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Regulating *Sukuk* in Indonesia: Challenges for Implementation

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Due to the differences between the *shari'a* and the conventional legal systems, regulations pertaining to the issuance of *sukuk* need special consideration. This is especially true in the Indonesian case, where the number of legal structures that can be chosen for the issuance of *sukuk* is very limited due to the basic building blocks of the law. While compliance to the principles of *shari'a* is paramount in any issuance of *sukuk*, lack of proper regulation may lead to a situation where some aspects of the *sukuk* transaction are not determined according to *shari'a*.

Indonesia has embarked on a path to regulate *sukuk*. However, since it is a relatively new concept, the regulation regimes for *sukuk* have tended to be reactive rather than proactive, particularly regarding the structure of the *sukuk* transaction. In light of this situation, it is imperative that proper regulation concerning the issuance of *sukuk* be implemented in Indonesia.

At the moment, the mobilization of resources in Indonesia is done through *shari'a* bonds (the terminology is used for lack of a better term). The *shari'a* bond is meant to be a *sui generis* bond that has characteristics that differ from conventional bonds. [2] The *shari'a* bond has been sanctioned and is not regarded as a debt instrument by the National *Shari'a* Board. However, Indonesian laws have a different view of them.

This issue has the potential to attract unnecessary debate, and therefore it is prudent to approach the issue of resource mobilization through other methods. In this juncture, asset securitization seems to be an optimal choice. Looking back at the successful issuance of conventional asset-backed securities between 1996 and 1997 in Indonesia, it is worth

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[1] Legal Office, OPEC Fund for International Development, Vienna, Austria.

[2] Among the different characteristics are that the s*hari'a* bond is not a debt instrument, and that the related coupons payments do not represent interest.

exploring the possibility of applying the techniques, with some modifications, to Islamic institutions.[3]

This paper argues for the introduction of legal reforms that would create a legal environment that would lay a foundation for effective regulations for Islamic asset securitization. The paper begins by explaining why asset securitization is the most appropriate financing for resource mobilization for Islamic institutions, and why the existing legal regime in Indonesia is not fully equipped to deal with it, thus requiring the introduction of certain reforms.

THE IMPORTANCE OF ASSET SECURITIZATION

While asset securitization is just one among many vehicles that can be employed for resource mobilization, it can be demonstrated that this vehicle is the most suitable one in the case of developing Islamic financial instruments in conventional environments. The subsection below explains the importance of asset securitization in this context.

Asset Securitization and the Ideal Islamic Banking System

Islamic banking is part of a broader system of Islamic economics that aims to introduce a system of Islamic values and ethics into the economic sphere. The concept of Islamic banking involves more than simply determining how to do banking according to Islam. It is the embodiment of submission to Allah, through adherence to Islamic precepts in all banking activities. Based on this tenet, Islamic banking can be defined as a system of banking that provides just financing, is free from factors unlawful to Islam, and offers benefits not only to the shareholder of the bank but also to the other stakeholders.

Some basic characteristics of Islamic banking can be identified. First, the prohibition of charging exorbitant profit is rooted in an element of justice. The distribution of profit depends upon the magnitude of risk assumed, while the distribution of loss is based on the ability of one to bear such losses. Moreover, Islamic banking is participatory in nature. An

[3] See Neil Campbell, *Securitization in Asia: A Legal Overview* (Hong Kong: Asia Law & Practice Publishing and Euromoney Publications, 1998), 4. Even though there are some doubts about the deals as to whether the sale of the receivables can be regarded as "a legal true sale," the outcome of some domestic transactions (such as the auto-loan securitization for Astra in 1996) suggests that it is possible under Indonesian law to securitize Indonesian receivables and achieve true sales. However, it is true that most of the transactions are cross-border and were completed out of Indonesia.

Islamic bank is supposed to assume all normal risks of business that a businessperson would assume. Profit or loss, irrespective of its quantum, should be shared between the bank and the customer. Return on the bank's investment is normally not the function of time, and when the return is predetermined, it is predetermined in absolute terms and not affected by any delay or prepayment.

Consequently, it is sufficient to say that Islamic banking should avoid the potentially huge divergence between real assets and real liabilities, which may translate into a profit-and-loss sharing (PLS) banking with some elements of morality and justice.[4]

However, in practice, Islamic banking mostly employs a non-PLS mode of financing on the assets side. The heavy reliance on the non-PLS mode often attracts sharp criticism. Critics comment that most Islamic finance techniques used today are no different in substance from those of conventional finance, and that the superficial distinction between Islamic and conventional finance lies mainly in the use of Arabic terms, or in the employment of disguised trade transactions that in substance are similar to those of conventional transactions. Even though this notion can be refuted by myriad *shari'a* justifications for the restricted application of certain conventional techniques, it is sufficient to say that efforts should be directed toward the revival of the early concept of double-tier *mudaraba* in Islamic banking in order to minimize the negative effects of such criticisms.[5]

In this context, assets securitization can play a significant role in conjunction with project finance. Such a connection will enable and encourage the creation of true double-tier *mudaraba*, which has been

[4] Equality and justice are the core principles of an Islamic economic system. These principles are manifested mainly in the form of prohibition of interest. However, the Islamic ban on interest does not mean that the capital is "free of charge" in an Islamic system. Islam recognizes capital as a factor of production but it does not allow this factor to make a prior or predetermined claim on the productive surplus in the form of interest. The permissible alternative is the profit-sharing system. The reason behind rendering profit-sharing admissible in Islam as opposed to interest is that in the case of the former it is only the profit-sharing ratio, not the rate of return itself, that is predetermined. Another rationale for Islamic finance is that wealth should be put into productive use in order that others may share in its benefits. It is therefore unjustified to charge interest for the mere use of money. The owner of wealth should invest it in a productive and real transaction. Profit-sharing is only one side of the coin. The other side is that losses should also be shared between the parties that can bear such losses. However, the inability to bear a loss will exonerate such obligation.

[5] It should be stressed here that it may be unrealistic to completely eliminate the element of debt and non-PLS instruments in the Islamic banking system. However, the point that the author makes here is that the double-tier *mudaraba* should form the dominant facet of Islamic banking.

difficult to implement so far. This mechanism can create an internal system that allows the matching of different maturities of the first-tier *mudaraba* (on the deposit side) with the second-tier *mudaraba* (on the asset side),[6] and allows for clarity regarding the source of the stream of income.[7]

In the structure based on the two-tier *mudaraba* model, depositors place their funds as a *mudaraba* deposit in the bank, which in turn invests the funds through *mudaraba* in several projects. Such *mudaraba* is structured as a non-recourse project finance transaction using leasing as a main vehicle where the repayment of the financing was convened only to actual revenues generated by the project. Then, each individual project is securitized and sold back to the bank. Because all projects are converted into marketable quasi-equity security, the risk of maturity mismatch between the first-tier *mudaraba* and the second-tier *mudaraba* can be avoided.

Alternative Method for Resource Mobilization

In the absence of a *shari'a* money and capital market, the only available option for resource mobilization is utilization of the existing conventional infrastructure, as long as such an infrastructure does not oppose the principles of *shari'a*. For that purpose, the capital market presents the most appropriate solution to this problem. As long as the means of mobilizing the capital is *shari'a* compatible, the structure is acceptable. The recent Indonesian experience with the issuance of *shari'a* bonds (in the form of *mudaraba* or *ijara* bonds) proved this point. However, this success is not without legal problems. While the trading of debt is not permitted by *shari'a*, the legal status of *shari'a* bonds is still that of a debt.

The conventional instrument that is most compatible with *shari'a* is the equity instrument. However, for any institution considering issuing a

[6] One factor that creates difficulty in matching the first-tier *mudaraba* and the second-tier *mudaraba* is the illiquid nature of the *mudaraba*. By using asset securitization, the second-tier *mudaraba* becomes liquid, making the redemption of the first-tier *mudaraba* much easier, even in the case of the maturity mismatch between the first and second-tier *mudaraba*.

[7] The certainty of the source of income can be achieved through other Islamic methods of financing, such as simple and straightforward *mudaraba*. However, in the case of multiple investors and multiple investments, it is difficult to trace the source of income. While it is theoretically possible to do so through production of several account books, namely one book for each category of investor, tracing the source of income for each investor can create an administrative nightmare. The other example is *murabaha*. While the source of income in this type of financing is also certain, the use of *murabaha* itself has always attracted criticism because the mode of financing is very similar in substance to a conventional loan.

debt-like instrument, changing its issuance into equity or giving up its equity position is not always desirable, as it can dilute their interest or simply prove to be too expensive. Therefore, the desired alternative is to find a quasi-equity instrument that behaves like a debt, yet has all the necessary characteristics to qualify it as equity. In this juncture, the viable alternative is an instrument created through securitizing the assets of such an institution or any subsidiary thereof.

INDONESIAN PRESENT ENVIRONMENT AND PRACTICES

For quite some time, Indonesia has had laws related to *shari'a* banking. Indonesian laws have adopted a dual banking system through the promulgation of Law No. 10 year 1998 concerning amendments to the banking law,[8] forming a legal basis for the development of Islamic banking in Indonesia, and through Law No. 23 year 1999[9] concerning Bank Indonesia,[10] which paved the way for the creation of the *shari'a* based regulatory and supervisory frameworks. The attempt to create a *shari'a* environment was quite promising, and Bank Indonesia has been very active in this regard. Soon after the promulgation of Law No. 10 year 1998, which gave Bank Indonesia the power to supervise and regulate the banking sector in Indonesia,[11] it promulgated several Bank Indonesia Regulations (*Peraturan Bank Indonesia*) that were intended to regulate Islamic banking. The regulatory regimes are quite comprehensive, covering almost every facet of Islamic banking.

However, this is not the case for other financial institutions. Other *shari'a* financial institutions or instruments such as asset securitization do not enjoy the same privileges that Islamic banks do. Other *shari'a* financial institutions or instruments have to rely on the laws of the conventional system. Unfortunately, those laws are not always very compatible with *shari'a*.

[8] *State Gazette* No. 182 (1998).
[9] *State Gazette* No. 66 (1999).
[10] The Indonesian Central Bank.
[11] See Article 24-35 of Law No. 23 year 1999. It is to be noted that under the previous banking regime in Indonesia, despite the fact that BI set and administered the operative rules and regulations related to banking operations, it was the Ministry of Finance that had the ability to enforce the rules, through its authority to issue and revoke banking licenses. See A. Nasution, "An Evaluation of the Banking Sector Reforms in Indonesia, 1983-1993," *Asia Pacific Development Journal* 1 (June 1994): 78.

Laws and Practices Related to Asset Securitization

Although asset securitization is one of the most important mechanisms for finance, Indonesia has not passed any comprehensive laws for asset securitization. There has been, however, an attempt by the government of Indonesia to create such a law.[12] Unfortunately, the draft law, if not modified, will face some issues of compatibility with Islamic legal principles. The problematic provision of the draft law is one that clearly states that securitization can only be conducted over debts.[13]

However, despite the absence of laws at the level of statutes, the law was implemented at the level of regulations in the capital market field.[14] In regard to assets securitization, the Indonesian Capital Market Supervisory Agency (BAPEPAM) has since 1997 issued regulations on asset-backed securitization. In particular, BAPEPAM issued regulation No. IX.K.1 on Asset Backed Securities. It governs the elements of a typical asset securitization. However, it still has some characteristics that are not favorable to the issuance of Islamic asset securitization. It is particularly doubtful whether the vehicle may be used as a vehicle for Islamic *sukuk*. Asset securitization according to such a regulation is done through a vehicle named *Kontrak Investasi Kolektif*, or Collective Investment Contract (CIC), between the portfolio manager and the custodian bank on behalf of the investors. This arrangement seems to attempt to mimic a trust special-purpose vehicle (SPV) for achieving bankruptcy remoteness. In this arrangement, the investment manager has the task of managing the portfolio while a custodian bank becomes a collective depository of the securities. Originators sell their receivables together with the attached security to the CIC. The CIC investment manager responsible for the portfolio, in turn, issues asset-backed securities for investors. The funds raised are transferred to the originators as contracted, and the servicing of the receivables is normally contracted back to the originators.

[12] At present, the Draft Law on Asset Securitization is being considered in the relevant ministries of the Republic of Indonesia.

[13] See Article 3 of the Draft Law on Assets Securitization. This will create difficulties for Islamic financial institutions, as *shari'a* prohibits selling debts at discount.

[14] The Indonesian capital markets are regulated by the Ministry of Finance through the Indonesian Capital Market Supervisory Agency (BAPEPAM). Under the Capital Market Law of 1995, BAPEPAM sets policy guidelines and regulations and is responsible for the day-to-day supervision of the capital markets. In essence, it has the power to interpret laws and legislation on matters within its jurisdiction, and to establish rules and issue independent decrees to that effect.

The Legal Issue of Sale of Debts

The most important aspect of asset securitization is that the sale of debt should be done as a "true sale" transaction to achieve the bankruptcy remoteness of the transferred assets.[15] The requirement of the Indonesian law is quite simple, namely that the transfer should be made through *cessie*, and the only requirement is notification to the debtors.[16] While it seems simple, some non-legal issues arise. The originator most of the time is hesitant to inform the debtor for various reasons. However, while the requirement of notice may create difficulties, there is a more pressing issue in relation to the rights attached to assets transferred. While Indonesian law has pronounced that all rights associated with the debts are transferred along with the transfer of debts,[17] it is not clear if the assets transferred are not in the form of debts. The same difficulties also arise in regard to debts that are the result of leasing or *mudaraba* transactions, in the absence of any collateral being placed in the leasing or *mudaraba* objects.

Laws Related to Leasing

Even though leasing is the closest mode of financing to *ijara*, the leasing law in Indonesia is still underdeveloped. Leasing is still governed through the Presidential Decree No. 61 year 1988 that was originally only intended to stipulate permitted activities to be carried out by a financial institution.[18] At the outset, this decree does not pose any legal hurdle for application of leasing according to *shari'a*. However, the implementing regulation on leasing activities contains one requirement that seems to contradict the *shari'a*. The Decree of the Minister of Finance No. Kep.Men.Keu.RI.No1169/KMK.01/1991 requires the parties to a leasing agreement to include a clause that determines the liability[19] of a lessee in the event of the non-functionality of the object of the lease agreement.[20] The point of the above example is that while the decree neither permits nor forbids that those activities be carried out through Islamic means, this

[15] It is possible to have asset securitization without sale of assets. This is known as synthetic securitization. However, it is beyond the scope of this paper.
[16] Article 613 of Indonesian Civil Code.
[17] Article 1533 of Indonesian Civil Code.
[18] Article 2 stipulates the activities, which are leasing, venture capital, trading in commercial papers, factoring, credit cards, and consumer finance.
[19] It is true that the contract can determine that the liability is zero. However, it is clear that this regulation is not intended to be the basis of Islamic leasing.
[20] According to *shari'a*, the leasee to an *ijara* contract cannot be held responsible for the damage or any loss due to the non-functionality of the object of the lease.

decree cannot be considered as the legal basis for Islamic leasing. Moreover, the fact that this decree was based on the laws that do not recognize the principles of *shari'a* [21] can further support the above argument.

Laws Related to *Mudaraba*

Mudaraba is also an instrument whose regulation is still uncharted. The tendency to equate *mudaraba* transactions with share-cropping transactions only makes the matter worse. The *mudaraba* transaction entails more than simply sharing revenue. The heart of *mudaraba* is the transfer of the asset in trust, namely, the transfer of assets into the ownership realm of the *mudarib* for the benefit of the investor. The *mudarib* owns the assets and is not merely the custodian of the assets. Indonesian laws unfortunately cannot adequately protect the parties to the *mudaraba* transaction, as the nature of the transaction is not within the ambit of its legal foundation. As the transfer of ownership in the *mudaraba* transaction resembles the common law trust,[22] Indonesia as a country that follows a civil law system, does not recognize dual ownership[23] in equity and in law. Unfortunately, such a split in ownership is the essential facet of the *mudaraba* transaction, which has not yet been covered by Indonesian law and cannot be governed by conventional civil law principles. [24] However, it is possible to cover the profit-sharing aspects of the *mudaraba* transaction through the freedom of contract principle.

[21] This decree was based on the Constitution, the Commercial Code, Civil Code, Law No. 12 year 1967 concerning cooperatives and Law No. 14 year 1967 concerning banking. See the Recital of the Presidential Decree No. 61 year 1988. It is to be noted that the Commercial Code and the Civil Code were initially intended for the European sector. They were the codification of living values of the Netherlands and western society. Prior to Indonesian independence, the Islamic-majority native Indonesians were subject to *adat* laws, which consisted of Islamic laws, among others.

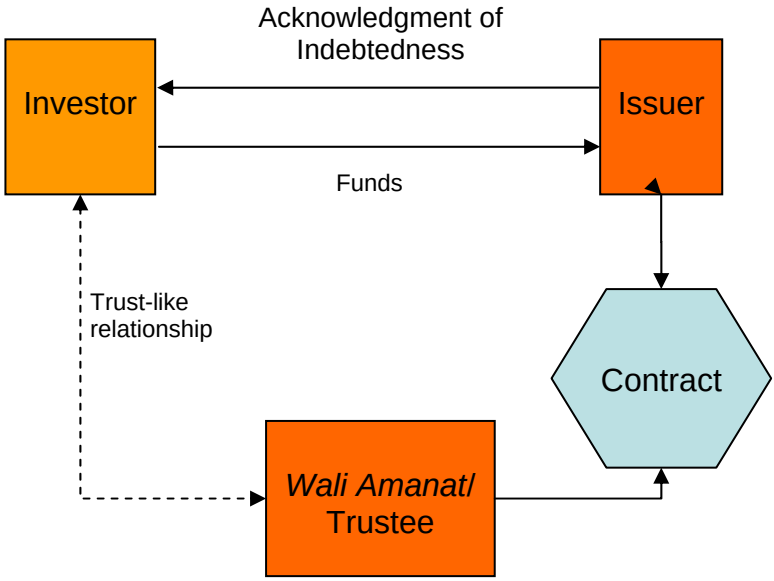
[22] Some Islamic financial institutions even used the terminology "trust financing" to denote the mechanism contemplated in classical *mudaraba.*

[23] It is true that the notion of ownership in *mudaraba* transaction is not exactly the same as the notion of ownership in common law trust. However, it is safe to say that they are similar. Therefore it is appropriate to take the example of dual ownership of the common law system to highlight the problem associated with the implementation of *mudaraba* under a legal regime following a civil law system.

[24] The consequences that may arise are related to the status of the *mudaraba* object in case of insolvency of the *mudarib,* the liability of the *mudarib*, and the rights of the investor. As a full explanation wouldl make this paper unnecessarily long, it is not undertaken here.

Indonesian Existing Practice (*Shari'a* Bonds)

Current *sukuk* in Indonesia are always manifested in the form of a bond, which is legally a debt instrument.[25] The structure of the *shari'a* bond is exactly the same as that of conventional bonds. Below are the structures of the only two types of *shari'a* bonds used, namely the *mudaraba* and *ijara* bonds.



The difference between the structures of conventional bonds and *shari'a* bonds lies in the contract between the *wali amanat*[26] and the issuer. The contract in *shari'a* bonds is not a loan contract. The contracts in

[25] In order to avoid unnecessary controversy, this paper will not name any specific case of *shari'a* bonds for the following reasons: (1) It is not the aim of this paper to criticize the practice, (2) the author does not have all documents pertaining to every single *shari'a* bonds issuance in Indonesia, and (3) the author does not wish to make generalizations about the issuance of *shari'a* bonds.

[26] *Wali amanat* is a legal creature that exists pursuant to articles 50–54 of Law No. 8 year 1995 concerning the capital market. It was fashioned in order to create a legal person similar to a trustee in bond issuance in common law jurisdictions. However, a *wali amanat* is not exactly the same as a trustee. It is a combination of a trustee, an administrator, and an agent.

mudaraba and *ijara* are respectively *mudaraba*[27] and *ijara*[28] contracts. Based on these underlying contracts, the National *Shari'a* Board[29] has pronounced the bonds to be *shari'a* compliant. The *fatawa* on the issuance of *shari'a* bonds stated that the *shari'a* bond is not a debt instrument, and that the coupon payments do not represent interest.[30]

While the *shari'a* pronouncement on the *shari'a* bond is very clear, the law views the *shari'a* bond as a debt instrument. Due to the absence of trust arrangements in Indonesian law, the contract between the *wali amanat* and the issuer cannot change the legal fact that there is a debt relationship between the issuer and the investor. It is to be noted that the legal opinion related to the issuance of *shari'a* bonds always stated that the *shari'a* bond is a debt instrument.[31] This creates a legal dilemma. On the one hand, *shari'a* prohibits the sale of a debt instrument not at face value. On the other hand, the nature of the bond and market necessity requires that the bond be freely traded, namely at discount or at premium. It is true even in the case of the *ijara* bond, where the bond represents not the ownership of the asset but the rental claims associated with the lease of the underlying assets.

Even if the *ijara* bond can be manifested in the ownership of the underlying assets and not merely in the rights to receive rental payment, the issue of liability of the owner of the assets may arise due to the principle of unity of ownership under Indonesian law. As an owner of an asset, the investor will be exposed to numerous risks that may result in the *shari'a* bond being less attractive than its conventional counterpart for rational investors.

CHALLENGES FOR IMPLEMENTATION

As explained above, the issuance of *sukuk* creates some legal complications in Indonesia. Therefore, some steps should be taken to overcome the obstacles. This represents the overall challenge in the implementation of *sukuk*, namely laying the foundation for effective

[27] The *mudaraba* contract employed in the *mudaraba* contract is different than the classical *mudaraba.* The repayment of principal in this contract is guaranteed and is based on the principle of revenue sharing (not profit-loss sharing).
[28] There is no transfer of ownership in this particular *ijara* contract. The subject of *ijara* is only usufruct and does not entail any legal and/or beneficial ownership. (The *sukuk al-manafi'*.)
[29] The National *Shari'a* Board has endorsed eight types of *sukuk*. However, there are only two types of *sukuk* currently used in Indonesia.
[30] The National *Shari'a* Board issued only individual *fatwa* for individual issuances.
[31] See the legal opinions issued in conjunction with the issuance of the *shari'a* bonds.

regulation. Below is an elaboration of some steps recommended for regulating such an issuance in Indonesia.

International Practices Related to Islamic *Sukuk*

It is important to look at international practices related to *sukuk*. While the issuance of *sukuk* takes different forms and methods, there is one similarity among all the issuances of *sukuks*,[32] namely the use of a trust structure, in the sense that there is always involvement of the splitting of ownership of the underlying assets into legal and equitable ownerships. This is the answer to the prohibition of the sale of debts under *shari'a*, and it results in the certificate issued or traded representing the ownership over a real asset. In the case of the famous first Malaysian *sukuk*, the traded certificates represented equitable ownership of the real estate parcel, while in the case of the Islamic Development Bank (IDB) *sukuk*, the traded certificates represent the equitable ownership of the pool of assets that consist of mainly real ownership.

In order to satisfy the *shari'a* requirement, the underlying transactions are almost always in the form of leasing. This is because leasing is the closest mode of financing acceptable to *shari'a* that involves real ownership over real assets. Such requirements resulted in all transactions being structured to involve the leasing of real assets, regardless of whether or not the intention of the would-be investor is in ownership of the associated real estate. Another development appears in the first IDB *sukuk*. It is no longer necessary to have the pool of assets consist of only leasing assets. The issuance of *sukuk* will be still acceptable to *shari'a* if the initial composition of the portfolio consists of at least 51 percent leasing, and at any one time does not drop below 25 percent of the portfolio.

While the *sukuk* structure is always done through a complex structured finance transaction, one simple fact can be identified in it: the foundation of the structure lies in the ability to split the ownership of the underlying assets into legal and equitable ownership.

As a civil law system, Indonesian law has the principle of unity of ownership. Therefore, it is difficult to assign and transfer only the part of the interest, namely equitable interest on the ownership of the income generating assets. While many problems can be sufficiently averted by simply splitting and securitizing the equitable ownership of the asset, the nature of Indonesian law does not permit such separation. This represents the first challenge: formulation of the means for Indonesian law to allow

[32] Except for straightforward *mudaraba* or *muqadara* bonds.

such separation, and the splitting of ownership like the common law counterpart.

Indonesian *Shari'a* Bonds

The second challenge is to create a uniform system that can cater to the conventional as well as the *shari'a* compatible bonds issuance. As previously explained, the only justification for the *shari'a* bonds in Indonesia being issued in the way they are issued is that the Indonesian Capital Market Agency still requires a uniform format in issuing bonds. Therefore the chosen approach adhered to all requirements regarding forms, while maintaining the substance of the matter in conformity with *shari'a*. This approach is not without problems. It creates inconsistencies, especially related to the treatment of bonds under Indonesian law. Indonesian law still views bonds as debt instruments. Although some quarters argue that allowing *shari'a* bonds has resulted in the broadening of the definition of bonds, Indonesian law still regards *shari'a* bonds as debt instruments. The paradox is that while trading in debt instruments that are not at par value is unlawful according to *shari'a*, the issuance of *shari'a* bonds is done precisely in order to allow such trading in debt.

Assets Securitization and *Shari'a* Compliance

The third challenge is related to the nature of asset securitization and its compliance to *shari'a*. In this regard, there are several issues that need to be overcome. While the majority of *shari'a* scholars prohibit the trading of debts, the rulings on the trading of debt-like instruments or non-debt instruments that behave like debt do not enjoy the same consensus.[33] Moreover, trading on proof of participation (whether in the form of shares of a company or unit trust) in a portfolio that consists mainly of debts might be considered as the trading in debts. This fact may potentially create difficulties in using asset securitization as a basis for Islamic *sukuk* in Indonesia. The Indonesian draft law on asset securitization requires that the asset to be securitized is in the form of debt.[34] Fortunately, in the existing regulations of BAPEPAM, there is no express requirement that the portfolio of the Collective Investment Contract (CIC) consist of only debts.

[33] The ruling regarding IDB's *sukuk* permits the trading of a certificate that represents ownership over a portfolio of assets consisting of both real assets and debts. The caveat is that the initial composition of the portfolio should be at least 51 percent of real assets and in any case should never drop below 25 percent of real assets.
[34] Article 3 of the Draft Law on Assets Securitization.

According to paragraph b of the Regulation IX.K.1, it is possible to have non-debt financial assets in the portfolio. However, while a lease rental payment can be categorized as a financial asset, it is not clear whether an asset subject to lease can be categorized as a financial asset.

The second issue is whether the transfer of the assets will attract a moral hazard problem. While in conventional asset securitization the only moral hazard problem is the possibility that the originator may apply different treatments between the sold assets under the servicing agreement and the unsold assets, the problem will add to the requirements for operation and maintenance of the lease assets if the whole asset (and not only the lease payment) is transferred to the portfolio.

The third issue is related to the CIC model required under the existing BAPEPAM regulation. Even though it has been used several times, the effectiveness of the CIC model remains questionable. The major issue is whether the CIC, which does not have a separate legal personality, can legally enter into contracts with other parties, such as investors and servicers, in the same way that a trustee can. The bankruptcy remoteness of the CIC scheme is also another issue, as its efficacy is still untested. The CIC is basically an SPV that insulates the securitized assets from the insolvency of the originator. While in the conventional asset securitization the SPV exists solely to sell and hold the securitized assets, and may not have obligations other than to those to be paid with the securitized assets, in the *shari'a* asset securitization the SPV may have additional obligations, as the SPV will hold real assets and not merely claims.

Problems with Non-Straightforward Debt

The fourth challenge is related to the problems associated with non-straightforward debts. While Indonesian law has a provision related to the rights attached to a debt, the lack of laws related to leasing poses another problem. The provisions of Article 1533 of the Indonesian Civil Code extend only to the security attached to a debt. In the case of transferring lease payments, the relationship between the lease payments and the lease assets is not very clear. The lease payment is not automatically secured by the lease assets, as the obligor of the lease payment and the owner of the lease asset are always different.

Another issue is related to the lease asset itself. A *shari'a*-compatible lease is limited to an operating lease and not extended to a financial lease. There is a problem in the ability to assign future debts. Under *ijara*, the payment of the rental is given for the enjoyment of the lease assets. Therefore, each payment of rental is considered a separate payment for the enjoyment of the lease asset and not an instalment of an existing debt. This

will create the problem of notification and transfer, as the notification has to be done for each and every rental payment.[35]

Conversion of Conventional Bonds

The last challenge is to convert conventional bonds into *shari'a*-compatible *sukuk*. The biggest issuer of bonds in Indonesia is the government of Indonesia. Therefore the epitome of the development of Indonesian *sukuk* is issuance of *sukuk* by the government of Indonesia. However, the issuance of *sukuk* by the government necessitates infrastructure that is presently not available. The most viable alternative is to convert existing government bonds into *sukuk*.

CONCLUSION

It is clear that *sukuk* can serve as the main vehicle for the development of Islamic banking. However, implementing it in Indonesia, a country following a civil law tradition, is no simple matter. There are several challenges that must be overcome in order to achieve successful implementation of *sukuk*. First, there must be a workable solution introduced to permit the splitting of ownership as in the common law counterpart. Second, there needs to be created a uniform system that can cater to both conventional and *shari'a*-compatible bonds issuance. Third, a legal system must be created that allows trading on quasi-debt instruments without breaching the rules of *shari'a* or attracting a moral hazard problem, while also achieving bankruptcy remoteness. Fourth, existing laws and regulations related to non-straightforward or future debts need to be revamped. Fifth and finally, there needs to be a mechanism allowing the conversion of government conventional bonds into *shari'a*-compatible *sukuk*.

The establishment of a comprehensive legal and regulatory framework that addresses such challenges will not only promote the development of Islamic finance and its regulatory regimes, but will also galvanize the establishment of an Islamic economic system in Indonesia. Although this paper does not offer solutions to those challenges, by identifying them it may lead to necessary reform in the Indonesian legal system. Hopefully, this paper will serve as a first step toward the alignment of the current Indonesian system with *shari'a* requirements.

[35] Article 613 of the Indonesian Civil Code.