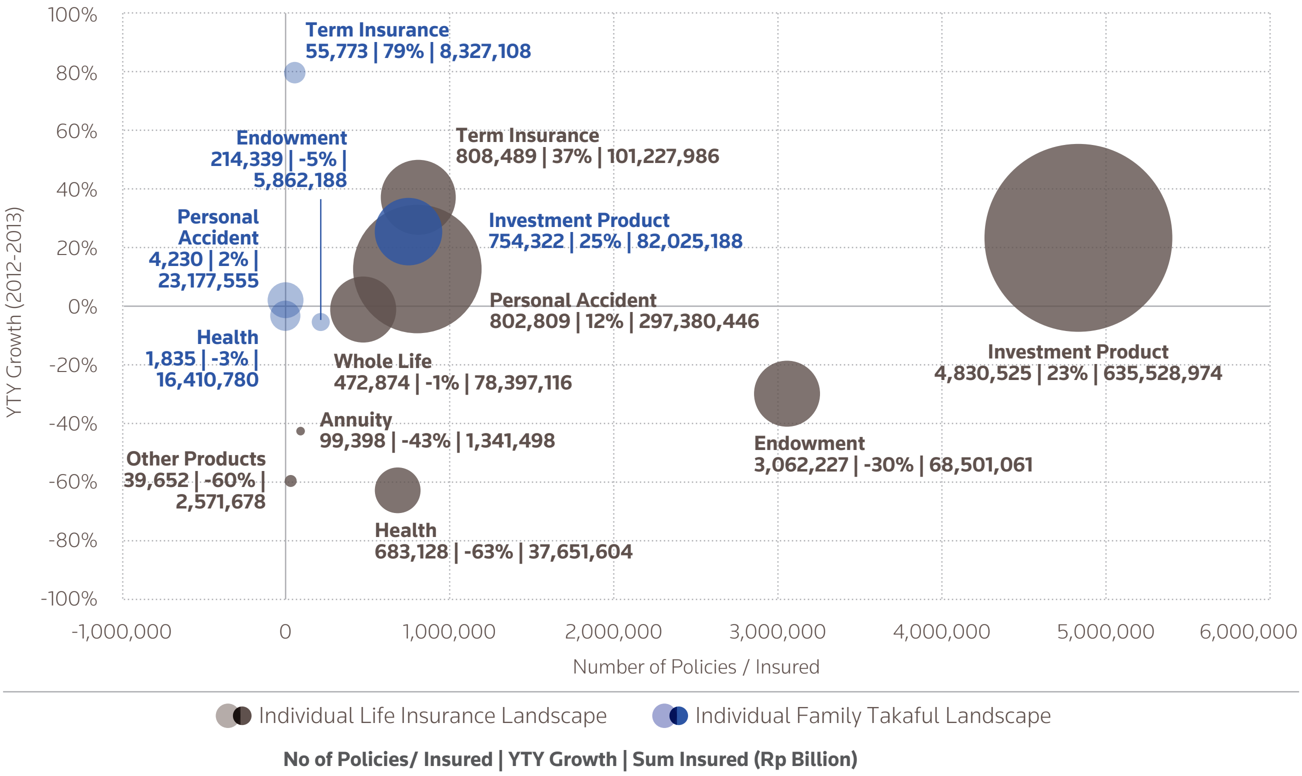
The Indonesian direct life insurance sector offers a wide range of products and the most in-demand are investment-linked policies. The year-to-year growth of investment products reached 20 percent for each sector — insurance and takaful.

Conventional insurance investment products lead the market and they have enjoyed buoyant growth partly due to supportive regulations which have eased the investment rules for insurance funds. Most life/family insurance/takaful products are aimed at the middle and affluent classes. However, a substantial population in Indonesia is Muslim and in the low- to middle-class market. This group is a huge growth market for takaful companies and those who will come up on top will be the ones who innovate new family packages and products that are affordable for the mass retail market.

There is one area of concern, though — the health insurance sector registered a huge drop at the end of 2013, ending up with a negative growth of 60 percent. Health insurance in the Republic is still in its infancy, however with the recent increase of health expenditure and the planned initiative by the government to offer national health insurance it is expected that this sector will flourish most in the coming years.

INDIVIDUAL LIFE INSURANCE AND FAMILY TAKAFUL LANDSCAPE

*Other Products include Pension Annuity. Portfolio as of Dec 31, 2013 & 2012



Source: Indonesia Financial Services Authority Insurance Statistics 2013

General Insurance & Reinsurance

Very low penetration rate and contribution income for takaful

In the retail insurance and takaful sector, conventional insurance holds 95 percent of all motor premiums and contribution incomes and 98 percent of all personal accident and life insurance income (2013 data).

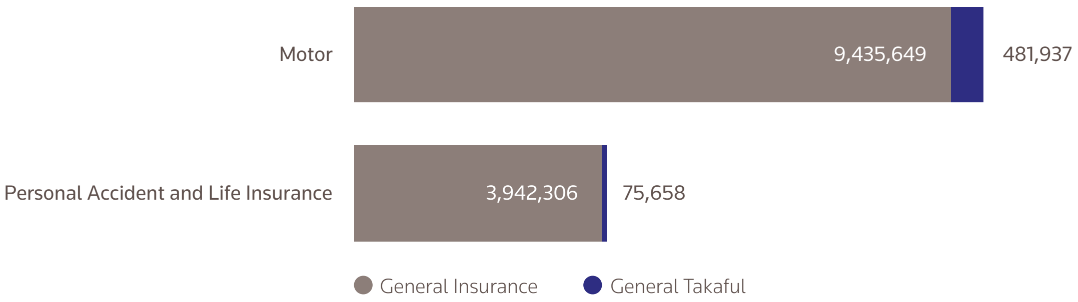
The general insurance sector is growing at a slower pace than the life insurance sector; nevertheless the listing of at least 77 automotive insurance companies, according to the Association of Indonesian General Insurance Companies (AAUI), will create a more competitive market.

New regulations that will see Shariah units of conventional insurance companies being spun out to become standalone takaful companies will strengthen the insurance sector. Mergers and acquisitions may be on the horizon, as will more foreign interest in the market.

Re-takaful is in a stronger position than the retail takaful sector. Motor re-takaful earned 17 percent of all premium and contribution income and 36 percent of all personal accident and life premium and contribution income. However, as the takaful industry is still under-penetrated, reinsurance and re-takaful premium and contribution income is still considered low.

RETAIL FOCUSED INSURANCE BUSINESS LINES* (PREMIUM & CONTRIBUTION INCOME, RP BN)

* Premium income for business lines include personal, business and corporate, individual and group insurance. Data as of Dec 31, 2013 & 2012.



Source: Indonesia Financial Services Authority Insurance Statistics 2013.

RETAIL FOCUSED REINSURANCE BUSINESS LINES* (PREMIUM & CONTRIBUTION INCOME, RP BN)

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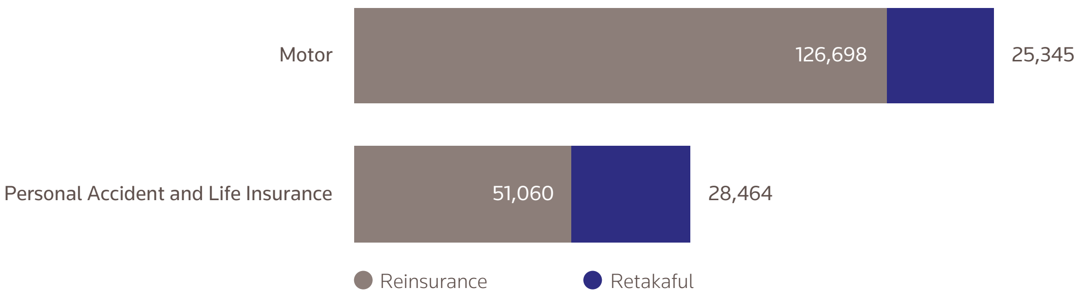


Source: Indonesia Financial Services Authority Insurance Statistics 2013

Retail Insurance Consumer Survey

Our exclusive retail consumer financial services survey results reveal a number of growth and investment opportunities for the Islamic insurance (takaful) sector in Indonesia. Analysing the survey results reveal strategic insights that point to possible opportunities for the insurance sector in general and takaful in particular.

DIRECT INSURANCE SECTOR HIGHLIGHTS

CUSTOMER AWARENESS

- Huge untapped potential — more than 50 percent of survey respondents do not use any insurance services

FINANCIAL INCLUSION

- New market entrants to shake the sector out of its niche
- Collaboration with international partners to improve technology and knowledge is a must
- Although micro-insurance generates lower premiums it has a high potential to cover the rural and low-income population

CUSTOMER EXPERIENCE & PRODUCT PREFERENCES

- Investing in frontline staff and digital infrastructure should be a top priority for insurance companies in Indonesia
- More solutions for microinsurance/takaful to cover natural disasters, education and income for entrepreneurs.

Customer Awareness

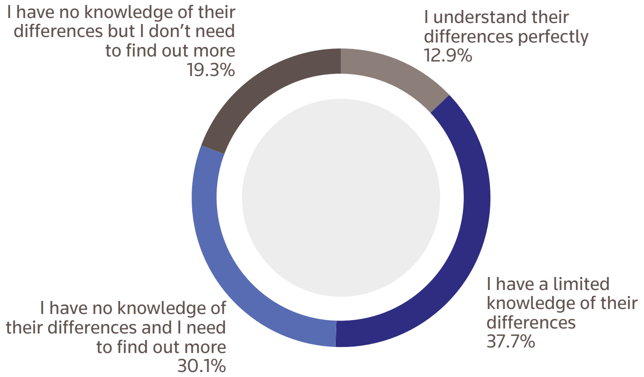
Huge untapped potential — more than 50 percent of survey respondents do not use any insurance services

Indonesia's insurance and takaful sector is small relative to the country's other financial services. Considering the size of the market, the low rate of insurance and takaful penetration, and Indonesia's young demographic the Indonesian insurance market is incredibly attractive for local and foreign investments.

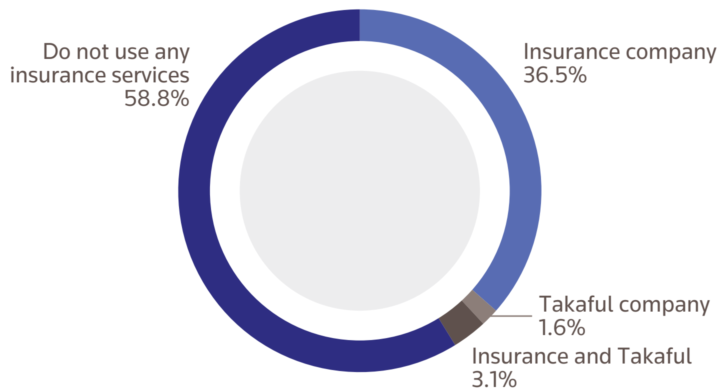
Only 3.1 percent of survey respondents use dual insurance services (i.e. conventional and Islamic insurance) but almost half of these groups — 1.6 percent — are dedicated takaful users. This is an encouraging number for the future of takaful in Indonesia.

Low or insufficient income is the top reason given by survey respondents who do not use any insurance services, followed by high fees and premiums. Takaful companies need to respond to this very large group by offering attractive and affordable pricing, as well as innovative products to cater to customer needs (to respond to the 21 percent of respondents who said they do not need insurance).

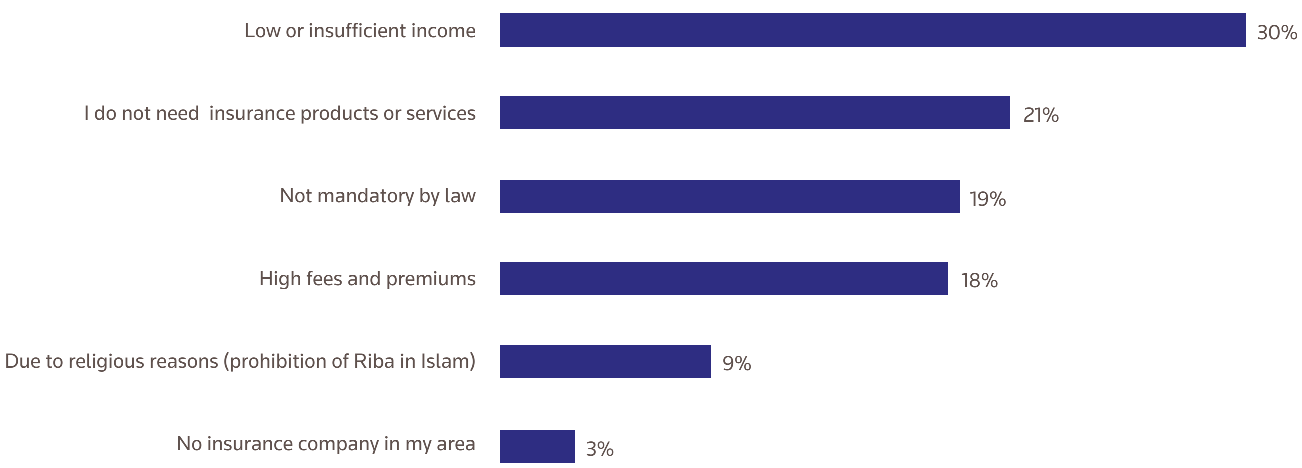
WHAT IS YOUR LEVEL OF UNDERSTANDING OF THE DIFFERENCES BETWEEN ISLAMIC AND CONVENTIONAL FINANCIAL SERVICES PRODUCTS?



WHAT TYPE OF INSURANCE SERVICE PROVIDERS DO YOU CURRENTLY USE?



IF YOU DO NOT USE ANY INSURANCE SERVICES, CAN YOU PLEASE EXPLAIN THE REASONS WHY



Insurance demographics and financial inclusion highlights

New market entrants to shake the sector out of its niche

Our survey findings reveal that most respondents — 59 percent — do not use any insurance services. Out of those who use insurance services, conventional insurance is used by almost 37 percent.

The insurance sector is in growth mode, driven by the expansion of the middle-class and dominated by a younger generation who are more financially-savvy and enjoying rising incomes. The majority of survey respondents who deal with insurance companies are in the 18- 54 age group. In contrast, only 2 percent of the same age group use takaful.

Takaful attracts a higher proportion of respondents who identify as Christians — 4 percent — compared to the 2 percent of Muslims who use takaful. For respondents who identify as Muslims 3 percent use both conventional and Islamic Insurance and 34 percent use conventional insurance only.

The life insurance sector enjoyed a sales growth of 80 percent year on year (2012 – 2013) for term assurance and 20 percent for investment products. The popularity of savings and investment products has been the key driver of this growth, which has also come from a higher level of education and awareness on the part of the growing middle-class.

Hence, an upward trend of more sophisticated products will be the next target for the sector, in order to meet the increasing demand for unit-linked products.

Collaboration with international partners to improve technology and knowledge is a must. In this context, takaful companies can play a big role in meeting demand from the growing middle-class, with Shariah-based investment products to fit with middle-class needs.

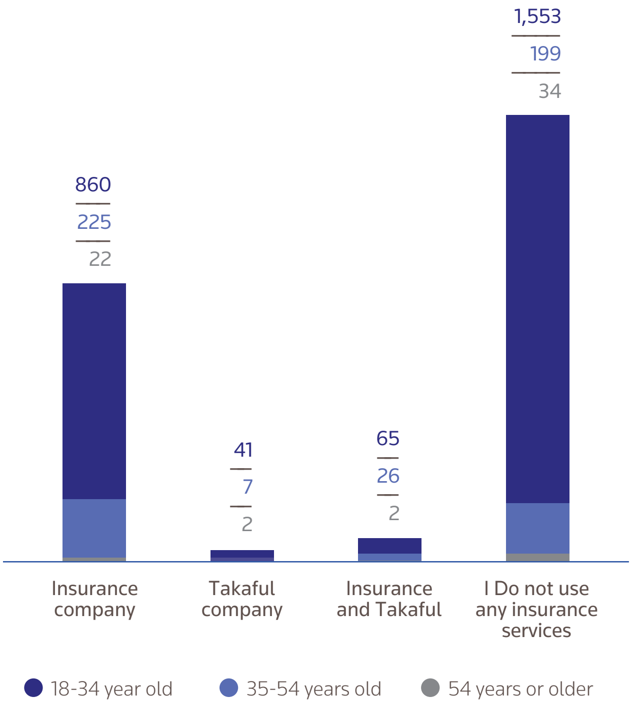
In 2011, the Capital Market and Financial Institution Supervisory Agency (BAPEPAM–LK) worked on enhancing the sector's involvement in micro-insurance by reducing the agent certification cost through the Indonesia Life Association.

Distributions channels are still a concern, mainly when it comes to reaching the rural and low-income brackets as agents' fees are too expensive.

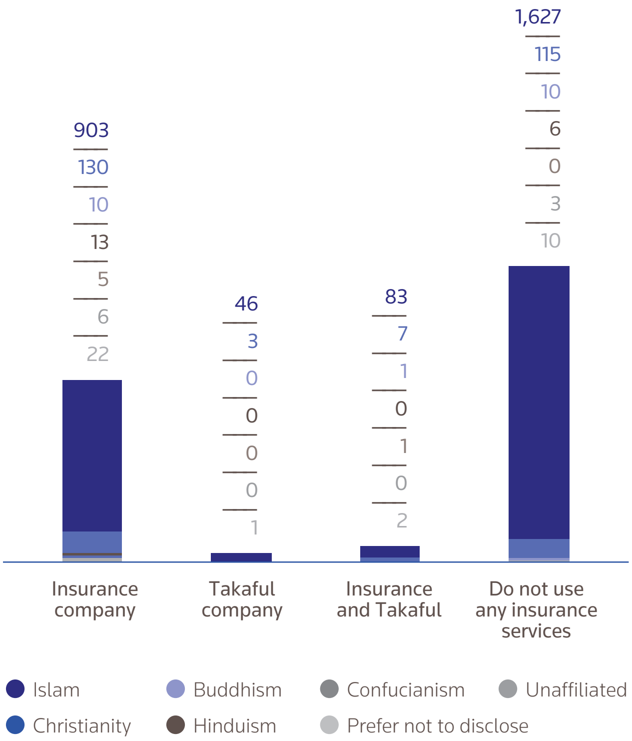
Although **micro-insurance** generates lower premiums it has a high potential to cover the rural and low-income population in the absence of social security coverage and unpredictable weather conditions affecting the farming and agricultural communities.

For example, "Si Bijak" is a new product developed under the "Grand Design Development of Microinsurance" blueprint initiated by OJK in October 2013 to promote microinsurance in Indonesia, adding to intensive awareness campaigns to educate the poor to low- income population about such products.

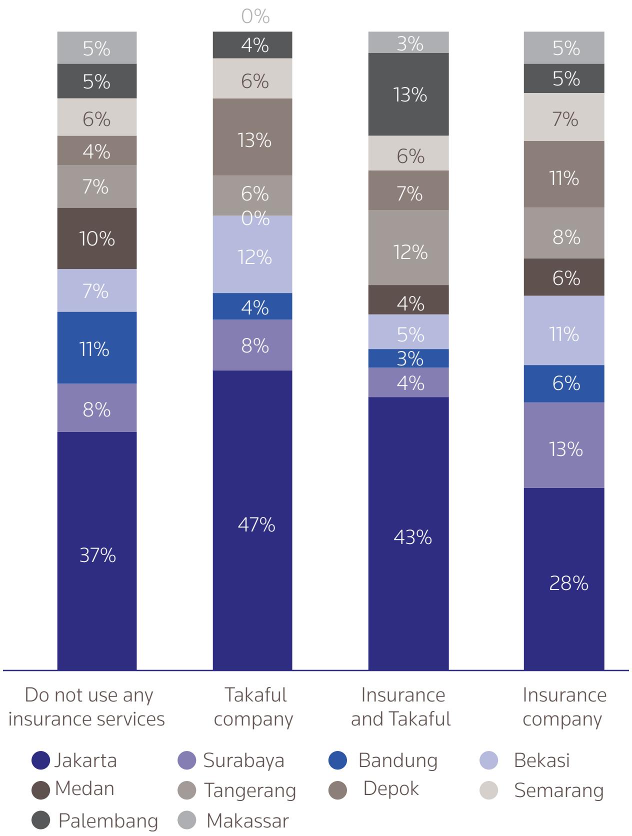
FINANCIAL INCLUSION BY AGE



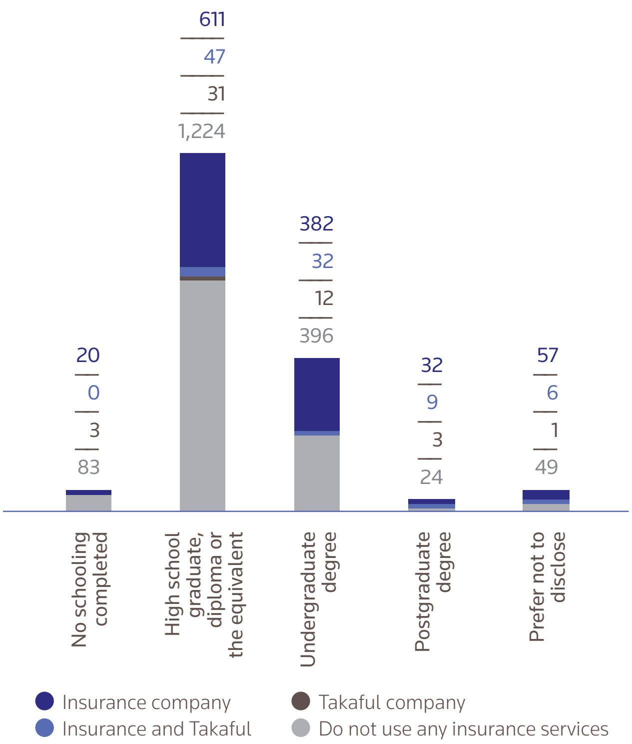
FINANCIAL INCLUSION BY RELIGIOUS AFFILIATION



FINANCIAL INCLUSION BY LOCATION



FINANCIAL INCLUSION BY EDUCATION



Experience and product preferences

Investing in frontline staff and digital infrastructure should be a top priority for insurance companies in Indonesia

Customer service is most important for survey respondents. Competitive reach is no longer determined by the proximity of branches, rather by customer service quality and digital infrastructure.

Unlike for banking services the first point of contact for insurance and takaful is the frontline staff (primarily agents). Therefore, investment should be pumped into training courses for human capital development to train agents to better interact with clients and to promote the benefits of takaful as a preference over comparative selling against conventional insurance.

Additionally, with mergers and acquisitions on the horizon following the new law that requires Shariah-compliant business units of conventional insurers to be spun out, takaful staff will be required to have specialized knowledge on takaful products and their Shariah aspects.

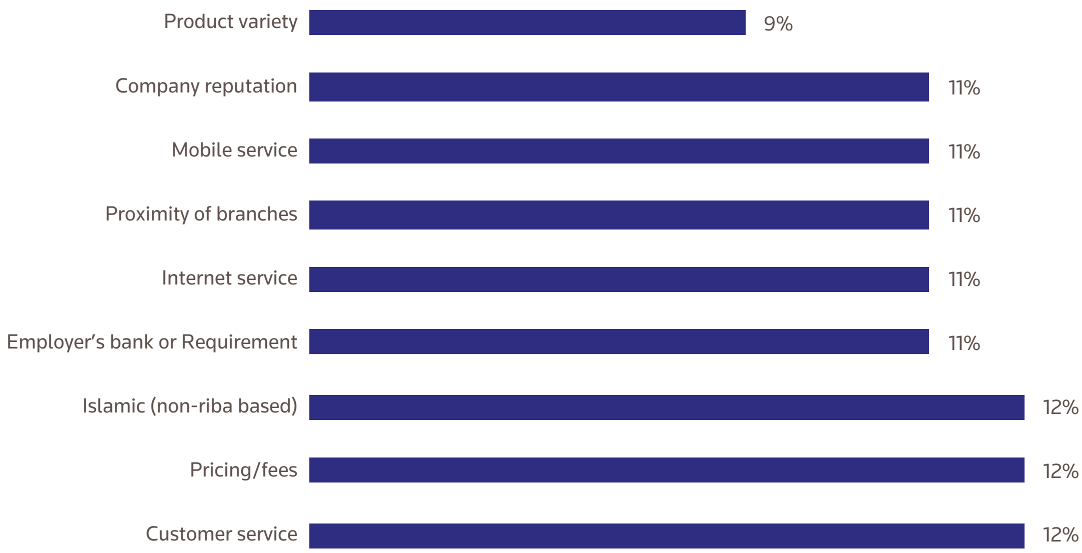
Shariah compliance is another important determinant to deal with financial institutions (chosen by 72 percent of respondents).

As competition increases within the sector, local insurance services providers should consider building relationships with international partners to gain a competitive edge by diversifying their product portfolio with attractive packages and gain insights into global best practices.

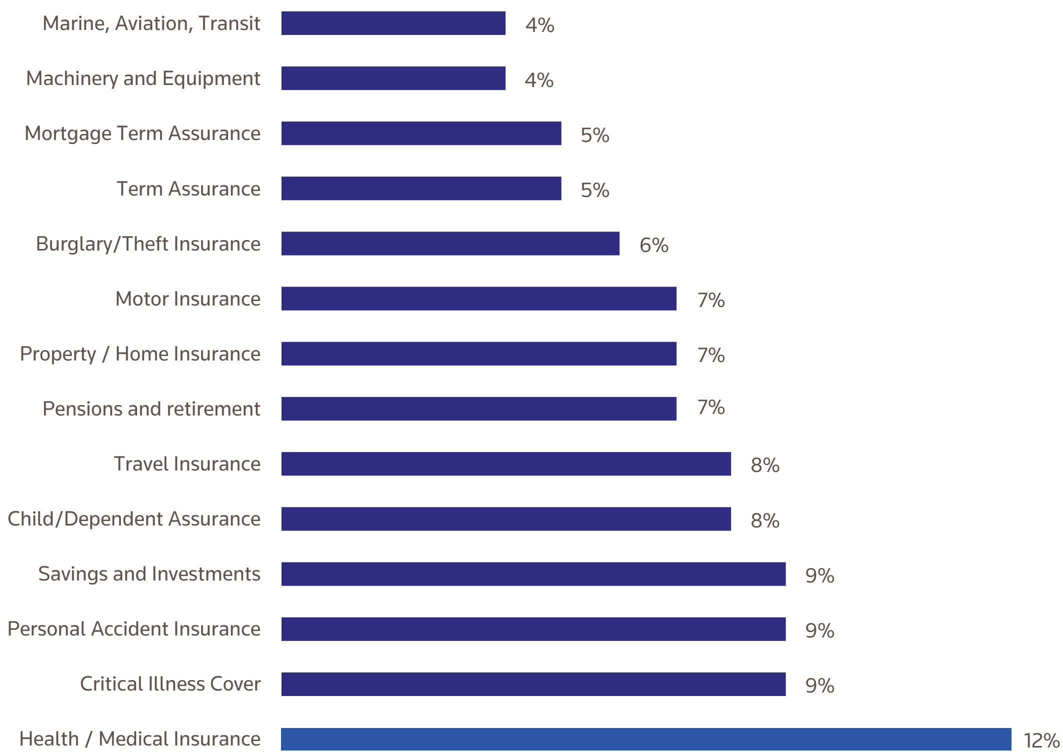
For retail consumers, health/medical insurance is the most desirable product as indicated by 12 percent of all respondents. Life insurance in Indonesia is considered the most in-demand segment for retail consumers. Critical Illness, personal accident, and saving insurance are the most preferred products.

This should attract the takaful companies. The types of products on offer should be extended to **micro-insurance/takaful that provides cover from natural disasters, and also covers education insurance and income insurance for entrepreneurs.** This would be a major boost for the sector as distribution remains a challenge to reach the rural population.

HOW IMPORTANT ARE THE FOLLOWING PRIORITIES TO YOU WHEN DEALING WITH YOUR MAIN INSURANCE SERVICE PROVIDER?



PLEASE RANK THE FOLLOWING INSURANCE PRODUCTS AND SERVICES BASED ON YOUR NEEDS



Survey Methodology

The consumer financial services survey was conducted in June 2015 in collaboration with a specialised consultant in Indonesia. The survey was distributed to a relatively fair sample of Indonesian residents over 18 years old. Apart from responses to the survey questions, we also gathered economic and demographic data about respondents' age, gender, religion, educational level, place of residence, occupation and monthly family income.

LOCATION: WHAT CITY DO YOU LIVE IN?

#1
JAKARTA
34.6%

#2
SURABAYA
9.6%

#3
BANDUNG
9.2%

#4
BEKASI
8.4%

#5
MEDAN
7.8%

#6
TANGERANG
7.0%

#7
DEPOK
6.7%

#8
SEMARANG
6.3%

#9
PALEMBANG
5.3%

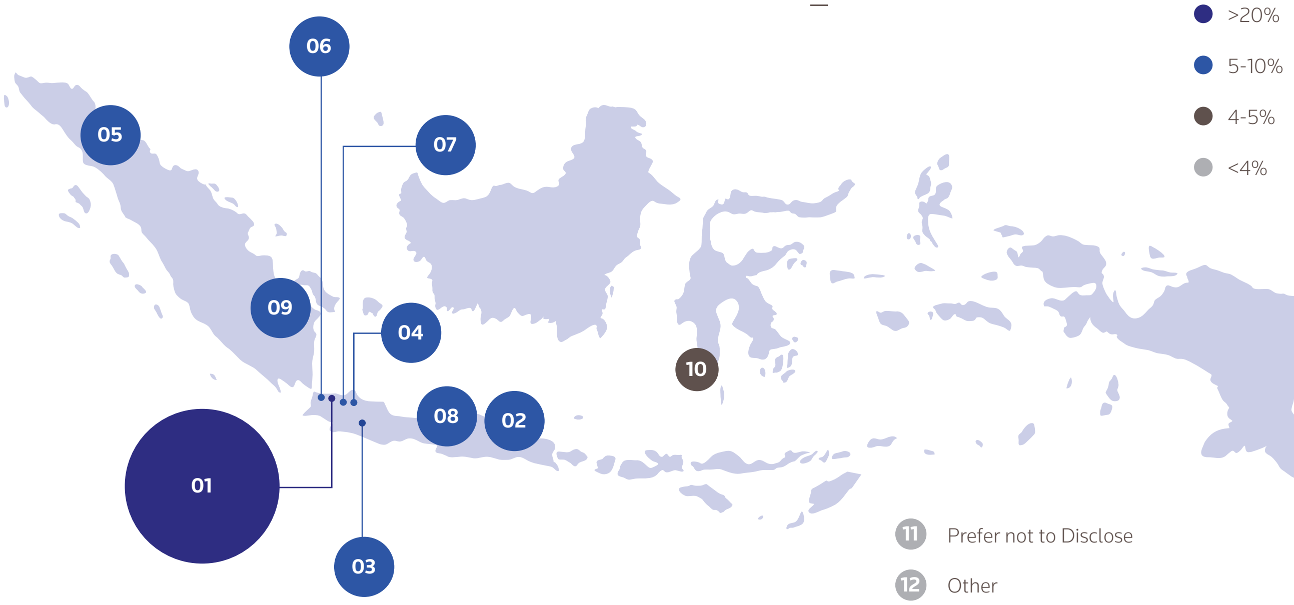
#10
MAKASSAR
4.9%

#11
PREFER NOT TO DISCLOSE
0.1%

#12
OTHER
0.1%

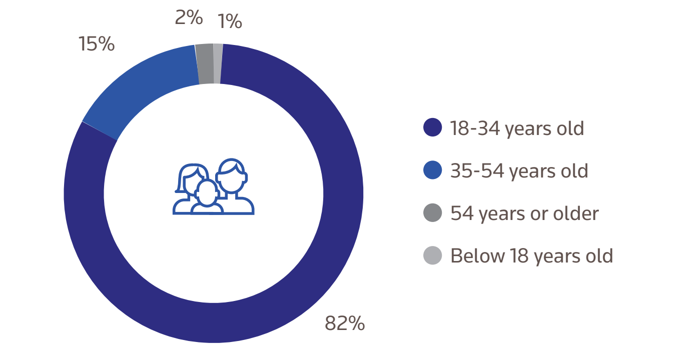
SAMPLE SIZE*

3,165

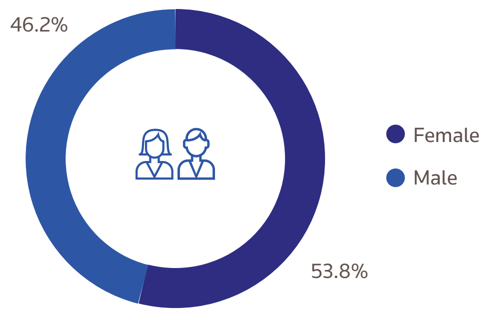


* The sample size does not represent the entire population, the survey was conducted on a best effort basis.

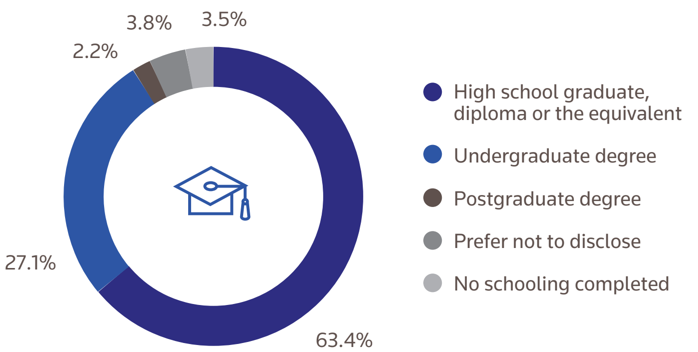
AGE DISTRIBUTION



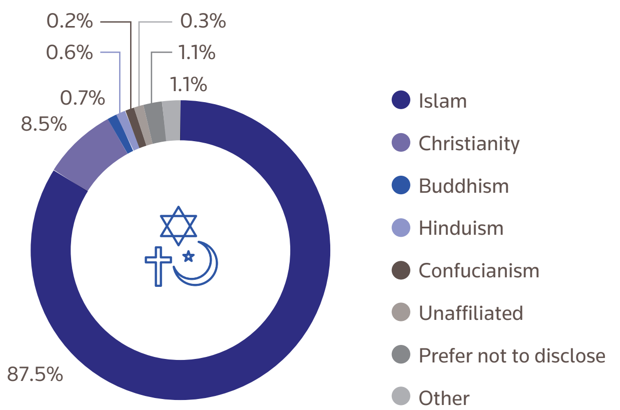
GENDER



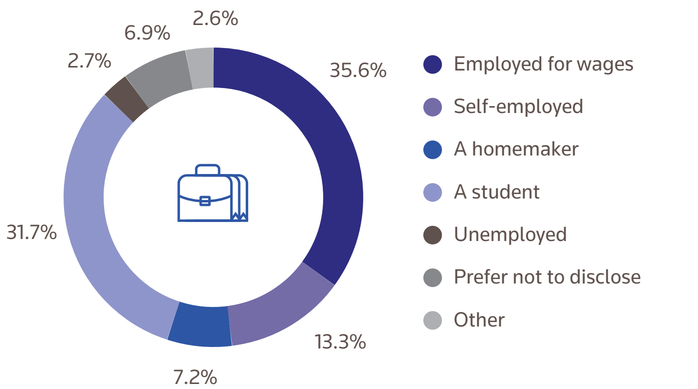
EDUCATION



RELIGIOUS AFFILIATION

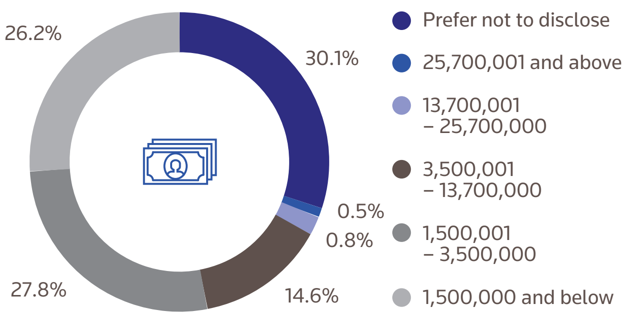


EMPLOYMENT STATUS



MONTHLY INCOME

(in Indonesia Rupiah)



Sukuk

Indonesia's retail sukuk on the right track

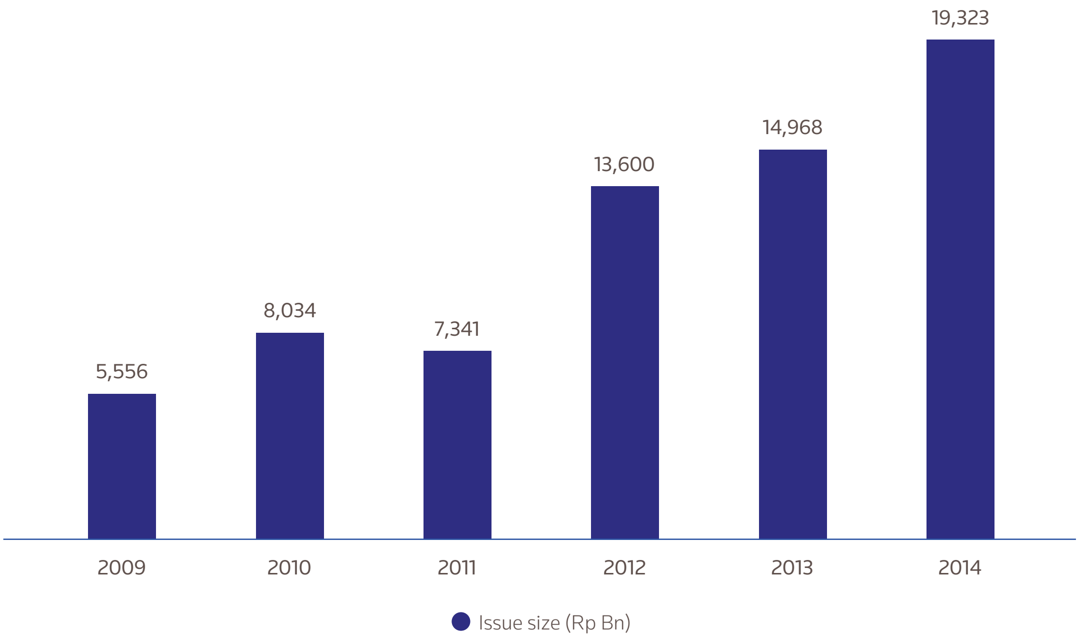
Indonesia kick started the retail sukuk sector in 2009, capitalising on its huge Muslim population through a Rp 5,556 billion issue from the government. Since then the government has issued one retail sukuk every year, with the latest in 2015. Each issue has been ijara sukuk with a three-year maturity.

Retail sukuk have also been issued in Malaysia, Pakistan, and Bahrain. They provide an investment avenue for the low- and middle-classes seeking better returns from other than savings accounts and fixed deposits.

Sukuk Name	Year	Sukuk Structure	Issue Size (RP Bn)	Margin
Indonesia Retail Sukuk (SR-001)	2009	Ijara	5,556.3	12.00%
Indonesia Retail Sukuk (SR-002)	2010	Ijara	8,033.9	8.70%
Indonesia Retail Sukuk (SR-003)	2011	Ijara	7,341.4	8.15%
Indonesia Retail Sukuk (SR-004)	2012	Ijara	13,600.0	6.25%
Indonesia Retail Sukuk (SR-005)	2013	Ijara	14,968.0	6.00%
Indonesia Retail Sukuk (SR-006)	2014	Ijara	19,323.4	8.75%

Source: Thomson Reuters Zawya

INDONESIA RETAIL SUKUK ISSUANCE 2009 – 2014



Source: Thomson Reuters Zawya

Benefits of retail sukuk

Increasing financial inclusion and diversifying the investor base are the chief motivations that governments have cited for issuing retail sukuk. They raise funds from a new investor base which remains significantly untapped in most countries and in a country like Indonesia retail sukuk could also be more effective to spread awareness due to a lack of knowledge about Islamic finance in general.

The government could tailor retail sukuk for people in the rural areas if it lowered the minimum subscription amounts from Rp 5 million to Rp 1 million to provide the lower income with investment opportunities. Lowering the minimum subscription amount to Rp 1 million is more in line with monthly per capita income of 312,328 rupiah in the rural areas (2014).

Further, for Indonesia, retail sukuk also comes in line with the government's plan to reduce its exposure to foreign debt.

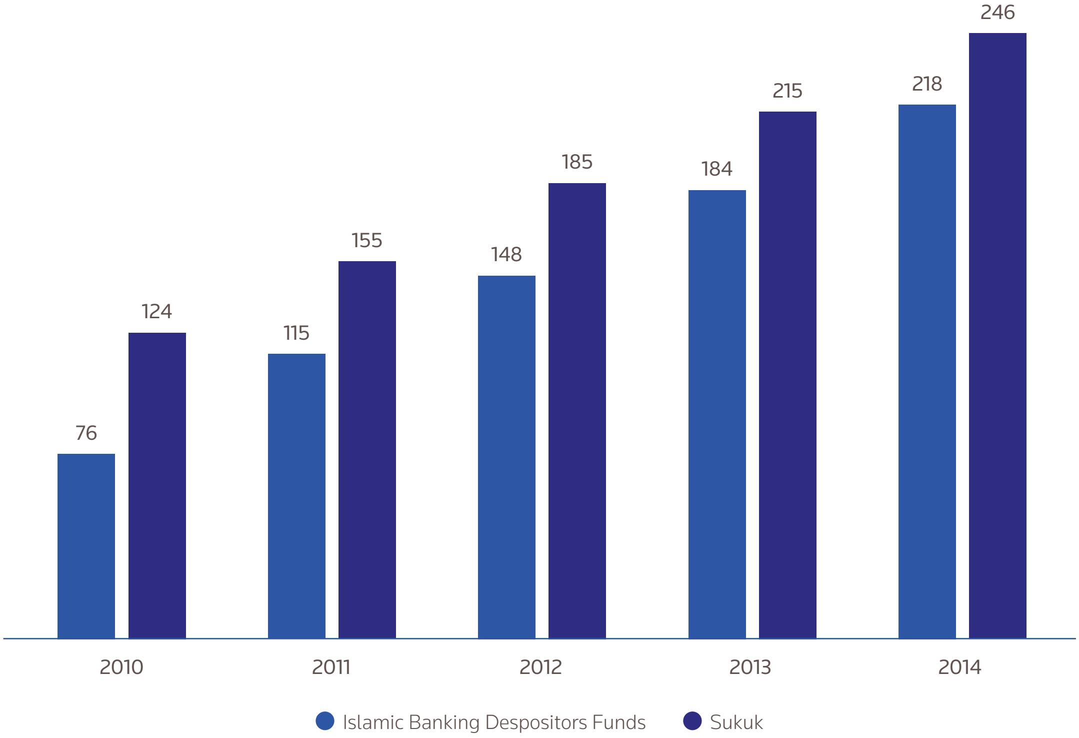
However, one of the downsides of retail sukuk is the shift away from bank deposits, which would lower the growth of Islamic banks or increase their financing to deposit ratio, although this is likely to be limited.

Apart from diversification of funding for issuers and financial inclusion for investors, retail sukuk provide a more secure investment opportunity when compared to a bank deposit.

A bank deposit is an unsecured obligation of a bank, and if the restricted mudaraba structure is applied, the deposit would be even more unsecured given the restrictions involved. In this case, the investors, as the rab ul-mal, would depend on the performance of the borrowers who receive financing from the bank, while remaining at risk to loss of principal. A government retail sukuk removes, or at the worst, limits the risk of loss of the principal amount.

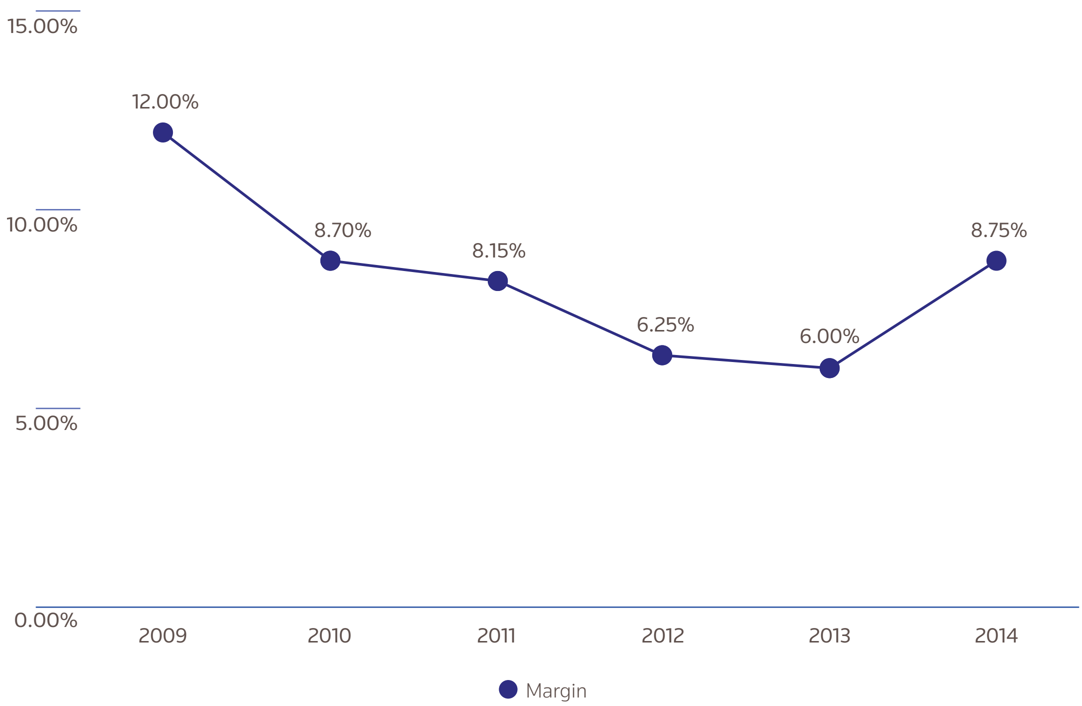
However, there may be a loss in value received at maturity which is associated with the devaluation of currency. This is the current case in Indonesia following the drop in the value of the rupiah. But as long as the country's central bank has control over its own currency through sound monetary policy, the government can always make good on its sukuk. The Indonesian government has taken into consideration the devaluation of the rupiah, and compensated investors with higher returns, which increased from 6 percent in 2013 to 8.75 percent in 2014.

ISLAMIC BANKING DEPOSITS VS SUKUK GROWTH IN RP TRILLION



Source: Thomson Reuters Zawya

GOVERNMENT RETAIL SUKUK MARGIN 2009-2014



Source: Thomson Reuters Zawya

Wealth Management

Fundamental revamp to revive retail investments

A country like Indonesia with a huge population of 240 million, out of which 90 percent are Muslim, can capitalise on its retail investors to grow its funds industry.

However, the work involved to nurture and grow the retail segment should not be underestimated. The majority of fund investors are institutional investors. However, there are tens of millions who are unbanked living in rural areas and villages, and who lack information, education and confidence in a financial system that is completely new to them.

Before familiarising retail investors with Islamic investment opportunities such as sukuk and funds, banks should educate the population on the fundamentals of banking and basic products, as the former is more complex for investors especially those who have never had a saving account.

According to the World Bank, 36 percent of Indonesians have bank accounts as of 2014, a significant increase from just 20 percent in 2011. Education and spreading awareness about Islamic finance is part of the government's five-year development roadmap to boost the industry.

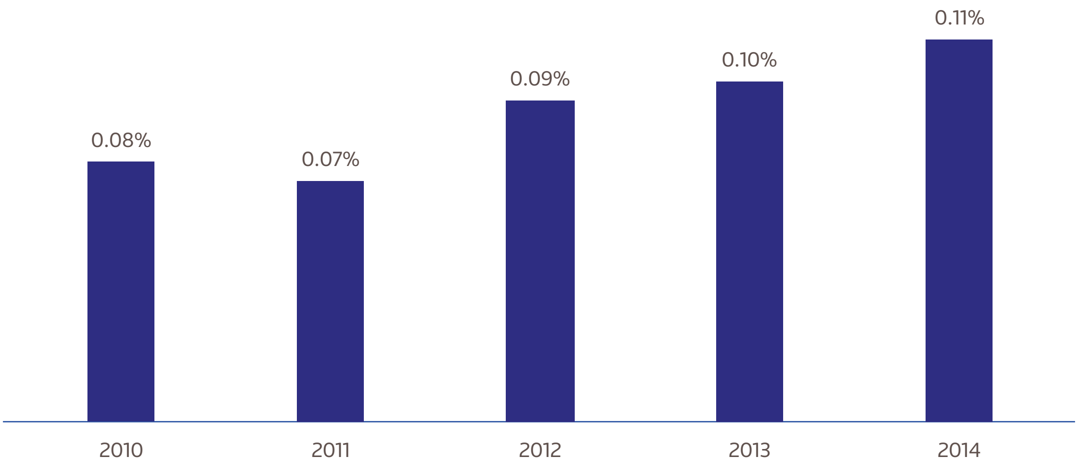
Hajj funds could push forward the Indonesian economy

Indonesia is setting up a separate Hajj Fund Management Body (BPKH) from its Religious Affairs Ministry. The BPKH will have the responsibility of pilgrimage management.

The state has been using the down payment for the hajj received from prospective pilgrims to diversify its source of funding and reduce reliance on foreign lenders. The Indonesian Ministry of Finance has said the cash, which amounts to about $5.4 billion, will be used to buy back sukuk and bonds from foreign investors to reduce exposure to the foreign investors who hold approximately a third of Indonesia's sovereign debt.

The hajj fund department wants to increase liquidity and transparency in the market, and believes it is more important than earning higher returns. The hajj fund is expected to increase in size over the coming years, in line with the increase in income that will make the cost of the hajj more affordable for a larger portion of the population.

INDONESIAN ISLAMIC FUNDS PENETRATION (AUM AS % OF GDP)



Source: Bank Indonesia, Indonesian Financial Statistics. Lipper data

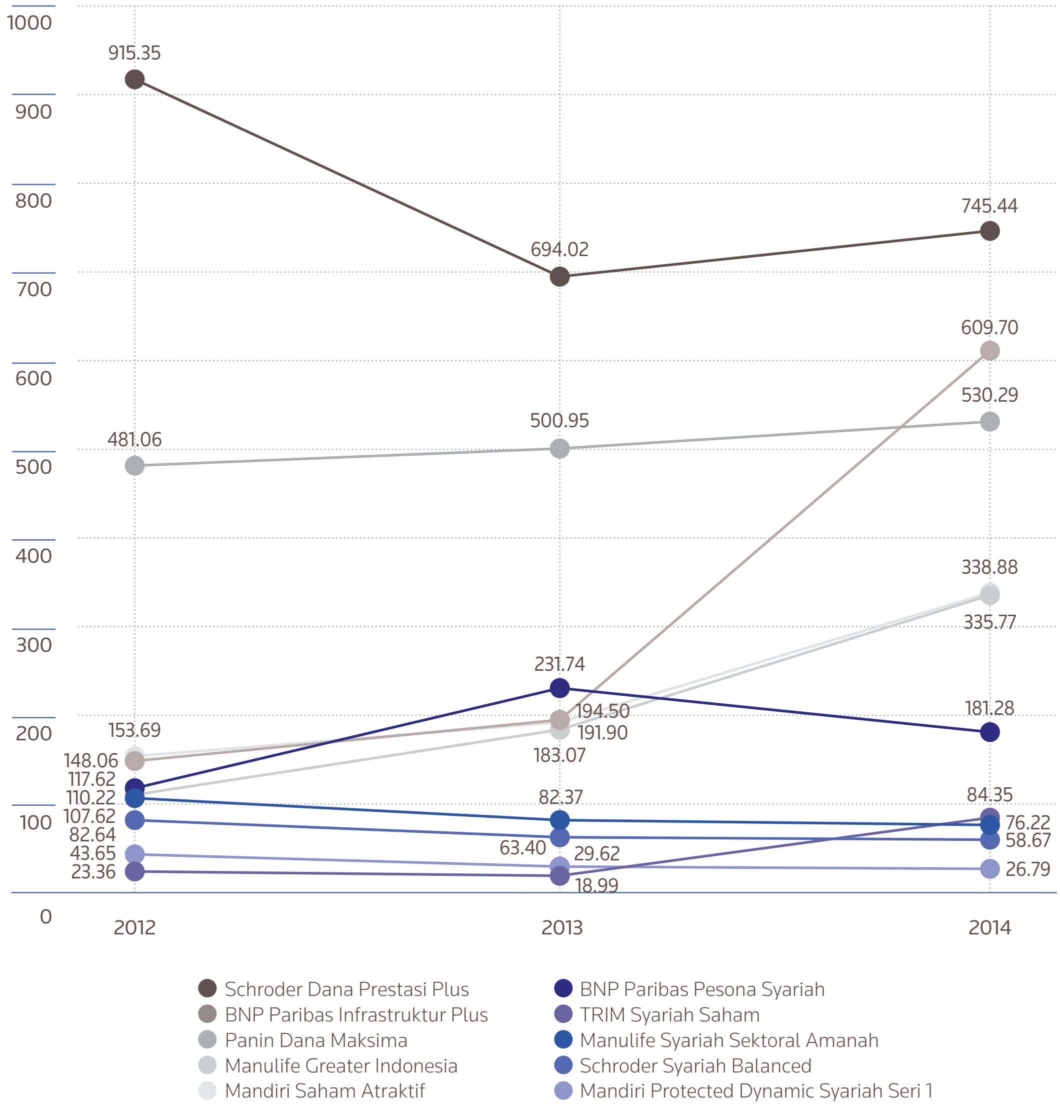
Muslims attend a mass prayer session "Tarawih" marking the beginning of the holy fasting month of Ramadan in a mosque in Makassar of Indonesia's South Sulawesi province. REUTERS/ Yusuf Ahmad

Shariah sensitivity

Shariah sensitivity of investors is also important as it measures the stickiness of investors to their Islamic investments. But poverty and low income status of a majority of the population is a challenge for the Islamic funds industry; Indonesians make investment decisions based on economic returns rather than on considerations of religion.

On the bright side, with the growth of Islamic finance, Islamic funds are becoming as attractive as their conventional counterparts, and at times they provide even better returns. But in the long run, it would be hard to retain investors who are not Shariah-sensitive. This is also partly due to a lack of qualified human resources to spread awareness about Islamic finance in the country. But the Financial Services Authority (OJK) has promised to tackle this hurdle by providing the required resources through its Islamic finance committee's five-year plan.

PERFORMANCE OF TOP CONVENTIONAL AND ISLAMIC FUNDS 2012 – 2014



Source: Thomson Reuters Lipper

Islamic Social Finance

Islamic social finance in Indonesia

This section presents the historical trends, future challenges and prospects for the various segments of the Islamic social finance sector — zakat, awqaf and Islamic microfinance — in Indonesia. We examine the macro-level regulatory and policy environment as well as good and bad practices at the meso- and micro-levels. The section is divided into three subsections and presents the overview, regulatory and policy framework and supporting infrastructure for the zakat, awqaf and Islamic microfinance sector, respectively.

A child reads a book in a Jakarta slum area. REUTERS/ Beawiharta

A. Zakat

Zakat mobilisation: now led by National Board of Zakat (BAZNAS)

In Indonesia, zakat collections show a steadily rising trend, multiplying by 32 times over the last decade. According to data obtained from the National Board of Zakat (BAZNAS) the ratio of muzakki to mustahiq currently stands at 1:12.

Another important dimension of the Indonesian zakat collection exercise is that private organisations, such as Dompet Dhuafa and Rumah Zakat Indonesia have traditionally led the collection effort, though their role is increasingly becoming diluted by the National Board of Zakat (BAZNAS), which assumed the role of the apex regulating body for zakat management in the year 2011.

BAZNAS is also engaged in direct collection of zakat. For instance, for the year 2011, the national collection data shows that BAZNAS-led network accounted for 62 percent while the private institutions (LAZ) together accounted for 38 percent of total zakat collected.

Can the steady growth in zakat collections be attributed to a sound and enabling regulatory framework?

A major change in the regulatory framework relates to the replacement of Zakat Act 1999 with the Zakat Act 2011. Among other things, the new Act brought all major private collectors under the supervision of National Zakat Board or BAZNAS.

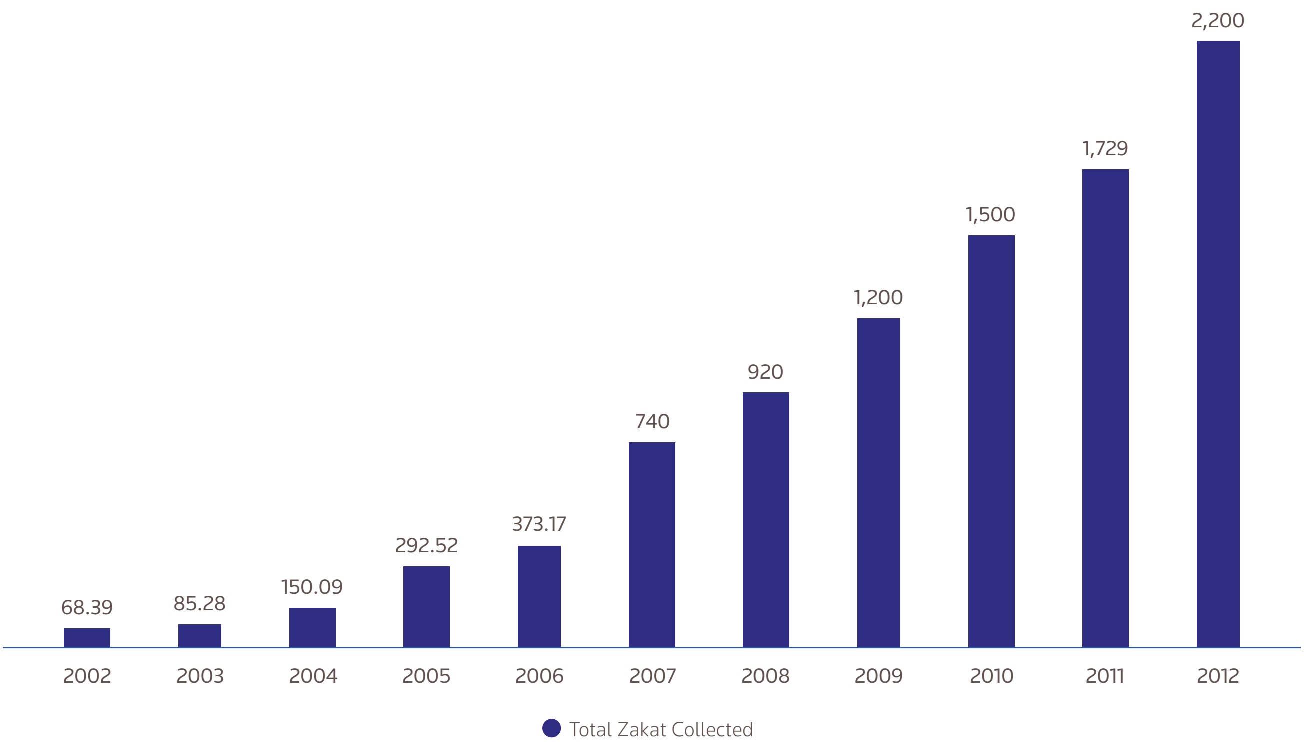
SHARE OF PRIVATE AND PUBLIC AGENCIES IN ZAKAT COLLECTION IN INDONESIA

Name of zakat collecting institution	Amount (Billion Rupiah)	% of Total
Rumah Zakat Indonesia (RZI)	144.03	
Pos Keadilan Peduli Ummat (PKPU)	77.35	
Dompet Dhuafa Republika	75.05	
Total for all LAZ (private institutions)	**659.96**	**38**
BAZNAS	40.40	
Total BAZNAS network	**1068.90**	**62**
Total national collection	**1728.9**	**100**

TIME SERIES OF ZAKAT COLLECTED IN INDONESIA

	Total Amount of Zakat	
Year	**(Billion Rupiah)**	**(Million USD)**
2002	68.39	7.2
2003	85.28	8.9
2004	150.09	15.8
2005	295.52	31.1
2006	373.17	39.3
2007	740	77.9
2008	920	96.8
2009	1200	126.3
2010	1500	157.9
2011	1729	182
2012	2200	231.6

TIME SERIES OF ZAKAT COLLECTED IN INDONESIA (RP BN)



Zakat distribution

A 2010 survey[8] on the distribution pattern of zakat as well as other Islamic charity funds (together known as ZISWAF) in Indonesia has some interesting findings.

Based on data from nine leading amil zakat institutions (known as LAZ), this survey reveals that disbursements by LAZ during the period 2004-2008 are primarily focused on consumption-oriented assistance such as humanitarian assistance programs (23.1 percent), direct grants to asnaf (15.0 percent), education (10.7 percent), health (5.8 percent), and assistance to da'wah activities (3.9 percent). On average, productive economic activity received an allocation of 10.7 percent.

PATTERN OF ZAKAT DISTRIBUTION BY LAZ IN INDONESIA (%)

Year	Productive and Economic	Education	Health	Humanity	Da'wah Assistance	Direct Grants to the Asnaf	Other Programmes
2004	20.34	12.95	8.54	11.54	4.43	17.58	24.62
2005	9.06	13.27	5.33	49.82	2.69	5.97	13.86
2006	9.18	9.29	6.69	29.06	2.21	13.55	30.02
2007	7.58	12.05	6.16	16.78	5.94	17.82	33.67
2008	7.38	5.87	2.44	8.44	4.32	20.35	51.20

A group of scavengers collect plastic and paper to recycle at Bantar Gebang main garbage dump in Bekasi district, on the outskirt of Jakarta. REUTERS/ Beawiharta

Indonesia's National Board of Zakat compiles data for distribution of zakat in four categories as follows:

1. Education Programme: comprises of two major programmes, namely Smart House for Children of the Nation and Cadre of 1,000 Ulama

2. Humanitarian Aid : consists of two major programs, namely Mustahik Services Counter and Disaster Emergency Aid

3. Health Programme: a programme that is intended to provide medical assistance. It is called Healthy House of Indonesia (cost-free hospital and mobile clinic serving mustahik in remote and backward areas)

4. Economic Programme: a programme that is developed to empower mustahik economically by using comprehensive and integrated approach, and it comprises two main programmes, namely zakat-based Community Development and Bayt al-Ma'mur.

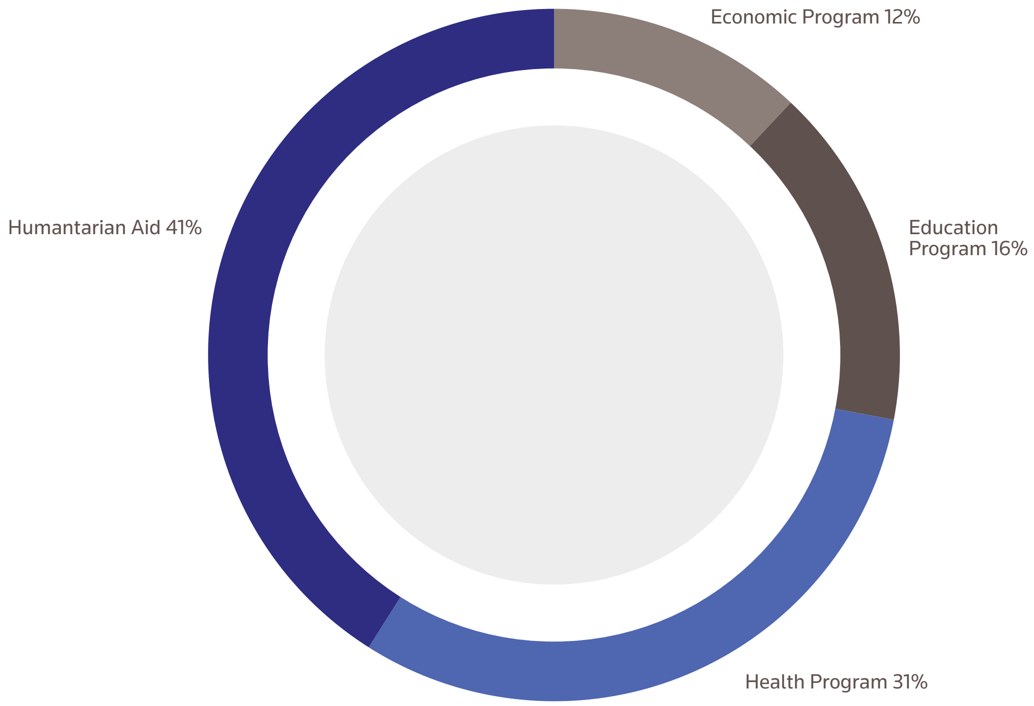
Official data of the National Board of Zakat (BAZNAS) 2013 reported the following distribution pattern for 2011-12.

PATTERN OF ZAKAT DISTRIBUTION BY BAZNAS IN INDONESIA (%)

No	Types of Program	2011	2012
1	Education Program	18.12	15.50
2	Humanitarian Aid	41.21	41.07
3	Health Program	26.71	31.10
4	Economic Program	13.96	12.33
	TOTAL	**100**	**100**

From below, it appears that economic empowerment programmes still account for a small percentage of the zakat collected, notwithstanding the visible success of some initiatives such as the community development programme of Dompet Dhuafa Republika.

PATTERN OF ZAKAT DISTRIBUTION BY BAZNAS IN INDONESIA



Institutional and regulatory environment for zakat

In this section we undertake a comparative analysis of the institutional and regulatory environment for mobilisation and use of zakat in Indonesia.

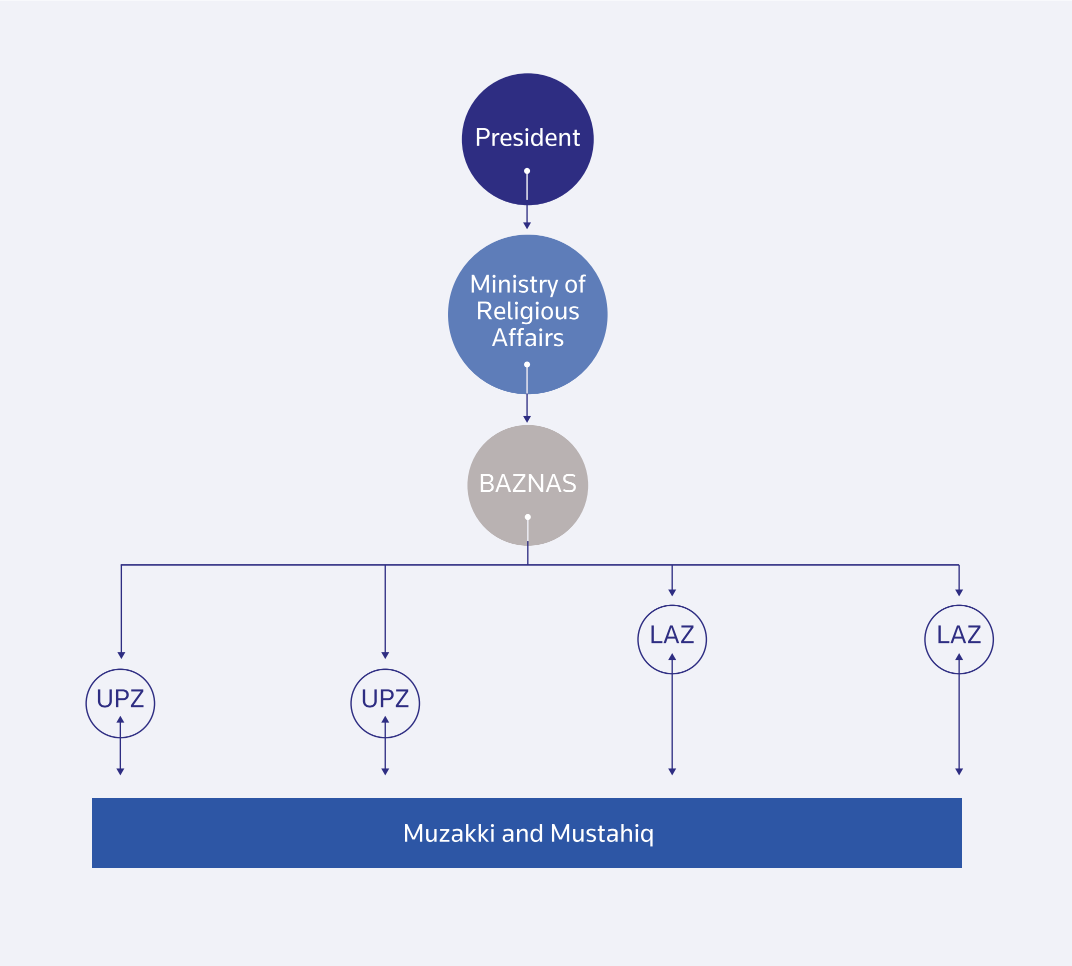
Indonesia offers a recent example of regulatory reforms in the field of zakat management with the Zakat Act 2011 replacing the Zakat Act 1999. The Zakat Act 2011 aims to create a national institutional infrastructure for zakat management that aims to "improve the effectiveness and efficiency of the management of zakat services, and optimise the benefits of zakat for public welfare and poverty alleviation." (Art.3)

The apex body in this infrastructure is the Badan Amis Zakat Nasional (BAZNAS) created by the government for the sole objective of zakat management. (Art 6) It is an independent body responsible to the President through the Minister of Religious Affairs. (Art 5.3) Its functions include planning, implementation, controlling the process of collection, distribution and use of zakat and reporting the operational performance of zakat management. (Art 7) Its executive committee includes members who are non-political, responsible and competent members from the community. (Art.11) It is supported by a Secretariat (Art.14) and has a network of offices in provinces, districts and cities where it forms zakat collecting units (UPZ) to assist the process of zakat collection. (Art.15-16)

The second tier in the zakat management infrastructure involves private community initiatives and comprises Amil Zakat Institutions (LAZ). Such community organisations must be registered not-for-profit legal entities with adequate competencies and programmes of social welfare. These institutions additionally must have Shariah supervisory boards and must undergo Shariah and financial audit periodically. These must be duly authorised by the government based on recommendation of BAZNAS. (Art.17-18) Further, these are required to report their audited performance to BAZNAS (Art.19).

> "INDONESIA OFFERS A RECENT EXAMPLE
> OF REGULATORY REFORMS
> IN THE FIELD OF ZAKAT MANAGEMENT
> WITH THE ZAKAT ACT 2011
> REPLACING THE ZAKAT ACT 1999.

Institutional Structure for Zakat in Indonesia



Zakat collection

Article 4.2 of the law in Indonesia identifies various zakatable assets as: gold, silver, and other precious metals; cash and other securities; trade inventories, produce from agriculture, horticulture, and forestry; livestock and fisheries; mining; industry; revenues and services, and rikaz.

The law recognises both individuals and business entity as muzakki (Art.4.3). It refrains from providing the applicable rates and method of calculating zakat liability and merely asserts that the terms and method of zakat calculation should be in accordance with Islamic law. (Art.4.4).

A muzakki may do self-calculation of their zakat obligation or seek the help of BAZNAS to calculate zakat obligation. (Art.21)

Zakat utilisation

The Indonesian Zakat Act prescribes zakat to be distributed to mustahik in accordance with Islamic law (Art.25) and based on priority after considering the principles of equity, justice, and territorial proximity. (Art.26) It remains short of providing objective and quantitative criteria for distribution of zakat among the various categories mandated by Shariah, but clearly stipulates that zakat can be used for productive activities in order to tackle poverty and to improve the quality of life, but only after fulfilling the basic needs of the mustahik. (Art.27.1-2)

In no other country do laws deal with the issue of prioritisation in zakat distribution.

Laws in many countries explicitly deal with the issue of meeting operational and administrative expenditure related to zakat collection and distribution. The Indonesian law does not stipulate any maximum limit (such as one-eighth, for example) for the use of zakat proceeds to cover administrative expenses of zakat collectors (amilin alaihi), it permits the same. While BAZNAS is required to cover its expenditure both by State budgetary allocation and part of zakat collection (Art.30), LAZ is also entitled to take parts of zakat collection to finance its operations. (Art.32)

Accountability, transparency and governance in zakat institutions

The law in Indonesia permits the zakat institutions LAZ and BAZNAS to collect other forms of charity funds such as infaq and sadaqa. (Art.28-1) However, these must also ensure that the use of such funds is in conformity with Shariah as well as with the intention of the donor(s) (Art.28-2).

Further, given the Shariah constraint regarding the nature of zakat beneficiaries, there is a need to ensure that zakat funds are not commingled with other forms of charity funds. The Act (Art.28-3) rightly stipulates that all non-zakat charity funds must be recorded in a separate book. No other law takes care of this important Shariah and governance-related issue.

The law also meticulously provides for mandatory reporting requirements for all zakat institutions at all levels in addition to their wide dissemination through all forms of media. While BAZNAS itself is required to produce and file detailed reports regularly to government — provincial and central — the LAZ in the voluntary sector is required to produce and file detailed reports to both BAZNAS and the government. The Act also requires flow of information at all levels within BAZNAS and government. (Art.29)

The law also seeks to ensure wider public participation in the functioning of BAZNAS and LAZ (Act.35). It is rightly based on the assumption that such participation will result in greater public awareness about the need to strengthen these institutions through acts of giving and acts of vigilance against mismanagement. This is also sought to be ensured by laws in most other countries stipulating nomination of respectable members from the community to state agencies entrusted with zakat management.

Penalties and Sanctions

The Indonesian law provides for administrative sanctions in the form of warning, temporary suspension of activities and even revocation of license for zakat institutions (Art.36), should they violate specific provisions (e.g. Art.19, 23-1, 28-2, 28-3, 29) relating to timely reporting to BAZNAS and non-compliance with Shariah and/or donor's wishes.

The Act prohibits individuals from owning, pledging, granting, selling, and / or diverting zakat, infaq and other religious social funds that exist in its management. (Art. 37) Any person who wilfully and unlawfully violates this shall be punished with imprisonment of five years and / or a maximum fine of five hundred million rupiahs. (Art.40)

The Act also prohibits one from deliberately acting as amil zakat to undertake the collection, distribution, or use of zakat without the consent of the authorities. (Art.38) Any person who wilfully and unlawfully violates this provision shall be punished with imprisonment for a maximum of one year and / or a maximum fine of fifty million rupiahs. (Art 41) Further, Article 39 stipulates that any person who intentionally unlawfully distributes zakat according to provisions of Article 25 shall be punished with imprisonment of five years and / or a maximum fine of five hundred million rupiahs.

Tax treatment of zakat

Most countries treat zakat at par with charity contributions made to voluntary organizations and provide tax relief in the form of allowing the same as a deduction to taxable income.

In Indonesia, Article 22 of the Act provides for tax relief to the muzakki by treating zakat paid to BAZNAS as deductable to taxable income. Further, BAZNAS or LAZ provide receipt of zakat payments to each muzakki that then is used to deduct income taxable. (Art.23)

Supporting infrastructure for zakat

Associations and networks for zakat

World Zakat Forum (WZF): The WZF was founded in 2010 in Yogyakarta, Indonesia. The Forum essentially aims to meet, discuss and share all zakat-related matters at a global level involving various stakeholders from state/government, government zakat organisations, non-government zakat organisations, academicians, ulama, and others, at least once in three years. It also aims to support and cooperate with the International Zakat Organization (IZO). In its maiden meeting, the WZF called all Muslim countries to accommodate and implement the policy of "zakat as tax credit".

Education and training providers

Indonesia provides the example of a pioneering initiative devoted to creation of a cadre of amil zakat or zakat professionals through continuous training and capacity building programmes. The *Indonesia Magnificence Zakat* (IMZ) undertakes a comprehensive range of training programmes in zakat management that includes various aspects of zakat, e.g. fiqh of zakat, modern fundraising techniques of zakat, transparency and governance issues in zakat management and the like. Programmes are short-term in nature.

ZAKAT DEVELOPMENT REPORT 2015: THE CASE OF INDONESIA

Irfan Syauqi Beik, Director, Centre for Islamic Business and Economic Studies (CIBEST)

IRFAN currently serves as the Director of Centre for Islamic Business and Economic Studies (CIBEST), Bogor Agricultural University, Indonesia. He is a lecturer and expert in the field of Islamic Economics and Public Policy, Zakat and Development Economics and visiting lecturer in various national and international universities. He is a member of the National Shariah Board of Indonesia and becomes Shariah Supervisory Council in two Islamic financial institutions, and also Deputy Secretary-General of World Zakat Forum. He is a regular contributor in various nationwide media, such as Republika and Media Indonesia, and has produced various journal articles, working papers, proceedings, and contributes in 12 books.

Zakat development in Indonesia entered new era after the issuance of the Zakat Management Act No 23/2011 which replaced the Zakat Management Act No 38/1999. This new era was indicated by two major aspects, i.e. institutional set up and deeper involvement of the government in the country's zakat management. In addition, this short report will also elaborate the impact of zakat distribution programs toward poverty and welfare level of the recipients of zakat.

In terms of institutional set up, there are two major changes from the implementation of the Act. Firstly, there is an extension of the authority of the National Board of Zakat of Indonesia (known as BAZNAS, which is an abbreviation of *Badan Amil Zakat Nasional*). BAZNAS has been given a new institutional status, which is non-structural and an independent government institution that is responsible directly to the President of Indonesia through Minister of Religious Affairs. Unlike the previous Act which did not specify the status of BAZNAS, this Act provides wider room and authority for BAZNAS to coordinate all legal zakat institutions in an integrated system.

In Indonesia there are two types of zakat institutions. The first one is BAZNAS, which is government-based institution following the structure of government from national, provincial and regency/city levels, and the second one is LAZ (*Lembaga Amil Zakat*), which is established by people's initiative. Initially, the two organizations were working independently in a competitive environment. However, the presence Act has given a mandate to BAZNAS to coordinate provincial and regency/city BAZNAS and all legal LAZ.

Secondly, recruitment of BAZNAS leadership was conducted in an open process. Previously, chairman of BAZNAS was purely determined by the President under the proposal of Minister of Religious Affairs. However, current Zakat Management Act No 23/2011 requires the establishment of a Selection Committee prior to appointment of the Board Member of BAZNAS comprising 11 members. These 11 members consist of society representatives (8 members) and government representatives (3 members). Government representatives come from officials of Ministry of Religious Affairs, Ministry of Home Affairs and Ministry of Finance, which act as *ex officio*. As for the society representatives, the selection must go through the Selection Committee that was set up by the Minister of Religious Affairs.

The selection started towards the end of 2014 and it was completed in the mid of 2015. The Selection Committee submitted 16 names to be elected by the President, and after the President selected 8 out of 16 names, he submitted these names to the House of the Representatives (known as DPR which is an abbreviation of *Dewan Perwakilan Rakyat*) for their recommendation. After obtaining the recommendation of DPR, the President issued Presidential Decree No 66/P Year 2015 that legalizes these 11 names. The chairman and vice chairman were then selected by these 11 board members. Prof Bambang Sudibyo and Dr Zainulbahar Noor were selected as the new chairman and vice chairman of BAZNAS for the period of 2015-2020. Presidential Decree No 88/P Year 2015 was issued to legalize the appointment of new chairman and vice chairman of BAZNAS.

Furthermore, in terms of deeper involvement of the government, the last two years, i.e. 2014 and 2015, have witnessed substantially increasing government attention on zakat issues. This could be observed from the enactment of Government Regulation No 14/2014 and issuance of Presidential Instruction No 3/2014, which instructed government civil servants at all level of government, military and police officers, and state-owned corporations to fulfil their zakat obligation through BAZNAS. However, there should be sufficient socialization of these regulations so that execution of the policy can be more effective.

In terms of total collected zakat, there was an increase of national zakat collection from Rp 2.70 trillion in 2013 to Rp 3.30 trillion in 2014. This 22.22 percent increase continues positive trend in the total collection of zakat for the last decade. However, as compared to the total potential of zakat as highlighted by Firdaus *et al* (2012), this actual collection is still less than 3 percent of the total potential.

As for the distribution side, BAZNAS and LAZ in Indonesia have distributed zakat funds to nearly 3.80 million recipients in various consumptive-based and productive-based zakat programs. This equals 12.67 percent of the total number of the poor published by the Central Board of Statistics of Indonesia. It is expected that zakat distribution programs are able to reduce the poverty incidence of the *mustahik* (zakat beneficiaries).

Regarding this impact on poverty, some studies have attempted to analyze the impact of zakat on poverty and welfare level of the mustahik. Among the latest is the study conducted by Beik and Arsyianti (2015), which is presented at the 1st International JIMF (Journal of Islamic Monetary Economics and Finance) Conference held by Bank

> “ZAKAT DEVELOPMENT IN INDONESIA ENTERED NEW ERA AFTER THE ISSUANCE OF THE ZAKAT MANAGEMENT ACT NO 23/2011 WHICH REPLACED THE ZAKAT MANAGEMENT ACT NO 38/1999.

Indonesia on 29-30 October 2015. The impact of zakat is assessed by using a standard of measurement called CIBEST Model[9]. The model was developed by Beik and Arsyianti (2015) and it attempted to combine poverty analysis from material as well as spiritual dimensions.

In the CIBEST Model, Beik and Arsyianti (2015) use household as unit of analysis and divide the household into four possible situations with regard to their ability in fulfilling material and spiritual needs. Firstly, a household is able to fulfil both needs, i.e. material and spiritual needs completely. This is called as prosperous household. They live under good welfare condition as mentioned by Allah SWT in the QS 16: 97.

Secondly, a household has capacity to fulfil spiritual needs only, while they are unable to fulfil material needs up to the minimum level. This household is basically living under material poverty condition (see QS 2: 155-156). Thirdly, a household is able to fulfil only material needs. As for spiritual needs, this household is intentionally unwilling to fulfil the needs. This household basically lives under spiritual poverty condition (see QS 6: 44). Fourthly, a household is not able to fulfil both material and spiritual needs. This household lives under the category of absolute poverty. This has been described by Allah in the QS 20: 124. They actually represent the weakest group of the society.

Based on this conception, Beik and Arsyianti (2015) further develop various indices comprising welfare index, material poverty index, spiritual poverty index, and absolute poverty index. These indices are gathered under CIBEST Model. In their study, Beik and Arsyianti (2015) have observed 221 households receiving zakat fund from BAZIS DKI Jakarta, which is one of the most outstanding Provincial BAZNAS, and Dompet Dhuafa Republika, which is the largest national LAZ. By utilizing CIBEST Model, they found that productive-based zakat programs of the two institutions have positive impact on poverty reduction as could be observed from the following Table.

CIBEST INDEX: PRE AND POST ZAKAT PROGRAM

CIBEST Index	Pre Zakat Program	Post Zakat Program	Percentage Change
Material Poverty Index	0,615	0,430	-30,15
Spiritual Poverty Index	0	0,009	+100
Absolute Poverty Index	0,104	0,009	-91,3
Welfare Index	0,281	0,552	96,8

Source: Beik and Arsyianti (2015)

It could be observed from the table that the presence of productive-based zakat programs, which aim to empower the recipients to have long term sustainable sources of income, was able to reduce material poverty index and absolute poverty index by 30.15 percent and 91.30 percent, respectively. However, spiritual poverty index witnessed surprising increase by 100 percent as there were additional two households suffering weakening spiritual condition despite materially better-off. This result indicates that zakat institutions should strengthen their spiritual monitoring on their beneficiaries by intensifying regular religious meeting discussing various aspects of Islam. In general, the study found that welfare index could be increased by 96.80 percent from 0.281 to 0.552. The results provide evidence on the need to have strong, reliable and trustable zakat institutions that can manage zakat effectively and efficiently.

For further development of zakat in the country, there are at least three steps needed. Firstly, public education creating massive awareness should be increased. This is very important step to reduce the gap between zakat potential and zakat actual collection. Secondly, there is a need to strengthen institutional capacity of BAZNAS and LAZ. Good amil governance is among top priority that should come into the picture. Thirdly, regulation support that can optimize the potential of zakat is highly needed. Government should be encouraged to utilize zakat as part of national economic policy aiming at reducing poverty and income inequality.

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B. Waqf

In Indonesia data obtained from the Ministry of Religious Affairs for the year 2012 indicate that:

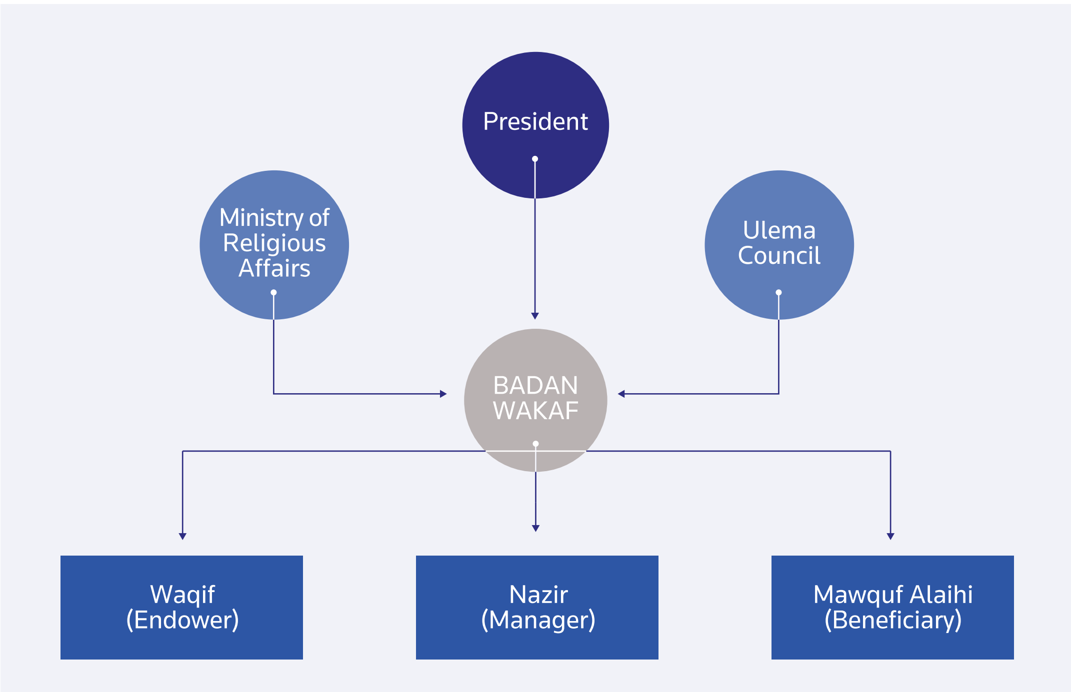
- The size of registered land waqf in Indonesia is equal to 1,400 km^2 and most of them are still idle
- Market value of registered land waqf is estimated to be equal to Rp 590 trillion ($60 billion)
- Collected cash waqf by Badan Wakaf is equal to Rp 3.60 billion ($370,000)

Institutional and regulatory environment for awqaf

Indonesia offers the most recent example of comprehensive regulatory reforms in the field of awqaf with the promulgation of the Act of Republic of Indonesia No.41 on Waqf, 2004. Article 47 of the Act established Badan Wakaf Indonesia as an independent institution "in order to improve and develop the national waqf". In performing its task, it heeds the suggestion and consideration of the Minister and Indonesian Ulama Council.

Institutional Structure for Waqf in Indonesia

In Indonesia, waqf is regulated by the Act of Republic of Indonesia No.41 on Waqf, 2004. It is perhaps the most recent and exhaustive piece of legislation.



Permanence of waqf

Indonesian law provides a comprehensive definition of waqf that includes both permanent and temporary waqf. However, once the waqf has been declared, it is irrevocable (Art 3).

Elements of waqf

Indonesian law recognises a waqf by an individual, organisation as well as by a legal institution (Art. 7). An individual waqif must be an adult, of sound mind, not put under legal restriction and must have full ownership on the article of waqf. (Art. 8.1) An organisation and a legal institution can endow a property as waqif if the same is in accordance with their respective deeds of establishment. (Art.8.2 and 8.3).

The iqrar of waqf or the waqfia is the most important document that formally brings a waqf into existence. Under current laws, the iqrar of waqf needs to be prepared by waqif as part of a formal legal process.

Indonesian laws stipulate that the iqrar of waqf is prepared before the authority empowered with issuing the legal document. (Art.17.1) The iqrar may be expressed by a simple pronouncement and/or a written statement by the waqif and then dictated in the waqf deed by the authorities. (Art.17.2) Personal presence of the waqif is not insisted upon and a letter of authorisation by the waqif and/or legal evidence of ownership of mawquf may be considered adequate for the purpose. (Art.18-19)

The process requires two witnesses, each one of whom must be an adult Muslim, of sound mind and not put under legal restriction. (Art.20) The iqrar of waqf must include at the minimum: the name and personal identity of waqif; name and personal identity of nazir; data and specification of waqf asset; the purpose of waqf and its intended beneficiaries; the clear designation of waqf asset towards the purpose and the terms of waqf. (Art.21.2).

Mawquf (Endowed Asset)

Indonesian law clearly states that an asset can be converted to waqf if it is legally-owned and authorised by the waqif. (Art.15) It recognises both movable and immovable assets as mawquf. (Art.16)

The range of immovable assets include: rights on land, building or part of building established on the land; agricultural cultivation and other goods related to land; rights of ownership on a housing unit; and other immobile goods in line with the Shariah provisions and the rule of law.(Art.16.2)

The range of movable assets includes any non-perishable and durable asset, such as money, ornaments, stocks, bonds and financial securities, transportation vehicles, rights of intellectual property, rights of leasing and other movable assets in line with the Shariah provisions and rule of law. (Art.16.3) Thus, the law incorporates the views of contemporary scholars and looks at the possibility of corporate awqaf and other innovations.

Indonesian law also deals explicitly with cash waqf in the following manner. Cash may be endowed through Islamic financial institutions duly identified by the government. (Art.28) While the waqif must express his intention to endow through a written statement, a certificate of cash waqf is issued by the Islamic financial institution to both waqif and nazir as the legal fact of assignment of waqf asset. (Art.29) The Islamic financial institution, on behalf of nazir, must register the cash waqf within a week after the issuance of certificate of cash waqf. (Art.30)

Mawquf Alaihi (Beneficiary)

Indonesian law specifies the purpose of waqf as ibada and/or public welfare. (Art 1.1 and Art 5) and therefore, does not recognise family waqf.

It clearly defines the purpose of waqf and its intended beneficiaries, restricting the same to facilitating religious activities, provision of education and health services, aid and assistance to the indigents, abandoned children, orphans, scholarships to students, overall improvement and development of economic community and finally, to development of public welfare in accordance with the Shariah rules and the rule of law. (Art.22)

The same must be stipulated in the waqf deed by the waqif. (Art.23.1) In the absence of a clear designation by the waqif, the nazir is entitled to designate the waqf asset in accordance with the purpose and function of waqf. (Art.23.2)

Management of Waqf Assets

Shariah provides for the institution of nazir or mutawalli as the trustee-manager of waqf assets. At the same time, the history of awqaf in most countries shows a steady move towards control by government agencies over management of awqaf assets eroding and in some cases, entirely replacing its role.

The circumscribing of the nazir's role was dictated mostly by cases of misuse of waqf property by the trustee-managers. At times, this was a case of deliberate usurpation by the governments and rulers.

In their current form, waqf laws across countries show wide variations with respect to how they define eligibility and responsibility of the nazir and how they seek to motivate him/her to function efficiently and with integrity through use of appropriate rewards and punishments.

Indonesian law permits an individual, or an organisation or a legal institution to be stipulated as nazir. (Art.9) An individual in order to qualify as nazir must be an Indonesian citizen, a Muslim, and an adult. He must also be trustworthy, physically and mentally healthy; and not be put under any legal restriction. (Art.10.1). Thus a non-Muslim individual cannot be appointed as nazir.

An organization or a legal institution may be nominated as nazir if its concerned official fulfills the requirements of individual nazir as above and the organisation or institution is engaged in social, educational, community and/or Islamic affairs. (Art.10.2 and 10.3)

Responsibility

Indonesian law clearly defines the tasks of nazir as: administering the waqf asset(s); managing and developing the same in accordance with the objective, benefit and designation of waqf; controlling and protecting the waqf asset(s); and submitting the report of waqf administration to Badan Awqaf, the central body created for the purpose of supervision of all Indonesian awqaf. (Art. 11 & 42)

With regard to management and development of waqf assets, the nazir must undertake the same in conformity with Shariah and with efficiency. (Art.43.1-2) It is also required to seek the services of an Islamic guarantee institution in this matter. (Art.43.3)

Compensation

Not all laws stipulate a compensation for the nazir. Indonesian law stipulates that the nazir is entitled to receive a maximum compensation of 10 percent of the net income from the administration and development of waqf. (Art. 12)

Accountability

All laws provide for centralised government supervision and control over awqaf and make the nazir accountable to the government body created for the purpose, though in varying degrees.

Deterrents against Abuse

Laws provide for deterrents against wilful negligence, mismanagement and misuse by nazir. These deterrents vary in their intensity and impact in bringing about the desired behaviour by nazir.

Some laws prescribe financial penalties and/or physical punishment against abuse of waqf assets.

The Indonesian law views acts of abuse of waqf assets as criminal offence.

Whosoever intentionally commits an act to mortgage, give, sell, bequeath, convert to another form of right of the waqf asset or to exchange the same without permission is liable to be imprisoned for a maximum of five years and/or a fine of maximum five hundred million rupiahs.

A lesser penalty exists for an act to convert the designation of waqf property without prior permission. It is imprisonment for a maximum four years and/or fine of maximum four hundred million rupiahs. Imprisonment for a maximum three years and/or fine of maximum three hundred million rupiahs is prescribed for the nazir who takes compensation higher than the stipulated 10 percent. (Art.67)

Preservation of waqf assets

Most laws seek to ensure the preservation of the waqf asset(s) in line with the classical principles relating to the same, such as ibdal and istibdal.

The Indonesian law explicitly prohibits the waqf asset from being used as a mortgage, confiscated, given away, sold, inherited, exchanged or being alienated into any form of right. (Art.40)

The waqf asset may however be exchanged as an exception to the above general rule, when this is deemed to be in the public interest. Such exchange would however, require prior permission from both the Ministry and the Badan Wakaf with an additional condition that the asset exchange must be against another asset of equal or higher value. (Art.41)

Indonesian law requires that in managing and developing the waqf asset, a nazir is not permitted to alienate the designation of waqf asset, except he has received a written permission from the Badan Wakaf Indonesia. (Art. 44.1) Such permission is given if the asset concerned is no longer beneficial as had been assigned in the waqf deed. (Art. 44.2)

Development of waqf assets

Indonesian law envisages the following progressive role for the central body (Art. 49) in the matter of waqf development.

- to bring improvements in the way the nazir manages and develops waqf assets;
- to manage and develop waqf assets at the national and international level;
- to give agreement and/or permission on the alienation of waqf designation and its status;
- to dismiss and replace a nazir;
- to give agreement on the exchange of waqf property;
- to give suggestion and consideration to the government on the designing of waqf policy.

The law however, is silent on how the development of waqf assets could be achieved or what models of development with or without private financing could be used.

Investment of waqf corpus

The Indonesian law dealing with cash waqf merely requires that the cash endowment must be made through an Islamic financial institution duly identified by the government. (Art.28) This is apparently to minimise the risk associated with investment of the corpus. Such undue precaution however, may be unwarranted. If a founder establishes a waqf in order to enhance entrepreneurship, he would not want to avoid risky ventures.

Dompet Dhuafa Republika, a leading Indonesian NGO through its subsidiary organisation, Tabung Wakaf Indonesia, has been investing cash waqf for microenterprise development.

Supporting infrastructure for awqaf

Education and training providers

In Indonesia, the *Indonesia Magnificence Zakat* (IMZ) in addition to programmes in zakat management, undertakes a comprehensive range of short-term training programmes in the area of waqf management that includes the following modules:

1. Fiqh and management of cash waqf
2. The role of state in development waqf in Indonesia
3. Strategic organisation and management of investment and productive waqf

PROBLEMS AND CHALLENGES OF AWQAF MANAGEMENT IN INDONESIA

Muhamad Nadratuzzaman Hosen, PhD, Vice Chairman, Indonesian Waqf Board

DR. MUHAMAD NADRATUZZAMAN HOSEN,
Vice Chairman of Indonesian Waqf Board. He obtained his PhD. in Economics at school of Economics, University of New England, Australia in 2001. In 2000, He worked as a Head of Environmental Technology and Biodiversity at Ministry of Research and Technology, and became a lecturer at the Faculty of Economics and Social Science, State Islamic University of Syahid in 2004. Since 2005, he has been lecturing at Faculty of Shariah and law, UIN Syahid, Jakarta. He also serves as a Director for Communication Centre of Shariah Economics (PKES) from 2005 until 2009. During 2006 - October 2009, he was also a Director of the Assessment Institute for Foods, Drugs and Cosmetics (LPPOM), MUI. He served as a Dean for Faculty of Economics at YARSI University, Jakarta From July 2009 - July 2010. He worked as Executive Director of Islamic Banking and Finance (IBFI) in Trisakti from 2011-2013. He published 11 books. He has been actively to give seminar internationally on Halal products and Islamic Economics. He was a President of World Halal Council from 2006 to 2009. He is currently a treasurer for Indonesian Council of Ulama (MUI) as well as for Council of Shariah Board of MUI.

Introduction

Historical background

In terms of awqaf assets, there are two categories which can be explained as follows. Firstly, awqaf assets can be utilized for social-activities of Islamic affairs and education such as land for Mosques, land for schools and Islamic cemetery or graves for Muslims. This type of utilization directly benefits the Muslim community and is usually implemented in Indonesia. Secondly, awqaf assets can be used for business and investment. This type of utilization is very rare, almost non-existent in some areas of Indonesia. In the Indonesia context, the first type of utilization was reasonable when Indonesia was under colonization and where the people needed many Mosques and Islamic schools, and the colonial government did not want to establish these. But it doesn't mean that the second type of utilization didn't exist at all. It can be seen in the 16th Century in Indonesia where there was awqaf for paddy fields or sawah in the swamp areas for getting money to maintain and organize Mosques (BWI, 2012).

Historical Regulations

On January 31st, 1905, the Netherland colonial government issued regulations regarding awqaf administration, where the Head of Regency had to make a list of awqaf assets. Moreover, on April 4th, 1931, the colonial government gave authority to the Head of Regency to resolve awqaf disputes among parties of conflicts and on May 27th, 1935, regulations were issued by the colonial government regarding procedures and the administrative system of awqaf. However, these regulations did not complexly follow Shariah principles and aims of awqaf. Hence, Muslims in Indonesia moved against the regulations and implemented Shariah law without the participation of the colonial government.

Government regulation number 33 in 1949 gave authority to the Minister of Religious Affairs to organize awqaf. Moreover, the Minister of Religious Affairs issued Minister Regulation number 9 in 1952 to give authority to the Head of Regency to investigate awqaf, collect data of awqaf and supervise the implementing of awqaf in the society. Furthermore, regulation number Pem 19/22/23/7:SK/62/Ka/59P, issued by Minister of Domestic Affairs together with Minister of Agrarian, gave authority for supervising awqaf matters to the Head of Regency Office of Minister for Agrarian Affairs.

The law of agrarian number 49 in 1960 about basic principles of agrarian regulations mentioned that the Republic State of Indonesia is to protect waqf activities and to regulate based on new regulations under the law of agrarian, where the new regulations were finally issued by government in 1977. From 1966 to 1998, regulations regarding awqaf did not have a significant impact on developing awqaf activities. Significant impact from regulations came when parliament issued law number 4 in 2004. This law reflected the political will of the government to utilized awqaf productively. One article mentioned that the government would establish the Waqaf National Board (BWI) for organizing all matters related to awqaf, including developing regulations, being a motivator, facilitator and providing services besides the Indonesian Government and the Ministry of Religious Affairs.

Issues with Awqaf in Indonesia

There are several issues related to awqaf. Firstly, Nazhir of awqaf has characteristics in traditional conservative utilization because Islamic leaders, Scholars and Muslims are more concerned with protection of awqaf rather than utilization of awqaf. They are conservative and aim to preserve awqaf rather that to utilize its wealth efficiently for the benefit of Muslims. Hence, awqaf assets are not optimized from a managerial aspect, and from the spirit of entrepreneurships. Waqif appointed Nazhir because of trust and Islamic knowledge; but many Nazhir have low motivation and limited capacity. Some also abuse the wealth of awqaf.

The second major issue is the lack of understanding of awqaf among Muslims. Most work in the practice of awqaf in very traditional ways. They don't follow government regulations and often appoint Nazhirs among each other (Ikrarwaqf or waqf contract) without any statement on paper. Hence, a lot of conflicts are due to administrative matters and lack of adherence to government regulations.

Thirdly, the second issue above also leads to many conflicts regarding awqaf assets after the Nazhir dies, and the children of the waqif appeals to the court to withdraw the wealth of awqaf. These issues are critical because these conflicts often result in the disappearance of awqaf wealth.

Also, a lot of awqaf lands are not registered as waqf land or land certificate of waqf. This is mainly because most Nazhirs are not aware of the important land title/status, the costs of land certification process are expensive and the procedures to get land titles are difficult due to complicated bureaucracy.

Finally, there is a lack of activities to educate and socialize new paradigm of cash waqf in Islamic Communities, and government budgets are limited to facilitating awqaf movement and providing services for awqaf administration. Hence, awareness of cash waqf is low.

Solution

There are several activities that can be done to address many issues in the areas of awqaf. Firstly, Government, BWI, Islamic leaders, scholars and organizations need to declare awqaf movement in Indonesia, in order to create necessary condition for developing awqaf and utilizing awqaf assets productively. Secondly, registrations of Nazhirs and awqaf assets has to be the prioritized, in line with building national data system of awqaf. Thirdly, BWI needs to become the only authorized body to manage national waqf, while government has to supervise all activities in awqaf. For example, revisions to the awqaf law of 2004 is necessary. The implication of a single authority means that there is no dualistic authority in developing the management system for awqaf.

Government also has to support the waqf movement by providing funds during the next ten years, then BWI can stand on its own budget. Also, improving and developing the roles of Nazhirs are the main priority to have awqaf core principles and to have road map of awqaf national programs. Finally, BWI and the Government have to put the cash waqf and certification of land title of waqf lands as a priority, working together with Islamic finance institutions and Islamic organizations.

Examples of Waqf best practices in Indonesia

A research report conducted by BWI and State Islamic University, Jakarta in 2011, showed that there are three categories regarding the productivity of awqaf in Jakarta, namely high level productivity of large size of land and high level competency and capability of Nazhir; medium level productivity of large size of land and medium level competency and capability of Nazhir; and low level productivity of small size of land and low level competency and capability of Nazhir. The model for all activities is that the Nazhir builds a mosque and then establishes the foundation. This foundation, as a patron in creating social capital and doing collective actions among community, has a legal entity and role in organizing education and other activities. The foundation's ability to influence the community and be a trusty body is a key factor of success for developing awqaf. Almost all Nazhir who build foundations are successful in organizing waqf because at the same time, they collect donations from zakat, infaq and shadaqah. It can be seen that waqf and zakat, as well as infaq, can work together for social-economic benefits.

At national level, there are several awqaf foundations which are successful:

- Yayasan Badan Wakaf Universitas Islam Indonesia (UII). This foundation was established in July 8th, 1945. It has 13,000 m^2 of awqaf land in the city of Jogjakarta. Scope of activities is in education covering university, high schools and kindergarden.
- Yayasan Waqaf Universitas Muslim Indonesia (UMI). This foundation was established in February 8th, 1953 in Makassar, South Sulawesi. It has land size of 11,200 m^2 for campus one, 140,200 m^2 for campus two, 7,000 m^2 for campus three and four, 292,300 m^2 for campus five and six with several buildings of dormitory. Scope of activities is education, research and empowerment for the Islamic community.
- PondokP esantren Modern Darussalaam Gontor, Ponorogo, East Java. This institution was established in October 9th, 1926. It has land size of 185,896 hectares consisting of upland and paddy fields or sawah and 15 big buildings for education and dormitory. Scope of activities is in education and several businesses, to support educational activities.
- Yayasan Badan Wakaf Sultan Agung , Semarang, central Java. This foundation was established in July 31th, 1950. It has land size of 368,507m^2 in Semarang, 386,678m^2 in some areas of out of Semarang and 52,175m^2 in Jepara. Scope of activities is kindergarden, primary schools,

junior and senior high schools and university.

There are also several institutions the operate cash waqf :

- Dhuafa Wallet (Dompet) has promoted awqaf since 2000. The program was initiated by Wallet Dhuafa, among other charitable programs in Dompet Dhuafa, namely, Clinical Services LKC ; Free Schools Smart and Excellence of Indonesia; Muallaf Care; Free Hospital and Integrated Health Home Care. Integrated Health Home Care is a healing model of homes that provide health services free of charge for the poor. The building of Integrated Health Home Care is on an area of 7,803 m2 in the village of Jampang district, Kemang, Bogor , West Java.

- Integrated Health Home Care serves the poor who have difficulty in gaining access to adequate health-care. In the first year of operation of this hospital hopes to serve a minimum of 54,000 needy patients, which are paid by the cash waqf with a value of around Rp. 65 billion.

- Additionally , Wallet Dhuafa also receives awqaf in the form of buildings in Wardah and Jannah, Villa Inspire (Islamic Village), Karawaci, Tangerang; kindergarten, elementary, junior Al Syukro Universal Ciputat ; preschool, elementary, middle Semen Cibinong (HOLCIM) , Narogong , Klapanunggal , Bogor , and portfolios of other awqaf such as land, shares, social property, social and other business assets .

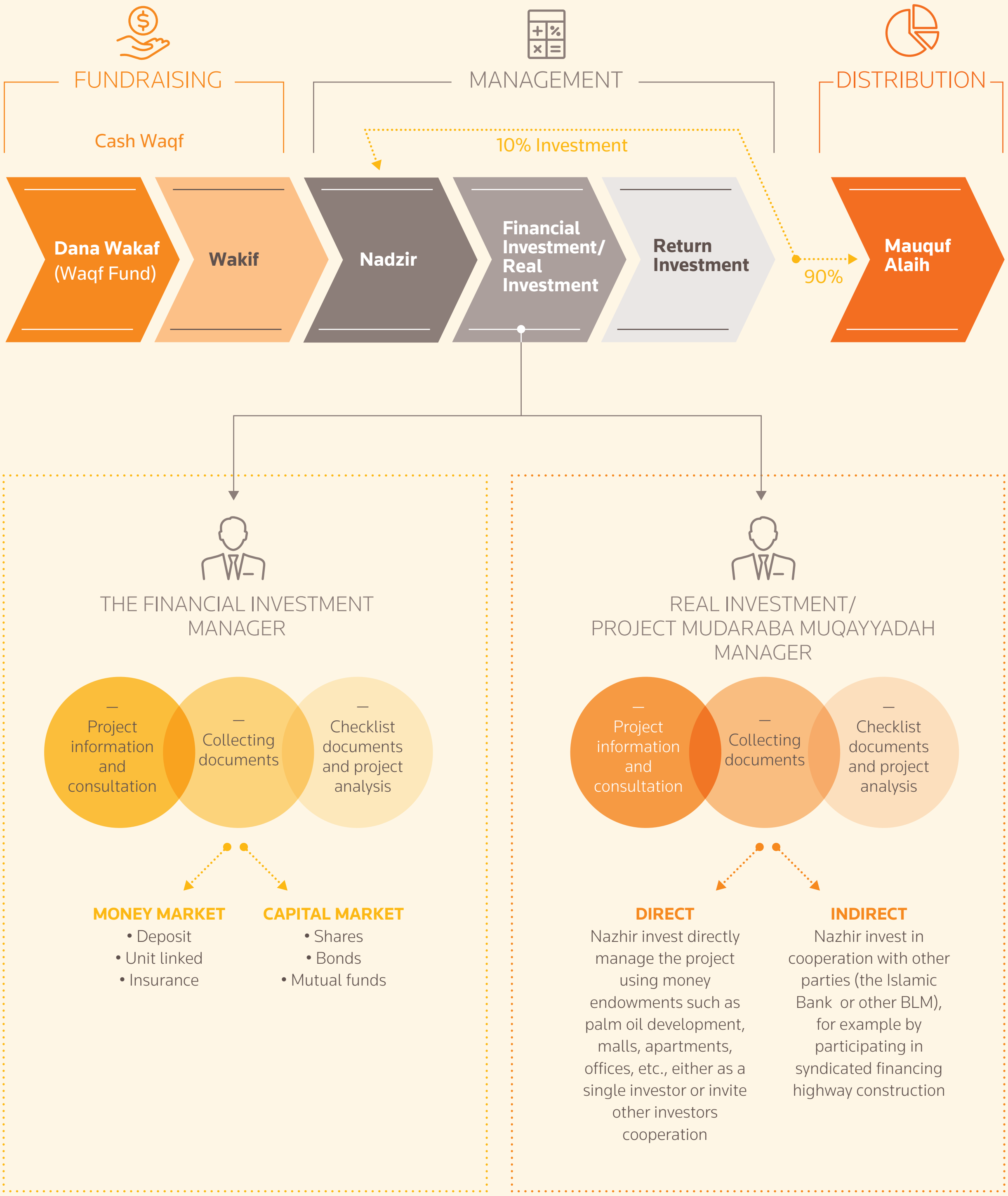
- Yayasan Bangun Nurani Bangsa (ESQ) has property awqaf assets to manage rent the buildings for the benefits of social and humanitarian programs. Commercial property assets can be seen in the form of building awqaf Convention Center & Office Tower. Until 2013, the foundation has been collecting funds of around Rp 47 billion of cash waqf .

- Yayasan Bangun Nurani Bangsa (ESQ) is currently owning securities in the form of shares of some wakif-awqaf.

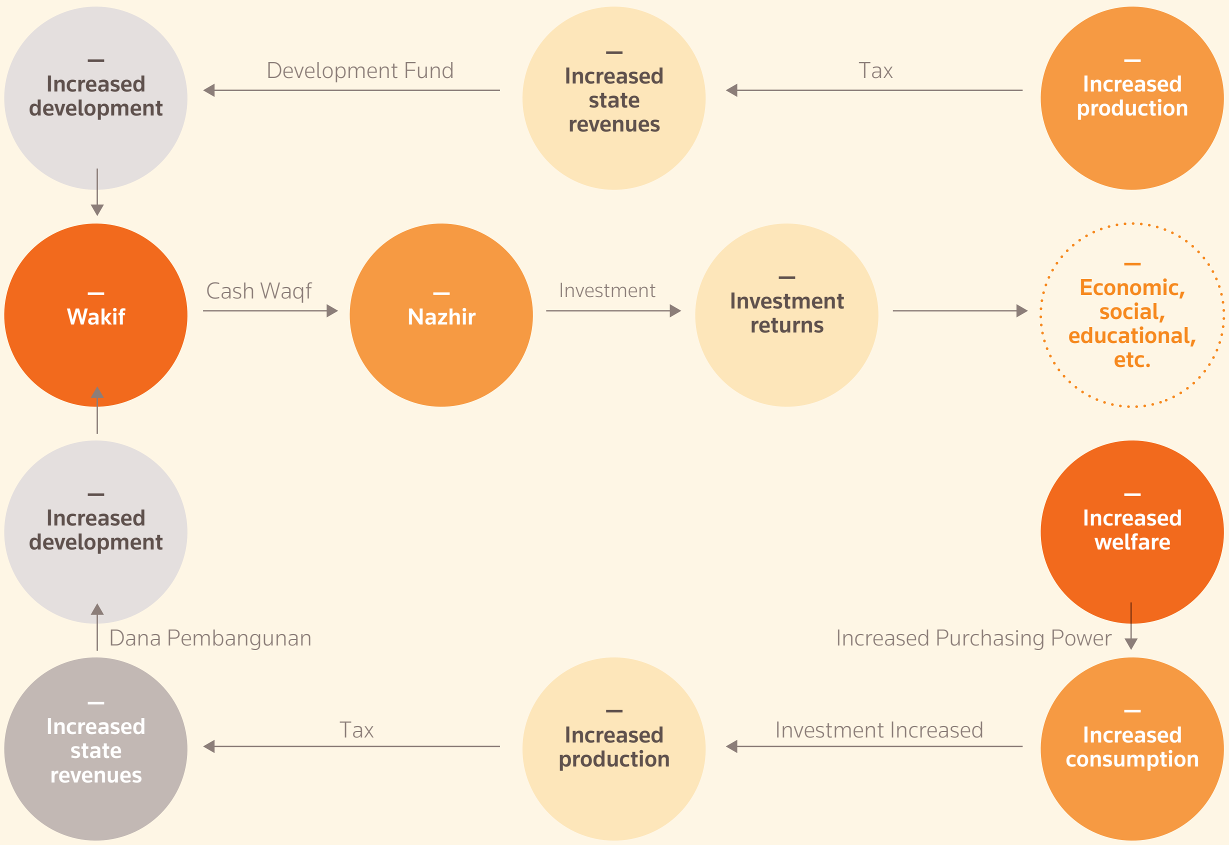
- Wakaf Al Azhar Indonesia is a business formed by the Waqf Islamic Boarding School Foundation (YPI). Its aim is to develop and to manage Waqf more productively to support education and religious affairs. Waqf Al Azhar Indonesia is currently collecting money from wakif waqf through several sources including Waqf Khairi, Waqf Property, Awqaf Transportation, Awqaf Card Productive and Awqaf trees of Jabon and palm plantations.

> “THERE ARE SEVERAL ISSUES IN DEVELOPING AWQAF IN INDONESIA, BUT A LOT CAN BE DONE BY AWQAF STAKEHOLDERS TO FOSTER AWQAF DEVELOPMENT

CASH WAQF MANAGEMENT SCHEME



EFFECTS OF CASH WAQF MANAGEMENT IN ECONOMY



Conclusion

There are several issues in developing awqaf in Indonesia, but a lot can be done by awqaf stakeholder to foster awqaf development. Traditionally, Indonesian awqaf has already successful supported educational institutions and hospitals. The new challenge is how to manage awqaf assets more productively, and ensure impact among the needy.

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C. Islamic microfinance

A major segment of the Islamic social finance sector comprises Shariah-compliant microfinance institutions that are not-for-profit and/or rooted in cooperation and self-help.

Some are in the nature of member-based organisations called financial cooperatives, credit unions, baitul-mal-wat-tamweels (BMTs). Others are organised as not-for-profit entities, e.g. societies, trusts, foundations, not-for-profit companies.

Therefore, the institutions covered in this section are either rooted in cooperation (so that profits are shared among all members) or, are legally not-for-profit entities (so that profits are ploughed back into the organisation and cannot be shared by promoters and founders).

What is common to all, however, is that charity and philanthropy contributes partially to the funding of operations.

In Indonesia, the Baitul Maal wat Tamweel (BMT) is an indigenous model of Islamic microfinance. Translated into English, the *House of Funds and Financing* is a financial cooperative.

Conceptually, BMT is deemed to be inspired by the institution of Baitul Maal which existed in the early days of Islam. Its uniqueness is said to lie in the marriage of two distinct institutional models.

The first is Baitul Maal or a pool of various kinds of Islamic charity funds, traditionally referred to as zakat-infaq-sadaqa-waqf funds (ziswaf).

The second is Baitut Tamweel or a pool of funds directed at profit-seeking financing using Shariah-compliant modes. The latter comprises funds in the form of founder equity, micro-savings and investment deposits. A more recent *avatar* of this institution is Baitul Maal wat Tamweel wat Tamin (BMTT) with the addition of micro insurance (tamin) as a third line of activity. Thus, BMT performs distinct economic and social functions for its members.

Size of Sector

The development of Islamic Saving and Loan Cooperatives or BMTs in Indonesia has been impressive.

According to latest estimates there were more than 3,000 BMTs all over Indonesia with consolidated assets of more than $100 million, employing more than 30,000 workers, more than 40 percent of whom are women.

BMTs served two million depositors and distribute micro credit to more than 1.5 million micro entrepreneurs.

A later study by the Centre of Business Incubation and Small Business (PINBUK) estimated that by the end of 2007, the number of BMTs in Indonesia had grown to over 4,000 with assets of about $150 million (PINBUK, 2008).

Among the various factors cited behind this phenomenal growth are:

1. Growing Islamic fervour among Indonesian Muslims;
2. Activism by several Islamic scholars and Indonesian intellectuals to find Islamic solutions to social, political and economic problems of the country;
3. Enabling legal and regulatory environment for Islamic banking and finance; and
4. Supportive policies in terms of various government initiatives that emphasise the role of BMTs as important vehicles of financing the SME sector.

Institutional and regulatory environment for Islamic microfinance

While examining the institutional structure for Islamic MFIs, we maintain the distinction that was attempted at the outset between three broad categories of entities.

First, there are not-for-profit societies, trusts, foundations and not-for-profit-companies that are not allowed to share profits from their operations with the promoters or founders (there are no owners).

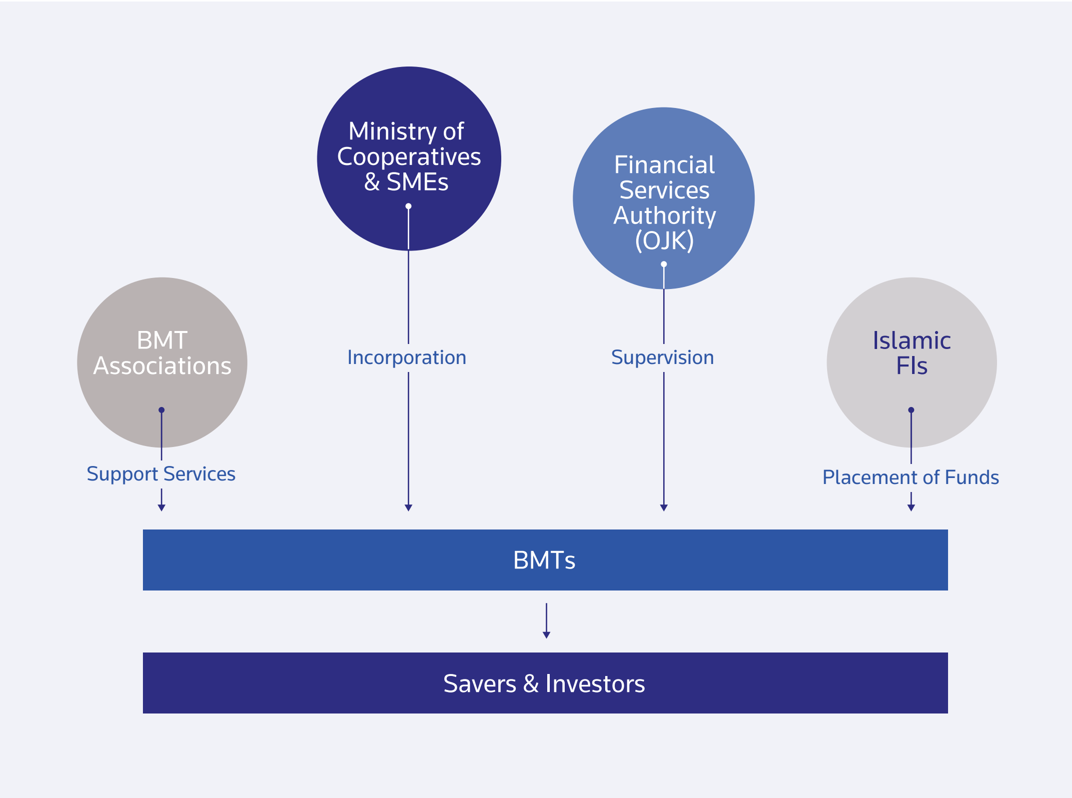
Second, there are member-based organisations, also known as cooperatives, mutuals, credit unions in different parts of the world that are allowed to share profits among their members. These are organisations formed to promote common and collective interest of their members. A primary characteristic of such organisations is that these are governed by one-member-one-vote rule as against one-share-one-vote rule governing modern corporations.

The for-profit corporations are the third dominant category of MFIs. This analysis restricts the coverage to entities in the first two categories only.

Institutional Structure for BMTs in Indonesia

The institutional structure of Islamic financial cooperatives has components at macro, meso and micro levels. At the macro level, the Ministry of Cooperatives and SMEs regulates the establishment of BMTs while the Financial Services Authority (OJK) regulates provision of microfinance services by these institutions.

BMTs receive various support services, e.g. capacity building, advocacy from meso-level players, the associations and networks. BMTs are linked to Islamic financial institutions under various linkage programmes, e.g. execution and channelling.



Rice farmers tend to their padi field in Lembor in Flores, East Nusa Tenggara province. REUTERS/ Candida Ng

In Indonesia two different sets of laws govern not-for-profit organisations and accordingly, there are two types of legal entities for NPOs, namely the association and foundation.

Foundations are regulated by Law No. 16 of 2001, as amended by Law No. 28 of 2004. A foundation is defined as a non-membership legal entity, established based on the separation of assets, and intended as a vehicle for attaining certain purposes in the social, religious, or humanitarian fields.

Associations are governed by the Dutch Colonial Government inherited law that is still valid, namely *Staatsblad* 1870-64 on Associations with Legal Person Status. There are two types of associations in Indonesia: (1) incorporated associations, which possess legal personality; and (2) ordinary associations, which do not.

An important characteristic of an association that is distinct from a foundation is membership. An association is a member-based organisation, whereas a foundation does not have members but is required by the Law on Foundations to have three organs: the Governing Board, Supervisory Board, and Executive Board.

As highlighted in the previous section, in Indonesia, the indigenous BMTs were allowed to continue as informal and unincorporated entities and have been following varied practices. While some used a simple notarial deed as their legal form, some other small BMTs operated as "pre-cooperatives" certified by the Center for Microenterprise Incubation (PINBUK). Most medium and large BMTs are however, registered as Shariah Cooperatives (KJKS) with the Ministry of Cooperatives and SMEs.

The legal basis of BMT has posed a dilemma for regulators and policy makers. The rationale underlying the creation of a cooperative is to provide services to its members. The law of cooperatives is not very demanding in terms of accountability, transparency and governance of the institutions and many are able to evade compliance on account of lax supervision.

For example, while the Ministry of Cooperatives and SMEs has set standard operational and management procedures for Islamic Financial Services Cooperatives (KJKS) and Financial Services Units (UKJS) in PP: 35.2/M.KUKM/X/2007, there has been no legal consequences for institutions in violation of the regulation.

On the contrary, a financial intermediary needs much higher degrees of compliance and effective supervision. BMTs function in a manner similar to standalone Islamic financial institutions and some even have more assets than individual banks, but are seen to be beyond the reach of regulatory arms of the central bank of the country.

In response to this and also with a view to give a fillip to the microfinance sector, the law No. 1 of 2013 on Microfinance Institutions was issued in 2013 with a view of providing legal certainty for microfinance providers (LKM). The government recognises the sizeable gap between microfinance availability and demand, especially from the low-income segment. The law that will become operational by 2015 aims to bridge this gap by providing a legal basis for microfinance operations as well as setting out standards that MFIs must follow.

Legal Form and Ownership Structure

An MFI must be established in the form of either a limited liability company (*Perseroan Terbatas*) or cooperative (*koperasi*). Where the MFI assumes the form of a PT, 60 percent of its shares must be owned by a regional (regency or municipal) government or region-owned company (*BUMD*). The remaining 40 percent may be owned by either an Indonesian national (natural persons only) or a cooperative.

Individual ownership is capped at 20 percent (Articles 5 and 8). The MFI must obtain a business license from the Financial Services Authority (OJK). Foreign nationals or any entity owned by foreign nationals or a foreign-owned enterprise are prohibited from owning an MFI.

Scope of Operation

An MFI is authorised to provide savings and financing services on a micro scale both to its members and to the public; savings management as well as providing consultancy services on business development (Article 11).

> “AN MFI IS AUTHORISED TO PROVIDE SAVINGS AND FINANCING SERVICES ON A MICRO SCALE BOTH TO ITS MEMBERS AND TO THE PUBLIC; SAVINGS MANAGEMENT AS WELL AS PROVIDING CONSULTANCY SERVICES ON BUSINESS DEVELOPMENT.

MFIs, according to the law, can operate on a conventional or Shariah basis.

There are a number of prohibitions in the law. MFIs cannot conduct business outside of their licensed geographical area, either a village, a district or a regency/city. An MFI that engages in business across different regions will be required to transform into a bank. Also, the law prohibits MFIs from offering giro service, acting as a guarantor, or providing loans or financing to other MFIs unless such financing is designed to save the other MFI from liquidation.

Deposit Protection

The law provides minimum deposit protection schemes. Unlike banks, LKMs are not required to participate in any deposits insurance scheme, including the deposit protection scheme under Indonesia Deposit Insurance Corporation (LPS). Article 19(1) of the Law makes it optional for MFIs to establish their own deposit insurance entity.

This implies that savers are not protected until such entity is established. It should be noted that rules concerning such deposit insurance entity will be regulated in detail under an implementing Government regulation.

The OJK is given extensive powers under the law to develop, regulate, and supervise MFIs. The OJK is authorised to approve the restructuring of an MFI through either a merger or consolidation, and it can also approve liquidation.

Supporting infrastructure

The meso-level infrastructure for cooperative and not-for-profit microfinance comprises networks and associations, training and education providers, standard setters, developers of software for the sector, rating providers, consultancy providers and the like.

Associations and networks

In Indonesia, as indicated earlier, the BMTs are generally affiliated to some parent organisation that seeks to provide some or all of the different types of support mentioned above. Institutions that seek to foster the development of their member BMTs are as follows:

Small Business Incubation Center (PINBUK), was founded in 1995 in Jakarta by the Ikatan Indonesian Muslim Intellectuals (ICMI), Majelis Ulama Indonesia (MUI) and others. It aims to encourage the emergence of business units that empowers the people through the development of micro, small and Islamic microfinance institutions.

Parent Cooperative Sharia (INKOPSYAH), was established in 1998 as a secondary cooperative. Its original aim was to facilitate access to capital for BMTs. But over time it has assumed a broader role in fostering the existing BMTs, with PT. Permodalan Nasional Madani (PNM) as a partner.

MicroFin Indonesia was established in 2001 with the aim of empowering small and medium enterprises and cooperatives (SMEs) through strengthening and development of Islamic microfinance institutions (LKMS).

BMT Center, established in 2005 was initiated by the leading NPO, Dompet Dhuafa Republika. The institute aims at capacity building of BMTs through advisory services, management and training. It also aims to intermediate between BMTs and undertake advocacy with stakeholders or agencies involved while seeking to improve cooperation among network members.

BMT Se-Indonesia Association (ABSINDO) was established in 2005. It serves as an association of BMTs in order to facilitate or advocate for vertical and horizontal communication among BMTs and to participate in policy dialogues for the sector.

Cooperative Center Sharia (PUSKOPSYAH) is an association of BMTs both at the provincial and district or municipal level. This agency serves in addition as an apex agency on a small scale, also serving as a lender of last resort for BMTs.

There is a second category of supporting institutions that provide liquidity facilities for BMTs. Major institutions in this category are:

PT. Permodalan Nasional Madani (PNM) Limited, established in 1999, is a finance company that aims at providing financing solutions to micro, small, medium, and cooperative enterprises, in collaboration with financial institutions such as venture capital institutions, commercial banks, credit unions etc.

Permodalan BMT Ventura, established in 2007, is a private finance company founded by Dompet Dhuafa Republika, BMT Center and others specifically aimed at helping BMTs in meeting their liquidity needs.

5 Corporate Sector in Indonesia: Investment Opportunities

A street vendor walks past a billboard advertising luxury apartments in Jakarta. REUTERS/Beawiharta

INSIDE THIS CHAPTER

Islamic Banking

Corporate Banking at a Glance

Five Islamic banks hold almost 70 percent of all Islamic corporate financing

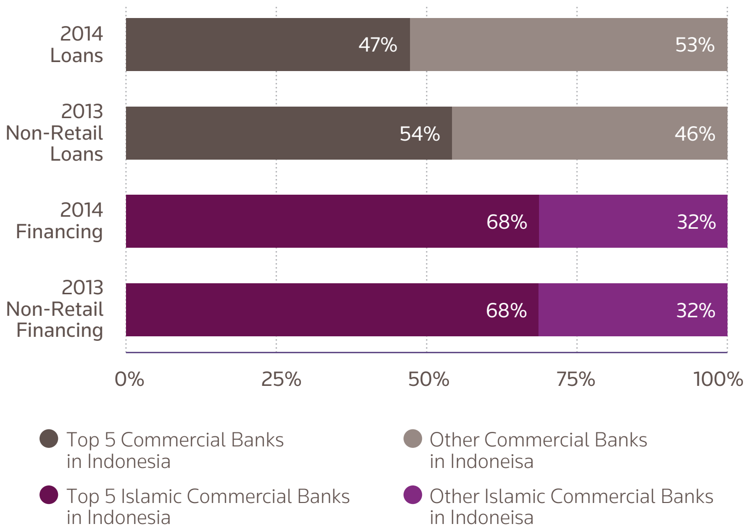
Shariah-compliant corporate financing makes up only 4 percent of Indonesia's total commercial banking industry's corporate loans. Five of 34 Islamic banks hold 68 percent of total Islamic corporate financing. This is much higher than for the conventional space where the top five are the source of 54 percent of all non-retail loans (investment and working capital loans).

Islamic corporate financing growing at a faster pace

Shariah-compliant financing (investment and working capital financing) grew at a CAGR of 21 percent over the past five years, while conventional commercial banking loans grew at a CAGR of 17 percent since 2010, equal to Rp 2,660 trillion. While both Islamic and conventional financing/loans achieved double digit CAGRs since 2010, their growth actually decreased to 12 percent for conventional loans and 14 percent for Islamic financing in 2014, from 2 percent and 27 percent, respectively, in 2013. Local banks retreated and became a lot more risk averse moving from 2013 to 2014 due to slower economic growth.

CONCENTRATION AND COMPETITIVENESS OF NON-RETAIL COMMERCIAL BANKING IN INDONESIA

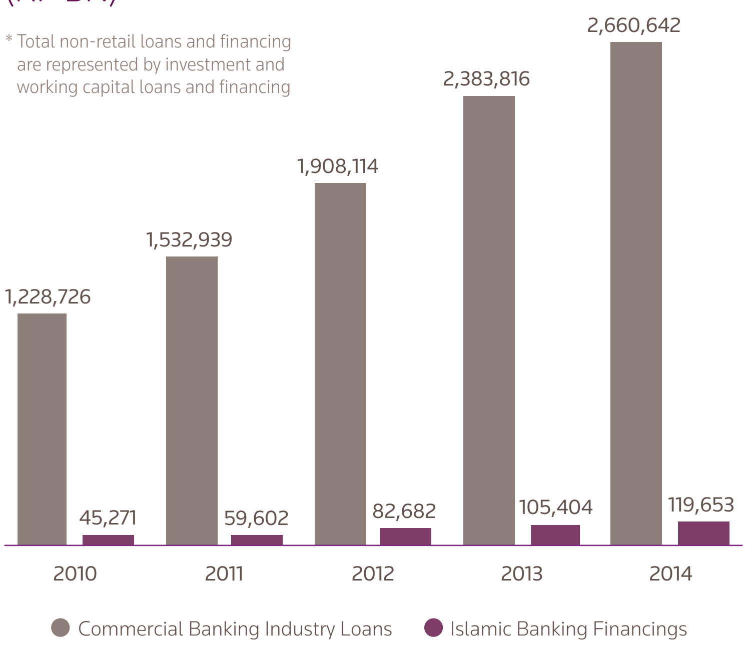
* Total non-retail loans and financing are represented by investment and working capital loans and financing



Source: IFG Database, Indonesian Banking Statistics December 2014, Bank Indonesia

NON- RETAIL CREDIT* BY COMMERCIAL BANKS (RP BN)

* Total non-retail loans and financing are represented by investment and working capital loans and financing

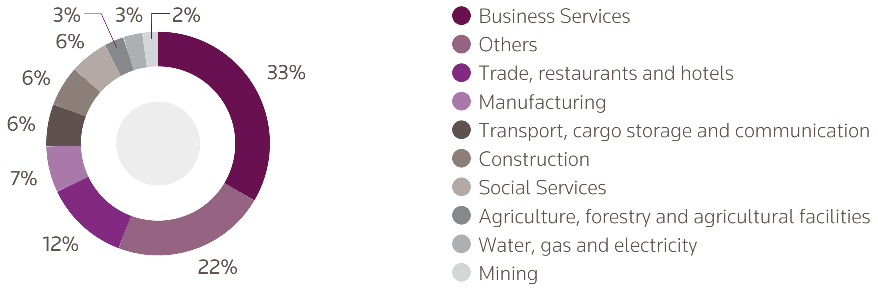


Source: Indonesian and Islamic Banking Statistics December 2014, Bank Indonesia

Corporate Banking Financing

FINANCING BY ISLAMIC COMMERCIAL BANKS BASED ON ECONOMIC SECTORS

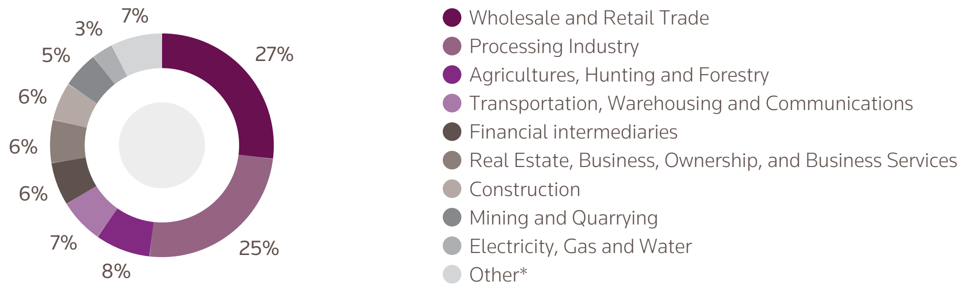
*Includes Shariah Business Units



Source: Islamic Banking Statistics December 2014, Bank Indonesia

LOANS BY CONVENTIONAL COMMERCIAL BANKS BASED ON ECONOMIC SECTORS

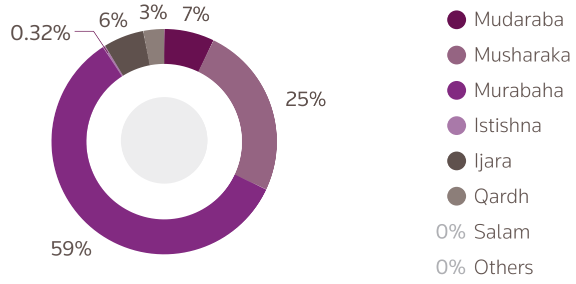
* Other include Provision of accomodation, Community, Sociocultural,Entertainment and Other Individual Services, Business Activities which are not clearly defined, Health Services and Social Activities, Fishery, Education Services, Individual Services which Serve Households and International Agency and Other Extra Agency International
* Includes Shariah Business Units.



Source: Indonesian Banking Statistics December 2014, Bank Indonesia

ISLAMIC COMMERCIAL BANKING FINANCING BY TYPE OF CONTRACT (2014)

* Includes Shariah Business Units



Source: Islamic Banking Statistics December 2014, Bank Indonesia

Indonesia's conventional banks and Islamic banks serve different corporate segments

Official financing/loans data from Indonesia's central bank are not based on similar economic sectors for both conventional and Islamic banks, which makes it difficult to compare like-for-like.

For Islamic financing, business services is the biggest sector (33 percent). This is a very large proportion considering business services only contributes 1.57 percent to GDP (current prices).

Wholesale and retail trade sectors' loans are the biggest for conventional commercial banks (27 percent) while the same economic sector only accounts for 12 percent of total Islamic financing.

Wholesale and retail trade constitutes 13 percent of total GDP. Meanwhile, Indonesia's biggest industry in terms of GDP, manufacturing, used 7 percent of total financing from Islamic banks, but 25 percent of conventional loans from commercial banks.

Islamic banks need to close the gap with its conventional counterpart by **providing suitable construction industry-specific financing using specific contracts such as istisna (7 percent of total Islamic financing in 2014) and salam (0 percent of total 2014 financing).**

"

ISLAMIC BANKS NEED TO
CLOSE THE GAP WITH ITS
CONVENTIONAL COUNTERPART
BY PROVIDING SUITABLE CONSTRUCTION
INDUSTRY-SPECIFIC FINANCING

Corporate banking investment opportunities

The country is moving towards the acceleration and expansion of its economic development, driven by the government under its master plan 2011 – 2025 to create a so-called self-sufficient, advanced, just, and prosperous Indonesia.

Plans for economic development are underlined by Indonesia's abundant natural resources, demographic potential, and geographical location. Infrastructure is top of President Joko Widodo's list for development and with the country's desire to shift away from public and government dependence to private support and involvement, cooperation between the government and the private sector through Public-Private Partnerships (PPPs) is expected to drive new investments.

In terms of funding, financial services providers (mainly banks) are expected to play a major role in the country's next phase of economic development through providing funding solutions to different economic sectors.

ACCELERATION AND EXPANSION OF INDONESIA ECONOMIC DEVELOPMENT 2011 – 2025 MASTER PLAN

KEY ASPECTS		TARGETED ECONOMIES
Acceleration: To accelerate development of existing programmes that add value by using a new way of thinking	Expansion: To develop Indonesia's economy across the country equally	8 main programmes across 22 main economic activities

INDONESIA'S POTENTIAL

Potential	Human Resources and Population	Natural Resources	Geographical Location
Description	The country is one of the most populous in the world	Lots of renewable (agriculture products) and natural resouces (mining and minerals)	Access to Malaccan Strait, prime and active route for global shipping as well as proximity to fastest-growing economies globally
Corporate Needs	Talent development, creating jobs through new projects, significant domestic market	Mining, manufacturing, fishery, agriculture and energy	Improve ports, airports, and supportive infrastructure

Infrastructure development opportunities

The key priority that has been identified as an accelerator of economic growth in Indonesia is the development of infrastructure and the need for much greater private sector participation in the sector, including the need for new financing models.

Most infrastructure funding needs are beyond the budgets of local and central government. Key areas include water and sanitation, waste disposal and treatment, road and transportation network, and health and education.

Access to long-term funding provided by commercial banks and private investors is crucial, and with such limited government support due to a limited budget public funding will be prioritised for poorer provinces. The bigger and richer provinces already have better access to commercial funding avenues such as banks.

If the country's planned infrastructure projects are to succeed, Indonesia's banks need to increase their financing/loans to infrastructure projects. Currently, the proportion of infrastructure loans accounts for only 10 percent of conventional commercial banks' loans portfolio. However, given that most of the local and state-owned banks have assumed very cautious positions, **the government needs to regain banks' confidence in the market in order to improve overall appetite for different financing models, such as syndications and sukuk.**

Transportation and energy constitute 13 percent of Indonesia's GDP[10] and are the main infrastructure development drivers for the near- to mid-term. In addition to extensive plans to build new roads, airports, sea ports and railway networks, the government also wants to build new oil refineries and develop existing ones.

Islamic financing for transport and water, and gas and electricity make up only 9 percent of Islamic banks' financing portfolio. Infrastructure financing and loans will speed up with the new Asian Infrastructure Investment Bank (which is also studying use of sukuk) and in particular, Shariah-compliant financing for infrastructure will be given a boost if plans for an Islamic infrastructure bank, to be set up by Indonesia, Turkey and the Islamic Development Bank, come to fruition.

ASEAN opportunities

The ten member states of ASEAN offer untapped and considerable opportunities for corporations.

One of ASEAN's goals is the creation of a single common regional market with a single production base and equitable economic development. A financial integration framework for banking, insurance and capital markets is being developed in order to give greater market access, and this framework offers flexibility to qualified banks in order to facilitate intra-ASEAN investment and trade for corporate clients. This in turn will offer improved financing services that cover infrastructure and will boost economic development.

In addition, other frameworks are being implemented with the aim to ease trade, such as the Principles for Product Transparency and Disclosure on Cross-Border Trade Settlement and Trade in Services Framework Agreement on Services (ATISA).

The presence of banking franchises within ASEAN nations could ease the process of servicing trade finance and cash management for foreign and local corporations in Indonesia, which is pivotal for managing corporate customer relationships.

Banks need to find best practices in such areas as well as FX risk management as there is a growing number of companies that are expanding their ASEAN operations and which would need their working capital cycles to be managed effectively, or ensure improvements to their suppliers' experience or supply chain financing.

Indonesia stands out in ASEAN as a nation with rich national resources, important geographical location and vast consumer base; its share in terms of attracting intra-ASEAN FDI inflows was highest among the countries of the grouping — 55.2 percent for 2014.

A worker stands next to steel rods at a construction site of Kuningan City super block in Jakarta. REUTERS/Beawiharta

Indonesia has a huge potential out of the 10-member ASEAN to attract multinationals that want a foothold both in the country and regionally. The continued growth of ASEAN markets as well as supportive regulatory changes within the region offer new opportunities for these multinationals.

The expansion of Islamic finance (mainly Islamic banking services) within ASEAN nations is strongly backed by governments especially in Malaysia, Indonesia, Brunei, Thailand and Philippines and with the region's demand for infrastructure investment, which is estimated to be $60 billion per year until 2022, Islamic financing such as sukuk can play a crucial role and Islamic banks can fill arrangements for the substantial demand.

The need is also indicated by the World Economic Forum's Global Competitiveness Report 2014/15 which shows a disparity between infrastructure competitiveness ranking between six ASEAN major nations — Singapore ranks second followed by Malaysia (25th), Thailand (48th), Indonesia (56th), and Philippines (91st).

Regional financial integration that can support shared regional infrastructure efforts (represented by the Master Plan on ASEAN Connectivity (MPAC) endorsed by ASEAN leaders in 2010) can close this gap.

Apart from a focus on infrastructure, other sectors also present substantial opportunities in ASEAN. Agriculture, for example, drives manufacturing activities along with resource-based and higher value-added products sectors.

For Indonesia, agriculture is the third largest sector in 2014 contributing 13 percent to GDP, which follows manufacturing (21 percent) that also includes manufacturing of agro-based food, beverages and tobacco products on top of manufacturing chain (30 percent of Indonesia's total manufacturing GDP) in addition to other agro products such as wood products (3 percent of total manufacturing GDP), paper (4 percent) and leather (1 percent).

Agriculture also contributes 8 percent to Malaysia's GDP, and agro-based manufacturing such as food, wood, and tobacco account for 13 percent of total manufacturing production in Malaysia. With regard to financing in Malaysia, manufacturing (including agro-based) is the biggest recipient of corporate loans (18 percent) and also gains the most in terms of Islamic financing disbursed in Malaysia (11 percent). For other ASEAN nations, agriculture contributes 12 percent and 11 percent of GDP for Thailand and Philippines, respectively.

Agriculture is definitely an area that should be supported strongly by Islamic banks, especially with regard to financing trade, working capital and capital expenditure needs.

Foreign ownership

Corporate loans and financing dipped in 2014 as banks became more cautious largely due to the economic slowdown that was triggered by lagging domestic consumption due to inflation, and decline in exports as well as lower credit growth forecasts by the Indonesian authorities.

A handful of major local banks — including Bank BCA, Indonesia's biggest private lender, and state-owned BNI — shifted their focus to consumer and SME loans.

Credit growth was higher for foreign banks for certain sectors in 2014; these include construction and transportation. Foreign banks have the potential to play a much bigger role in corporate lending and financing given their smaller role in supporting the local retail business line. However, under a 2012 rule, a single foreign or domestic shareholder or corporate group can only own up to 40 percent of a bank in Indonesia; this was introduced amid calls by local politicians to ensure that such lenders are not captive to single interests, and to negative consequences.

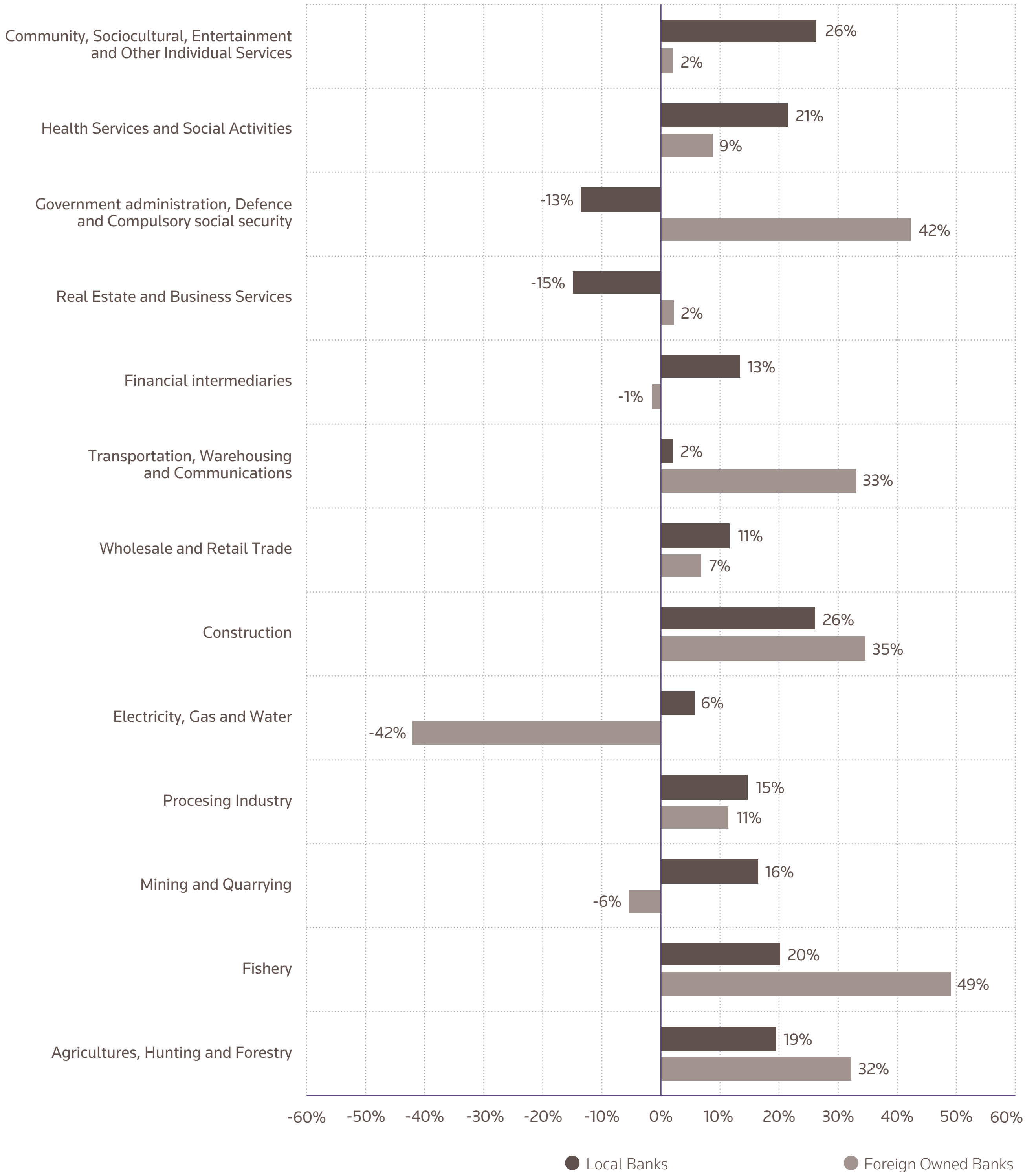
In addition, a new bill is being drafted to cap foreign ownership to 40 percent of an Indonesian bank (from 99 percent currently) which will affect Indonesian banks with more than 40 percent of foreign shareholding (or majority-owned by foreigners) in a grace period up to 10 years thus affecting foreign investment in Indonesia's banking sector.

Announcements in early- to mid-2015 suggest there may be an easing of foreign ownership rules for Islamic banks and some exceptions will be allowed if certain conditions are met. If such foreign ownership rules are eased, we may see Middle Eastern Islamic banks such as Al Baraka move into Indonesia and Dubai Islamic Bank increasing their shareholding in PT Bank Panin Syariah (DIB currently controls 24.9 percent since June 2014 and plans to increase its shareholding to 40 percent.)

“
CREDIT GROWTH WAS HIGHER FOR FOREIGN BANKS FOR CERTAIN SECTORS IN 2014; THESE INCLUDE CONSTRUCTION AND TRANSPORTATION.

Islamic banking has the potential to increase its contribution to corporate financing if foreign ownership rules are eased.

GROWTH OF CREDIT BY SECTOR (2014)



Source: Indonesian Banking Statistics December 2014, Bank Indonesia

Takaful

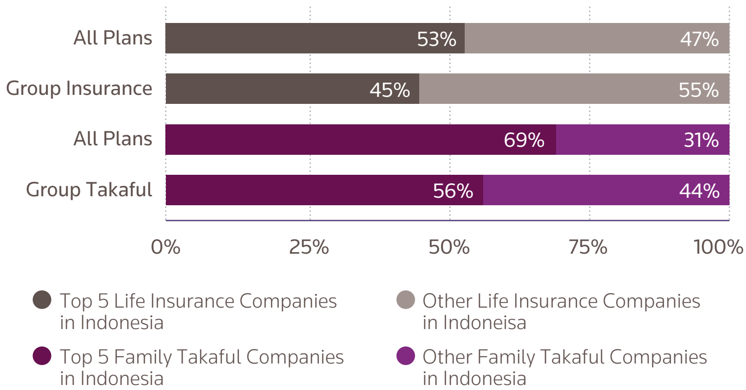
Business (corporate) insurance at a glance

Corporate-focused insurance more competitive than corporate-focused takaful

Indonesia's conventional group life sector is more competitive than the family takaful sector — the top five life insurance companies hold 45 percent of group sum insured while the top five family takaful operators hold a higher amount — 56 percent — of the family takaful industry's group sum insured. When compared to the concentration of sum insured for all plans, both life insurance and family takaful group business lines are less concentrated.

Similarly, general insurance and general takaful corporate lines are less concentrated in the hands of the top five or each of the conventional and Shariah-compliant sectors, when compared to premium income for all plans. However, the same trend persists — the takaful sector is less competitive than the conventional insurance sector in that the top five general insurance companies (out of 79 operators) hold 34 percent of all plans while the top five general takaful operators (out of 26 operators) hold double that — 65 percent of all plans.

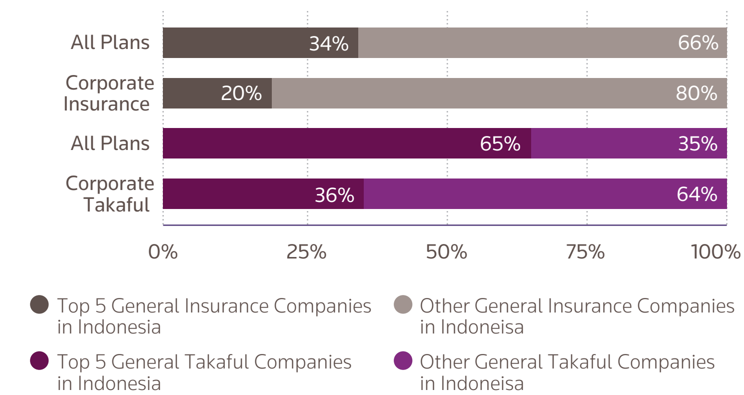
CONCENTRATION AND COMPETITIVENESS OF GROUP LIFE INSURANCE IN INDONESIA (SUM INSURED)



Source: Indonesia Financial Services Authority Insurance Statistics 2013

CONCENTRATION AND COMPETITIVENESS OF CORPORATE* GENERAL INSURANCE IN INDONESIA (PREMIUM INCOME)

* When it comes to business clients, group life insurance contracts are covered on a wholesale basis that is mostly offered to corporate clients to cover employees. As a result, group contract is deemed suitable as an indicator for corporate business line within life insurance industry for the purpose of this chapter. Meanwhile, corporate insurance business lines for general insurance and takaful use products introduced for business or corporate clients which are property, marine cargo and hull, credit and suretybond, engineering, liability, energy offshore and onshore, aviation and satellite. Motor vehicles along with personal accident and life insurance offered by general operators are considered for this report individual focused despite having group contract offerings, so they are covered in the retail insurance chapter.



Source: Indonesia Financial Services Authority Insurance Statistics 2013

Life insurance

Takaful operators need competitive advantage in order to attract group policies

Term insurance is the cash cow for both conventional and Shariah-compliant insurance in terms of both sum insured and number of policies. However, term insurance grew at 47 percent in 2013 while term takaful did not achieve any growth.

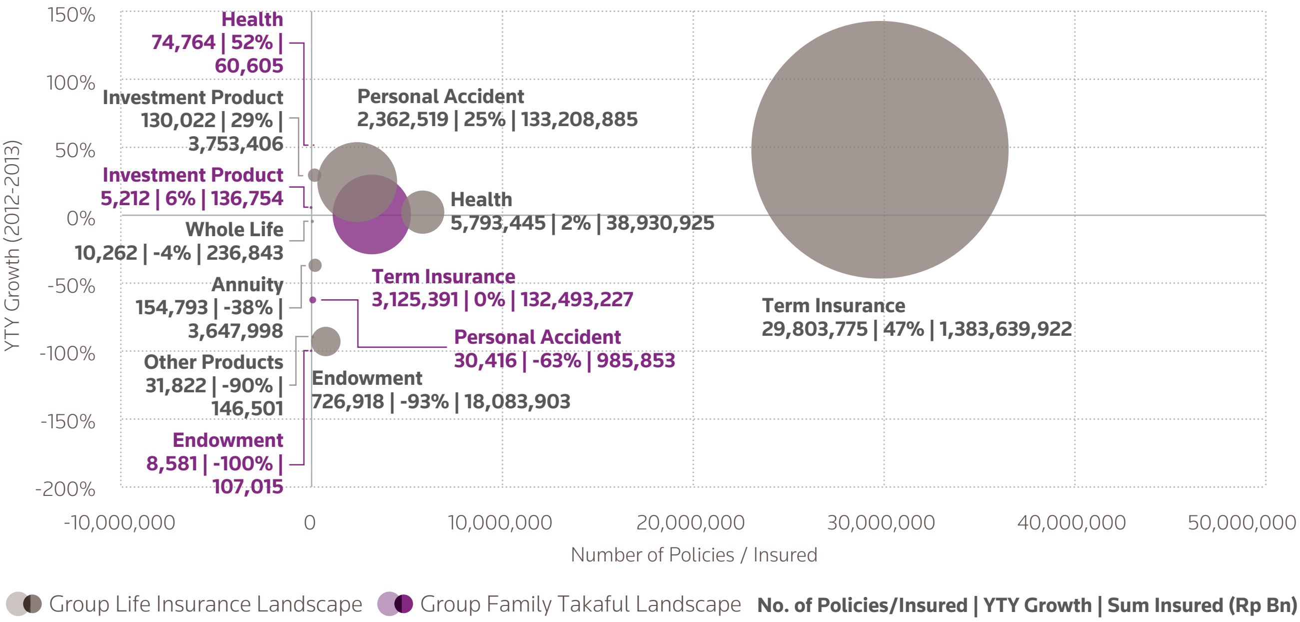
The gap between the growth of term products for insurance and takaful points to **the requirement for takaful operators to target corporations heavily in terms of group takaful by offering greater benefits and customised sum covered arrangements to be invested in a Shariah-compliant manner for employees, as well as additional coverage and competitive fees.** This would require better marketing and awareness especially as term insurance is the biggest earner for both insurance and takaful.

For the group health insurance business line, the sum insured for takaful grew at a faster pace (52 percent) than conventional life insurance (2 percent). Meanwhile, personal accident takaful plunged by 63 percent compared to growth of the conventional sector of 25 percent from 2012 to 2013. This plunge was due to a drop in sum insured for national private life operators while joint venture life operators such as PT Asuransi AIA Indonesia witnessed an increase, which, however, was not enough to offset the drop for national operators. Both life and non-life operators compete for health and personal accident policies, but life remains dominant. For personal accident, **takaful operators need to create custom Shariah-compliant personal accident coverage for corporations or groups, especially for hajj and umrah committees or groups.**

Investment products are less popular for group insurance and takaful than they are for individual contracts. Conventional investment products are growing faster than those in the Shariah-compliant sectors.

GROUP LIFE INSURANCE AND FAMILY TAKAFUL LANDSCAPE

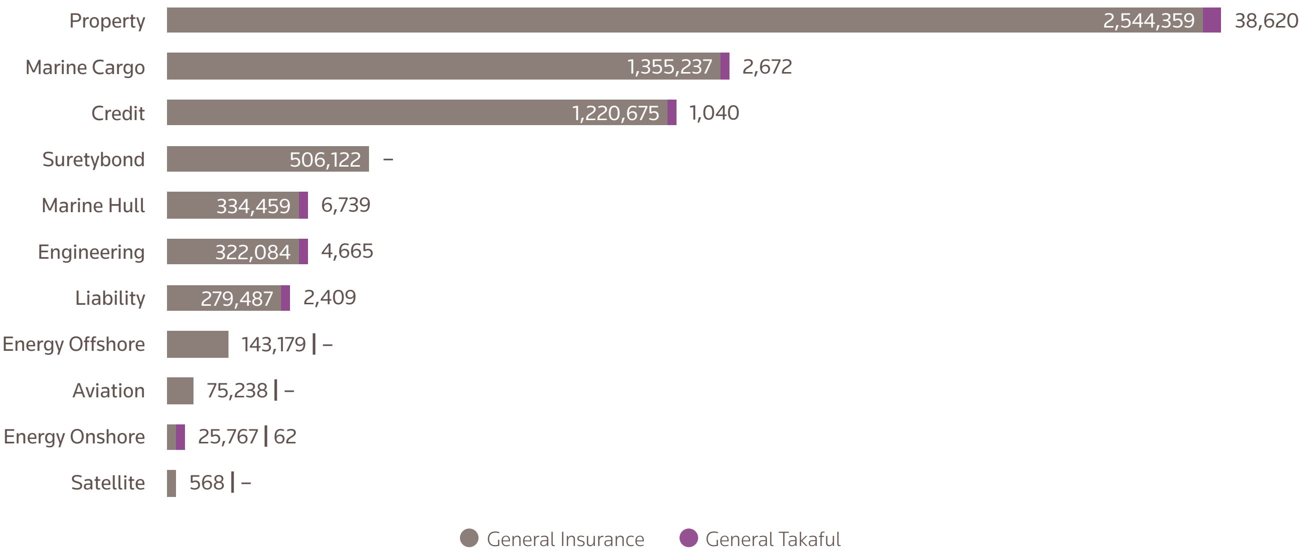
*Other Products include Pension Annuity. Portfolio as of Dec 31, 2013 & 2012



Source: Indonesia Financial Services Authority Insurance Statistics 2013

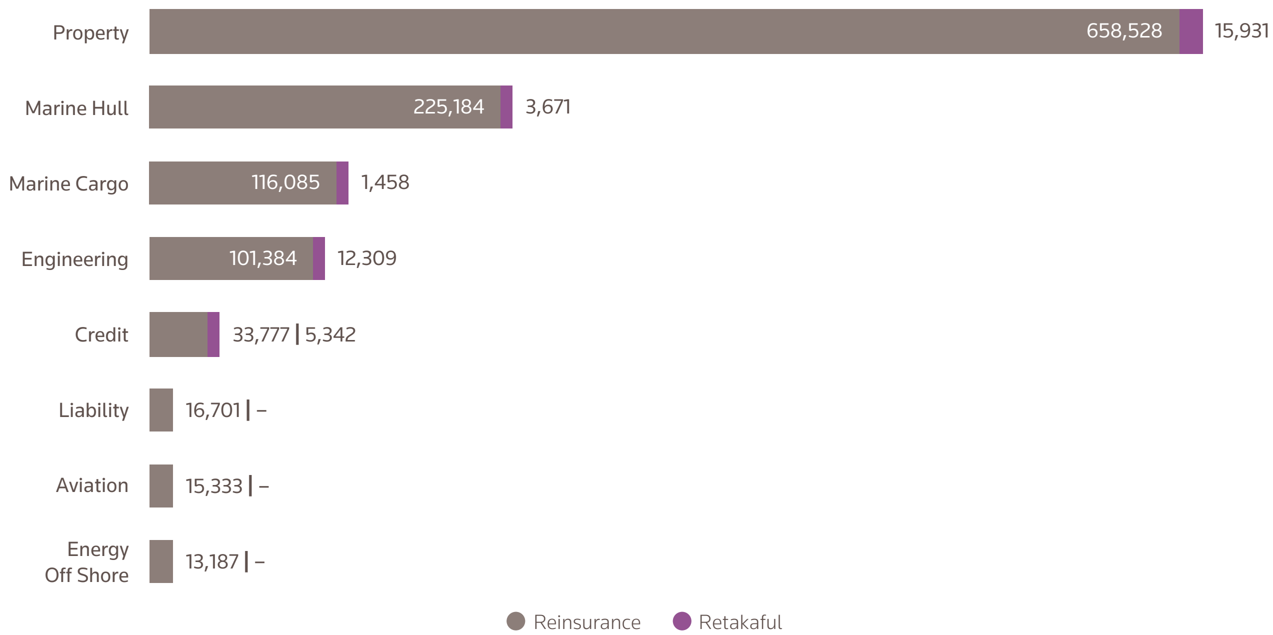
General insurance and reinsurance

CORPORATE GENERAL INSURANCE BUSINESS LINES (PREMIUM/ CONTRIBUTION INCOME) IN RP BILLION



Data as of Dec 31, 2013 & 2012
Source: Indonesia Financial Services Authority Insurance Statistics 2013

CORPORATE REINSURANCE BUSINESS LINES 2013 (PREMIUM/ CONTRIBUTION INCOME) IN RP BILLION



Data as of Dec 31, 2013
Source: Indonesia Financial Services Authority Insurance Statistics 2013

General takaful plays a small part in Indonesia's general insurance industry despite better growth than general insurance, and retakaful needs to extend its capacity locally

Property insurance attracts the highest premium/contribution income for both general insurance and takaful. Property is followed by marine cargo for the conventional insurance sector (with total premium income of Rp 1,355, 237 billion) and marine hull for takaful (Rp 6,739 billion in contribution income); the marine hull sector was takaful's biggest growth area in 2013 while credit insurance was conventional insurance's biggest growth sector.

With the introduction of a new property insurance tariff in 2014 underwriting practices by non-life operators will be stabilised through determining floor and ceiling pricing thus sustaining a healthier competition and eliminating severe under-cutting/under-pricing (Indonesia's general insurance market is crowded and highly competitive so under-cutting and discounts can go up to 50 percent) or overpricing. **Takaful operators could benefit from such controlled tariffs.**

IDX Director of Surveillance and Compliance Hamdi Hassyarbaini stands in front of an electronic board showing stock information at the Indonesia Stock Exchange (IDX) in Jakarta. REUTERS/ Nyimas Laula

Business insurance investment opportunities, especially in infrastructure

The Indonesian insurance sector has plenty of growth opportunities supported by the current economic climate driven by the government to spur economic development through infrastructure enhancement.

The insurance and takaful sector in Indonesia is evolving in terms of regulations; the newly-introduced law calling for a phase-out of Shariah-compliant takaful window operations in favour of full-fledged takaful companies is likely to trigger mergers and acquisitions in the market and hence new entrants to the market are expected.

As funding is required by private banks to support the development of infrastructure, the higher risks of such projects need to be insured under commercial contracts, which opens the door for the private sector. **Attractive pricing and corporate (business) product offerings are also in demand in anticipation of premiums to the local market rather than seeking foreign protection.**

New products are needed to help with the growth of the economy and this could be another opportunity for foreign expertise and market consultants to join the market.

Attractive reinsurance market and micro-insurance business potential

In the reinsurance sector, property is the largest contributor for both reinsurance and retakaful.

The local insurance market is covered by five reinsurers, three of which have Shariah windows. By law, insurance companies need to obtain automatic reinsurance for each business line they market. However, retakaful capacity remains constrained in Indonesia and the Financial Services Authority OJK differs with the Shariah scholars on Majelis Ulama Indonesia (MUI) in terms of shifting risk priorities; OJK gives priority to onshore reinsurance (including conventional) if local retakaful is unavailable or insufficient while the Majelis Ulama Indonesia prefers that such risk is ceded regionally to other retakaful operators mainly through Malaysia's Labuan (which is an offshore financial centre), especially for higher risk corporate business lines.

The new rule that requires underwriters with proportional reinsurance treaties to secure natural catastrophes excess-of-loss programmes from 2013 will further encourage **demand for reinsurance capacity.** Hence there are even **more opportunities to enter the reinsurance market to serve the high-risk and high-income business lines** that will boost the insurance market share in the financial services industry.

In Indonesia, the retakaful operators are windows of conventional reinsurance companies and hence would have to be spun off as standalone companies under new guidelines. We could be seeing **new joint ventures with local conventional insurance companies, while foreign retakaful companies could also emerge, thus stiffening the competition.**

Micro-insurance and micro-takaful is another huge growth opportunity for Indonesia considering its vast rural population. Micro-takaful and insurance companies could open up new lines in Indonesia in partnership with rural banks and other companies such as technology and alternative distribution channels.

> "FUTURE GROWTH [FOR HEALTH INSURANCE] WILL COME FROM THE GROWING MIDDLE-CLASS AND INCREASING NUMBER OF THE YOUNG WORKING POPULATION WHO WILL BE NEEDING HEALTH INSURANCE.

Healthcare and pharmaceutical opportunities will drive group health insurance

The year-to-year growth of group health takaful in Indonesia measured by the sum insured reached 52 percent by the end of 2014; this growth is substantial compared to the 2 percent growth in the conventional space.

Future growth will come from the growing middle-class and increasing number of the young working population who will be needing health insurance. These growing healthcare premiums/contributions will drive demand for premium pharmaceuticals in Indonesia.

The government's plans for a national health insurance (NHI) system (the plan came into effect in 2014) which aims to provide health insurance protection to all citizens by 2019 will mostly capture the middle class bracket with limited pharmaceutical packages. More affluent Indonesians will opt for private healthcare that offers a wider healthcare and pharmaceutical coverage.

We anticipate that the insurance **sector will drive new investment opportunities through multinational pharmaceutical companies, by investing in local facilities or establishing local collaborations.** We also anticipate growing demand from insured Indonesians for higher quality care and more sophisticated therapies with innovative drugs and medicines. This will have an effect primarily on group (business) insurance that cover employees under private healthcare.

Distribution channels opportunities

Indonesia's insurance sector is supported by 163 licensed insurance brokers as well as 31 reinsurance brokers, which are the driving forces for attracting the country's corporate consumer base for insurance.

Retail consumers are more driven by bancassurance than through brokerage. Six more insurance brokers were granted licenses along with four reinsurance brokers, reflecting the potential higher demand for insurance brokerage services in Indonesia.

Many of these brokers are specialised and some dominate insurance brokerage markets in certain corporate sectors such as oil and gas, marine hull, employee benefits and commercial property. As a result of specialisation, the insurance brokerage market witnessed some acquisitions.

Insurance brokerage in Indonesia enjoyed a 215.93 percent growth to reach Rp 34.310 trillion in brokerage gross premiums and 315.97 percent growth to reach Rp 4.950 trillion in commissions in 2013 from 2012. Investment opportunities are considerable for brokerage companies that can focus on certain sectors or products.

For corporate insurance, **insurance agents also play a significant role especially for group life insurance** which dominates products that are not unit-linked.

The number of life insurance agents is expected to reach 500,000 by the end of 2015. A statement by the Chairman of the Indonesian Life Insurance Association (AAJI) stressed that no agent has ever had his or her license revoked. Such a positive outlook comes from an observation that many insurance companies want to hire more agents and that OJK is asking industry stakeholders to improve distribution of agent training materials using the internet and reduce the cost of agent certification while maintaining consumer protection.

Additionally, with the introduction of the new 2014 Insurance Law, consumers can pay their premiums or contributions to their agents if approved by an insurance company and the insurance policy will be effective from the date the premium/contribution is received by the agent (who should be registered with OJK) and not premium/contribution received by the insurance company. Thus, the agency role is further stressed and underlined.

Sukuk

Corporate sukuk at a glance

Big players dominate the corporate sukuk market

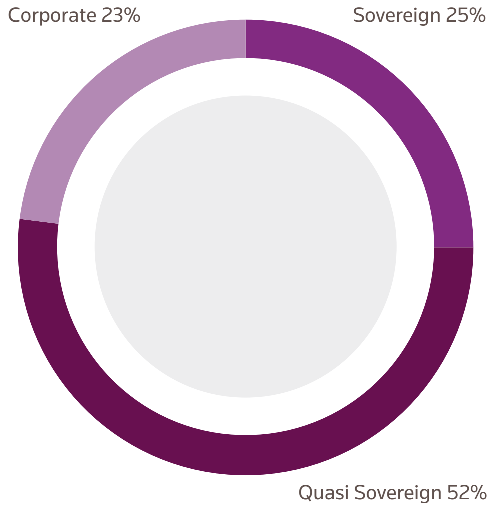
Indonesia's corporate sukuk market is relatively small comprising about a quarter of the country's total sukuk market as of December 2014.

Quasi sovereign issues make up the biggest market at 52 percent. The corporate sukuk market remains domestically-focused with all sukuk issued in the local currency. The only international corporate sukuk to date was the one issued in May 2015 by the national airlines Garuda.

By sukuk structures, corporate issuers mainly use ijara and mudaraba, as approved by the National Shariah Board. At the end of 2014, 60 percent of all corporate sukuk used ijara.

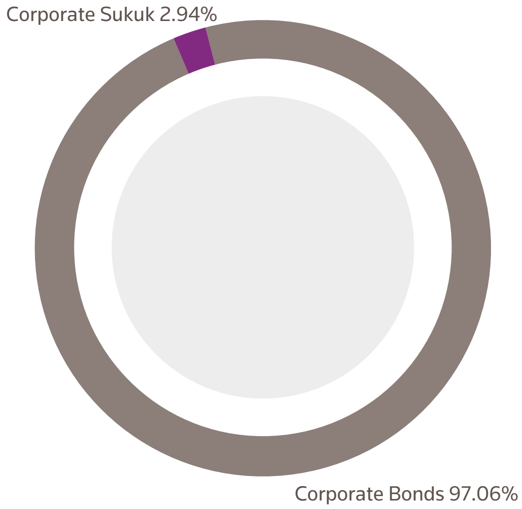
The Indonesian corporate bonds market started in 1989 at a time when sukuk had still not been used by any Islamic finance market. The first sukuk issued out of Indonesia was a corporate sukuk from the telco Indosat, which is a regular issuer of both bonds and sukuk.

SUKUK VALUE BY TYPE OF ISSUER DEC 2014



Source: Thomson Reuters Eikon

CORPORATE SUKUK AND BONDS BY VALUE DEC 2014



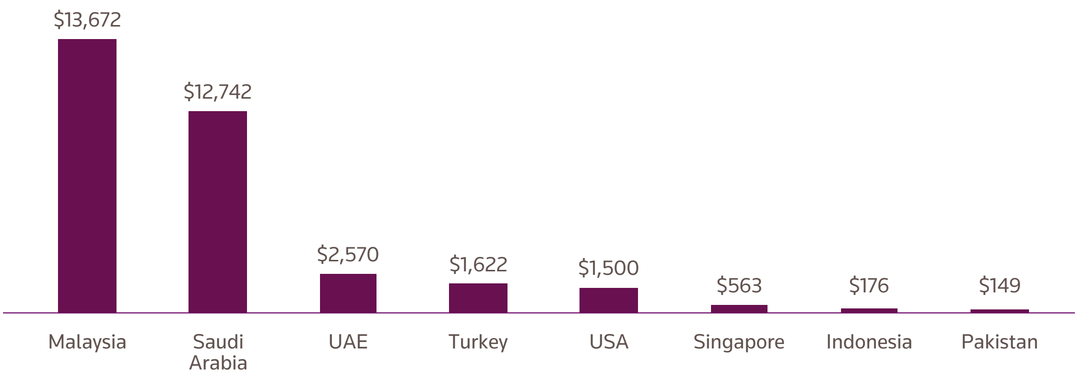
Source: Thomson Reuters Eikon

The Indonesian corporate sukuk market makes up less than 1 percent of the value of the global corporate sukuk market. Malaysia and Saudi Arabia combined hold about 80 percent of the global corporate sukuk market, with issuances amounting to over $26 billion.

Indonesia's corporate sukuk market is dominated by three big players, namely energy company PLN, Bank Muamalat, and Indosat. The three combined hold 54 percent market share, equivalent to RP 5,206 billion.

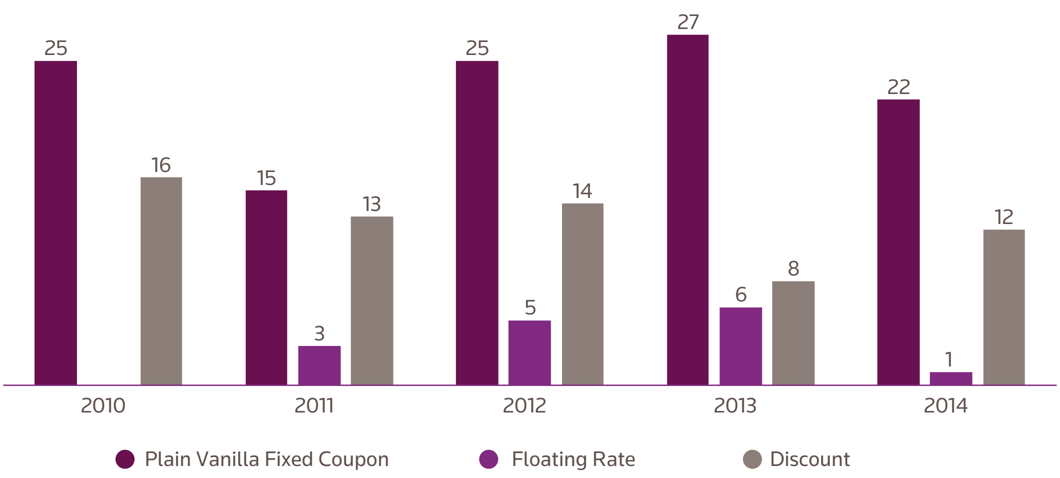
Most corporate sukuk are priced on the basis of discounting, a pricing method which has been consistent over the years. Plain vanilla, considered the simplest form of sukuk, is also common in the country. Floating rate gained some momentum in 2012 and 2013 when interest rates were a bit unstable, but with stabilising interest rates, the market has seen fewer floating sukuk.

TOP CORPORATE SUKUK ISSUERS IN 2014 (AMOUNT IN US$ BN)



Source: Thomson Reuters Zawya

NUMBER OF SUKUK IN INDONESIA BY COUPON TYPE 2010–2014



Source: Thomson Reuters Zawya

Corporate sukuk investment opportunities

Room for growth especially in transportation, oil & gas, and construction sectors

There is much room for growth in Indonesia's corporate sukuk space because many companies need funding. Sukuk works well generally for the transportation sector, particularly for the aviation sector given the match between the long-term nature of its assets with a regular income stream from passenger traffic.

Garuda Airline was the first sukuk issuer from Indonesia's aviation sector as well as the first corporate in Indonesia to tap the international market. The airline's $500 million 5-year sukuk sale came in May 2015, and was priced at 6.25 percent. The company said the proceeds will be used to finance some of its existing debts. The offering was structured as a wakala sukuk based on rights to travel using an orphan-based SPV.

Oil and gas companies can also benefit from sukuk; the structure that is typically suitable for these companies is istisna which has often been used in Malaysia by its oil and gas companies.

Other sectors, such as construction, can capitalise on the forward ijara structure which enables investors to undertake payment during the construction period, while the obligor payments start within a specific period after completion. This could benefit the issuer until the project is completed. Although forward sales are impermissible under Shariah, forward contracting through ijara is allowed provided that the rent amount is paid only after delivery of the underlying asset. There have been neither sukuk nor conventional bond coming out of Indonesia's construction industry to date.

Infrastructure development is another area that the Indonesian government has been putting emphasis on; mainly to improve and ensure its infrastructure development is in line with international standards. International standards imply that infrastructure development should be equivalent to 5 percent of the country's GDP and by the end of 2015, Indonesia's infrastructure stood at 2 percent of its GDP. In order to meet this standard, the Ministry of National Development Planning in the country, also known as Bappenas, has reported projects worth of IDR 6,541 trillion (Approx US$ 485 billion) in the next 5 years, which constitute improvement in a number of sectors, mainly roads, water & sewage, and electricity.

Sukuk by far remains a better option to finance infrastructure projects, given its nature and characteristics but until now the issuances globally have been confined mostly to issuing mid-sized deals with shorter tenors. However, sukuk investors' appetite is now shifting to prefer longer maturities given the limited sukuk supply in the Islamic capital markets. Historically, Jeddah-based Islamic Development Bank and Malaysia have been at the forefront of issuing sukuk to fund infrastructure projects. Indonesia also has huge a potential to capitalize on the demand for sukuk from Shariah compliant investors to finance some of its infrastructure projects.

Asset Management

Institutional funds at a glance

Promising days ahead

The Islamic asset management market in Indonesia comprises solely of mutual funds. Unlike other Islamic markets, the Indonesian market has a high concentration of institutional investors, and only a small portion of funds is contributed by retail investors. According to the professional body Asosiasi Pengelola Reksa Dana Indonesia (APRDI), or the Mutual Funds Association of Indonesia, the total number of investors in mutual funds (both Islamic and conventional) is 240,000.

The stock market drives the fund industry in Indonesia as most investors will invest their capital in equities. However, the Indonesian corporate market is still fragile, although slowly recovering, following the Asian financial crisis in 1997, and more recently the collapse and exit of many foreign investors amid valuations that started to appear more expensive owing to the weaker macroeconomic climate and volatility which forced capital outflow.

Lack of diversification

Most portfolios lack diversification due to market conditions. The biggest fund manager in Indonesia, Schroders, invests 90 percent of its portfolio in equities, according to its fact sheet as of May 2015.

Another leading asset management company, Panin, also invests mainly in equities, which at times have reached as high as 95 percent of its portfolio. Panin attracts mainly institutional investors. Other asset classes, such as money market and bonds, are offered but they are not as attractive as equities. Real Estate Investment Trusts (REITs) are overlooked and almost non-existent, while Exchange traded funds (ETF) are still very new to the market.

Performance bouncing back

Indonesia's performance in 2014 improved significantly from 2013. The average performance of the four asset classes — sukuk, equity, mixed assets, and money market — was 12.2 percent in 2014, a significant boost from -22.4 percent in 2013, which was Indonesia's poorest performance since 2008 at the height of the global financial crisis.

Equity performed the best in 2014 at 20.5 percent, from -24 percent the year before. Mixed assets and money market also performed well at 14.1 percent and 5.6 percent, respectively. Of the four asset classes, sukuk had the worst performance in 2014 at 3.6 percent from -19.1 percent in 2013.

There is a renewed drive in the Islamic space, with the country hitting the accelerator pedal to widen and deepen its Islamic finance industry and in its pipeline is a mega Islamic bank as well as revisions to takaful, retakaful, Islamic pension funds, and pilgrimage funds. The new government has also ramped up infrastructure spending and hopes to introduce more underlying assets to boost sukuk volumes that would be needed to part-finance the state's budget deficit.

INDONESIA ISLAMIC FUNDS AVERAGE CUMULATIVE PERFORMANCE BY TYPE

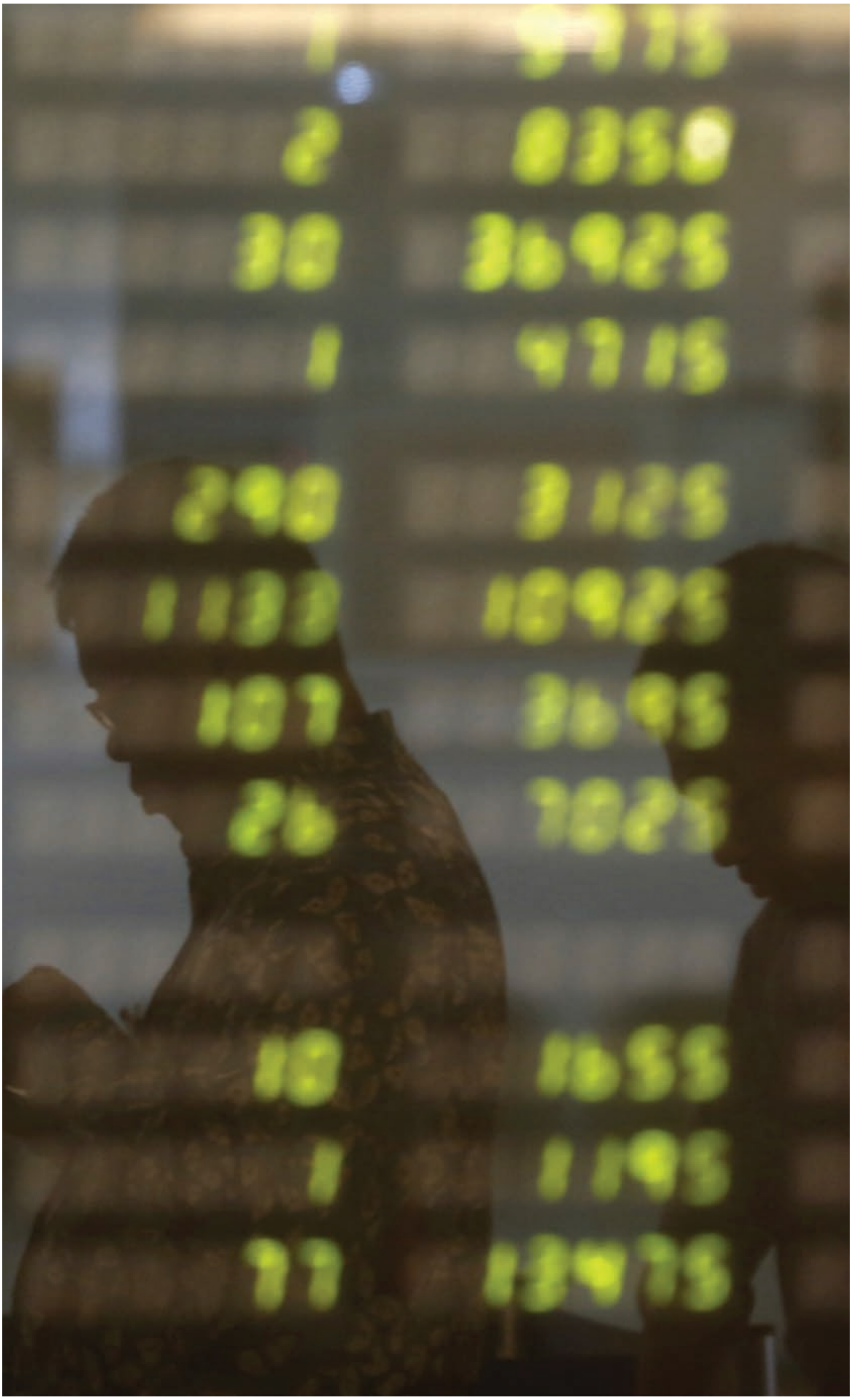
Source: Thomson Reuters Lipper.

Regulatory environment

Regulations could be more flexible for Indonesia's mutual fund industry. Current regulations do not allow a foreign asset management company to just sell funds locally, but instead it has to establish a local branch as a standalone company in order to sell.

Another challenge is that no more than 15 percent of the net asset value (NAV) sold in the country can actually be invested in stocks traded on an offshore stock exchange, except for government debts and securities issued abroad for the advantage of Indonesian corporates.

> "THERE IS A RENEWED DRIVE IN THE ISLAMIC SPACE, WITH THE COUNTRY HITTING THE ACCELERATOR PEDAL TO WIDEN AND DEEPEN ITS ISLAMIC FINANCE INDUSTRY AND IN ITS PIPELINE IS A MEGA ISLAMIC BANK AS WELL AS REVISIONS TO TAKAFUL, RETAKAFUL, ISLAMIC PENSION FUNDS, AND PILGRIMAGE FUNDS.



> People stand near an electronic board showing the stock market index at the Bank Mandiri Sekuritas trading floor in Jakarta. REUTERS/ Beawiharta

Institutional funds investment opportunities

Islamic Pension Funds in the development phase

Islamic pension funds is an area where the government has shown great interest to develop, thanks to the demand from corporates looking to invest in Shariah-compliant products for their employees' retirement funds.

The Financial Services Authority (OJK) reported 266 pension funds, which are all conventional. The only investor base that can develop Islamic pension funds would be the Islamic institutional investors as they are more Shariah-sensitive compared to the low-income population that privilege economic returns over religious considerations.

It will be some time before there will be an Islamic pensions sector to speak of for Indonesia but prospects are looking good — in November, 2013, the OJK and National Shariah Council started discussions related to the formulation of fatwa and regulation for Islamic pension funds.

Innovation through Islamic Venture Capital

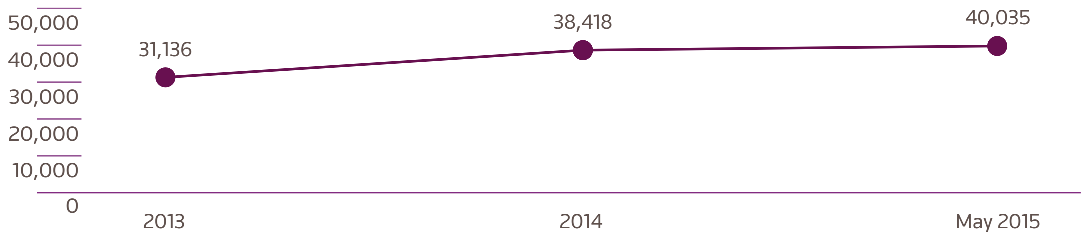
Venture capital in Indonesia is immature with only four full-fledged companies and one Shariah-compliant window with very minimal activities.

The root causes for the significantly slow development comes down to 1) lack of players and 2) insufficient regulation to spur development and attract more players.

However, the OJK is aware of the issues that are obstructing growth and OJK officials said in an exclusive interview with Thomson Reuters that they are in the process of reviving venture capital role to boost start-ups.

The OJK can capitalise on venture capital to bring new innovative ideas to the market through empowering entrepreneurs to turn their ideas into products and services. The biggest and most successful companies globally such as Apple, Amazon, Google, and Microsoft were all founded with venture capital. While these companies may not necessarily be dedicated to Islamic finance, it gives an indication of the opportunities in venture capital.

THE DEVELOPMENT OF ISLAMIC VENTURE CAPITAL IN INDONESIA (IN RP BN)



Source: OJK

6 Islamic Economy Impact Investment

Cranes are seen over a construction site for office and residential buildings in central Jakarta. REUTERS/ Darren Whiteside

INSIDE THIS CHAPTER

Major Industries and Sectors

GDP contribution by Industrial Origin

Indonesia's GDP growth rate averaged 5.35 percent from 2011 until 2015 with slowest growth registered in 2015 at 4.79 percent (Rp 8,977 trillion) after reaching 5.02 percent in 2014.

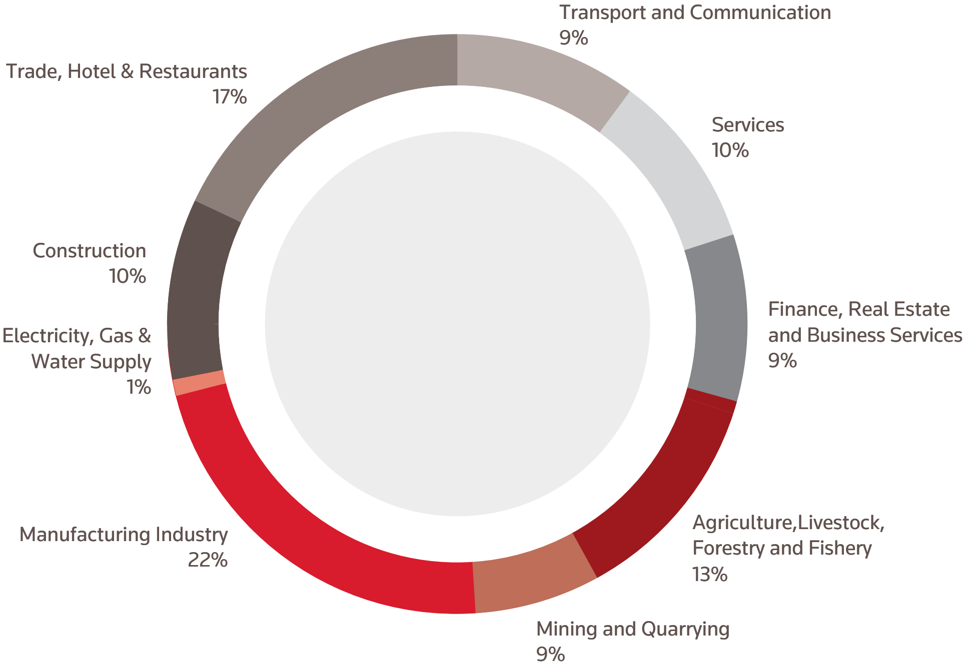
The economy is dependent on three major industries that constitute more than 50 percent of total contribution to GDP: manufacturing (22 percent), trade, hotel and restaurants (17 percent), and agriculture, livestock, forestry and fishery (13 percent).

The agriculture sector's contribution to GDP has been falling since 2004 and the economy is shifting away from the primary agriculture sector to become a more balanced economy that is less dependent on agriculture with an increasing share of the manufacturing industry followed by the services sector, particularly trade, hotel and restaurants.

	1965	1980	1996	2010
Agriculture (% of GDP)	51	24	16	15
Industry (% of GDP)	13	42	43	47
Services (% of GDP)	36	34	41	38

GDP CONTRIBUTION BY INDUSTRIAL ORIGIN 2015*

* Preliminary figures – Based on constant market prices

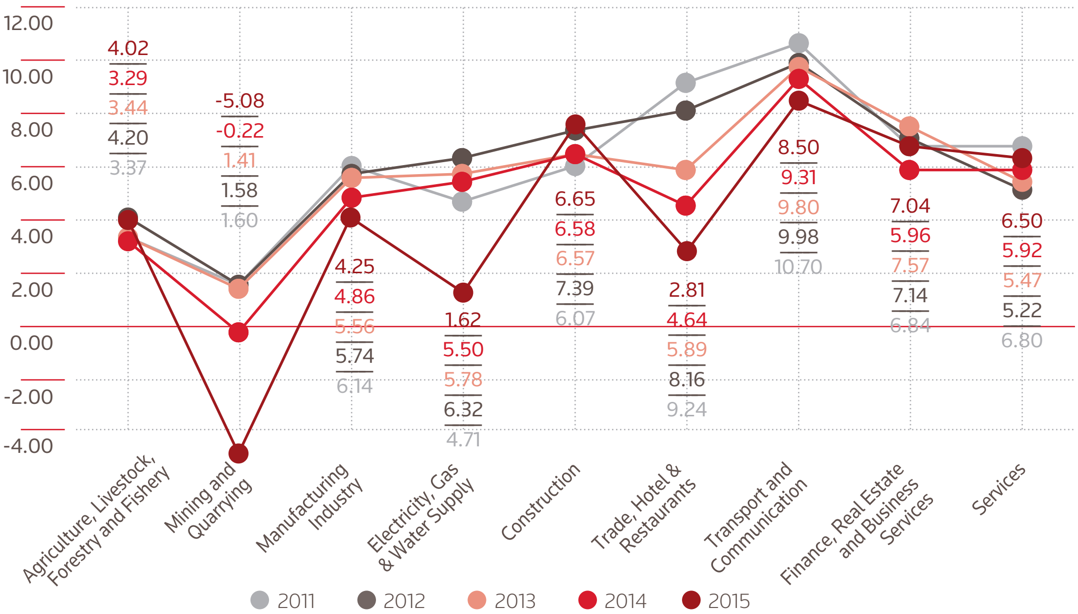


Source: BPS-Statistics Indonesia

Workers make clothes in a factory at Cakung, a small industrial settlement in Jakarta. REUTERS/Beawiharta

GDP GROWTH RATE 2011 – 2015 (BASED ON CONSTANT MARKET PRICES)

* Very preliminary figures – Based on constant market prices



Source: BPS-Statistics Indonesia

MAJOR INDUSTRIES THAT CONTRIBUTED TO GDP IN 2015

INDONESIA GDP 2015

(Based on constant market prices)

Rp 8,976,932 billion

MAJOR INDUSTRIES

Manufacturing (22%)	Trade, Hotel & Restaurants (17%)	Agriculture, Livestock, Forestry and Fishery (13%)

SECTORS

Manufacturing	Trade, Hotel & Restaurants	Agriculture, Livestock, Forestry and Fishery
a. Oil and Gas Manufacturing b. Non-Oil & Gas Manufacturing	a. Wholesale & Retail Trade b. Hotels c. Restaurants	a. Food Crops b. Estate Crops c. Livestock and its Products d. Forestry e. Fishery

The manufacturing industry: star performer

Manufacturing contributed 22 percent to GDP in 2015. Indonesia's manufacturing industry is open to foreign investors, who can own 100 percent in most manufacturing sectors excluding small and medium enterprises (SMEs).

Java continues to attract the strongest flow of investments as 70 percent of Indonesia's estates are located there. West Java, specifically around Jakarta, is facing an increase in land and labour costs, which is decelerating the country's competitiveness in attracting manufacturing investments.

In response, the Indonesian government announced in July 2014 its plan to establish 36 new industrial hubs over 20 years in areas other than Java. With this, the Republic is aiming to increase the number of manufacturers operating outside Java to 40 percent by 2025.

Manufacturing is led by the non-oil and gas sectors, which represent 89 percent of total manufacturing contribution to GDP in 2015. The non-oil and gas manufacturing sector is controlled by five main sub-industries: Food, Beverages and Tobacco (32 percent), Basic Metals, Chemicals, Rubber and Non-Metallic Material Products (20 percent), Transport Equipment, Machinery and Apparatus (12 percent), Textile, Leather Products and Footwear (7 percent) and Wood, Paper and Furniture (8 percent).

Indonesia's agriculture industry: A station for potential investors

Indonesia's agriculture industry remains large and contributed 13 percent to the country's GDP in 2015. The industry is classified into food crops (24 percent), horticultural and plantation crops (42 percent), livestock and its products (12 percent), forestry (5 percent) and fishery (17 percent).

The growth of the agriculture industry has been backed by technological advances that have increased the country's agriculture productivity level. The Ministry of Agriculture has 11 research and development centres that focus on managing research on various agricultural commodities.

The country is home to vast fertile lands that enable it to produce a wide variety of agricultural commodities including rice, corn and soybeans.

The Indonesian government is advancing a policy of self-sufficiency with regard to certain products such as rice and beef which are top-ranked commodities on the agenda. This policy has led to the imposition of import quotas which have pushed up local prices. All eyes remain on the inflation rate, which is likely to exacerbate if prices continue to climb.

In order to keep resources in the country and provide local industries with sufficient raw materials import quotas are balanced out with export tariffs and plans to enhance agriculture production capabilities.

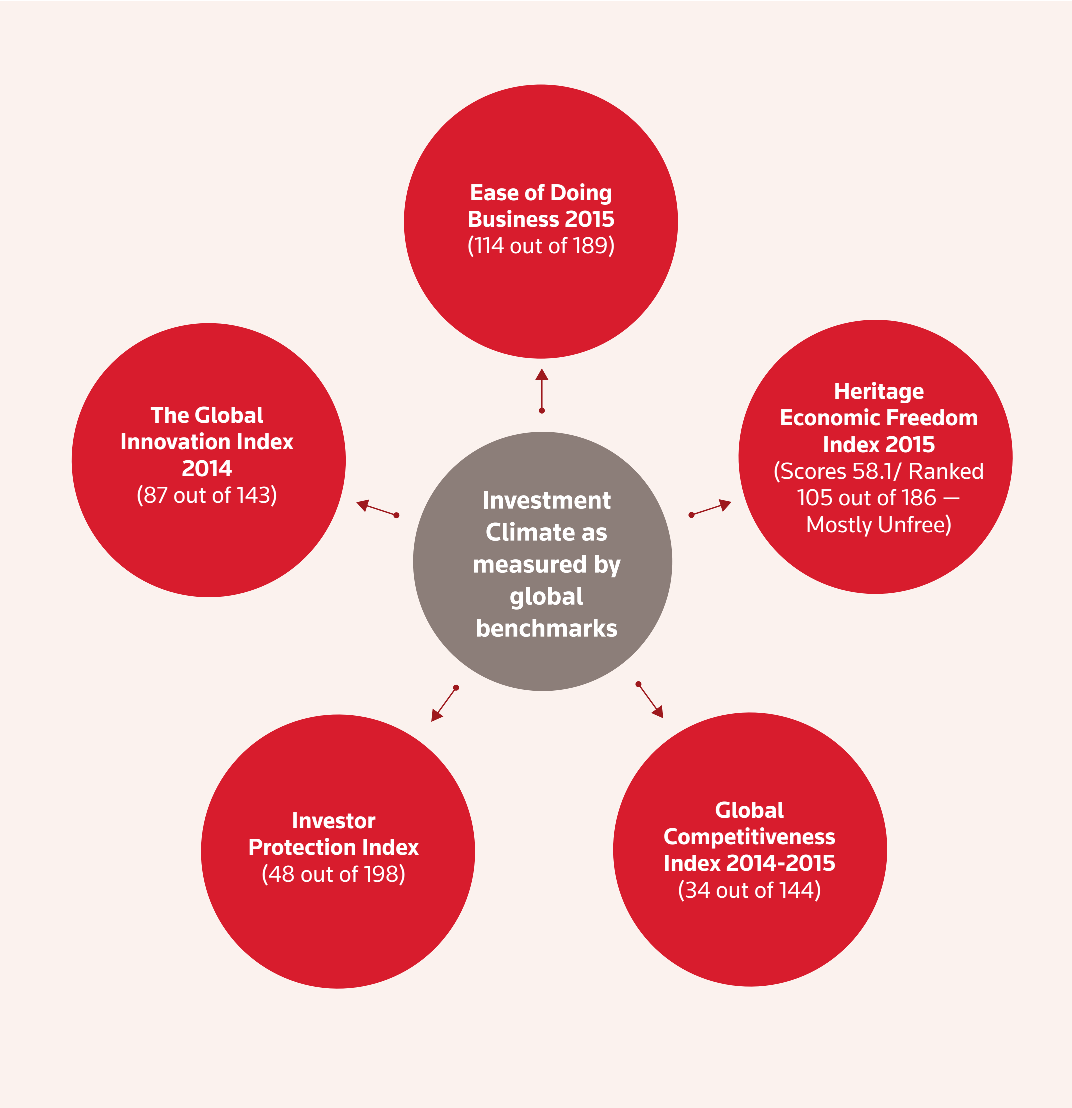
In early 2015, the government announced its aim to achieve rice self-sufficiency and stop all imports within three years. This could push up local investment in domestic farming.

A worker holds harvested chillies at a chilli plantation in Pasir Datar Indah village near Sukabumi, Indonesia's West Java province. REUTERS/ Beawiharta

Investment Climate

Indonesia has a growing middle class, rich natural resources, expanding internal market and attractive location in Southeast Asia. All these factors position the country as a lucrative investment destination for potential investors. However, Indonesia was hit hard by the Asian financial crisis of 1997 – 1998 when economic and political turmoil in turn negatively affected economic activity, including investments, and the country still lags behind its regional peers in attracting investments.

INVESTMENT CLIMATE INDICATORS MEASURED BY GLOBAL BENCHMARKS



Customers are seen at a counter inside the Bank Indonesia complex in Jakarta, Indonesia. REUTERS/Darren Whiteside

Improvements to boost investment

Reducing bureaucracy and streamlining investment process:

In early 2015 Indonesia launched a one-stop shop for completing investment licensing procedures that simplified the process for starting an investment in the country.

Human capital development:

In line with the new wave of growing middle class consumers which has increased purchasing and consumption power, the retail market especially in food, beverages and financial services are flourishing. To better harness this growth the Republic should boost the productivity of front-line channels through enhancing the quality of customer services and providing easier access to consumer products and services by improving the ICT infrastructure.

To enhance customer services and to cope with rapid urbanisation, the country will need to invest heavily in human capital in order to upgrade skills and build sustainable markets. Access to education has been improved and the next focus areas should be the quality of education and the availability of more training centres.

There are also still insufficient investment levels in R&D and more needs to be pumped in if Indonesia is serious about developing its human capital. Indonesia's 2015 allocation to R&D was $3 billion, or 0.2 percent of its GDP, while much smaller neighbour Singapore has a much higher allocation of $9 billion, or 2.7 percent, of its GDP, according to Battelle's 2014 Global R&D Funding Forecast.

Disaster risk management:

Indonesia is prone to different natural disasters, which have in the past disrupted investments. Apart from the National Risk Management Plan 2011 – 2014 and disaster management law, Indonesia should have a comprehensive framework for risk financing and effective systems for the management of post-disaster activities.

Islamic Economy Focus

The global Muslim population is approximately 1.65 billion and Indonesia is the country with the largest number of Muslims in the world: totalling approximately 202.9 million (87.2% of the total population)[11].

Indonesia currently ranks 10th on the 2015 – 2016 Global Islamic Economy Indicator, which is published annually by Thomson Reuters. The Republic lags behind even the frontier markets in the Islamic Economy, such as Oman (6th) and Jordan (9th).

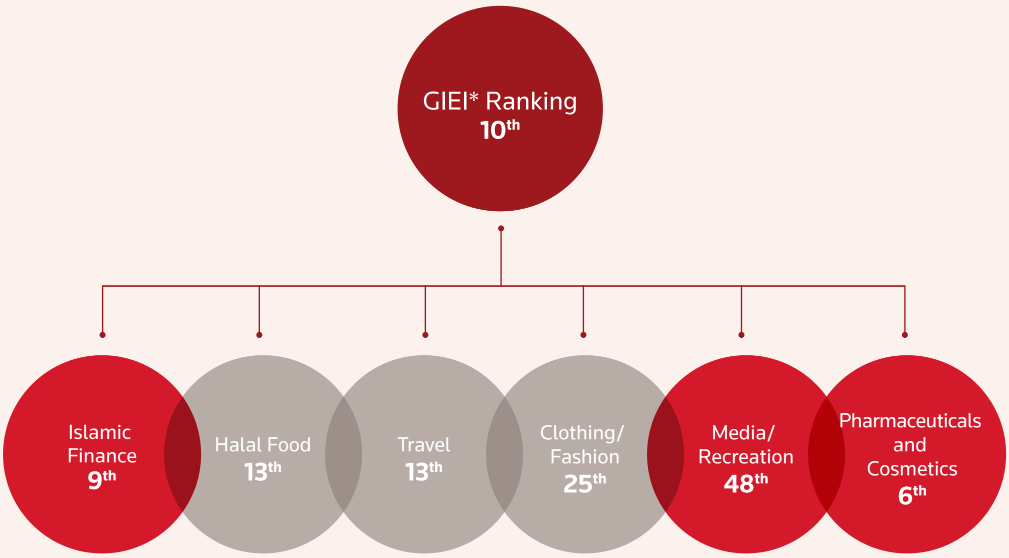
Indonesia's Islamic Economy potential is substantial and the country is now more fully cognisant of the need to prioritise plans and policies catering to the different pillars of the Islamic Economy.

Growing demand for halal-friendly market

Global Muslim consumer spending for food and lifestyle sectors reached $1.8 trillion in 2014 and is forecasted to reach approximately $2.6 trillion in 2020, according to the GIEI report. The halal or Islamic-focused sub-sectors are growing rapidly in line with the increasing level of awareness among Muslim consumers about halal products.

INDONESIA'S GIEI RANKING

* GIEI: Global Islamic Economy Indicator, as published in the State of the Global Islamic Economy Report 2015–2016[12], Thomson Reuters and DinarStandard



ALEXANDER RUSLI

Present Director and Chief Executive Officer, Indsosat

ALEXANDER assumed the role of President Director and CEO of Indosat in November 2012 after serving as an Independent Commissioner since January 2010. Before November 2012, Mr. Rusli was a Managing Director in Northstar Pacific, a private equity fund which focuses on Indonesian and Southeast Asian opportunities. Prior to his role in Northstar Pacific, Mr. Rusli served the Government of Indonesia for nine years.

Prior to his posts in the Government, Mr. Rusli was Principal Consultant for PricewaterhouseCoopers Management Consulting in Indonesia. Mr. Rusli completed all his formal tertiary education in Curtin University, Western Australia. He holds a Doctor of Philosophy degree in Information Systems.

1. Indosat has been active in both sukuk and bonds markets. What drives your decision as to which paper to issue?

The first sukuk issued in Indonesia was actually done by PT Indosat Tbk. back in 2002. So we were one of the pioneers in the sukuk market in Indonesia.

We were also the first sukuk issuer in Indonesia under the self-registered program.

At present, Indonesia's market share in Islamic banking and debt capital market is small relative to other Islamic countries such as Malaysia and of course the Middle East countries.

However, the potential to develop sukuk in Indonesia is enormous. As one of the largest telecommunications providers in the country, we require substantial sources of finance and one key avenue is to raise funds from the capital markets. Both sukuk and bonds are financial instruments we seek, in particular for longer term financing.

For over 10 years, we have issued sukuk in virtually every bond issuances as part of our commitment to develop and support the sukuk market in general.

2. Is there enough demand for sukuk in the local markets? What types of local investors are you seeking?

Most of our issuances have been oversubscribed. However, we've also had under-subscriptions. It really depends on the market condition.

However, we do acknowledge that there is demand for sukuk in the local market but the size has not caught up yet to the level where it can completely cover the entire demand.

In Indonesia, we think that, over time there will be increasing demand for Islamic banking products from pension funds, insurance companies, individual investors, as well as corporations.

Financial institutions have the opportunity to educate the market about the benefits of

Islamic banking. We see this in non-Islamic countries interested in Islamic products; I think that Indonesia, sooner or later, should take the lead.

3. Would the company prefer to or consider issuing sukuk or bonds abroad?

We do not have any experience issuing sukuk internationally; however, we have issued conventional bonds overseas. That is obvious because we are issuing in foreign currencies.

We have issued bonds on three occasions in the international market since 2001. What we see in sukuk issuance abroad is the variety on both the requirements and structures where for the local regulators were still under discussion, particularly in relation to the tax agreements are concern. We think that until everything is resolved; we may consider this as a viable option.

4. Will you consider selling Eurosukuk? Is there attraction for dollar sukuk in Indonesia from local and foreign investors?

At this moment, we are not considering any Eurosukuk yet, but we do see some attraction and there is definitely potential for Eurosukuk for the future.

5. What was the company's main purpose for issuing your latest sukuk and is there a potential for another issuance? What were the assets used to back the sukuk?

Sukuk issuance is part of our commitment to support the development of the sukuk market in the country. We chose this type of instrument as part of our financial program, which we will continue with going forward. In fact, we have used our revenue streams from the satellite and internet businesses to back the sukuk.

6. What other Islamic funding options are you considering apart from sukuk?

At the moment, we do not have any.

7. What are you planning to do to enhance your company credit and get better pricing?

Obviously we are moving at full speed to regain our market share after completing our network modernization project that we started two years ago. We are also maintaining our gearing at the most optimum level while at the moment aiming to lower our foreign exchange debt exposure to a local base currency, which is all part of our efforts to manage currency risk.

8. Given interest rate movements, will you consider issuing floating papers?

Around 80 percent of our debt is on fixed rates under a low interest rate environment just like today. Nevertheless, we see that more and more new financing facilities are now offering floating rate facilities. As part of our policy, we also take necessary steps to manage interest rates; in this regard, floating rate papers is really not an issue.

9. What stands in the way of the growth of corporate sukuk in Indonesia?

First thing is the yield factor. By offering similar yields to conventional bonds while the market demand is not yet sizeable is a consideration. It would take quite some time to attract investors, but other factors are already in place. That is why educating the benefits and showing sukuk as alternative for conventional bonds is worth the effort.

Additionally, the domestic demand is coming mostly from Shariah Banks and Islamic financial institutions. Individuals have not become a major and significant investor in this market. The domestic sukuk market requires more support from the Islamic banking industry or financial institutions that must at least educate people to get to know Islamic financial instruments such as sukuk.

10. What should government and regulators do to develop the Islamic Capital Market in Indonesia and boost local market liquidity?

We think the government should provide more value add for issuers. For example, extending some kind of tax relief, tax incentives, or any other incentives or concessions that are practical and that can help facilitate and attract companies to issue such instruments. At the end of the day, attractive yields will entice investors and promote growth of the Islamic Capital Market in Indonesia.

Halal Tourism

Service Providers → **Channels** → **Customer**

Service Providers
- Airlines
- Hotel

Channels
- Travel Agencies
- Destination Management Companies (DMCs)
- Travel websites

Ecosystem: Shariah-compliant financial services, compliance and training

Halal tourism depends heavily on Halal food and beverages

Halal Food

Suppliers → **Technology** → **Food Processing** → **Channels** → **Customer**

Suppliers
- Agriculture
- Livestock and its products

Technology
- Machinery
- Specialised Equipment

Food Processing
- Processed food manufacturers
- Halal certification bodies

Channels
- Wholesalers or agents
- Retailers
- E-commerce

Ecosystem: Training, R&D, marketing, Shariah-compliant financial services, regulations and compliance

Islamic / Modest Fashion

Clothing Designers → **Clothing Manufacturers** → **Distribution Channels** → **Customer**

Clothing Designers
- Unique modest clothing designs for Muslim consumers

Clothing Manufacturers
- Manufacturing modest fashion

Distribution Channels
- Retailers
- E-commerce

Ecosystem: Shariah-compliant financial services, marketing campaigns, media and events

HALAL/MUSLIM-FOCUSED TOURISM	Indonesia	Malaysia	UAE
Travel Indicator Ranking	13	1	2
Inbound Muslim Travel	1,009,000	2,915,000	2,506,000
Halal-Friendly Ecosystem	3	3	3
Awareness (No. of news articles)	2	17	17
Awareness (No. of events)	1	6	0
Contribution to employment	8%	14%	9%

Source: State of the Global Islamic Economy 2015 – 2016 Report, data collected as of December 2014

HALAL FOOD	Indonesia	Malaysia	UAE
Halal food Indicator Ranking	13	1	3
Export to OIC countries (USD)	526,000	12,659,000	59,181,000
Halal-Friendly Ecosystem	3	3	3
Awareness (No. of news articles)	7	168	74
Awareness (No. of events)	2	15	5
Food Pricing Index	1.05	1.12	0.89

Source: State of the Global Islamic Economy 2015 – 2016 Report, data collected as of December 2014

ISLAMIC / MODEST FASHION	Indonesia	Malaysia	UAE
Clothing/ Fashion Indicator Ranking	25	23	2
Clothing Export to OIC countries (USD)	439,048,000	113,076,000	808,366,000
Awareness (No. of news articles)	0	0	6
Awareness (No. of events)	2	2	0
Clothing Pricing Index	1.20	1.28	1.02
Labour Fairness Index	2	1	1

Source: State of the Global Islamic Economy 2015 – 2016 Report, data collected as of December 2014

Focus: Islamic/Family-Friendly Tourism

CONTRIBUTION TO GDP 2015

As part of Trade, hotel and restaurants

1% Hotels

2% Restaurants

THE TRAVEL & TOURISM COMPETITIVENESS INDEX 2015

Regulated By: Ministry of Tourism and Creative

Source: World Economic Forum

Global Rank	Regional Rank
50	11

FOREIGN TOURIST ARRIVALS IN INDONESIA

2010	2011	2012	2013	2014
7.00 Millions	7.65 Millions	8.04 Millions	8.80 Millions	9.44 Millions

Source: BPS-Statistics Indonesia

GDP TOTAL CONTRIBUTION

2013
Rp 841,413 bn
(9.2% of GDP)

2014
Rp 904,261 bn
(9.4% of GDP)

INVESTMENTS

2013	2014
Rp 161,115 bn	Rp 166,593 bn

EMPLOYMENT DIRECT CONTRIBUTION

2013	2014
3,042,500 jobs (2.7% of total employment)	3,162,500 jobs (2.8% of total employment)

Source: Forecast, World Travel and Tourism Council, Travel and Economic Impact Indonesia 2014

ASSOCIATIONS AND INSTITUTIONS INCLUDE:
- Association of Indonesian Hotel and Restaurant (Perhimpunan Hotel & Restoran Indonesia, PHRI)
- Bali Tourism Board (BTB)
- The Indonesian Heritage Trust (Badan Pelestarian Pusaka Indonesia, BPPI)
- Indonesia Tourism Industry Board (Gabungan Industri Pariwisata Indonesia, GIPI)
- ASTINDO (The Association of Air Ticketing Companies)
- Council of Indonesian Ulama (Majelis Ulama Indonesia, MUI)
- Shariah Hotel and Restaurant Association (Ahsin)

ASSOCIATED EVENTS AND SEMINARS: Indohalal Expo

TOURISM REGULATIONS:
- Law no.10/2009 on Tourism Act
- Regulation No. 50/2011 Dated 2 December 2010 on Master Plan for National Tourism Development (RIPARRNAS 2010 -2025)
- Regulations for Shariah Tourism: Four Ministerial Regulations issued in order to support Shariah tourism in Indonesia: namely Shariah standards for the travel agents, hotels, restaurants and spas.

TARGET DESTINATION OF SHARIAH TOURISM:
- 12 provinces that would serve as major Shariah destinations: Aceh, West Sumatra, Riau, Lampung, Banten, Jakarta, West Java, Central Java, Yogyakarta, East Java, West Nusa Tenggara and South Sulawesi.

Investment Opportunities

Islamic/Muslim-focused hotels

Indonesia's number of inbound Muslim travellers (936,000: 2013) is significantly lower than for Malaysia (3,264,000: 2013) and UAE (2,143,000: 2013).

There is much room to develop the country's Islamic Economy ecosystem.

Currently, there is a limited number of Islamic/ Muslim- focused hotels in Indonesia, creating an opportunity for investments in hotels and hospitality. There are currently only two hotels licensed by the Majelis Ulama Indonesia (MUI) — Sofyan Hotel Betawi in Jakarta, and Tuara Natama Hotel in Sidempuan, West Java.

Halal certification is not mandatory but it provides comfort to conservative Muslim travellers that all their (Islamic) needs are met. Facilities or services would include supply of prayer mats, indication of the qiblat (prayer direction), segregated exercise and recreational facilities and ensuring that no alcohol is served on the premises.

Bali, which is one of Indonesia's biggest tourist attractions and world-famous for its beaches and spas, lacks Islamic/Muslim-focused hotels and facilities. The potential to attract Muslim tourists to more freely enjoy Bali's beaches is held back by the absence of segregated beaches for men and women and dry (alcohol-free) establishments, for example. However, Bali is considered under the Masterplan for Acceleration and Expansion of Indonesia Economic Development 2011 – 2025 to be the Gateway for Indonesia Tourism.

Themed travel

There is also a growing opportunity to offer themed travel trips designed to cater to Muslim needs and sensitivities. Some examples include historical and cultural tourism, ecotourism and nature tourism, shopping tourism, sports tourism and culinary tourism.

Growth opportunities for Islamic Economy ecosystem

Growth in the Islamic/Muslim-focused tourism sector will create new opportunities in adjacent and related businesses such as halal food and Islamic media and recreation. These connected and supporting sectors present exciting opportunities to potential investors as they are expected to grow in line with the Islamic/Muslim-focused tourism sector.

Infrastructure

The growing number of foreign visitors to Indonesia (at an average annual growth rate of 7 percent since 2007) is generating demand to boost the Republic's infrastructure such as roads, airports and electricity supply. Indonesia's infrastructure is ranked 61st out of 148 countries on the World Economic Forum Global Competitiveness Index 2013 – 2014. Developing infrastructure is President Joko Widodo's priority and his government is keen to promote public-private partnerships and private sector participation, both foreign and domestic.

Wellness-related tourism is big business and Indonesia should be ready to become a centre for hotel/ resort spas and wellness tourism. Indonesia is well-known for its wellness resorts and spas but a new focus should be on halal and Islamic/ Muslim-focused wellness tourism that leverages Indonesia's rich heritage of traditional remedies and therapies.

Business consultancy and advisory services have the opportunity now to step in and help local companies re-focus on offering halal and Islamic/Muslim-focused products and services.

Focus: Halal Food

CONTRIBUTION TO GDP 2015

Non-oil Manufacturing and as part of Agriculture

6%
Non-oil Manufacturing

5%
Agriculture

FOOD CONSUMPTION GROWTH

Forecast 2014

9.1%

Regulated By: Ministry of Agriculture
Source: BKPM

INVESTMENTS GROWTH

Source: GAPMMI

2010	2011	2012	2013	2014	2015
25.6	17.8	26.1	35.0	50.0	55.0

Investment in IDR trillion

projection (2014, 2015)

SALES OF FOOD AND BEVERAGES

Turnover in Indonesia's food and beverage industry was:

Rp 1.020 tn
(US $82 bn) **in 2014**

up from

Rp 940 bn
in 2013

Source: Indonesian Food and Beverage Association (GAPMMI), as cited in Indonesia Investments

EMPLOYMENT DIRECT CONTRIBUTION

Source: BKPM

2011
785,462 jobs
(5% of Manufacturing sector workforce)

2012
931,213 jobs
(6% of Manufacturing sector workforce)

POTENTIAL LOCATION

ASSOCIATIONS AND INSTITUTIONS INCLUDE:

- Indonesian Food and Beverage Association (GAPMMI)
- Agency of Control of Food and Drugs (BPOM) Indonesian Palm Oil Association (GAPKI)
- Indonesian Cocoa Association (ASKINDO)
- Indonesia Food & Beverage Industry Association (GAPMMI)
- Indonesian Business Competition Supervisory Committee, KPPU to oversee the development of retailer expansion case.
- Indonesian Agency for Agricultural Research and Development (IAARD)
- Centre for Innovation, Indonesian Institute of Sciences (LIPI)
- Bogor Agricultural University (IPB)

NATIONAL HALAL FOOD REGULATIONS:

- Food Law (#7 /1996)
- Food Label and Advertisement law (#69/1999)

CERTIFICATION AND LABELLING:

Indonesian Council of Ulama (MUI):

- Assessment institute for Foods, Drugs and Cosmetics (AIFDC) or LPPOM
- Fatwa commission
- National Agency for Drug and Food control (NADFC) of BPOM: for Processed packaged foods
- Department of Agriculture: for primary meat and poultry

ASSOCIATED EVENTS AND SEMINARS:

- Indohalal Expo / HB&F Expo: Indonesia Halal Business and Food Expo

Investment opportunities

Infrastructure opportunities

The halal food sector enjoyed a recent upsurge in sales growth as a result of rising incomes and increased household consumption by the growing middle-class; this highlights the need to develop the retail infrastructure for more modern retail outlets such as hypermarkets and malls, especially for the urban areas. Hypermarkets and malls now account for over 40 percent of overall food sales. With higher consumption, this will open up new local and foreign investment lines especially for retail grocery shopping outlets.

The eastern islands of Sumatra, Sulawesi and Bali have been identified as the main corridors of growth in the national economic master plan. The demographic change of the country has resulted in a much larger Muslim population in the eastern part of Indonesia which was formerly dominated by Christians. This is an opportunity for halal restaurants, hotels, halal retailers and hypermarkets investors to expand halal businesses in these areas that still lack modern retailers.

Manufacturing and exports opportunities

Multinational manufacturing companies are attracted to the Republic's production base of natural resources and pool of plentiful and cheap labour.

Indonesia is considered a production hub for cocoa, palm oil, rubber, and fishery, but it lacks competitive advantage in wheat and processed food.

With national policy pushing self-sufficiency this could be the time for local and foreign wheat manufacturers and processed food producers to re-think growth strategies.

The Indonesian processed food market is dominated by local companies such as Indofood Sukses Makmur, Wings Group, Mayora and Garuda Food. However, multinational foreign companies such as Nestle and Kraft Unilever have been successful at integrating into the market in joint ventures with local companies and responding to local food preferences.

Indonesia is the top Muslim food consumption market ($157.6 billion), according to the Global Islamic Economy Indicator report 2015 – 2016. If local companies can grow to achieve scale, the Republic could significantly increase its halal food exports and franchising especially to other Muslim-majority countries such as those in the Middle East.

Market trends

Health and nutrition centres which offer healthy and organic food are the next market leaders in the halal food sector, i.e. the rise of 'tayyib'. With the growing demand for ethical and healthy products by non-Muslims and Muslims alike a focus on growing the 'tayyib' halal food market could reap substantial profits and drive sustainable growth.

Cooking, processing and eating healthy require clean and safe drinking water. Water treatment and engineering is one of the key sectors for expansion in Indonesia. There are opportunities for private companies in drainage arrangement, waste water management and water sanitation and specialised consultancy companies for water engineering will play a key role in building treatment plants.

Focus: Islamic/Modest Fashion

CONTRIBUTION TO GDP 2015

1%

As part of Non-oil Manufacturing

NUMBER OF TEXTILE COMPANIES (2013)

Source: Indonesia Investments

2,900

MOST IMPORTANT TEXTILE EXPORT PRODUCTS:
Garments, fabric and yarn

EMPLOYMENT DIRECT CONTRIBUTION AS OF 2009

IN TEXTILES INDUSTRY
498,005 jobs

IN CLOTHING INDUSTRY
464,777 jobs

Source: UNIDO: International Yearbook of Industrial Statistics, Vienna, 2013, CD-ROM,

TURNOVER GROWTH OF INDONESIA'S TEXTILE INDUSTRY (IN US$ BN)

	2009	2010	2011	2012
Total	14.6	17.8	20.6	20.2
Export	9.3	11.2	13.3	12.6
Domestic Sales	5.3	6.6	7.4	7.6

Source: Indonesian Textile Association (API)

ONLINE SHOPPERS

2013	2014
4.6 mn	5.9 mn

Source: eMarketer

FASHION SECTOR IS MOVING TOWARDS THE DIGITAL AND ONLINE SPACE AND E-COMMERCE IS ON THE RISE IN INDONESIA

*Netizen is defined as someone who spends at least three hours online per day.

	2010	2011	2012	2013
Internet users (in millions)	42.2	55.2	61.1	74.6
Netizen penetration*	18.98%	24.99%	39.62%	42.49%

Source: Tech in Asia

MOST POPULAR ONLINE PRODUCT CATEGORY (2013)

Apparel
67.1%

Source: Statista

ASSOCIATIONS AND INSTITUTIONS INCLUDE:
- Indonesia Fashion Designers Association (APPMI)
- Indonesian Textile Association (API)
- Indonesia Islamic Fashion Consortium (IIFC)
- Indonesian E-commerce Association (idEA)

AWARENESS:
- Indonesia Islamic Fashion Fair (IIFF)
- Indonesia Fashion week 2015

Investment opportunities

Indonesia's textile industry including clothing manufacturing could be further strengthened with the use of more high-tech/mechanised equipment and capital. The Republic's banks are often reluctant to lend to/finance improvements and upgrades for the mechanisation of the textile industry and this funding/financing gap could be filled by investors through joint ventures, partnerships and private equity investments.

E-commerce in Indonesia is growing in line with growing internet penetration, social media inclusion, innovative online platforms and the middle class. In the Islamic space, foreign investors have swooped in for leading Islamic/modest fashion company Hijup, which has received funding from a pool of intentional investors such as 500 Startups, Fenox Venture Capital and Skystar Capital.

The growth of the Islamic/modest fashion industry in Indonesia will increase the need for brand marketing expertise to support designers and entrepreneurs in sending out the right messages to Muslim consumers.

Most of Indonesia's clothing production is exported. Islamic fashion designers can leverage on this to start venturing out to other markets where they can create Islamic/modest fashion franchise models.

Models present creations by Indonesian designer Nur Zahra during the Jakarta Fashion Week 2015 in Jakarta. REUTERS/ Darren Whiteside

Acknowledgement

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The goals and motivations of this report follow in the same vein as the previous country reports – to serve the needs of the Islamic finance industry and to provide financial institutions, governmental bodies & associations, customers and other stakeholders with high quality intelligence and insights into the Islamic finance opportunity in Indonesia in order to help all parties make informed decisions. This report reflects the efforts of a broad and diverse group of experts.

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Sincerely,

IFCR Team

Main Contributors

Thomson Reuters

Mustafa Adil
Head of Islamic Finance

Emmy Abdul Alim
IFG Global Editor

Ammar Radhi
Project Leader
Research & Product development Manager — Emerging Markets Specialist

Shaima Hasan
Research & Product development Manager — Islamic Capital Markets

Ameena Al-Haddad
Senior Research Analyst

Redha Al-Ansari
Senior Islamic Capital Markets Analyst

Shereen Mohamed
Research Analyst

Zahraa Eid
Research Analyst

Islamic Research & Training Institute

Prof. Mohamed Azmi Omar
Director General

Dr. Turkhan Ali Abdul Manap
Team Leader
Senior Economist

Dr. Abdul Ghafar Ismail
Manager — Research Division

Dr. Mohammed Obaidullah
Senior Economist

Yahya Aleem Ur Rehman
Manager — Advisory Division

Dr. Hylmun Izhar
Economist

Dr. Tamsir Cham
Economist

Ahmed Fadhlan Yahaya
Shariah Specialist

Report Design: studio of KUNG PIK LIU

Contribution & Interviews Conducted

Institution	Name	Designation
Indonesia Financial Services Authority (OJK)	Dr. Mulya E. Siregar	Deputy Commissioner of Banking Supervision
	Nasirwan Ilyas	Deputy Director, Research Islamic Banking Department
	Triyono	Director, International Affairs
	Moch. Muchlasin	Director of Shariah NBFI
	Novita Bachtiar	Deputy Director, International Affiars
	Deden Firman H.	Deputy Director of Policy Review and International Standard, Islamic Banking Department
	Fadilah Kartikasasi	Director, Shariah Capital Market Directorate
	Muhammad Touriq	Deputy Director, Shariah Capital Market Directorate
Muamalat Institute	Isnaini Mufti Aziz	Executive Director
Maybank Syariah	Norfadelizan Abdul Rahman	President Director /CEO
	Habibullah	Head of Product and Strategy
Indonesia Waqf Board	Ir. H. M. Dr. Nadratuzzaman Hosen	Wakil Ketua
PT Bank Syaraih Mandiri	Eka B. Danuwirana	Senior Vice President
	Agus Sudiarto	Direktur Utama
	Agus Dwi Handaya	Director, Finance & Strategy Directorate
Bank Muamalat	Hendiarto	Director of Finance, Chief Finance Officer
	Afrid Wibisono	Vice President, FI & International Banking Division

Institution	Name	Designation
Bank Indonesia	Dr. Dadang Muljawan	Deputy Director, Macro Prudential Policy Department
	Diana Yumanita	Macro Prudential Policy Department
	Mega R. Chalid	Macro Prudential Policy Department
	Jhordy Kashoogie	Macro Prudential Policy Department
BAZNAS	Prof. Dr. Didin Hafiduddin	Former Chairman
Institut Pertanian Bogor	Dr. Irfan Syauqi Beik	Lecturer
PBMT Social Venture Ltd	Jamil Abbas	General Manager
CIMB Niaga www.cimbniaga.com	Pandji P. Djajanegara	Chief of Sharia Banking
CIMB Islamic Bank Berhad www.cimbislamic.com	Mohamad Safri Shahul Hamid	Senior Managing Director/Deputy Chief Executive Officer
	Mohd Zaid Bin Othman	Vice President — Strategic Communications, Business Management Office
	Dayana Mhd. Nordin	Assistant Manager — Strategic Communications Business Management Office
Karim Consulting	Adiwarman Azwa Karim	Founding Partner

Endnotes

1. Fiscal Policy: Aiming at Growth & Stability in Indonesia by Reza Y. Siregar of Goldman Sachs, Singapore.

2. According to Steven Tabor, country director of Asian Development Bank, Indonesia Resident Mission, reforms signal continued commitment to PPPs such as committee for accelerated infrastructure delivery, infrastructure SOE's capital infusion and enhancement the function of Indonesia Infrastructure Finance (Sarana Multi Infrastruktur).

3. The Top 5 Islamic banks represents only 15% of all Islamic banks (34 banks including fully fledge Islamic banks and business units) in Indonesia.

4. Financial Services Authority (OJK) data, and cited by Indonesia's Vice President Jusuf Kalla – June 2015.

5. *Sukuk* (sakk, in the singular) are non-interest bearing Sharia-compliant certificates that represent an undivided ownership interest in an underlying tangible asset proportionate to the value of the holder's investment. The certificates entitle the holders to receive a pro rata share of the cash flows or revenues generated by and from the underlying tangible asset.

6. The ADB's current voting structure is led by the EU (15.71%), Japan (12.83%) and the US (12.74%); China has significantly less control with a voting share of 5.47%.

7. It should be noted that in May 2015 the World Bank committed US$11 billion to Indonesia for its infrastructure projects.

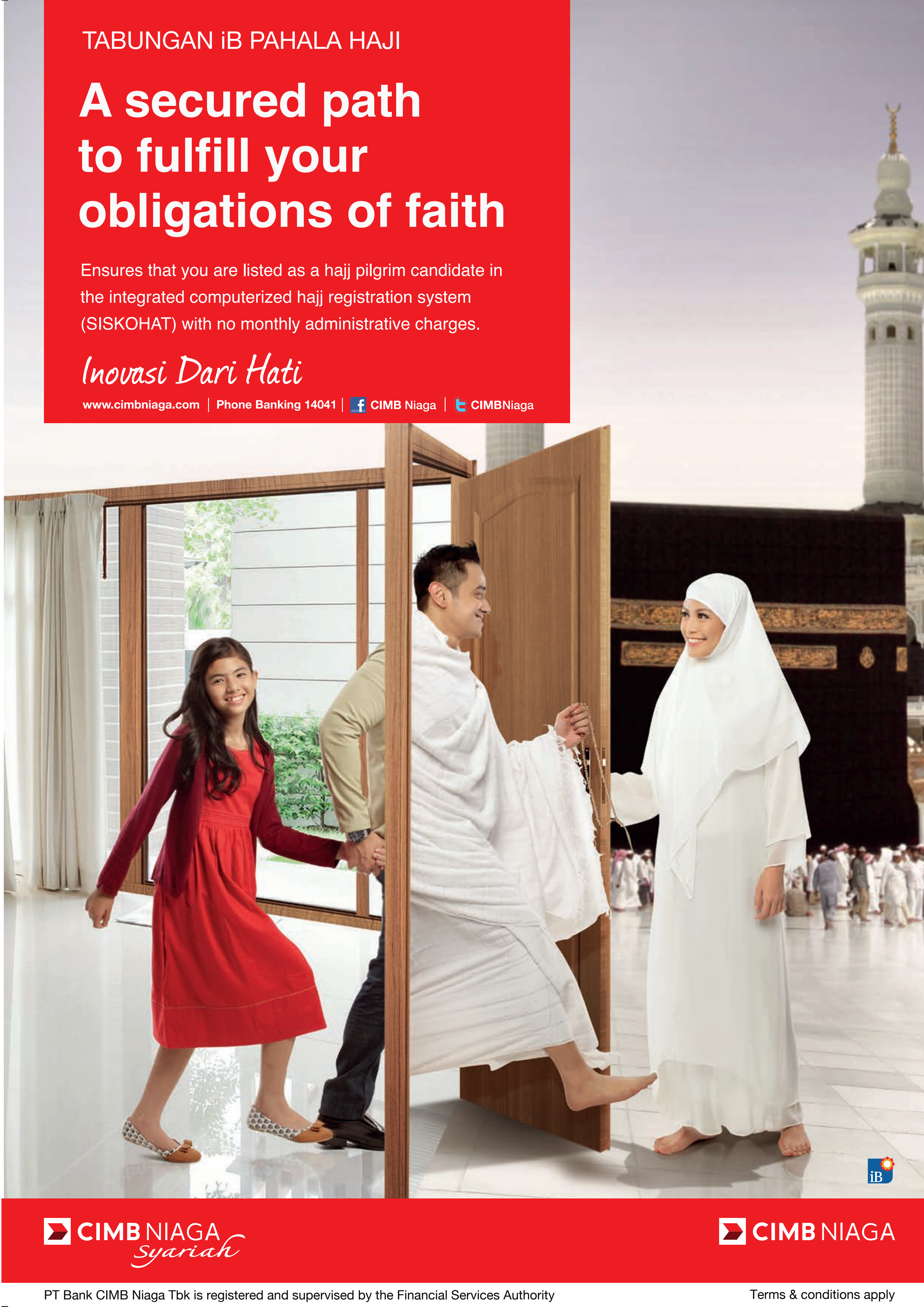
8. Mintarti N. (2013) *Models of Zakat Distribution*, Presentation at International Workshop on "Strengthening Islamic Social Finance Sector" held at Bogor, Indonesia.

9. CIBEST stands for Center of Islamic Business and Economic Studies (CIBEST), Bogor Agricultural University – Indonesia. Please refer to reference part to obtain the details of the CIBEST Model.

10. The GDP contribution of transportation and energy is summed up as follows: Mining and Quarrying (7%), Oil and Gas Manufacturing Industry (2%), and Transport (4%).

11. The World FactBook.

12. State of the Global Islamic Economy Report introduces a formal global Islamic Economy indicator (GIEI), a composite index that presents the current development health of Islamic Economy sectors across 70 core countries.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