

# *Innovation in Awqaf Sector to Support the Inclusive Economic Development*

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## Introduction



## Awqaf Development



## Sukuk Development within Islamic Finance Landscape



## An Awqaf Linked Sukuk: A Proposed Model



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# Introduction



## Background:

- ✓ Enormous waqf asset in Indonesia
- ✓ Time for new innovation for global sukuk issuance that has social dimensions within Shari'ah parameters
- ✓ Strategic alliance across institutions and synergies with all relevant stakeholders are needed

## Scope:

- ✓ Properties of awqaf asset in relation to sukuk issuance
- ✓ Potential sukuk structure
- ✓ Potential for monetary operations and Islamic financial deepening

## Research Objectives:

- ✓ Altering the usage of awqaf assets based on the mandate stated by the asset provider (waqif) to a more prospective economic arrangement without violating the sharia principles.
- ✓ Up-grading the status of awqaf projects to sovereign so that financial resources can be mobilized through innovative vehicles.
- ✓ Explore the potential of utilizing the proposed sukuk structure in deepening the Islamic financial market and in altering the Central Bank monetary instrument.

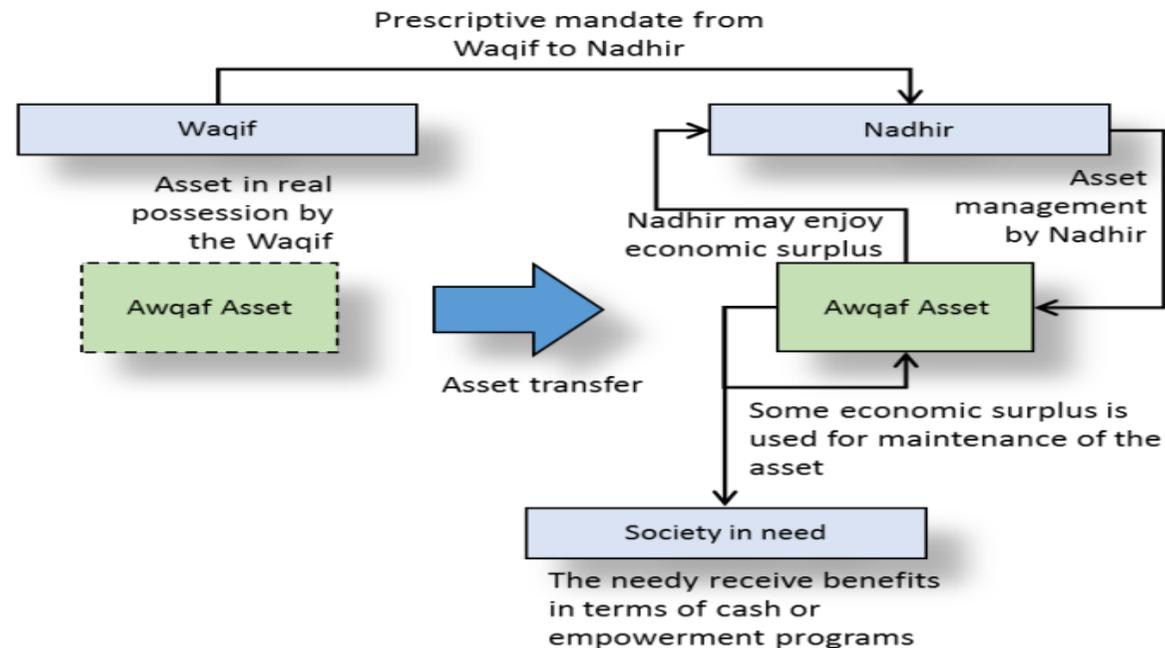


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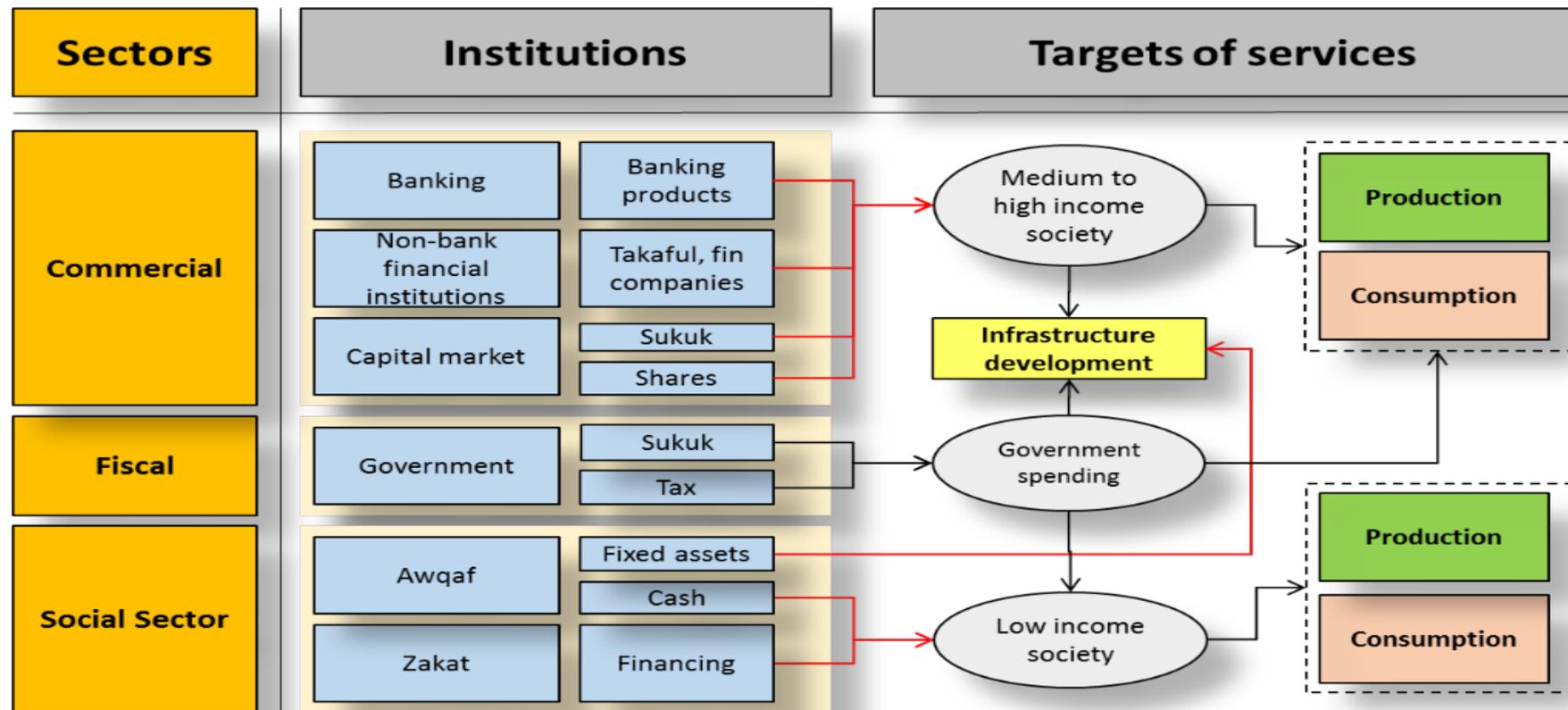
# Awqaf Development



- ✓ The term of Awqaf was literally derived from Wuquf which means stands still or remains. The term was then absorbed into the financial term to represent the responsibility of an economic agent to maintain the value of the mandated asset.
- ✓ Traditionally, awqaf is defined as holding an asset transferred by an asset provider (waqif) and delivering its usufruct to the benefits of the public .
- ✓ The mandate of awqaf management assets is commonly held by the nadhir permanently until the asset lasts or in the perpetuity manner to produce economic benefits to the societal welfare.
- ✓ In the traditional *awqaf* practices dated back to the Ottoman Empire era, cash waqf is commonly practiced as a form of investments whereby the principal funds are continuously invested in potential investment opportunities.
- ✓ In the current contemporary practices, cash waqf practice is still inherent with a modern awqaf asset management yielded for various investment purposes such as real estate, school buiding, and hospital.

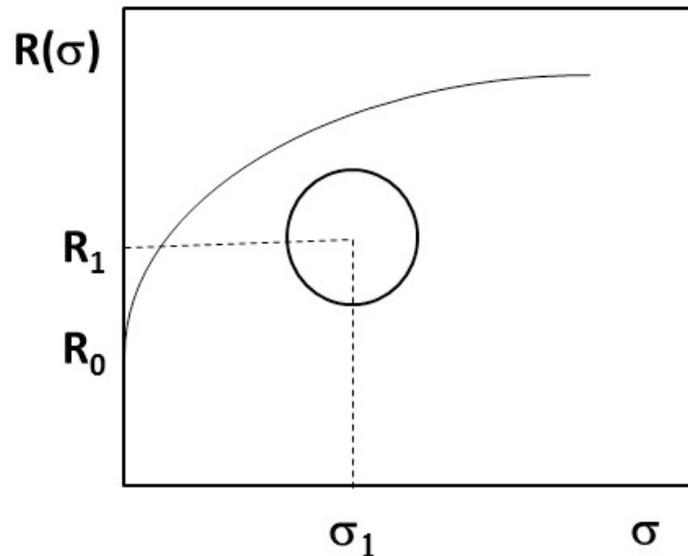


- ✓ An awqaf asset is originated when a waqif transfers his asset that is in his real possession to an awqaf manager (*nadhir*) accompanied with specific prescription to manage the asset.
- ✓ Any economic excess generated from the awqaf assets is solely meant for the society welfare.
- ✓ The nadhir should technically be able to maintain the value of the assets mandated to them from the waqif in a good trust and manage the awqaf assets to generate economic gain out of the awqaf assets.
- ✓ The economic surplus will be distributed to recipients (*mauquf alaihi*).

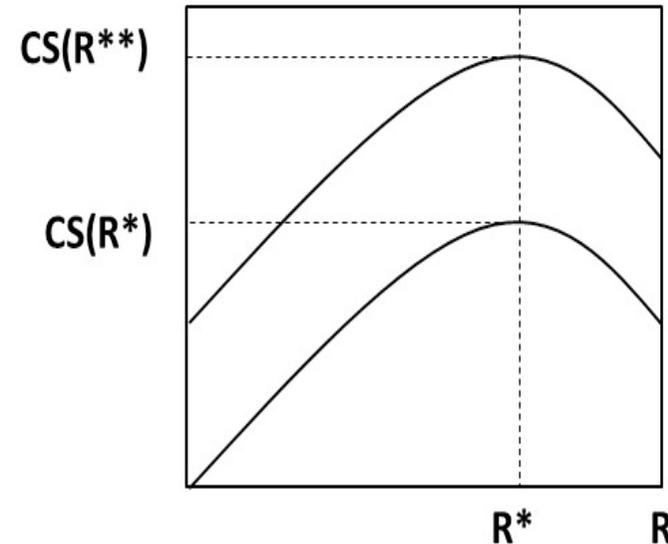


- ✓ From the macroeconomic point of view, the Islamic social sector can be viewed as a vehicle that is suitable to complement the government efforts in poverty alleviation initiatives.
- ✓ The awqaf assets are beneficial in terms of infrastructure, low cost of funds, and underlying basis for Islamic securities

## Position of Zakat and Awqaf in efficient frontiers



## The Role of Zakat and Awqaf in Credit Supply



Sources: Chi-Fu Huang (1991, Modified)

- ✓ illustrates the role of the Islamic social sector in providing investments to the 'sub-optimal' investment portfolios  $(R_1, \sigma_1)$  to later on standing in the efficient frontier line with higher return  $(R\sigma)$  and more contribution in the economy.
- ✓ Holding the market economic rate the same  $(R^*)$ , the presence of zakat and awqaf funds is opening the opportunity to increase credit supply to the society (from  $CS(R^*)$  into  $CS(R^{**})$ ) without necessarily increasing the potential of moral hazard since the facility is availed through dedicatedly designed contracts and zero cost of funds

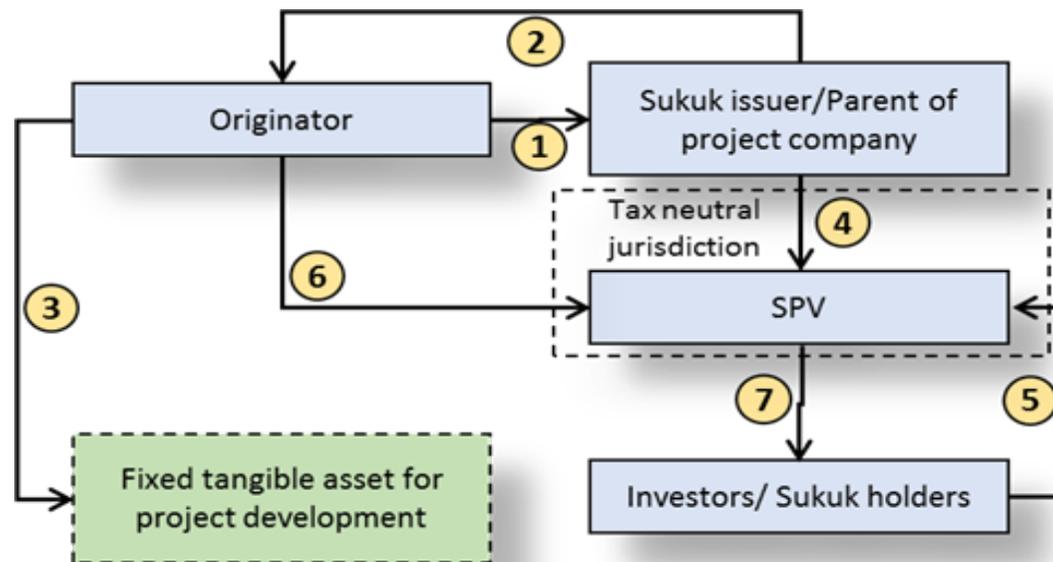


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# Sukuk Development within Islamic Finance Landscape



- ✓ *Sukuk* plural; singular *sak* are defined by the Accounting and Auditing Organisation for Islamic Financial Institutions ('AAOIFI') as “certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services or (in the ownership of) the assets of particular projects or special investment activity” (AAOIFI 2003, p.298).
- ✓ Within ICM landscape, Sukuk is deemed as a financial instrument to fund specified projects and also liquidity management instrument.
- ✓ Sukuk structure with a variety of Islamic financial contracts as classified by AAOIFI has evolved from traditional structure through attempts to innovate on sukuk so as to gain popularity in Islamic financial market.



## Risk Factors:

- ✓ No guarantee
- ✓ Investors have recourse to sukuk asset
- ✓ The risk is attached to the performance of asset
- ✓ Sukuk's asset can be recourse in case of sukuk default

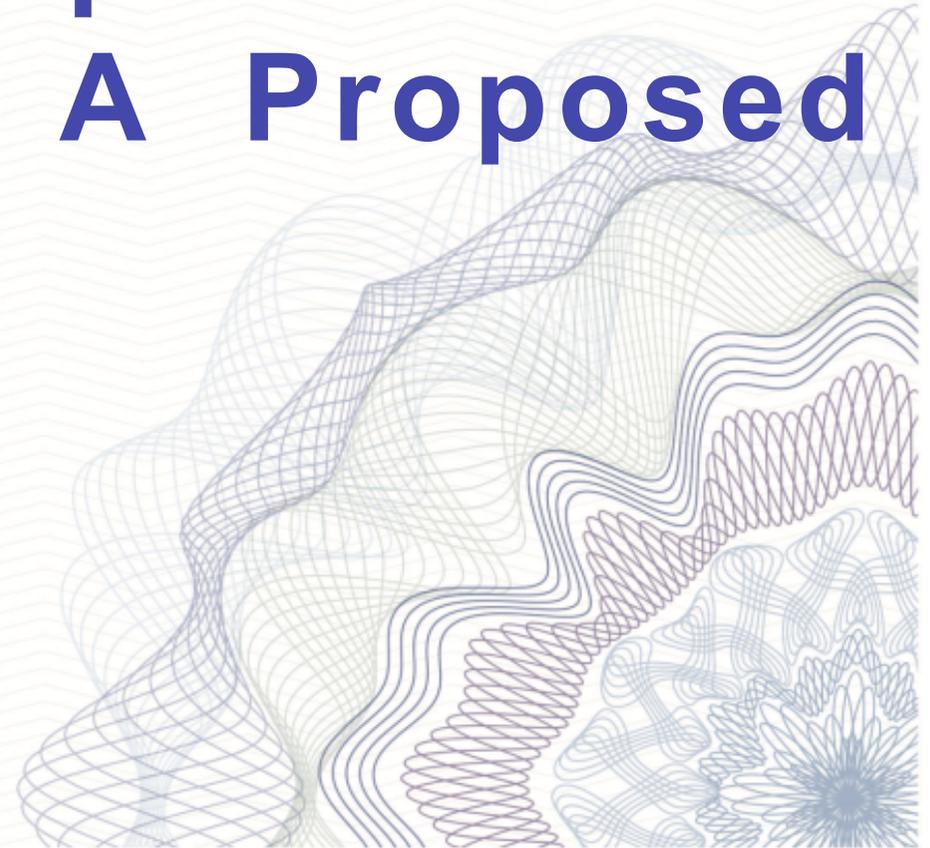
1. The fixed asset is offered/ to be transferred to the parent of project company.
2. The purchase price is paid to the originator based on certain values of money as agreed ex-ante of the contract;
3. The originator initiates the project development with its fixed tangible asset;
4. The SPV, usually established in tax neutral jurisdiction, passes through the beneficial ownership of the fixed tangible asset to the issuer,
5. The investors/lessors secure ownership of the fixed tangible asset represented in the *sukuk*,
6. The originator passes all the proceeds to the SPV,
7. Finally, the SPV distributes all the proceeds to the investors/lessors. By the end of the tenure of contract indicated by the completion of the project, the ownership of fixed tangible asset is transferred back to the originator.

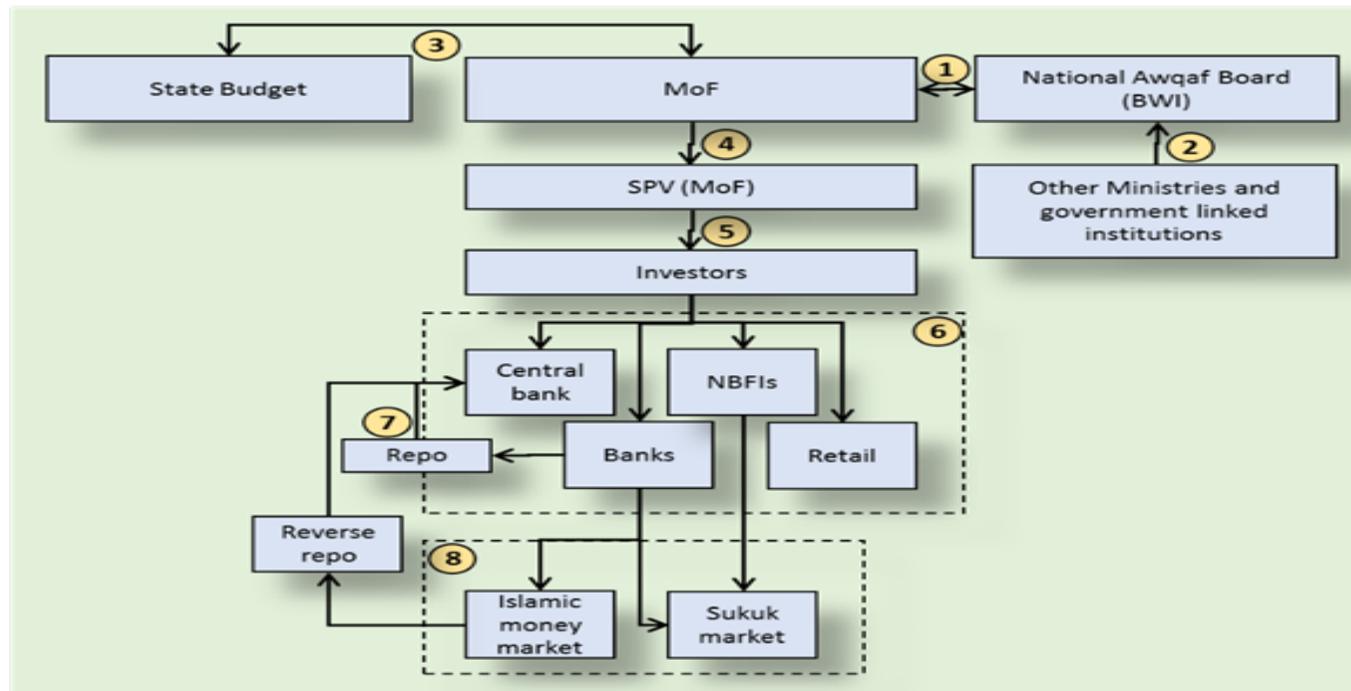
No.	Sukuk features	Asset backed	Asset based	Asset linked
1.	Presence of right to sukuk asset	Present	Absent, as recourse to the guarantor	Absent, as recourse to the guarantor
2.	Risk and return	Deriving from the real asset performance	Based on the guarantor's performance	Based on the guarantor's performance
3.	Presence of true sale transaction	Present	Absent	Absent
4.	Presence of guarantee	Absent	Present	Present
5.	Asset composition	Highly dominated by real assets	Highly dominated by real assets/with mixture of financial assets	Highly dominated by financial assets



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# An Awqaf Linked Sukuk: A Proposed Model





1. The Ministry of Finance and National Awqaf Board identify the infrastructure projects that can be done by using suitable awqaf assets.
2. The Ministry of Finance would then register those assets in the list of programs to be developed by the state budget. The projects listed would then be scheduled for government sukuk issuance.
3. In order to proceed with sukuk issuance, the Ministry of Finance will establish an SPV to fulfil sharia compliance requirements in the investment structure.
4. Other Ministries could also identify their project development programs that can be done by using suitable awqaf assets.

5. For a global sukuk issuance, the SPV will then issue the sukuk in a territory that has tax neutrality regime and capable to accommodate both legal interests of the investors and the issuers
6. The investors could comprise of central bank, commercial banks, non-bank financial institutions (NBFIs), and retail investors.
7. For the banks, the sukuk issued can be considered as liquid instruments since it has a sovereign class, particularly when the central bank provides an acceptance for repo facility and the bank can trade among themselves under “Islamic repo/repo syariah” transaction. (ii) For the central bank, the sukuk acquired in their inventory could be used as an alternative instrument when conducting monetary policy namely reverse repo transaction in the Islamic money market. The central bank may use the sukuk as the monetary instruments or retrench the assets through securitization process using the sukuk inventory as the underlying assets.
8. The Islamic banks and the non-bank financial institutions may also use the sukuk acquired for liquidity management purposes (for example, as a secondary reserve requirement) in the inter-Islamic bank money market or with other financial institutions for the same liquidity reasons.

In a true project based sukuk, the repayment capacity to the financial obligation depends upon the profit generating capacity as a function of income (I), cost of operations (C), amortization cost (A), and cost of fund (F).

$$\Pi = I - C - A - F \quad (1)$$

If the equation (1) is expressed in terms of unit, it becomes

$$\pi = r - c_O - c_A - c_F$$

Consider that the probability of default of the sukuk ( $K(C_A)$ ) is represented by the ratio of the financial returns ( $\pi$ ) and ( $c_F$ ). The equation becomes:

$$K(C_A) = \frac{\pi}{c_F} = \frac{r - c_O - c_A}{c_F} - 1, \text{ with } 0 < K(C_A) < 1$$

If the probability of default is compared between sukuk that has zero land acquisition cost and otherwise, the ratio becomes the following.

$$\frac{K_O}{K(C_A)} = \frac{r - c_G - c_F}{r - c_G - c_A - c_F} = I_K$$

The sensitivity of the ratio with respect to  $c_A$  is as follow.

$$\frac{dI_K(c_A)}{dc_A} = \frac{-dc_A}{(r - c_G - c_A - c_F)^2}$$

It is assumed that a project generating much higher gain (in term of net profit before interest) than its fixed financial obligations would have a greater chance succeed.



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# Conclusion and Policy Recommendations





## Conclusion:

- ✓ The awqaf linked sukuk is indeed an impetus for global sukuk issuance if it is realized by government or corporate for doing financing with societal impacts.
- ✓ Islamic financial deepening efforts in the Islamic financial market by adding the innovation structure on sukuk, which is currently driven by commercial purposes.
- ✓ Indonesia that has tremendous waqf assets can be an ideal role model to issue the awqaf linked sukuk
- ✓ an awqaf linked sukuk are a pivotal development in Islamic capital market to contribute sustainable economic development that needs full supports from government institutions and relevant stakeholders.



## Policy Recommendations:

1. Islamic financial deepening efforts with product enhancement and innovation on sukuk that has tremendous benefits for social welfare;
2. Zero initial outlay as no acquisition cost and government financial resources cost saving with the impact of quadratic reduction on sukuk pricing;
3. Enhancement of Islamic cross-sector financing between financial sector, real sector, and social sector within Islamic economic system to realise the objective of shari'ah (*maqasid al-shari'ah*).