

ISLAMIC FINANCE IN INDONESIA: WAKING UP THE SLEEPING GIANT

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Indonesia Alert

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Financial institutions have a largely untapped market in Indonesia's "digitally enabled but unbanked" population. Providers with digital capabilities are particularly well placed to facilitate transactions, capitalising on the Indonesian government's drive to promote its domestic Sharia'h-compliant capital market.

This alert will bring to your attention the significant measures the Indonesian government has taken to provide the regulatory environment necessary to germinate and stabilise their Islamic finance market including:

- branchless banking;
- promoting Sharia'h-compliant capital markets; and
- regulating Sharia'h principles and experts.

As the market grows, digital banking services will become more important for consumers and corporates. As the market matures and stabilises, businesses, especially small to medium-sized enterprises, will begin looking to the domestic Indonesian market to satisfy their capital needs. This will provide opportunities for advisors, arrangers and other market participants to assist these entities.

BRANCHLESS BANKING - THE "DIGITALLY ENABLED BUT UNBANKED"

Indonesia represents an unbanked market where banking penetration is only approximately 30% of the population.^[1] Furthermore, Islamic banks in Indonesia only hold about 5% of the market share.^[2] Therefore, despite having the largest Muslim population in the world, Islamic banking remains underdeveloped in terms of numbers and sophistication as compared to, for example, Malaysia. The Islamic Economic Society (*Masyarakat Ekonomi Syariah*) in Indonesia indicated a growth projection that could be as high as 17% for the development of Islamic banking in Indonesia in 2016.^[3]

Nevertheless, the population of Indonesia is becoming digitally enabled. Statistics show that in 2015 there were approximately 55.4 million^[4] smartphone users in Indonesia (representing 37.1%^[5] market penetration) as compared to 38.3 million smartphone users in the United Kingdom^[6] (representing 73.6%^[7] market penetration).

The Indonesian Financial Services Authority (*Otoritas Jasa Keuangan* (the "OJK")) has issued regulations on Branchless Banking Services.^[8] Branchless banking and financial services, *Laku Pandai* (*Layanan Keuangan Tanpa Kantor Dalam Rangka Keuangan Inklusif*), according to the regulation is an activity in which banking and financial services are provided without reliance on a physical network.^[9] This step by the OJK places information technology at the centre of the growth of the Islamic finance market. This could increase levels of banking

penetration in rural areas where mobile technology may be more prevalent than land-based technologies (as has been the case in the mobile banking phenomenon in parts of Africa^[10]).

The regulation allows for services including savings accounts, credit, financing and insurance. In order to provide the branchless banking services, a financial institution must have approval from the OJK^[11] and (specifically for banks) their business plan must set out, for example, the advantages of providing the services and demonstrate that they have the requisite infrastructure, such as mobile banking and internet banking.^[12] Islamic banking assets in Indonesian dollars in Islamic rural banks grew from \$IDR 2.7 trillion in 2010 to \$IDR 6.6 trillion in 2014.^[13]

The provision of branchless services is not limited to banks and given that in many remote areas without banks, there may be other centres for economic activity, the OJK seems to have made relevant provisions to allow for non-banking entities to provide banking and financial services as agents of banks. Individuals or legal entities as agents of banks can provide banking services after the bank has conducted the requisite due diligence^[14] on the agents. Such agents, once appointed, must display the appointment to anyone at their offices^[15] and enter into relevant written legal agreements with the bank to cover, for example, agent classification, operational area, amendment and termination and dispute settlement.^[16]

PROMOTING SHARIA'H-COMPLIANT CAPITAL MARKETS

In further efforts to develop the Islamic finance market in Indonesia, the OJK has also issued a package of regulations in an effort to stimulate their Sharia'h-compliant capital markets.^[17] The regulations are designed to clarify and simplify existing regulations, with one new regulation on qualification and competence, which we discuss below.

The impact of this reform is likely to be a reduction in costs for companies wanting to issue Sharia'h-based products or to engage in Sharia'h-related activities. This is the OJK's intention as stated by its Chief Executive of Capital Markets, Ir. Nurhaida.^[18]

The consequence of such a reduction in costs is likely to mean greater engagement with the market and possibly a rise in transactions, allowing the market and its participants to gain experience across the life cycle of a transaction. This change is designed to create a more robust capital market servicing the capital needs of those looking for Sharia'h-compliant investment or financing opportunities.

In particular, the Issuance of and Requirements for Asset-Backed Sharia Securities regulation^[19] addresses Sharia'h asset-backed securities based on collective-investment contracts or in the form of participation letters. This is a step in attempting to grow the Indonesian Islamic finance market through more complex asset-backed structures (securitisations).

Asset-based structures are more prevalent than asset-backed structures, with the difference between the former and the latter being found in the type of credit risk investors hold, essentially the rights the investors have to the underlying assets. This is important if there is a default because in asset-based structures noteholders have an unsecured debt claim against the originator while in an asset-backed structure noteholders have a secured claim on the underlying asset itself. One of the most well-known asset-backed structures was issued by Dubai-based Tamweel in 2008. It was a Residential Mortgage-Backed Security (RMBS) deal in which Tamweel securitised a portfolio of Sharia'h-compliant mortgages that were originated by Tamweel.

In the OJK regulation, asset-backed securities are portfolios, contracts (*akad*) and management arrangements that are structured according to Sharia'h principles (discussed below). Asset-backed securities based on collective investment contracts must be supported by a compliance statement from the Sharia'h monitoring council or a Sharia'h expert team. The contracts must also include the word "Sharia'h" on the issued asset-backed securities, and statements that the securities do not contravene Sharia'h principles and that the investment manager and custodian bank represent the interest of the holders of the securities.^[20] Disclosure must also be included in the prospectus covering information on the investment manager's Sharia'h monitoring council, the custodian bank and the ranking of publicly offered securities.^[21]

If there is a failure to comply with these requirements, the OJK can change the investment manager or order the contracting parties to terminate the contract. If the contracting parties fail to terminate the contract, the OJK can terminate the contract.^[22] These forms of intervention by a regulator should not come as a surprise in the current investment climate. In Western economies such as the United Kingdom and United States, "bail-in" powers give regulators a wide remit to intervene in a financial institution prior to insolvency to minimise any systemic damage that the failure of a significant financial institution can cause to the market.

In addition to asset-backed Sharia'h securities based on collective investment contracts, the regulations also provide for asset-backed Sharia'h securities based on participation letters. These letters make reference to investment portfolios that are constituted of receivables or real estate investment funds. Like the collective investment contracts, participation letters must comply with Sharia'h principles. The prospectus must also comply with regulations and include disclosure on compliance with Sharia'h principles, guarantees of the securities, Sharia'h contracts and transaction schemes and rankings for public-offered securities.^[23]

For both forms of asset-backed securities, not unlike the issuance of a prospectus in a Western capital market, there are continuing reporting obligations after the issuance of the securities.^[24]

SHARIA'H PRINCIPLES WITHIN THE CAPITAL MARKET AND CAPITAL MARKET SHARIA'H EXPERTS

The OJK has also issued regulations on Sharia'h principles^[25] and Sharia'h experts in the market.^[26] This is recognition that individual markets require rules for governance that can allow investors to plan and secure their investments.

The regulations for implementing principles of Sharia'h in the capital market cover three main areas; (a) eligibility for parties who want to engage in the Sharia'h capital market; (b) characteristics of Sharia'h transactions and financial instruments and (c) sanctions for non-compliance.

Essentially for eligibility, a party must expressly state in its constitutional documents that it is compliant with Sharia'h principles or, if not making such a declaration, must have either a Sharia'h business unit or offer Sharia'h-based financial services, act as a custodian bank for Sharia'h investment activities or have issued or assisted in the issuance of Sharia'h securities; so, generally already engaging or associated in Sharia'h investment/finance activities.^[27]

Activities such as gambling, interest payment (*riba*), unfixed sales and purchases, goods that involve prohibited materials (*haram*), transactions involving bribery, speculation, fraud, non-disclosure, or misrepresentation for

example are prohibited in the Sharia'h capital market.^[28] Many of these prohibitions would come as no surprise to an investor familiar with Western capital markets and issues involving white collar crime.

Sanctions for non-compliance range from warnings and fines to annulment of business activities.^[29]

As to the capital market experts, regulations from the OJK set out clearly the criteria for what constitutes an expert for an individual and a corporation as summarised in the tables below.^[30]

Individual

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Integrity Requirements	Competence Requirements
Have the relevant legal capacity	Possess a bachelor's degree or equivalent
Have no criminal record in the financial sector	Possess a capital market sector specialisation certificate issued by an educational institution recognised by the OJK
Have not been sanctioned regarding Sharia'h activities in the capital market during the last three years	Have secured an individual licence from the OJK or be registered with the OJK as a capital market supporting professional
Have never been sanctioned by the revocation of a licence during the last three years	Have relevant work experience of capital market supervisory institutions amounting to at least two years (for managerial positions) or five years (for executive positions)

Corporations

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Integrity requirements	Competence requirements
Have the relevant legal capacity	Have at least one manager and one other employee who have secured Capital Market Sharia'h Expert licences
Have no criminal record in the financial sector	Possess supporting facilities for advising and overseeing the implementation of Sharia'h principles in the capital market
Be committed to developing the Sharia'h capital market	
Be independent with regard to capital market	

activities	
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Experts must also be licensed with the OJK. Sanctions by the OJK in relation to non-compliance with its requirements and license procedures for an expert include written warnings, fines and revocation of the licence.^[33]

Conclusion

The Indonesian government is sending clear signals that it intends to pursue a programme aimed at attracting Islamic-compliant investors and borrowers.^[34] Enhanced clarity in relation to Sharia'h and how its principles are viewed under Indonesian domestic law will give market participants the certainty they require to properly engage with the market. These signals, coupled with technological innovation, means Indonesia could be set to wake from being known as the sleeping giant of the Islamic finance world.

Notes:

[1] "Special Report, Top Islamic Financial Institutions" (November 2015) *The Banker*, page 30

[2] *Ibid*

[3] See <http://www.indonesia-investments.com/news/todays-headlines/islamic-finance-in-indonesia-prospects-for-2016/item6202>, which references the information from The Islamic Economic Society (*Masyarakat Ekonomi Syariah* - "MES")

[4] "Worldwide Internet and Mobile Users - eMarketer's Updated Estimates for 2015" (August 2015) *eMarketer*, page 16 (which can be accessed at: https://insights.ap.org/uploads/images/eMarketer_Estimates_2015.pdf)

[5] *Ibid*, page 16

[6] *Ibid*, page 18

[7] *Ibid*, page 18

[8] Regulation No. 19/POJK.03/2014 and Circular Letter No. 6/SEOJK.03/2015 on Branchless Banking Services under the Inclusive Finance Framework to implement Regulation No. 19/POJK.03/2014, ("Circular Letter No. 6/SEOJK.03/2015")

[9] Regulation No. 19/POJK.03/2014, Article 1(3)

[10] See e.g., "Is it a phone, is it a bank" (30 March 2013) *The Economist*; "Why does Kenya lead the world in mobile money", (27 May 2013) *The Economist*

[11] Regulation No. 19/POJK.03/2014, Article 3(1)

[12] See Regulation No. 19/POJK.03/2014, Articles 10 and 11; Circular Letter No. 6/SEOJK.03/2015, Section III.A and Section III.B

[13] See <http://www.indonesia-investments.com/news/todays-headlines/islamic-finance-in-indonesia-prospects-for-2016/item6202> which references the information from the OJK

[14] Circular Letter No. 6/SEOJK.03/2015, Section V.B

[15] Circular Letter No. 6/SEOJK.03/2015, Section V.D and Section V.F

- [16] Regulation No. 19/POJK.03/2014, Article 22 (1b); Circular Letter No. 6/SEOJK.03/2015, Section V.E.1
- [17] See <http://www.ojk.go.id/en/press-release-ojk-holds-freks-iv-2015-to-build-sharia-capital-market>
- [18] See <http://www.thejakartapost.com/news/2015/11/13/ojk-working-stimulus-grow-sharia-capital-market.html>
- [19] Regulation No. 20/POJK.04/2015
- [20] Regulation No. 20/POJK.04/2015, Article 7(1)
- [21] Regulation No. 20/POJK.04/2015, Article 7(2)
- [22] Regulation No. 20/POJK.04/2015, Article 9
- [23] Regulation No. 20/POJK.04/2015, Article 12
- [24] Regulation No. 20/POJK.04/2015, Article 6
- [25] Regulation No. 15/POJK.04/2015
- [26] Regulation No. 16/POJK.04/2015
- [27] Regulation No. 15/POJK.04/2015, Articles 4(a), (b), (c), 7, 8
- [28] Regulation No. 15/POJK.04/2015, Article 2
- [29] Regulation No. 15/POJK.04/2015, Article 13(1)
- [30] This table is a summary that was taken from English Hukum online, *Indonesian Legal Brief*, Issue 2776, 4 December 2015
- [31] See Regulation No. 16/POJK.04/2015, Article 3(1)(a) (in relation to Integrity requirements) and Article 3(1)(b) (in relation to competence requirements) for a complete list
- [32] See Regulation No. 16/POJK.04/2015, Article 3(2)(a) (in relation to Integrity requirements) and Article 3(2)(b) (in relation to competence requirements) for a complete list
- [33] See Regulation No. 16/POJK.04/2015, Article 26(1)
- [34] See the following article discussing the challenges with reforming the Indonesian economy. "The unstimulating stimulus" (17 October 2015) *The Economist*

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