



The Legal Protections of Investment in Sovereign Sukuk: Evidence from Indonesia

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DECLARATION

I Suwadi hereby affirm that except where stated otherwise, this dissertation submitted is based on my own written work under the guidance of [prof.mr. E.P.M. Vermeulen](#), and that I have used no sources and aids than those indicated. All passage quoted from relevant sources are adequately cited and attributed.

Signature :

Date : June 10, 2016

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ABSTRACT

Sukuk, as one of the Islamic financial instruments, has become increasingly well-known for both sovereigns and corporations in raising funds from investors in recent years. Nevertheless, like other financial instruments, sukuk are facing with various types of risks. The most important ones are the Syariah compliance risk and default risk that refers to credit risk that includes the possibility that the underlying assets or loans would be unpaid because of a default or delay in settlements.

This thesis will especially examine and analyse Indonesian Sovereign Sukuk (ISS), whether they have been fully complying with Syariah law principles and whether the issuer/obligor has given full legal protections for the investors in case of defaults.

From some literatures, interviews and fact findings, we can analyse and conclude that ISS have not fully complying with Syariah law principles as ISS are typically known as asset-based sukuk, which basically the sukuk holders could not recourse the underlying asset in case of defaults, and this situation bring about uncertainty (gharar). However, this gharar could be classified as gharar qualil, meaning that there is just minor uncertainty which means that it still can be tolerated and be executed and donot result in void and unenforceable.

Because of that reason, automatically Indonesian government has yet to fully legally protect the sukuk holders, particularly in case of defaults. Sukuk holders are not able to benefit from the cashflows and the liquidity of the underlying asset.

The liquidity management and facilities of ISS regulated by Law No. 19 of 2008 on Sovereign Sukuk, however, has surely given investors certainty and enjoyment in the payment rights, both the coupon and the principal value because they have been allocated in Indonesian state budget annually until the maturity, unless defaults or bankruptcies happen.

INTRODUCTION AND BACKGROUND

In recent years, instability in global financial market has given prominent to an alternative financial system, Islamic finance.¹ Sukuk are formed using structural application of Islamic finance and consider as the most recent products in the capital market.² Sukuk were basically designed to facilitate the liquidity management of the Islamic banking sector (Usmani, 2010) which otherwise needed to keep excess reserves to mitigate liquidity risk. The sukuk development is also intended to give the opportunity to choose alternative investment for those who want to capitalize their money based on their religious beliefs. Because Islam prohibits pious Muslims to invest in interest based securities, then sukuk is designed to accommodate their funds to be invested in through a kind of debt financing which is Syariah compliant. Banks and hedge funds have been attracted in these kind of instruments because of the asset-backed sukuk structure and attractive returns offered by these securities. From the issuers' point of view, sukuk are considered as capital market instruments innovation that the issuer can pool funds from a larger range of investors.³

Indonesia, as one of the issuers of sukuk both corporate as well as sovereign sukuk has been playing an important role in international global market. In term of sovereign sukuk issuance, as of December, 2015, Indonesian government positioned as the first issuer of international (foreign currency) sovereign sukuk, among other countries, like Uni Arab Emirate, Malaysia, Qatar, Bahrain, Turkey, Hongkong, Pakistan, and South Africa.

Like other financial instruments, sukuk are facing with different types of risks. The most important are the operations risk, market risk, and syariah compliance risk. There are many risks specific to the sukuk operation, which are basically related to the structure of the issuances. Default risk deals with credit risk that includes the possibility that the underlying assets or loans would be unpaid because of a default or delay in settlements. Because of the Islamic financial instruments nature that has become the principle of pooling of the underlying, the credit and counterparty risks related to Islamic finance are unique (Corporate Governance in Islamic Financial Institutions by Chapra Umer and Habib Ahmed, 2002). In addition, a coupon risk payment, where the obligor cannot pay the coupon payments in scheduled time, is also related to sukuk. The repurchase undertaking risk may happen when as the underlying assets may not be fully repurchased by obligor from the sukuk holders.⁴

Ijarah sukuk is the first and the most popular issuance of the Indonesian Sovereign Sukuk (ISS) types, which is typically known as asset-based sukuk because Indonesian government may sell the beneficial ownership of state-owned assets, while maintaining the legal title/ownership, so that comply with Law No. 1 of 2004 on State Treasury.

According to Securities Commission Malaysia (SCM), sukuk fall under the asset-based class if the underlying asset which is used to construct the issuance continue staying on the balance sheet of the obligor/originator/issuer after the issuance of such sukuk. In this classification, the obligor merely transfers beneficial ownership of the underlying asset to sukuk holders, while still maintaining its legal ownership (Hidayat, 2013). In other words, from a legal perspective there is no

¹ Youtube, *Islamic Finance: Sukuk*, July 20, 2015, <https://www.youtube.com/watch?v=AaVS4uWpVeA>

² Capital Market Central Asset Management Co., *Sukuk benefits and its essential infrastructure for developing Sukuk market*, <http://english.sukuk.ir/index.php/31-archive-latest-developments/259-sukuk-benefits-and-its-essential-infrastructure-for-developing-sukuk-market>

³ Sweder van Wijnbergen and Sajjad Zaheer, *Sukuk Defaults: On Distress Resolution in Islamic Finance*, Amsterdam School of Economics, University of Amsterdam and Tinbergen Institute, First draft, July 2013, <file:///C:/Users/lenovo%201/Downloads/Sukuk%20Defaults%20on%20distress%20Resolution.pdf>

⁴ Financial Islam-Islamic Finance, *Risk Underlying Sukuk*, <http://www.investopedia.com/walkthrough/corporate-http://www.financialislam.com/risks-underlying-sukuk.html>

real sale in the asset-based structure as sukuk holders do not care about the underlying asset. As a result, the sukuk holders do not have ability to sell the underlying assets to a third party. It also can be said that the sukuk holders only have the recourse to the obligor and vice versa not to the underlying assets. This type of sukuk is the most prevalent both in the local and global sukuk markets, similarly in Indonesia. Many scholars have criticized this type of asset-based sukuk on the ground that the assets are employed only as a way to Islamize and in another way to conventionalize debt tool.⁵ Moreover, in the case of bankruptcies or defaults of the obligor, the sukuk holders cannot benefit from the liquidity and cashflows of the underlying asset.

From the explanations and the facts mentioned above, we will focus on examining and analysing whether ISS have already been syariah-compliant sukuk and whether Government of Indonesia (GOI) as an originator/obligor/issuer has been giving full legal protections to the investors, especially in the event of default/bankruptcy and how GOI gives them to the investors, particularly to Ijarah sukuk holders which mostly have the underlying of state-owned assets as the basis of the issuance of them as well as the resolution of ISS default and how to mitigate the default risks of ISS.

Key words: Sukuk, Underlying Asset, Originator/Obligor/Issuer, SPV, recourse, default/bankruptcy, Ijarah Sukuk, Syariah-compliant, sukuk holders, asset-based, asset-backed, repurchase undertaking, gharar, e-kathir, qualil

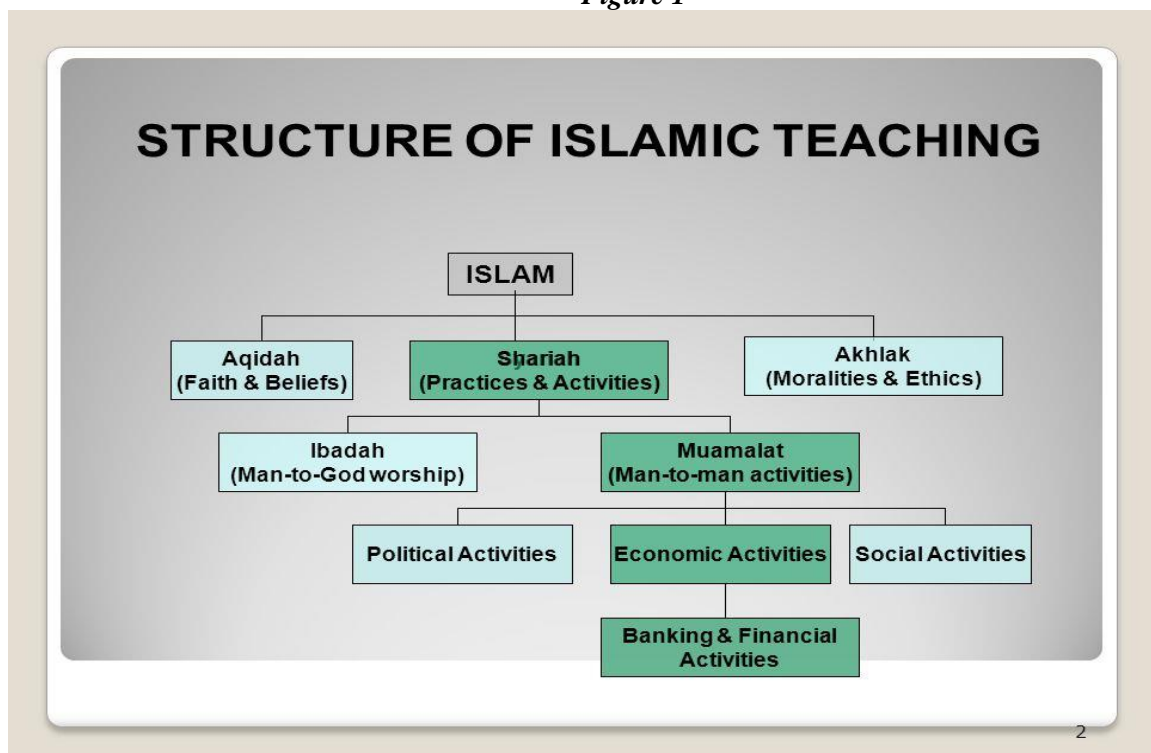
⁵ Abdulmalik Oricha Ali, *A Critical Look at Assed Based and Asset Backed Sukuk Default*, INCEIF – The Global Institute to Islamic Finance, http://www.academia.edu/6943153/A_critical_look_at_Asset_based_and_Asset_back_Sukuk_defaults

I. ISLAMIC FINANCE

A. The Basic Principles of Islamic Finance

Islam is actually more than just a religion; meaning it is also a rule of life that corresponds to economic, social, and political affairs. Anyone who comes after Islam is called a Muslim, and every Muslim is required to live based on the Islamic rule, which is syariah (Islamic law). Every problem dealt by syariah is interweaved with all kinds of problems; so, economic problems are connected to religion, ethics, culture, politics, and etc.⁶ In Islamic jurisprudence specifies the next principle: “All sorts of Muamalat (transaction among human beings) are allowable, except otherwise forbidden by a book”. Hence, basically, all sorts of dealings are permitted unless there is a ground (nash) that forbids them.⁷ In the Koran Allah says: “Allah has allowed trade and disallowed riba”. It means that Islam guards trading from riba.⁸ In Figure 1 below we can see the structure of Islamic Finance.

Figure 1



Source : INCEIF

Islamic finance is funding which is line with the principles of the Islamic law called as “Syariah”. The terminology of Syariah can be defined as “direction” or “way” which is designated to govern the connectedness between a Muslim and Allah personally, and among transactions with other Muslims in social, economical and spiritual relationship. So, Syariah

⁶The Concept and Principles of Islamic Finance, <http://www.dummies.com/how-to/content/the-concepts-and-principles-of-islamic-finance.html>

⁷ Mirza A Karim, *Sukuk in Indonesia: A Legal Review*, Legal Guide, 2007, <http://www.kantakji.com/media/7812/f199.pdf>

⁸ Riba can be roughly translated as "Usury", or unjust, exploitative gains made in trade or business. Riba is mentioned and condemned in several different verses in the Qur'an (3:130, 4:161,30:39 and perhaps most commonly in 2:275-280). It is also mentioned in manyhadith.

broaden to affecting the financial, economic, and banking activities of Muslims. The origins of Syariah (in ranked order) are: The Koran (the holy book); Sunnah (the instructions and implementations of The Prophet Muhammad (Tranquility Be Upon Him)); and Ijtihad and Fiqh, so called Islamic jurisprudence. The term Fiqh means comprehensive understanding of every aspects or “knowledge” or in other words the interpretation of the Koran and Sunnah conducted by Islamic scholars as well as jurists. Basically, there are four mazhabs or streams of view on which scholars and jurists found their Fiqh. These are: the Hanafi stream that is adopted mainly in Iraq, Lebanon, Turkey, Syria, Pakistan, Jordan, Bangladesh, India and Afghanistan; the Maliki (conventionalist) stream that is adopted in Africa; the Hambali stream that is adopted in Saudi Arabia; the Shafii stream that is adopted in South East Asia region.⁹

Additionally, according to Mirza A Karim (2007), a Muslim can carry out a dealing on investments, business cooperation, loans, sale and purchase, borrowings with other people as long as the dealings do not have any forbidden subject matters. Moreover, in the term of Muamalat, Syariah law does not separate the rights and obligations among muslims and non-muslims. Everyone has right and obligation related to what has been agreed upon. From muamalat perspectives, there are several principles that should be followed by a muslim: (1) avoid making a living from any forbidden things, both in substance or the way of getting them and avoid using them as well; (2) avoid doing suppress and being suppressed; (3) be honest and/or fair; (4) do the transaction that is based on of mutual sincerity; (5) avoid riba; (6) avoid maysir (gambling); (7) avoid gharar (uncertainty/vagueness); and (8) donot make money from money. In order to ensure transparency, honesty, and ethical transactions in trade, basic principles were set up in Syariah law, for instance the forbiddance of maysir, riba, qimar, gharar, and jahala.¹⁰ In Figure 2 below, you can see the diagram of Islamic Financial System.

⁹Linklaters, *Syaria-compliant Securities*, September 2012,

file:///C:/Users/u1234651/Downloads/161211_Sharia_Compliant_Securities_Sukuk_Flyer.pdf

¹⁰Sherin Kunhibava & Shanthly Rachagan, *Syariah and Law in Relation to Islamic Banking and Finance*,

<http://repository.um.edu.my/16659/1/Article%206%20-%20%20Kunhibava.pdf>

Figure 2



Source: BPMS1013 Theory & Practice of Islamic Business 4, 2013

B. Islamic Financial Instruments

Some Islamic financial market instruments have been brought out to comfort market players in order to manage their liquidity that normally are issued by means of direct bidding to Islamic financial organization only. Several conventional financial organizations which have these Islamic financial instruments (such as sukuk), however, because these instruments are also traded in the secondary market, were found to have been using these instruments as underlying asset in their conventional dealings (for instance repurchase agreement) to meet their liquidity necessity.¹¹

Instruments are identical to securities, and the tradability is main consideration of its characteristic. It cannot be argued they are only purchased in the first issuance, or repurchased undertaking or bought back. It can be said that the instruments are able to be traded on secondary markets. The most globally popular type of financial instruments, for example bonds, are perhaps, because most buyers need such securities in order to trade them in secondary markets, and minority of market players will be favoring to keep bonds until maturity. Certificates of deposit have been supposed a growing importance in recent years especially in the United States and Western financial markets in general. Both of them can be a beneficial tool for a safer choice to bond holdings and liquidity management.¹²

As we have seen today, most of Islamic financial instruments were evolved in the day-to-day practices of Islamic banking and finance. Gradually, these financial instruments have been grown according to business nature of specific Islamic financial institution and

¹¹ I-Fikri Isra, *Islamic Financial Instrument as Underlying Asset in Conventional Transaction*, <http://ifikr.isra.my/nl/fatwa/-/fatwa/getFatwaDetail/4086>

¹² Dr. Rodney Wilson, *Islamic Financial Instrument*, Legal Guide, 2007, http://www.jstor.org/stable/3381836?seq=1#page_scan_tab_contents

necessity of specific markets. The diversity of Islamic financial instruments are also growing as Islamic financial industry is springing up wider and more complicated.¹³

In addition, Islamic finance is becoming increasingly improving as a piece of the financial field in the Islamic domain. In Islamic finance there is no restriction to Islamic communities, but is expanding wherever there is a substantial Muslim group.¹⁴

Islamic markets provide sort of instruments in order to satisfy issuers and investors of funds, there are: trade financings, sales, and investments. The fundamental instruments involve cost-plus murabaha (financing), mudaraba (profit-sharing), ijarah (leasing), bay' salam (forward sale), musharakah (partnership), bay' mu'ajjal (deferred-payment sale), and deferred-delivery sale (bay' salam) contracts, in addition to area of sales, that are used for performing credit sales.

Recently, by using a new tool, so-called sukuk, has been increasingly taken into account in Islamic countries for example Saudi Arabia, Malaysia, Pakistan, Qatar, Kuwait, Bahrain, and even in European countries, like the United Kingdom. Sukuk is a financial tool supported by tangible assets and balance sheet and sukuk can be used by both government agencies and private companies for financing method.¹⁵

Moreover, sukuk have been constructed to provide the sort of incomes as paid out in conventional bonds, hence they are often classified as debt capital market instruments. According to Syariah law, it is allowed to trade sukuk certificates when the underlying assets, usufructs or services they are reflected for are recognizable and tangible, for instance in ijara sukuk. If they are only described but cannot be identified, for example in a salam sukuk, it is not allowed to trade them because it would lead to the trading in debt..¹⁶

¹³ http://shodhganga.inflibnet.ac.in/bitstream/10603/11410/12/12_chapter%204.pdf

¹⁴ Islamic Finance in Malaysia, <http://islamikfinance.blogspot.nl/2007/11/islamic-financial-instruments.html>

¹⁵ Zaenab Rezaei, *Sukuk: An Islamic Financial Instrument*, p.261, Academy of Business and Scientific Research, 2013, http://www.jstor.org/stable/3381836?seq=1#page_scan_tab_contents

¹⁶ Istisnaá Corporation, *Islamic Financial Instruments*, http://www.istisna.kz/eng/?page_id=46

II. SUKUK IN GENERAL

Hanifah explains why both Muslim and non-Muslim investors are taking notice of Shariah-compliant vehicles, including sukuk.

“Sukuk are seen as an attractive alternative investment class because they have delivered comparable returns to conventional investments, with the added potential benefit arising from Syariah-compliant fundamentals that require ethical business practices, underlying productive assets, equitable risk sharing, social responsibility and avoidance of speculation. Sukuk can also provide diversification. While they are influenced by movements in other (traditional) markets, they have been generally less correlated; one reason is because sukuk generally have lesser banking sector exposure. During the global financial crisis in 2008, for example, the lower banking exposure helped limit the downside of the sukuk portfolio slightly better than conventional investments did. So the difference in sector composition contributes to this diversification argument between a sukuk portfolio and traditional bond portfolio.”¹⁷

A. Sukuk Category

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)¹⁸ has specified 14 categories (Financial Accounting Standards No. 17) of permissible sukuk and a number of techniques that can be employed to structure a sukuk transaction. They are as follows: 1) Sukuk of ownership in leased assets; 2) Sukuk of ownership of usufructs of existing assets; 3) Sukuk of ownership of usufructs of described future asset; 4) Sukuk of ownership of services of a specified party; 5) Sukuk of ownership of described future services; 6) Salam sukuk; 7) Istishna sukuk; 8) Murabahah sukuk; 9) Musharakah sukuk; 10) Mudharabah sukuk; 11) Wakalah sukuk; 12) Muzara'ah sukuk; 13) Musaqah sukuk; and 14) Mugharasah sukuk. Of those 14 categories, they could be classified into 3 groups: Ijarah Based Sukuk, Sale/Debt Based Sukuk, and Partnership Based Sukuk.¹⁹

Some scholars also categorized sukuk to be tradable and nontradable. And the early literature come up with two types of category: sovereign sukuk (government or quasi-government) and corporate sukuk.²⁰

The option of structure type will depend on different factors, including the character of the underlying assets, regulatory and taxation considerations, the targeted-based investor and the fatwas/opinions of the Syariah scholars who have to consent to the issuance of such sukuk. As a consequence of the Statement of AAOIFI, the most current and commonly market are ijarah, mudaraba-wakala, and murabaha. The prevalent of the mudaraba and musharaka sukuk has decreased dramatically if compared to the others recently, as a result of the Statement of AAOIFI, that put limitations on repurchase's requirement at face amount and forbidden obligatory free loan of interest or facility of liquidity that are usually used to

¹⁷ Franklin Templeton Investments, *Is Islam debt a Salve for the Risk-Averse?*, August 30, 2012, <http://global.beyondbullsandbears.com/2012/08/30/islamic-debt/>

¹⁸ AAOIFI is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari'a standards for Islamic financial institutions and the industry.

¹⁹ Directorate of Syariah Financing, Directorate General of Financing and Risk Management, Ministry of Finance Republic of Indonesia, *Sukuk Negara: Instrumen Keuangan Berbasis Syariah Edisi Kedua*, Jakarta, 2015,

²⁰ Meysam Safari, Mohamed Ariff, and Shamsheer Mohamad, *Sukuk Securities*, John Wiley & Sons Singapore Pte, Ltd, Singapore, 2014, https://books.google.nl/books?id=t-uMBAAAQBAJ&pg=PA26&lpg=PA26&dq=sukuk+category+according+to+AAOIFI&source=bl&ots=U-BIQEQePf&sig=ctkj9ZP21w4CN85pi9rtzDKtRs&hl=en&sa=X&ved=0ahUKEwj_35jCweDMAhXIA8AKHb8UCIEQ6AEIUTAI#v=onepage&q=sukuk%20category%20according%20to%20AAOIFI&f=false

settle for any insufficient earnings generated from the underlying assets of sukuk. Without regard to the chosen structure, nevertheless, the institution wanting to pool finance (the obligor) will basically form an intermediary institution, so-called an SPV and pass on the SPV a title of the underlying assets. Next, the SPV will issue sukuk and exercise the funds that have been pooled to give payment to the obligor for those underlying assets. Theoretically, the underlying assets of sukuk are pulled apart from the obligor's remaining assets. Practically, in contrast, the obligor keep using assets (such as under a lease agreement in ijara sukuk), or to make out the assets (such as under a mudaraba or musharaka agreement). Generally, in issuing such sukuk, they are structured as credit-risk tools of corporation and in the event of default and redemption setting, the sukuk holders would definitely not have recourse to the underlying assets. Redemption is typically influenced by the sukuk holders claiming their rights inimical to the originator by way of a purchase undertaking. From syariah point of view, sukuk are representing the ownership of assets, but the reality in economics and commerce, most sukuk are unsecured and classified equivalently as conventional bonds.²¹

B. Potential Challenges of Sukuk

Although the sukuk market is significantly developing in the recent years, it is still facing a number of potential challenges which could potentially impede its growth and could restrict future development. Latham & Watkins LLP (2015) classified some of these potential challenges as follows:

– Legal Regime:

In every issuance of sukuk, the forming of an Special Purpose Vehicle (SPV) is required and the transfer of assets underlying the sukuk by the entity seeking to raise finance (the obligor) to such SPV. This may give rise to extra taxes and stamp costs, placing sukuk at an unfavorable as compared to unsecured conventional bonds. The enactment of taxation and transfer and registration land law by the Malaysian government which do not impose penalty to sukuk issuances compared to the conventional bond issuance was the main ground that Malaysia keep accounting for above 60 percent of the issuance of its global sukuk. Many countries seemingly want to track this format in developing an Islamic finance market and want to enact legislation to asphalt the way for their sukuk issuances. For instance, by implementing the UK's Finance Act 2009, the UK government took away the tax barriers that had put the financial products complied with Islamic laws less efficient in tax than their conventional ones. The inauguration of this such legislation has triggered the UK's desire to be the pioneer of international hub for Islamic finance. In July 2014, the UK Government also recorded as the first sovereign sukuk issuance in Europe by issuing a sovereign sukuk worth £200 million. In September 2014, Hong Kong Government come behind suit by issuing sukuk that worth US\$16 billion, that served a taxation structure for sukuk issuances similar to conventional bonds issuance. Singapore and Japan have also inaugurated the same reforms in an effort to mitigate asymmetries of the treatment of sukuk's tax and conventional bonds so that sukuk can battle with the products of conventional debt.

²¹Latham & Watkins LLP, *The Sukuk Handbook : A Guide To Structuring Sukuk*, 2015, file:///C:/Users/u1234651/Downloads/guide-to-structurings-sukuk-2015.pdf

– Standardization:

A fatwa, as a component of issuing a sukuk, is generally required from syariah scholars to bestow obligor and sukuk holders with enjoyment that such sukuk are substantially Syariah compliant. Nevertheless, these recommendations tend to dissimilar interpretations; and these differences of recommendation can bring about instability in the market. In order to have a standardization in sukuk issuance around the globe, it should be developed a guiding set of principles which a number of syariah scholars accord to abolish any doubts in relation to syariah compliant. The government of Malaysian has made an effort to tackle this issue by instituting a syariah supervisory board that is centralized to make sure that every sukuk issuance in Malaysia is fully complying with syariah principles. At the time of publication, The GCC region has not improved the same supervisory body or met with syariah laws, but would probably take advantage from the foundation of the same body immediately.

– Mechanics for Default:

Sukuk investors need to comprehend his or her rights and obligations in the event of default or bankruptcy in connection with the growing of a recent market. A number of early investors see sukuk as a secured investment, taking advantage from the securitization of the underlying assets of sukuk. Nevertheless, following some popular cases of sukuk defaults, sukuk holders should learn the difficult path that most sukuk instruments are not absolutely safe in the conventional perspective. But if seen from a syariah point of view, sukuk are contemplated to reflect an undivided share in the ownership of tangible assets, usufructs and/or services, that give rise a question whether sukuk holders have a right towards these assets in case of a default. It absolutely will depend entirely on the structure of sukuk issued. For instance, sukuk which are structured with asset-based, do not need to accomplish in assigning registration formalities, because there is no true sale in this transaction. In the absence of a true sale, the sukuk holders are actually regarded as unsecured creditors. Even if such sukuk are structured with a true sale of sukuk issuance or known as asset-backed sukuk, there has to be contractual agreements to make sure that sukuk holders has legal right to recourse the underlying assets. A purchase undertaking will be given by the obligor which guarantee that the obligor via an SPV has to deliver the underlying assets back to that obligor upon the redemption of the sukuk or the default situation. This repurchase undertaking gives right to the SPV accompanied with a contractual claim towards the obligor to anticipate unpaid principal as well coupon equal to the face value of the sukuk, but there is no claim towards the underlying assets, which puts the sukuk investors in a place similar to bonds investors. The rank of protection given to investors, hence depends on the structure of such sukuk. AAOIFI seem to support an asset-backed structures's movement, in which they will give the investors an actual recourse to the underlying assets, especially in the case of a default. In fact, however, most sukuk in the market are structured to treat sukuk holders in the position the same as bond holders in an insolvency or restructuring. Although it is highly recommended by AAOIFI, it comparatively rare to find the asset-backed sukuk structures in the market recently.

C. Ijarah Sukuk Structure

From many types of sukuk, in this paper we will focus on Ijarah sukuk, because it is one of the most significant ones, which in fact relates to the securities in which jointly the owner, posses some part of the underlying assets that the profits would have been consigned to the sukuk holders or the obligor as stated in Ijarah agreement. In Ijarah Sukuk, the right of making the revenues of the underlying assets are transferred from the obligor to sukuk holders in replace of the rent payment. The Ijarah contract tenure is clearly stated and the rent payment could be paid both at the beginning or end of the period or with monthly, quarterly, or annual payment until the maturity dates. This kind of sukuk represent a joint ownership, and is tradable at secondary markets with a price which is predetermined by market agents before traded.²²

Almost every countries issues this type of sukuk for the first time. Currently, global trend indicates that investors prefer sukuk Ijarah due to their more stable returns.²³ Even, some scholars see that the Ijarah sukuk as the ancient sukuk structure and it has become the most commonly used structure by issuance volume since 2008. This popularity derives from its undisputed syariah-compliance and the familiarity of investors with the structure of sale and leaseback. It is natural as a sale and leaseback agreement creates it appropriate with the need of the issuing company that is free of encumbered assets that are commercially leasable, for instance land, building or real estate, aircraft or ship. In calculating the rental payments, it can use the reference, like LIBOR or EIBOR to determine the market rate.

As already mentioned, Ijarah sukuk is very well-known in most countries-issued sukuk, particularly in volume of issuances and is taken into account by some scholars as the ancient sukuk structure compared to other sukuk structures issued. Why Ijarah is popular? It is mainly because of its simplicity, widely accepted and easy to understand by conventional inventors, sukuk investors and the international rating agencies. Ijarah sukuk requires the consignment of proprietorship or usufruct/benefits of tangible assets for example real estate, land, building, ship or aircraft from an obligor to an SPV, which then issues sukuk certificate to investors that are representing undivided ownership of the underlying assets. The underlying asset is then leased back to the obligor by the SPV for identified conditions, which is typically equivalent with the conditions of the certificates. The sukuk holders have right to accept the rental payments coming from that lease of the underlying asset pro rata among the sukuk holders. The total of these rental payments is equivalent with, and SPV will use it to pay the regular distribution payment at that time. On the date of sukuk issuance, the obligor will get into a repurchase undertaking agreement which bestows the claim to the SPV to require the obligor to repurchase the underlying assets upon dissolution event or the maturity, at face value equivalent with the amount of principal and unpaid cost. The proceeds accepted by the SPV would be utilized to pay the unpaid amount that investors have not received yet. Because the payments of sukuk's coupon closely depend on the payments done by the SPV, so the obligor under the ijara agreement and repurchase undertaking, it can be argued that it is similar to the obligor's credit risk. If sukuk is structured under asset-backed, the recourse will definitely be available in the event of default, therefore sukuk holders can claim the non-payment amount of the buyback price of the underlying assets in regard to the

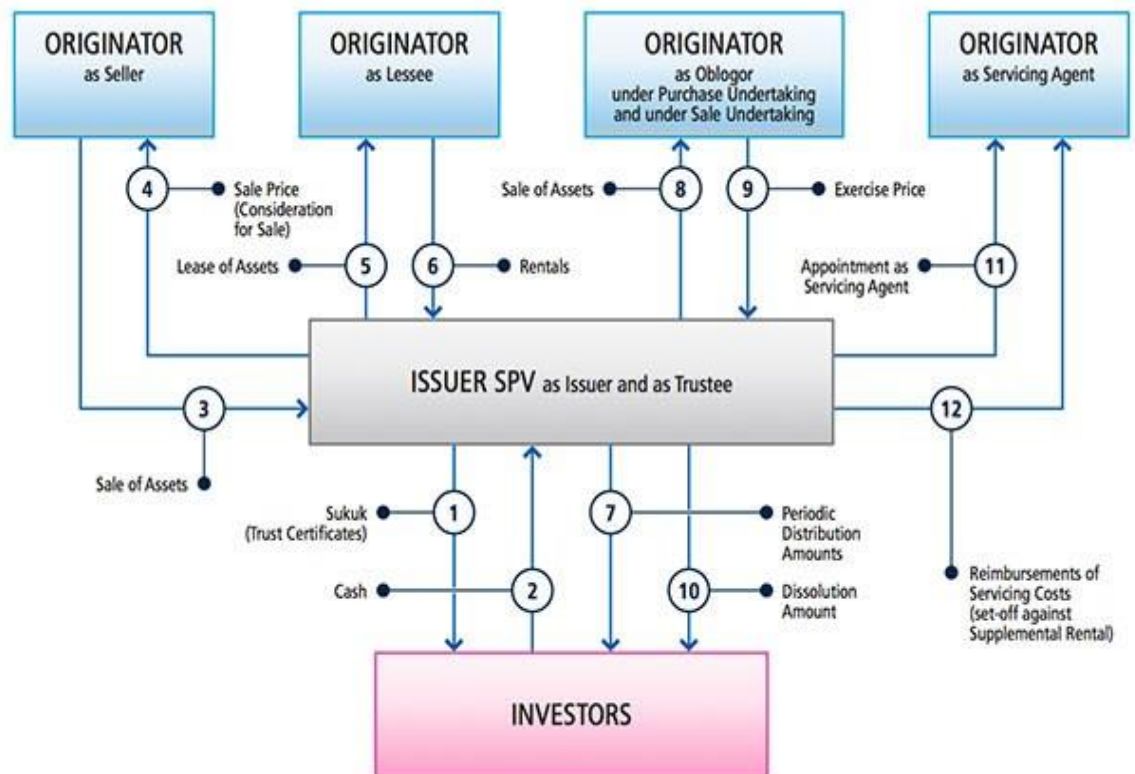
²² Capital Market Central Asset Management Co., *Sukuk benefits and its essential infrastructure for developing Sukuk market*, <http://english.sukuk.ir/index.php/31-archive-latest-developments/259-sukuk-benefits-and-its-essential-infrastructure-for-developing-sukuk-market>

²³ Mirza A Karim, *Sukuk in Indonesia: A Legal Review*, Legal Guide, 2007, <http://www.kantakji.com/media/7812/f199.pdf>

repurchase undertaking, that places the sukuk holders the same position of a regular unsafe bonds.

Furthermore, the lease in an ijara must comply with all of the following general syariah requirements applicable to leases: (1) The lessor has to have legal ownership of the underlying asset, usufruct, or services before coming into a lease agreement; (2) The advantage/profit derived from this ijara structure has to be lawful under Islamic principles, for example prohibiting of leasing a property to sell alcohol, because it is unlawful; (3) The assets which are leased should exist as long as the period of lease agreement and are prohibited to be leased another parties; (4) The specification of both amount of payment and period of the lease must be determined beforehand; (5) The lessee has to utilize the leased underlying asset merely for designing in the lease agreement; (6) The lessor has to take care and guarantee that during the leasing period, delegate this obligation to a trustee during the leased period,; and (7) The liabilities coming up from the ownership of the underlying assets, for instance any loss or harm, are conveyed by the SPV, as lessor. Ijarah sukuk structure could be described in Figure 3 below.

Figure 3



Source: Islamic Banker

The abstract of Ijarah sukuk structure:

1. SPV as issuer on behalf of originator/obligor issues sukuk to the sukuk holders.
2. The sukuk investors buy or subscribe for sukuk and give payment (the proceeds) to SPV.
3. Originator/obligor comes into a sale and purchase arrangement with SPV (as a trustee), to which constitutes that originator/obligor agrees to sell, and otherwise trustee agrees to purchase the underlying assets from the originator.
4. Trustee gives the proceeds obtained from sukuk holders to originator.
5. Trustee then leases the underlying assets back to originator by signing a lease agreement.
6. Lessee (originator) pays rental payments at periodic time as specified in the lease agreement.
7. SPV as issuer pays each periodic rental payment to sukuk holders..
8. In the event of bankruptcy/default or at maturity date (under the repurchase undertaking agreement), and originator will repurchase the underlying asset from trustee.
9. Originator give the proceeds as result of repurchase undertaking of the underlying assets to SPV.
10. SPV gives the payment (proceeds) to sukuk holders.
11. Trustee and originator come into a service agency agreement.
12. Reimbursement of servicing cost by SPV to originator.²⁴

D. Special Purpose Vehicle (SPV)

In every issuance of such sukuk is required to form an entity, so-called Special Purpose Vehicle (SPV) which plays an important role in the successful and efficient operation of them throughout its tenor. Even for large corporations, an SPV is used to meet specific purposes by way of raising funds, performing specific investment and transferring risk.

An SPV, in the realm of securitization, is generally built in the common law where it has two functions both as a trustee on behalf of investors which represents the interest of investors, such receiving the proceeds from the originator, then transferring it to the investors and as an issuer on behalf of the originator/obligor which has the authority to issue such sukuk. The members of an SPV is usually derived from the side of originator, because basically the forming of this entity is to facilitate the obligor interest in raising funds from investors. The SPV is taken into account as a legal entity that connects the interest of obligor and its investors. By having beneficial interest of the underlying asset is not sufficient to render the sukuk holders a full claim of ownership as contemplated under Syariah laws because all their beneficial rights are executable only by means of the trustee/SPV. The main purpose of forming this SPV is to reach, the so-called bankruptcy remoteness that means that whatever occurs to the obligor/originator will not take effect the underlying assets put into the legal ownership (custody) or in other word the SPV is vulnerable to any legal action conducted by creditors of the obligor give thank to the fact that it is conveyed to the trustee's legal ownership; and the fact that it will isolate similar to any recovery action conducted by other possible creditors.

This effect will no doubt effectively applicable if the SPV is absolutely a neutral entity which has no link with the obligor, and be independent entity, similar to an orphan child rather than a subordinate of the obligor. In practice, the establishment of an SPV is mainly used to raise funds for the sake of obligor's purposes and mandated to take care of the underlying assets upon sukuk issuance. In conducting its functions, the SPV normally posses a limited amount of capital as well staff, that actually it is just a tool to accomodate the issuance and transfer of such sukuk/bonds, and it is not regarded to do any tradings or any factual business actions for the profit of the sukuk holders. In ijarah sukuk, for instance, the underlying assets will be leased

²⁴Islamicbanker, *Sukuk Al-Ijarah*, <https://www.islamicbanker.com/education/sukuk-al-ijara>

back to the obligor and the rental revenue (profit) will be vice versa used to give payment to the sukuk holders on scheduled time.

It is supposed very difficult to be truthful in transferring the legal ownership to sukuk holders and mandating by Syariah law mainly because the very close relationship between the SPV and obligor. Moreover, at maturity of sukuk, the obligor is required to repurchase the underlying asset, hence, this is another signal that the intention is no more than borrowing and lending agreement between the sukuk holders and obligor where the SPV will act effectively as a trustee named to manage the underlying asset as a collateral.

By contrast, in the *mudarabah* structure, the manager/*mudarib* of fund's investment acts as a trustee who conduct the business on behalf of the investors. The investors here act as a capitalists who provide fund to run a business venture and the manager/*mudarib* is only providing human resources who are running the daily business. If there is a loss, this loss will be fully imposed to the investors unless it is caused by the manager/*mudarib*. In other word, the manager/*mudarib* has to be actively running this business and is supposed to manage trading for the profit of the investors and generated revenue that will be shared according to an agreed ratio. All commodities or assets that are under *mudarib*'s supervision should be sold in the market to get cash in order to get to know if there is any loss or profit in conducting their business at the end of the contract. The obligor normally will repurchase the underlying assets at the maturity or in the event of defaults. It seems to be compromised, if the motivation or reason for forming the SPV is to facilitate the sukuk holders interest that the SPV is becoming such a collateral of the obligor, particularly in the case of sukuk under structure of asset-based sukuk that there is no true sale to repurchase the underlying assets which formally under the control of SPV as a trustee. So, in this concept seems to be syariah compliant. It is crucial for sukuk holders to do comprehensive due diligent to make sure that the true sale of ownership accompanied by all risk and other aspects is bestowed by syariah laws, otherwise the sukuk holder will have doubts about their right, especially their periodic return payment that is generated from the underlying assets. It is very important for sukuk investors to be cautioned and be honestly notified about the main different between purchasing sukuk and investing conventional bonds in which, in conventional bonds, the role of the SPV is as an entity which are managing the underlying assets as a collateral for obligor in borrowing funds from the investors.²⁵

E. Tax Neutrality for Sukuk Issuance

The government support, among other things, to make sure that there will be tax neutrality, is the key element for the success of sukuk issuance, better than from conventional bonds issuance.²⁶

The treatment difference between interest and profit might be a hurdle in forming the mandatory sukuk's legal structure in a state's legislation. On one hand, the payment of interest is tax deductible, but on the other hand, profit payment is taxable. Several kinds of transactions are influenced by extra obligations. For instance, sukuk *murabahah* has to give payment of sales tax and sukuk *ijarah* are often imposed with the payment of extra stamp duty. Recently, Malaysia, the United Kingdom, Turkey, and Qatar are the best countries in having taxation systems and legal structures for creating Islamic financial instruments. Malaysia, the most important sukuk issuer in the world, has created sukuk to be the most significant component for its economic

²⁵Dr. Z.A. Abd. Rahman, *Sukuk, SPV and Borrowing with Collateral??*, Islamic Law of Finance, January 12, 2011, <http://islamiclawoffinance.blogspot.nl/2011/01/sukuk-spv-and-borrowing-with-collateral.html>

²⁶Marocco Gazette, *Government support and neutrality on tax vital for sukuk issuance*, April 04, 2016, <http://www.marocgazette.com/story-z2266911>

development strategy and tackled taxes differently. In an effort to charm more investors, especially sukuk investor, Malaysian government, by creating tax code, offers a significant incentives to investors that would benefit from it going beyond conventional bonds. That is why Malaysia has become the center of Islamic finance and absolutely been successful recently.²⁷

F. Underlying Asset

What makes the difference between bonds and sukuk is, among other things, there must be an underlying asset, used to back the asset-based or securitization process of sukuk issuance.²⁸ Even, the necessity for the underlying asset is a clear requirement in all Islamic financial transaction. Despite the clear requirement for underlying asset, many modern issuers seem to have walked away from making sure of compliance with this requirement. This phenomena has been one of sukuk issuance's controversy in recent years. Basically, there are two issues related to the underlying assets: (1) Whether the underlying asset has to represent tangible assets only or includes intangible assets for example receivables; (2) Should the underlying asset serve for backing the sukuk issuance or only just serve for the basis of sukuk issuance. Starting from the structure of asset-backed sukuk, which give "collateral" to sukuk holders, it seems there is a trend leading to asset-based sukuk. In the construction of an asset-based sukuk, there is a sale of asset conducted by the obligor to the SPV (which is basically the issuer of sukuk) that from a legal perspective, sukuk holders do not have right to recourse the underlying asset. The merely assurance which sukuk holders have is the repurchase undertaking that contains a unilateral guarantee or promise to purchase the underlying assets back at maturity in a wa'd form. The price of this repurchase undertaking is the outstanding value of sukuk that generally equal to value in redemption. Furthermore, only the obligor that can buy the underlying asset back and not allowed to be sold to any other third party.²⁹

Next, what are the basic elements which are important in terms of underlying asset comply with Syariah law? Firstly, the asset has to be qualified that means that it should be in position to be very clearly described what exactly the asset is. Secondly, it has to be quantified, meaning we need to know the specification of the asset, for example, if the asset is real estate, we should know what is the size, shape, etc. Thirdly, the asset needs to have a value. It means that you cannot use the asset that has not value, for instance the broken building that does not have marketable value as an underlying asset. Finally, the underlying asset has to be revenue generating. It is very important, take an example in Ijarah-based sukuk, the underlying asset should be leased back to the obligor so that the asset can generate certain incomes that can be shared with the investors. Moreover, the underlying asset could be tangible asset or intangible asset.³⁰

²⁷Naveed Mohammed, *Sukuk, Taxation, and its Necessary Legal Structures*, Sukuk.com, August 09, 2014, <https://www.sukuk.com/article/sukuk-taxation-legal-structures-2332/>

²⁸Islamic Capital Market, *Underlying Asset In Sukuk Issuance*, 2015, http://119.110.108.29:9117/301_264_264/Web/WebPage/Underlying-Assets-In-Sukuk-Issuance/Underlying-Assets-In-Sukuk-Issuance.html

²⁹Obiyathulla Ismath Bacha and Abbas Mirakhor, *Islamic Capital Markets A Comparative Approach*, John Wiley & Sons Singapore Pte. Ltd, 2013,

<https://books.google.nl/books?id=vR5wAAAAQBAJ&pg=PT173&lpg=PT173&dq=underlying+asset+in+sukuk&source=bl&ots=LyLQBLE-iP&sig=yD980hPWRGz-lri8frwey6v1HGY&hl=en&sa=X&ved=0ahUKEwiysebtv-rLAhUE0xQKHaxpAQo4ChDoAQgsMAM#v=onepage&q=underlying%20asset%20in%20sukuk&f=false>

³⁰Marifa Academy, *Sukuk, Structures-Issuers, Assets and SPV: Lesson-2ndonesian law on Sovereign Sukuk*, https://www.youtube.com/watch?v=HNQ1Q1L8SaI&ebc=ANyPxKqeN1G7W4rXfaUSB4UKjpHEnPUEU3aoAwn5KI-ptSDwLKS5IFeTGoexQWT_leJB45CR9jzkQpp9SW8C_arwsev9ITG0Jw

G. Asset-Based and Asset-Backed Sukuk

As already stated that sukuk are generally classified as either asset-based or asset-backed. In term of asset-based sukuk, the dominance of sukuk issued nationwide, there is only transferring of beneficial of the underlying assets ownership, not of legal one. The beneficial ownership is passed by the obligor to the investors. It means that the assets keep on the balance sheet of the obligor and the payments to investors mainly generates from the cashflows of the obligor.³¹

In relation to the above statement, it makes the asset-based sukuk a very different structure from the opponent, the ancient asset-backed sukuk. In asset-backed sukuk, there will be a true sale, meaning that the legal ownership of the underlying assets would be legally transferred to the SPV, which is basically bankruptcy-remote. The obligor gets the so-called a call option that requires the obligor to repurchase the underlying assets from the SPV at maturity of such sukuk. In the event that the obligor cannot afford to buy back the underlying assets at maturity or at financial crisis, the sukuk holders basically could recourse or sell the underlying assets to another party. Hence, it is clearly stated that there is a great difference between the structure of asset-backed or asset-based sukuk, mainly from the risk profile that has to be taken into account by sukuk holders. In asset-based sukuk, sukuk holders is equal to conventional bond holders. From the obligor's perspective, asset-based sukuk structure may be more desirable, mainly because of the lower transaction costs and convenience but the most important reason is the obligor will not lose control of the underlying asset because the legal ownership still remain on obligor's authority. This would be the main consideration, particularly if the sale of the underlying asset in asset-backed sukuk issuance could provoke the negative promises that are commonly found in loan or bond's feature standard.

Even though the structure of asset-based sukuk definitely gives an enjoyment to obligor and stay away from complicated problems coming from the transfer of the underlying asset, etc., on the other hand sukuk holders would suffer loss from it. Why? Because in a sukuk transaction where the underlying asset is intangible assets, such as receivables, the sukuk may not be traded at a secondary market, lower price, or even may not be less worth than recovery cost. Nevertheless, in spite of these drawbacks in sukuk holders side, the sukuk market seems to be advancing in the course of asset-based and abandoning from asset-backed sukuk.

If sukuk are asset-backed, the risk profile is dependent on the underlying asset, whereas in asset-based sukuk, because sukuk holders have no recourse to the underlying asset but are dependent on the repurchase undertaking, the risk profile is dependent on the financial ability of the obligor. Figure 4 provides some of the key differences between asset-backed and asset-based sukuk.

³¹Steven Friel and Silke N. Kumpf, *Sukuk default*, Financier Worldwide, March, 2015, <http://www.financierworldwide.com/sukuk-default/#.Vv6uvP197RY>

Figure 4

ASSET-BACKED VERSUS ASSET-BASED	
Asset-Backed Sukuk	Asset-Based Sukuk
<ul style="list-style-type: none"> • Sale: True sale of asset to SPV. • Recourse: Sukukholders have recourse to underlying asset. • Potential purchaser: Can sell asset to third party. • Purchase price: market value of asset at maturity. • Profile: Sukukholders get upside potential from rising asset value. • Risk category: Collateralized (based on type and value of underlying asset). 	<ul style="list-style-type: none"> • "Sale" of asset to SPV. • Sukukholders have no recourse or stake in underlying asset. • Originator is the only possible purchaser. • Redemption/outstanding value of sukuk. • Sukukholders do not benefit from rising underlying asset value • Unsecured (sukuk will be rated as unsecured debt of originator)

H. Repurchase Undertaking

In issuing sukuk, there is a promise called a repurchase undertaking – a promise that the borrower will buy back the underlying assets at their face value at maturity, or in the event of default, mirroring the structure of a conventional bond.³²

This repurchase agreement is basically an independent agreement, apart from the master sukuk agreement. It also gives the opportunity to sukuk holders to redeem and reimburse the amount or unpaid payment. Consequently, obligor's trust is disappeared. So, the obligor which will repurchase the underlying assets on market price will bear the value risk of residual asset. The significant issue on Ijarah sukuk is that the rent should be equivalent with the value of the underlying assets.³³

In sukuk issuance, the purchase undertaking is the key of credit document in sukuk issuance. It gives return on an investment for sukuk holders at maturity and on other situations, such as early redemption right, as well as in the event of defaults. Some scholars have scrutinized this repurchase undertakings that have been evolving to be such an instrument to guarantee a return on specific types of sukuk which have to be an equity investment, hence there is the investment risk in them. It seems that AAOIFI has moved sukuk away from a pure debt instrument classification toward an equity instrument reclassification, in an effort to better represent the status of sukuk in the Islamic financial market. This evolution will require to move disclosure of transaction risk, and therefore sukuk investors will focus on the obligor with its repurchase undertaking and greater focus on the creditworthiness of the underlying assets, too.³⁴

Moreover, according to Barry Cosgrave, the repurchase undertaking may also become applicable in the event of nondefault occurrence, for example early redemption by the sukuk holders. The most nondefault event is the exercise of sukuk at maturity date. Basically, a repurchase undertaking set out in a way that is suitable with all the circumstances and in details manner. Certain rights will picture sukuk holders of their right on redemption.

How to exercise a repurchase undertaking? Islamic law obliges that any sale and purchase of assets happens on a certain places. This is the main reason why using a repurchase undertaking in sukuk transactions. Islamic law forbids a sale agreement that contains gharar

³²Reuters, *Most sukuk 'not Islamic', body claim*, Arabian Business.com, November, 2007, <http://www.arabianbusiness.com/most-sukuk-not-islamic-body-claims-197156.html#.Vw5r3fl97RY>

³³ Sweder van Wijnbergen and Sajjad Zaheer, *Sukuk Defaults: On Distress Resolution in Islamic Finance*, Amsterdam School of Economics, University of Amsterdam and Tinbergen Institute, First draft, July 2013, <file:///C:/Users/lenovo%201/Downloads/Sukuk%20Defaults%20on%20distress%20Resolution.pdf>

³⁴ Barry Cosgrave, *Sukuk Issuance and Issues in Purchase Undertakings*, QFinance, <http://www.financepractitioner.com/asset-management-best-practice/sukuk-issuance-and-issues-in-purchase-undertakings?page=1>

(uncertainty) such as the date and place of the transaction has to be clearly defined. This can particularly be applied to early redemption rights, especially in the event of default or undefault. To address this requirement, a repurchase undertaking is finally applied. To exercise the rights in the repurchase undertaking, the SPV is needed to render a notice to the obligor (stating that the obligor is required to repurchase the underlying asset, accompanied by the sale and purchase agreement. After exercising the repurchase undertaking, the obligor transfers it to the SPV and finally the SPV send it to the sukuk holders immediately.

While exercising of this repurchase undertaking rights at the maturity date of sukuk is a direct matter, it is done on behalf of sukuk holders, but on the early redemption framework, it seems to be more complicated. The repurchase undertaking is acting as a mirror reflecting the rights of the sukuk holders, surely under the terms and conditions. In line with the function of SPV, the issuer will inaugurate an administrator to conduct its day-to-day operation, for instance, notices issuance, sukuk holders's liaising agreement, act according to the instructions under the terms and conditions of the sukuk agreement. Both the SPV and administrator will not wish to presume the sukuk holders right in connection with whether they will exercise or not the underlying assets at the early redemption, and it is only done by the sukuk holders' instructions.

Even though a repurchase undertaking will usually apply cash to resolve the payment of exercise price of underlying asset, other forms of instruments can be used. The example is in the exchangeable or convertible sukuk market. In achieving this conversion or exchange, there must be an amendment of the clauses related to the payment of the exercise price that will be fulfilled through the delivery of such shares. These shares has to be delivered so that it can be calculated in the same way similar to exchangeable investment or conventional convertible.

This repurchase undertakings are usually drafted so that the value of the exercise price of the underlying assets could be calculated with reference to such a formula that is resulting an amount equivalent to the principal amount plus any accrued but unpaid profit amounts. This formula is easily adopted in connection with physical assets in ijarah or ijarah/istisna structure, because there is no investment management relationship or partnership between the parties and an agreement to share the losses related to the underlying assets. Ijarah sukuk assets are hard assets, so they are not subject to the concern of syariah, they cannot be destroyed, and they can be bought at agreed price between the parties.

This formula also could be used in the valuation of the musharakah, mudarabah, and wakalah structures as this structures are used in connection with intangible asset of investment. Some syariah scholars feel uncomfortable with the notion that the value of an asset as a syariah-compliant equity instrument could be attributed five years in advance from its purchase date, and provide an implicit guarantee that the value of the asset will not change significantly. This idea of the exercise price would be opposed to syariah principle because the investor has to share appropriately (such as, in a musharakah) or has to absorb wholly (such as in mudarabah or wakalah), losses related to the underlying assets. These statements were formally announced in February 2008 by AAOIFI in handing down the guidance to Islamic finance institutions on the issuance of sukuk.

That AAOIFI announcement have an impact on an ending the market of musharakah, mudarabah, and wakalah sukuk. Although this is just the first reaction of the market, some financial institutions clearly do not own a big inventory of tangible assets that will be required to get funding in a syariah-compliant way in the future. How to use sukuk to fund such operations? The simple answer is that it is necessary to apply a more sophisticated valuation methodology in the sukuk market to accurately pricing the underlying assets in a

repurchase undertaking, for the returning of principal to sukuk investors that coincide with the requirements of both potential sukuk investors and syariah scholars.

I. The Development of Sovereign Sukuk In Some Jurisdictions

There have been a number of sovereign backed sukuk of this nature across the Muslim world and elsewhere, such as the UK, where the government issued its first sukuk in 2014³⁵ that was worth £700 million. According to GOV.UK, the book closed with 75 orders, totaling around £2.3 billion. The main reason in issuing sukuk is to finance the government and corporate debt and to attract investors from Islamic regions. And it is the first country outside the Islamic world to issue sovereign sukuk. Furthermore, in 2014, the South African government began issuing sukuk worth \$500 million. That sukuk issuance oversubscribed four times, pointing out the passion of this product.³⁶ It used an ijarah (lease) sukuk structure that as already mentioned reflect ownership of equal shares in leased assets or the usufruct of the property.

It proved that sukuk, especially sovereign sukuk have been successfully created in a non-Muslim country. And, like in South Africa, Britain's sovereign sukuk also uses Ijarah structure, which is the most popular for issuing sovereign sukuk by three central government properties to be the underlying assets.³⁷

Interestingly, Malaysia has been to be a pioneer in global sukuk market development by launching the first sovereign global sukuk worth US\$600 million for five-year's tenor. After that, Malaysia has recorded as the largest issuers of sukuk over the years, because of the fast growth of its sukuk.³⁸ Although Malaysia is known as a sovereign issuer, the most structure of its sovereign sukuk is asset-based rather than asset-backed. The first sovereign sukuk issuance in 2002 was asset-based sukuk.³⁹

J. A History of Sovereign Sukuk's Defaults

East Cameron's sovereign sukuk, might be, the most relevant example of sovereign sukuk's default in this regard, that defaulted in 2008. And the sukuk holder (EC Offshore Properties, Inc.) then filed this bankruptcy to get protection after failing to generate the targeted return of its offshore Louisiana oil and gas wells. Surprisingly, even though the majority of sukuk are Reg-S, this kind of East Cameron sukuk was the first sukuk that are registered under US 144A regulation sukuk, which can be in a position similar to bonds in terms of transparency and disclosure. The problem in this case was about the sukuk holders' ownership of oil and gas owned by the company. East Cameron claim that there was no real or true transfer of ownership of oil and gas production, which was known as royalties into SPV

³⁵ Youtube, *Islamic Finance: Sukuk*, July 20, 2015, <https://www.youtube.com/watch?v=AaVS4uWpVeA>

³⁶ Norton Rose Fulbright, *Sukuk: South Africa accessing Islamic debt capital markets*, December 2, 2014, <http://www.nortonrosefulbright.com/knowledge/publications/124592/sukuk-south-africa-accessing-islamic-debt-capital-markets>

³⁷ HM Treasury and The Rt Hon George Osborne MP, *Government issues first Islamic bond*, GOV.UK, August 14, 2014, <https://www.gov.uk/government/news/government-issues-first-islamic-bond>

³⁸ Malaysia World's Islamic Marketplace, *Introduction to Sukuk*, 2016, http://www.mifc.com/?ch=ch_kc_definitions&pg=pg_kcdf_overview&ac=229

³⁹Slide Presentation, *Sukuk Negara Market Update as of December 21, 2015*, Directorate of Islamic Financing, Directorate General of Budget Financing and Risk Management, Ministry of Finance, Republic of Indonesia, 2015

and only a loan that was secured by royalty, meaning that in the event of default, the sukuk holders should share the East Cameron's royalties with other creditors.⁴⁰

In the court proceedings, East Cameron Partners (ECP) that was filed for Chapter 11 bankruptcy in Louisiana was basically trying to claim that the sukuk should be classified to be a secured loan and vice versa not a true sale of asset. Finally, the court was not persuaded and commanded the parties to render the legal title of the ORRI to the sukuk holders. Finally, the judge gave approval of ECP and EC Offshore Properties, Inc. purchase and sale agreement of the asset, which is possessed by the sukuk holders.

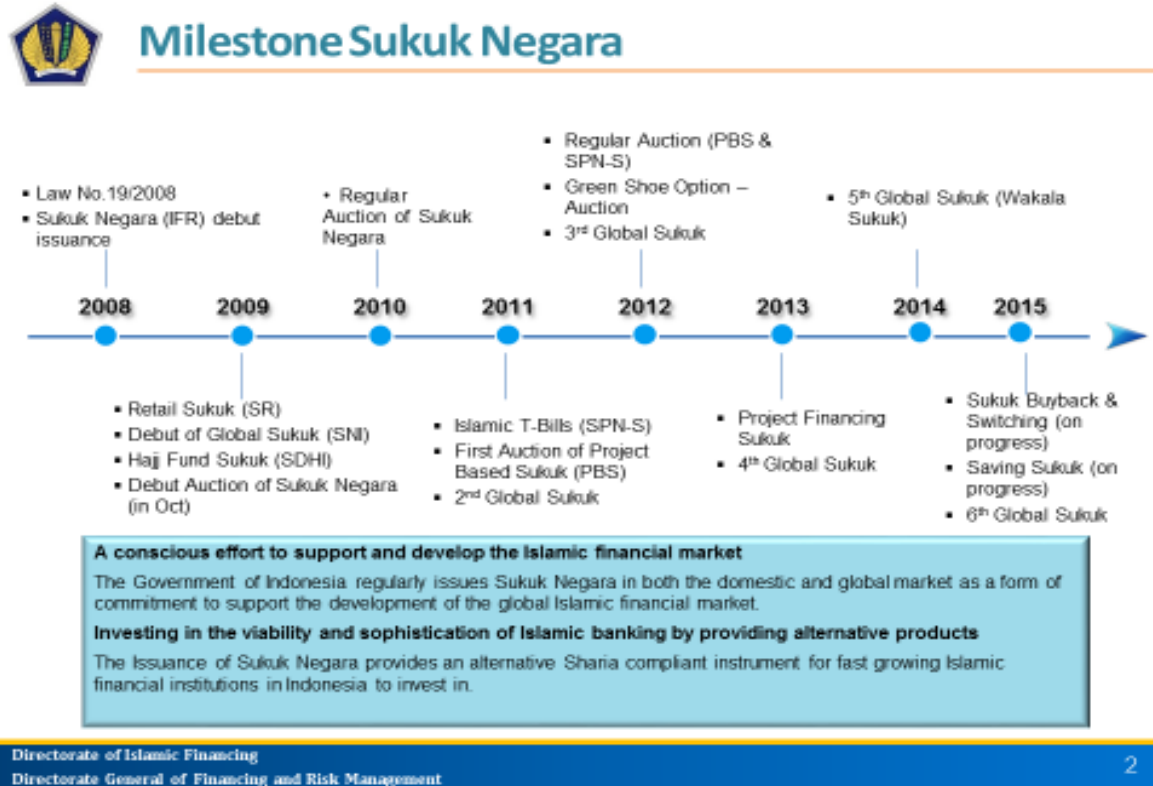
⁴⁰Kamal Abdelkarim Hassan and Muhammad Kholid, *Bankruptcy Resolution and Investor Protection in Sukuk Markets*, QFinance, <http://www.financepractitioner.com/regulation-best-practice/bankruptcy-resolution-and-investor-protection-in-sukuk-markets?page=4>

III. SUKUK IN INDONESIA

A. The Milestone of ISS

ISS issuance by Government of Indonesia (GOI) has allowed the government to get alternative source of financing in an effort to balance its budget deficit while diversifying its investor base. Indonesian government has successfully launch its first sovereign sukuk in the international market since 2009. The of IFR series of ISS has also become a regular sukuk issuance in the domestic market from its first launch in 2008 and then followed by the T-bills debut in 2011. In Figure 5, we can see the milestone of ISS from 2008 to 2015.

Figure 5



Source : Directorate General of Budget Financing and Risk Management , Ministry of Finance, Republic of Indonesia

As an responsive attempt to develop and support the Islamic financial market, GOI regularly launches sovereign sukuk in both the domestic and global market as a manifestation of commitment to prop up the evolvement of the global Islamic financial market. The sovereign sukuk issuance provides an alternative financial instruments that comply with Syariah laws for fast growing Islamic financial institutions in Indonesia to invest in.⁴¹

B. ISS Development

An effort to put strong foundation in pricing, GOI has permitted corporations to come into the international market by using the Global Sukuk issued by GOI as the benchmark. Meanwhile the issuance of the domestic sukuk will result in developing the local fixed

⁴¹ Sukuk Report, Chapter Four: Case Studies & Articles on Sukuk issuances – Institution Contribution, p.52, http://www.mifc.com/?ch=ch_kc_definitions&pg=pg_kcdf_overview&ac=229

income market. This GOI's strategy has help handling the budget deficit via developing domestic sukuk, such as SR, PBS, IFR, SPN-S, and SDHI series through frequent regular issuance program and regular Global sukuk (SNI) issuance in the international market. The implementation of the primary dealership also another alternative initiative of GOI which offers greater price transparency, secondary market liquidity, and wider investor's base.

Specifically, Indonesia began its debut of issuing sukuk in 1992 by the corporation of Bank Muamalat Indonesia's syariah bank. And its first sovereign sukuk was begun in 2009 after the promulgation of Law No. 19 of 2008 on Sovereign Sukuk, Law No. 21 of 2008 on Syariah Banking and Government Regulation No. 56 of 2008 on the Sovereign Sukuk Issuing Company. In Figure 6, we can see that there are a rapidly growing number of issuing sukuk by volume both in series and year with total issuance from 2008 to 2015 is IDR297,57 trillion. Interestingly, Indonesia is the largest international outstanding (USD denomination) of sovereign sukuk issuer in the world (see Figure 7), reached USD7.000 billion.

Figure 6

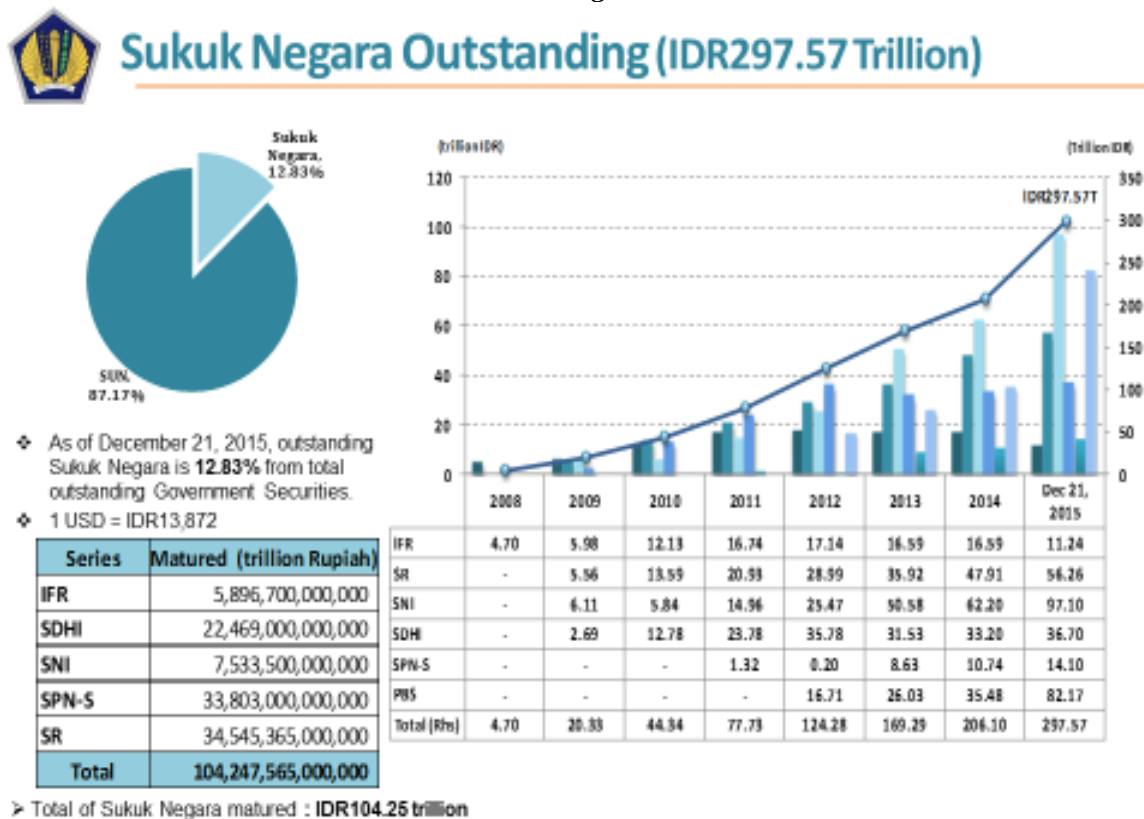
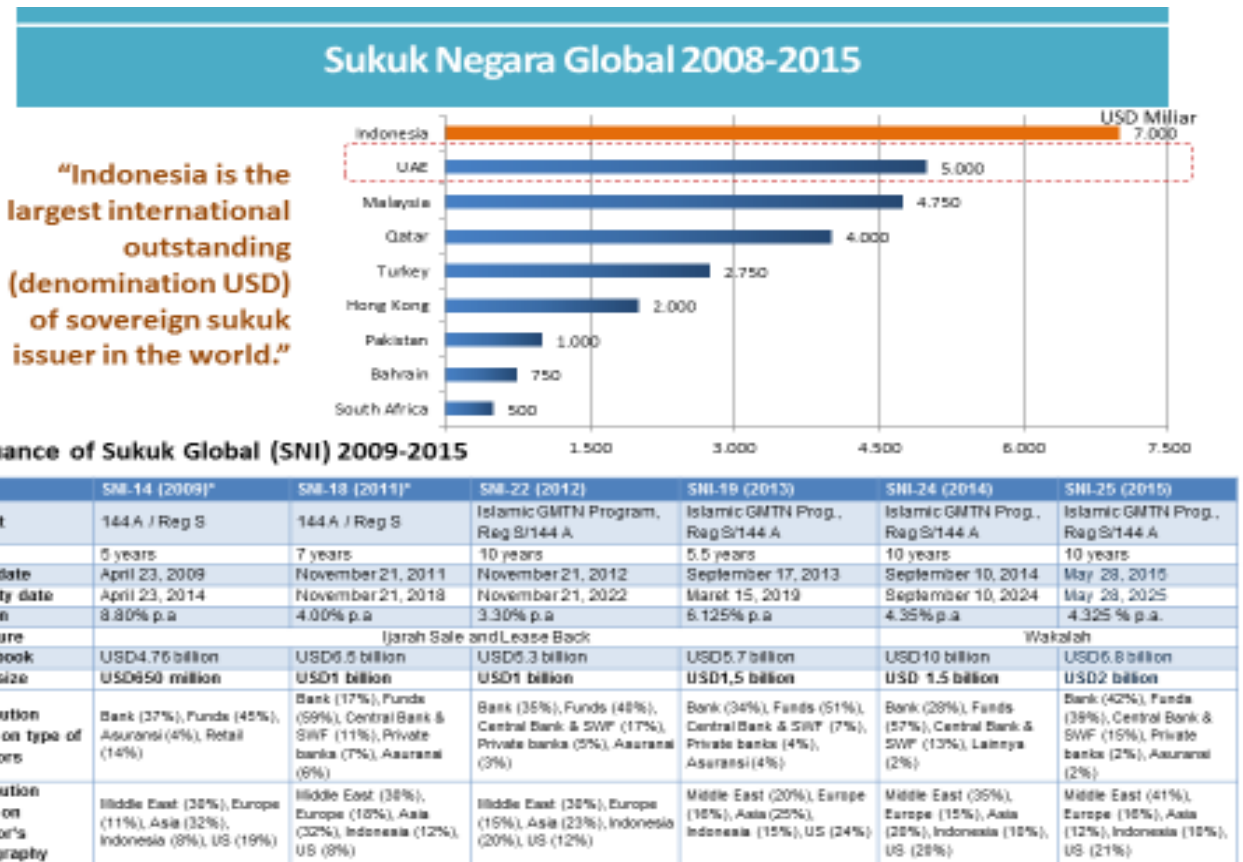


Figure 7



Source : Directorate General of Budget Financing and Risk Management , Ministry of Finance, Republic of Indonesia

Unlike any other countries mentioned above, ISS has special treatment in maintaining its liquidity, among other things, by providing its fund for the coupon and principal payments in Indonesia’s State Budget (ISB) annually. If there is not sufficient fund, among other things, for example because of currency exchange difference, GOI will add the allocation, surely with the permission of the parliament in advance. The liquidity management⁴² of ISS regulated by Law No. 19 of 2008 has surely given investors certainty in the payment rights, both the coupon and the principle value. Also, without an efficient capital market to operate within, ISS will not continue to grow meaningfully. Sukuk increase the liquidity of the originator.⁴³ Basically, the market requires liquidity and price transparency to enhance a secondary market.⁴⁴ By listing them in the secondary market, sukuk holders can sell them whenever they want to and the other investors also can buy them in the trusted market.

⁴² International Financial Review, *Issues in Islamic liquidity*, 2007, <http://www.investopedia.com/walkthrough/corporate-http://www.ifre.com/issues-in-islamic-liquidity/552713.fullarticle>

⁴³ Capital Market Central Asset Management Co., *Sukuk benefits and its essential infrastructure for developing Sukuk market*, <http://english.sukuk.ir/index.php/31-archive-latest-developments/259-sukuk-benefits-and-its-essential-infrastructure-for-developing-sukuk-market>

⁴⁴ International Financial Review, *Issues in Islamic liquidity*, 2007, <http://www.investopedia.com/walkthrough/corporate-http://www.ifre.com/issues-in-islamic-liquidity/552713.fullarticle>

Since the first issuance in 2008, there have been four structures of sukuk issued by GOI: SBSN Ijarah Sale and Leased Back, SBSN Ijarah Al-Khadamat, SBSN Ijarah Asset to be Leased, and SBSN Wakalah (Figure 8). SBSN Ijarah Sale and Leased Back are Sukuk issued based on Islamic principles using sale and purchase mechanism, where the purchaser then lease them back to the seller (obligor). SBSN Ijarah Al-Khadamat are Sukuk issued based on Islamic principles as a proof of ownership of part of underlying asset that commonly in the form of hajj services. Meanwhile, SBSN Ijarah Asset to be Leased are Sukuk issued based on Islamic principles as proof of ownership of part of the assets SBSN become the object of Ijarah, both are existing and will exist. And SBSN Wakalah could be defined as Sukuk issued based on Islamic principles as proof of ownership of part of the assets in the PP SBSN as a Trustee of SBSN holders. SBSN Ijarah Sale and Leased Back has state assets (mostly lands and buildings) as the underlying asset. Whereas SBSN Ijarah Al-Khadamat use hajj Services as the underlying asset. Moreover, SBSN Ijarah Asset to be leased has infrastructure projects as the underlying asset. Finally, SBSN Wakalah is the combination of state assets (51%) and infrastructure (49%) in the basis of underlying assets. All of these four sukuk structures give rewards to the sukuk holders in the form of fixed coupon, which commonly paid monthly. In addition to that, all of them are tradable in secondary market, except SBSN Ijarah Al-Khadamat because it has been using hajj service as the underlying asset, so there is no tangible asset in it.

Figure 8

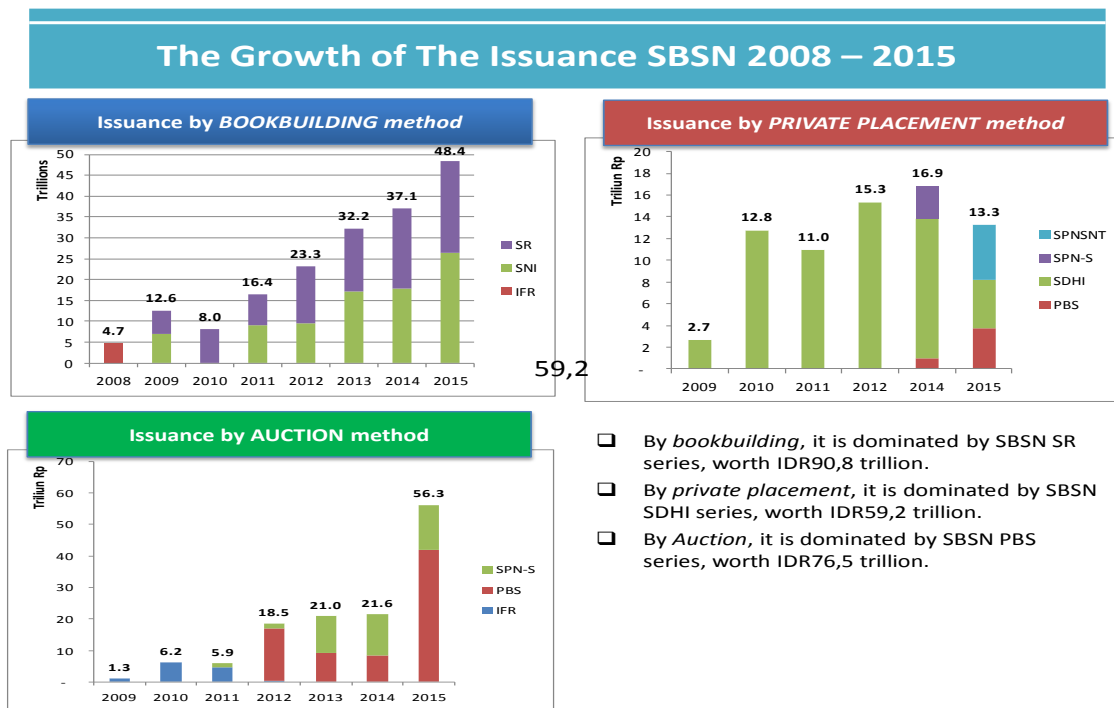
Indonesian Sovereign Sukuk Structure's Description				
Structure	SBSN Ijarah Sale and Leased Back	SBSN Ijarah Al Khadamat	SBSN Ijarah Asset to be Leased	SBSN Wakalah
Description	Sukuk issued based on Islamic principles using sale and purchase mechanism, where the purchaser then lease them to the seller (originator).	Sukuk issued based on Islamic principles as a proof of ownership of part of underlying asset that commonly in the form of hajj services.	Sukuk issued based on Islamic principles as proof of ownership of part of the assets SBSN become the object of Ijara, both existing and will exist.	Sukuk issued based on Islamic principles as proof of ownership of part of the assets in the PP SBSN as a Trustee of SBSN holders
Fatwa DSN-MUI	No. 72/2008	No. 9/2000	No. 76/2010	No. 95/2014
Underlying Asset	State Assets (Land and Building)	Hajj Services	Infrastructure Projects	State Assets (Land and Building: 51%) and (Infrastructures: 49%)
Reward	Fixed coupon	Fixed coupon	Fixed coupon	Fixed coupon
Tradability	Tradable	Non-Tradable	Tradable	Tradable
AAOIFI Sharia Standards' Category	Certificates of ownership in leased assets (3/1)	Certificates of ownership of described future services (3/2/4)	Certificates of ownership of assets to be leased (3/1)	Investment Agency Sukuk (3/1)
Series	IFR, SR, SNI (SNI-14,18,22,19)	SHI	PBS, SR	SNI (SNI-24, 25)

Source : Directorate General of Budget Financing and Risk Management, the Ministry of Finance, Republic of Indonesia

Furthermore, in the term of method used to issue ISS, GOI has three different types of methods (see Figure 9). First, bookbuilding method, a method of issuance of securities, where investors would submit bids on a secondary market, which are usually in the form of quantity and price (yield) bidding, and are recorded in the book orders by investment banks that act as bookrunner. Second, private placement is a method of issuance of securities, where the activities of

the issuance and sale of securities made by the issuer to certain parties with the terms and conditions to be mutually agreed. Third, trough auction securities which is a method of publishing and sale of securities, followed by the auction participants by way of proposing competitive bids and/or offers noncompetitive purchases in a bidding period predetermined. In Figure 10, we can see the auction participants of sovereign sukuk that mostly coming from banks.

Figure 9



Source : Directorate General of Budget Financing and Risk Management, Ministry of Finance of Republic of Indonesia

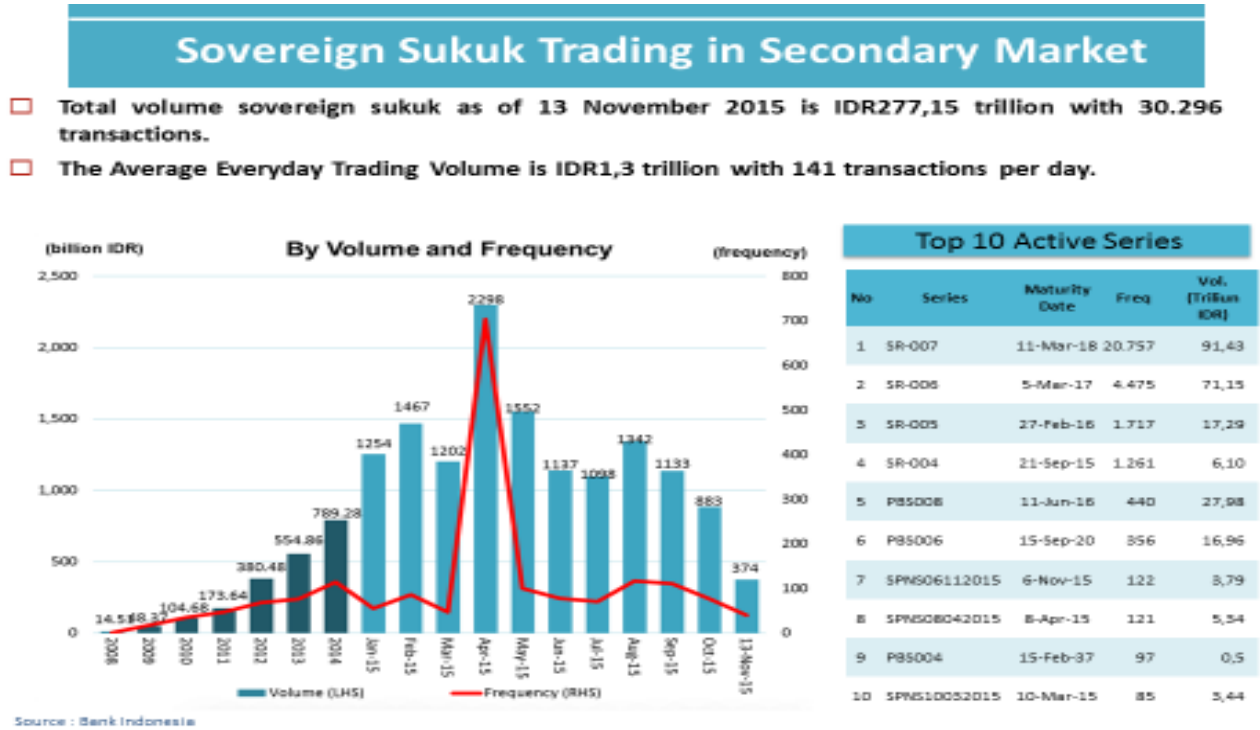
Figure 10

The Auction Participants of Sovereign Sukuk	
A. BANK	B. SECURITIES COMPANY
1 Citibank N.A.	1 PT. Bahana Securities
2 Deutsche Bank AG	2 PT. Danareksa Sekuritas
3 J.P. Morgan Chase Bank, N.A.	3 PT. Mandiri Sekuritas
4 PT. Bank BNP Paribas Indonesia	4 PT. Trimegah Securities, Tbk
5 PT. Bank BRI Syariah	
6 PT. Bank Central Asia, Tbk	Keterangan:
7 PT. Bank CMB Niaga, Tbk	: BRI Syariah as an auction participant as of Sept 2015
8 PT. Bank Mandiri (Persero), Tbk	: BSM, as an auction participant of SBSN as of April 10, 2015
9 PT. Bank Maybank Indonesia, Tbk	
10 PT. Bank Negara Indonesia (Persero), Tbk	
11 PT. Bank Negara Indonesia Syariah	
12 PT. Bank OCBC NISP, Tbk	
13 PT. Bank Permata, Tbk	
14 PT. Bank Rakyat Indonesia (Persero), Tbk	
15 PT. Bank Syariah Mandiri	
16 PT. Pan Indonesia Bank Tbk	
17 Standard Chartered Bank	
18 The Hongkong and Shanghai Banking Corporation Limited	

Source : Directorate General of Budget Financing and Risk Management, Ministry of Finance of Republic of Indonesia

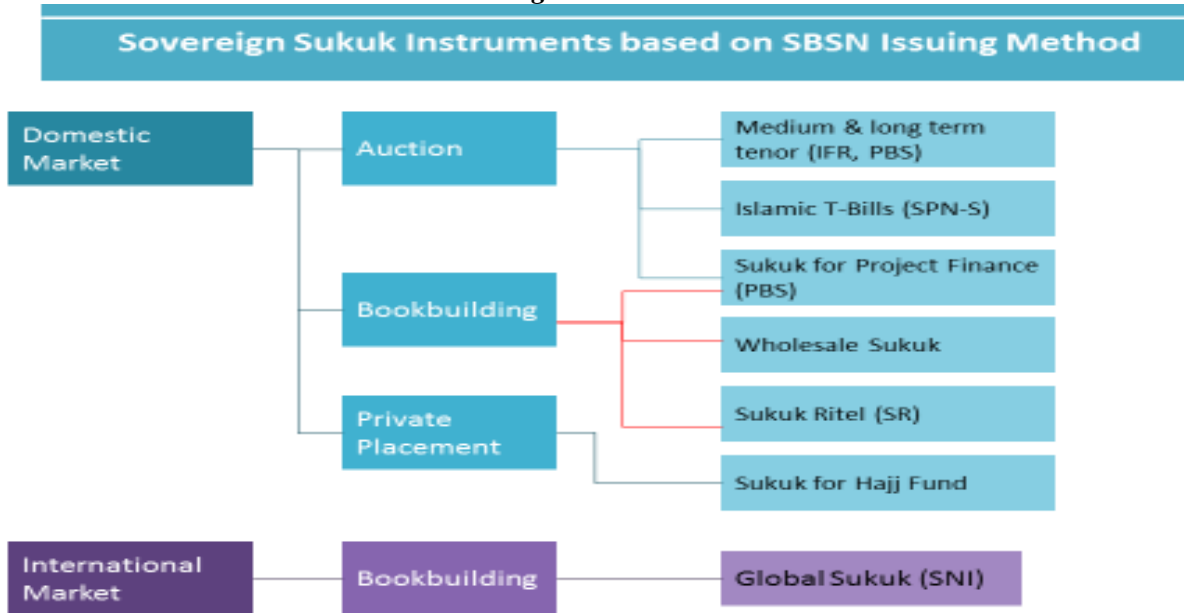
In figure 11, we can see that ISS trading in secondary market, in which SR-007 had the highest frequency (20.757) and the highest volume (IDR91,43 trillion). The total volume of sovereign sukuk as of 13 November 2015 is IDR277,15 trillion with 30.296 transactions. Moreover, the average everyday trading is IDR1,3 trillion with 141 transactions.

Figure 11



In addition, there are some instruments (products) according to the method used in issuance of ISS (see Figure 12). By using auction method, there are Islamic Fixed Return and Project Base Sukuk (both medium & long term tenor), SPN-S (Islamic T-Bills), and Project Based Sukuk (Sukuk for Project Finance). By using bookbuilding method, there are Project Base Sukuk (Sukuk for Project Finance), Wholesale Sukuk, and Sukuk Ritel (SR). Finally, by using private placement method, there is sukuk for Hajj Fund. In contrast, for international market, there is only one method used, bookbuilding that has instrument, so-called Global Sukuk (SNI).

Figure 12

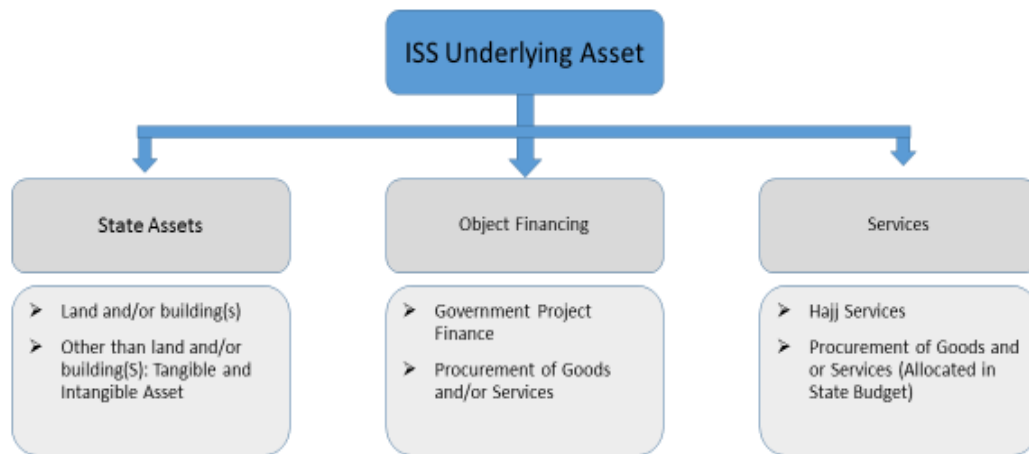


Source : Directorate General of Budget Financing and Risk Management, Ministry of Finance of Republic of Indonesia

C. The Importance of Underlying Asset in ISS

As already mentioned in Chapter II. F., in order to generate returns for investors, all sukuk structures rely upon either the performance of an underlying asset or a contractual arrangement with respect to that underlying assets. There are several kinds of underlying assets of ISS (Figure 13). Although these such underlying assets are basically only used as the basis of the issuance of sukuk, they have been proving that they could be used to attract the investors interest. Some people might believe that this kind of underlying asset is such a collateral as bank loan does, but in fact it is just a transfer of usufruct.

Figure 13



Source : Directorate General of Budget Financing and Risk Management , Ministry of Finance, Republic of Indonesia

D. What is the Special and Unique Characteristic of ISS?

ISS, especially in Ijarah sukuk, have special and unique characteristics as mention below:⁴⁵

1. Based on underlying transactions

There are many transactions that have been underlying the issuance of ISS. As already mentioned, since the first issuance in 2008 to 2015, GOI has launched four structures of sukuk based on underlying transaction, there are: SBSN Ijarah Sale and Leased Back, SBSN Ijarah Al-Khadamat, SBSN Ijarah Asset to be Leased, and SBSN Wakalah.

2. There is the beneficial rights transfer only

Law no. 1 of 2004 on State Treasury prohibits the sale or transfer of state-owned assets. ISS is basically known as asset-based sukuk that there is only beneficial ownership which is transferred to sukuk holders and on the other hand the legal ownership remains on the hand of the obligor as an effort to keep controlling the underlying assets, for example GOI still can use such a building to its daily operation that in the same time used as underlying asset of sukuk issuance. In other word, GOI may sell the beneficial rights of state-owned assets, while retaining the legal title so that comply with Law no. 1 of 2004.

In this asset-based sukuk category, there is no true sale of the underlying assets, but GOI is only transferring the usufructs of the underlying asset that basically the sukuk holders donot have concerns in this. The sukuk holders donot regard this because they have been

⁴⁵Ilman Rakhmat, Mirza Karim and Karen Mills, *Indonesian law on Sovereign Sukuk*, Financier Worldwide magazine, December, 2015, <http://www.financierworldwide.com/indonesian-law-on-sovereign-sukuk/#.VvrASOJ97RY>

enjoying the stable, fix-income periodically and they believe in the creditworthiness of GOI in paying their rights both the principal and coupon until the maturity of such sukuk.

3. SPV is a single actor both as Issuer and Trustee

The law no. 19 of 2008 on Sovereign Sukuk mandates that GOI may issue sukuk both directly or through a special purpose vehicle (SPV), the so-called Perusahaan Penerbit SBSN Indonesia (PP SBSN). This entity is established by government regulation, and every issuance of such sukuk needs prior parliament approval in dealing with the state budget. PP SBSN acts representing both issuer and trustee interest. PP SBSN may sell sukuk to investors, and grasps the beneficial ownership for the of the sukuk holders, as well as representing the government in relation with the investors and the investors in relation with the government. The organ management of PP SBSN is inaugurated by finance minister and consist of board of directors. Interestingly, there is no supervisory board in this entity.

4. Requirement for fatwa from the Ulema Council

Also, in every issuance of such ISS, it is required to first get the recommendation or fatwa from syariah scholar or ulema council, the so-called Majelis Ulama Indonesia/DSN-MUI to ensure that they are syariah-compliant.

5. Principal and coupon payments are allocated in State Budget

Unlike the majority countries in the world issued sukuk, as atated above, ISS holders will get a guarantee from government which has already allocated funds for the payments of the principal and coupon every year in its Indonesia's state budget.

6. ISS is rather Asset-Based Sukuk than Asset-Backed Sukuk

As seen from point 2 above, it could be stated that ISS have been asset-based sukuk rather than asset-backed sukuk, which equates them to conventional unsecured bonds⁴⁶ because there is no legal title transfer of the ownership of the underlying asset – it is a just right of usufruct or beneficial ownership. The main consideration of choosing this type is to avoid the infringement of Law No. 1 of 2004, in selling the state-owned asset either in a selling and purchasing transaction with SPV or in recouring the underlying assets by sukuk holders in a case of defaults or bankruptcies.

E. The Role of Syariah Board In Issuance of ISS

As mentioned above, the role of syariah board is very important before issuing ISS. The fatwa or recommendation should be available in structuring ISS, because without this fatwa, it is impossible to issue ISS. The minister of finance should ask for a fatwa (opinion) on syariah compliance from the Indonesia's syariah scholar or Ulema Council of Indonesia (Majelis Ulama Indonesia/DSN-MUI) in order to give assurance to the investors that investment in sovereign sukuk, including buying and selling thereof, does not breach Syariah principles.⁴⁷ Although this fatwa is not legally binding, the issuer has the obligation to first request it before issuing such sukuk. There are several fatwas that have been issued by DSN-MUI: (1) Fatwa No. 69/DSN-MUI/VI/2008 on Syariah Sovereign Securities; (2) Fatwa No.

⁴⁶Fawaz Elmalki & Dennis Ryan, *Sukuk – An Evolution*, Conyers Dill & Pearman, January, 2010, http://www.conyersdill.com/publication-files/109_10_01_04_Sukuk_An_Evolution.pdf

⁴⁷Ilman Rakhmat, Mirza Karim and Karen Mills, *Indonesian law on Sovereign Sukuk*, Financier Worldwide magazine, December, 2015, <http://www.financierworldwide.com/indonesian-law-on-sovereign-sukuk/#.VvrASOJ97RY>

70/DSN-MUI/VI/2008 on Syariah Sovereign Securities Issuance Methods; Fatwa No. 71/DSN-MUI/VI/2008 on Sale and Lease Back; fatwa No. 72/DSN-MUI/VI/2008 on Syariah Sovereign Securities Ijarah Sale and Lease Back; Fatwa No. 76/DSN-MUI/VI/2008 on Syariah Sovereign Securities Ijarah Asset to be Leased.⁴⁸

In addition to issuing fatwa or syariah rulings to validate that sukuk structures, syariah council should also carefully scrutiny or review all the relevant contracts as well as documents related to the sukuk transaction and make sure that the actual means of implementation, operations and investments comply with syariah standards.⁴⁹

⁴⁸ Sukuk Report, *Chapter Four: Case Studies & Articles on Sukuk issuances – Institution Contribution*, p.50, http://www.mifc.com/?ch=ch_kc_definitions&pg=pg_kcdf_overview&ac=229

⁴⁹ Sweder van Wijnbergen and Sajjad Zaheer, *Sukuk Defaults: On Distress Resolution in Islamic Finance*, Amsterdam School of Economics, University of Amsterdam and Tinbergen Institute, First draft, July 2013, <file:///C:/Users/lenovo%201/Downloads/Sukuk%20Defaults%20on%20distress%20Resolution.pdf>

IV. THE CRITICAL ANALYSIS OF ISS

A. Is Asset-Based Sukuk Fully Comply with Syariah Law?

As mentioned previously that there have many risk arisen in issuing ISS, among other things, is syariah compliant risk that basically has to be the foundation stone for its issuance. The right of investors to get full protection both spiritually and legally is a crucial part of obligor obligation. Specifying the rights held by the investors in any different sukuk structures, especially in the event of default is one of ways to protect the sukuk holders. The courts have to decide the rights of sukuk holder, whether it is asset-based or asset-backed structures as an effort to protect the sukuk holders' right. The courts are required to determine the current legal dispute over sukuk holders' right, surely based on transactional documents agreed by parties involved. In asset-based sukuk structure, the courts ideally has to decide that this structure close to a conventional bond that results in less compliance with syariah principles.⁵⁰ In ISS, we can see that they are more likely asset-based sukuk rather than asset-backed sukuk because the GOI as obligor typically transfers only the beneficial ownership or only beneficial rights to the sukuk holders over the underlying assets. There is no true sale that means that in the event of default, the investors would be dependent only on a repurchase undertaking, which means the originator will buy back the underlying assets to sukuk holders, allowing sukuk holders to position at best *pari passu* with unsecured creditors, however without direct asset recourse.⁵¹

In recent years, the asset-based sukuk has dominated remarkably in the sukuk market. Dusuki and Mokhtar (2010) found that only 11 out of a total of 560 sukuk issuance (or around 2 per cent of the total) is qualified to be asset-backed that indicate these comply with syariah requirements with an actual sale over the underlying asset to the sukuk holders. In February 2008, the Syariah Board of AAOIFI issued a statement that highly recommend the true sale of the underlying assets to the sukuk holders with all associated rights and obligations of ownership as well as it must be mirrored in the accounting books. That was one of the AAOIFI's concerns over the incoherent practice in the sukuk market.⁵²

Although the majority of some countries have issued asset-based sukuk structure, it could not be justified that they are in the right direction, mainly because this sukuk structure has been inconsistent with syariah laws and prevailed non-Islamic legal framework as well as economic incentives of suppliers and demanders of sukuk. Some countries such as Malaysia and the Gulf Cooperation Council region argue that the reason to issue the asset-based sukuk is, among other things, the legal obstacles, but this argument is not fully right. Malaysia and the Gulf Cooperation Council region also issue the asset-backed sukuk that the legal obstacles are not compelling factors. It is weak to say that the economic arguments is the reason not to use asset-backed sukuk structure. The originators could get higher ratings in asset-backed sukuk compared to their asset-based, that can fundamentally reduce fund costs. For example, the Tamweel's asset-backed sukuk got rate from Moody's in the UAE of Aa2. Meanwhile, an asset-based sukuk at the same company was at A3, four notches below during 2009 (Howlader 2009).

So, why did GOI issue the asset-based sukuk, not asset-backed ones? To answer this question, we first have to know the legal background of the issuance of ISS. There are

⁵⁰Fawaz Elmalki & Dennis Ryan, *Sukuk – An Evolution*, Conyers Dill & Pearman, January, 2010, http://www.conyersdill.com/publication-files/109_10_01_04_Sukuk_An_Evolution.pdf

⁵¹Steven Friel and Silke N. Kumpf, *Sukuk default*, Financier Worldwide, March, 2015, <http://www.financierworldwide.com/sukuk-default/#.Vv6uvPI97RY>

⁵²Habib Ahmed, *Islamic finance at a crossroads: the dominance of the asset-based sukuk*, Durham University, January 27, 2011, <http://dro.dur.ac.uk/7736/1/7736.pdf>

actually two main laws as a foundation stone of the issuance of ISS, namely Law No. 19 of 2008 on Sovereign Sukuk and Law No. 1 of 2004 on State Treasury. In Law No. 1 of 2004 prohibits the sale or transfer of state-owned assets to a third party. The Sukuk Law No. 19 of 2008 thus presented the separation concept of beneficial rights and legal title in order to consistent with syariah law, GOI may sell the beneficial ownership of state-owned assets, while maintaing the legal title, thereby complying with Law No. 1 of 2004. In this case, GOI have been benefiting from controlling the underlying assets, more specifically keeping using to the daily operation of government acitivities. In other word, the using of the state-owned assets used to be the underlying asset is in no way harm, since the sukuk holders donot have concern over them and actually they could not do anything over the underlying assets because they do not hold the legal title. Even, under the term of beneficial ownership that the sukuk holders have is no meaning at all. It seems to be as a term instrument to meet the syariah principles. This is generally known as right of usufruct. In ISS' Ijarah Sukuk, for example, the GOI sell may be based upon transfer or lease of the beneficial ownership of such state-owned assets such as land, buildings, projects, or other state-owned assets.

Abdul Karim Abdullah (2012) said that the first defaults of sukuk took place in 2008 financial crisis and it was a surprise since the investors were firstly aware of the differences between the "asset-based" and "asset-backed" sukuk as well as its implications of the differences that have on sukuk holders's protection. The sukuk defaults were confined to the "asset-based" and many questions arose as to why in particular the asset-based sukuk defaulted while the asset-backed did not.

The simple answer may be the asset-based type were constructed to copy conventional bonds. Bonds is a debt structure that provide both investors and issuers with the desired structure, and at the same time also reflect the risk of defaults. In bonds, issuers are required to guarantee for both interest (fixed income) as well as capital (the amount of loan principal) to creditors. Default means that the debtor (issuer) fail to repay a loan or a part of it to a creditor. The main cause of sukuk defaulted, is the condition of economic downturn and of financial crisis that triggered it, obligors did not generate sufficient income from the underlying assets to pay their payments obligation.⁵³

Conversely, there was no asset-backed sukuk defaults. The asset-backed sukuk were structured in the form of sharing profits and losses (PLS) principles rather than duplicate bonds, or unlike its counterparts. That is the main reason why there was no case of asset-backed sukuk defaults or only happen in few cases. There is no promise from the obligor to the investors to provide liquidity facility which is determined in advance both quantum and due dates. This kind of sukuk cannot default since issuer do not offer both capital guarantee and fix income to investors. PLS issuers will only pay profits to investors if the underlying assets could generate profits. In bonds, such guarantees are provided by issuer and this is the main features of it. Capital and income (interest) are incorporated into sukuk structures. This incorporation does not ensure that there will be no default. Musyarakah and mudarabah sukuk are also constructed to duplicate debt instruments.

Moreover, many syariah scholars argue that asset-based sukuk tend to deviate from syariah principles. Nevertheless, without overriding the preference of asset-backed sukuk, the large majority of sukuk issued to date are *de facto* asset-based. This condition leads to uncertainty in connection with their legitimacy makes what can be defined as a syariah risk.

⁵³Abdul Karim Abdullah, *Asset-Backed vs asset-based sukuk*, 2012, www.iais.org.my/.../203_31e61f1c75b415be0dc937ab5ed2006d.html

In 2008, Sheikh Muhamed Taqi, stated that 85 percent of sukuk issued around the world was not syariah compliant.⁵⁴

So, according to the characteristics and some arguments mentioned, ISS have not been fully syariah-compliant mainly because they are asset-based sukuk that have given uncertainty to sukuk holders in case of default/bankruptcy of the issuer. The next question is if such issuance of sukuk fall foul of syariah, would it be automatically null and void?

B. Is There any Gharar in Issuing ISS?

From the legal point of view, gharar as a concept refers to a contract or an agreement that contains elements of gharar, or in other words, an agreement which implies cheating, uncertainty or risk. If any element of gharar in contractual agreement between the parties, basically it is supposed to be null and void according to law. The term of gharar and the invalidity of the contract embrace two key resolutions of the contract. There are remuneration and subject matter that are the most significant component of the contract and their existence is mandatory. Therefore, when one of the two resolutions comprises gharar, the whole contract is supposed to be invalid. Nevertheless, it would be different if the gharar is only the slight/minor matters of the contract. If they have a component of gharar, simply they can be abolished from the contract without demolish its core. The parties involved can of course argue and assess about the significant of such slight/minor matters and know exactly what can be regarded as slight/minor. In a western contract, for example, provisions that are no longer applicable could be taken out from the contract without risk of breaching its core resolutions.⁵⁵

To facilitate the matters of interpretation, some scholars came up with a division of gharar into two categories: gharar-e-kathir/fahish (excessive/major), for example the sale of fish in the sea, the sale of bird in the air, and the sale of unborn animals and gharar qualil/yasir (minor/slight). Gharar-e-kathir means excessive uncertainty in respect to the key resolutions of the contract. This gharar cannot not be permitted and may bring about in null and void and the contract leads to be unenforceable. Meanwhile, gharar qualil relates closely to the uncertainty of nominal, which the area of gharar exist does not lead to the nullity of the contract and still could be tolerated to execute. The contract which contains gharar-e-kathir is simply invalid and prohibited in Islam. Gharar can refer to: 1) uncertainty towards the existence of the subject matter; 2) uncertainty towards the possession/ownership of the subject matter; 3) uncertainty towards the price; 4) uncertainty towards the payment of the price; 5) ignorance (jihalat).⁵⁶

How about ISS in term of syariah compliance related to gharar? It can be argued that there is just a gharar qualil, simply because ISS are asset-based sukuk that give rise an uncertainty in recouring the underlying asset in the event of defaults or bankruptcies of the obligor. The investors will not have right to execute the underlying asset because there is no transfer of legal title of them. In this regard, GOI has also provide some risk mitigations, for

⁵⁴Steven Friel and Silke N. Kumpf, *Sukuk default*, Financier Worldwide, March, 2015, <http://www.financierworldwide.com/sukuk-default/#.Vv6uvPI97RY>

⁵⁵Institute of Islamic Banking and Insurance, *Sukuk: Where Next?, Islamic Working Capital Financing, Understanding Gharar, Shari'ah-Compliant Asset Management: Myth or Reality, Takaful: Keeping True to Its Spirit, Academic Article: Share Murabaha No. 172*, July-September 2009, http://www.islamic-banking.com/resources/7/newhorizon%20previous%20issues/newhorizon_julysep09.pdf

⁵⁶Institute of Islamic Banking and Insurance, *Sukuk: Where Next?, Islamic Working Capital Financing, Understanding Gharar, Shari'ah-Compliant Asset Management: Myth or Reality, Takaful: Keeping True to Its Spirit, Academic Article: Share Murabaha No. 172*, July-September 2009, http://www.islamic-banking.com/resources/7/newhorizon%20previous%20issues/newhorizon_julysep09.pdf

example, by promising that it will repurchase the underlying asset at maturity or in the event of default as well as adding the allocation of fund to pay principal and coupon in case of currency changes that degrade the allocated fund in state budget.

C. What is the Role the Repurchase Undertaking in case of default?

This kind of repurchase undertaking basically gives obligation to the obligor to fulfill its payments, especially the principal at maturity date or in the event of defaults. That is creating an obligation on the part of the obligor when certain events do take place that will undoubtedly give a guarantee of capital that is not in connection with the syariah requirement. It also can be argued that this repurchase undertaking is considered as the replacement of sukuk holders recourse right to the underlying assets that generally in the asset-based sukuk structure cannot be recoured by sukuk holders, especially in the event of defaults. Nevertheless this issue requires more explanation to make clear the doubt that has been keeping around about the aspect of syariah compliance of these sukuk. Any undertaking which needs to repurchase usually made possible breach or negligence or wrongdoing or on obligor part, who is likely a project or fund manager (in Mudarabah sukuk) or even a partner in an Islamic partnership (in sukuk Musharakah), would not breach syariah principle since the manager has to be imposed liable for any loss coming from his wrongdoing or negligence or or both. In other words, this repurchase undertaking is functioned just to rehighlighted the syariah compliance related to the obligors if they are doing negligence or wrongdoing. In the event of default, the meaning of obligation to buy back requires to be further clearly defined to address only to problems where such inability is caused by the wrongdoing or negligence of the obligor. From syariah point of view once wrongdoing or negligence is committed, the obligor or manager has the responsibility to repay the investment capital of investors. In an effort to fulfill this obligation, the relevant underlying assets have to be liquidated or sold, usually in an open market for value, and the proceeds (money resulted) would be paid back to the investors. The principle of “no pain no gain” in syariah needs to be practically implemented and not just be said in theory repeatedly.⁵⁷

Furthermore, sukuk accompanied by repurchase undertaking will not have higher rating than the rating given to the entity which the underlying assets can be used to recourse unpaid principal, as the main risk to the investors is not the underlying asset risk but a credit risk of the obligor. Some scholars argue that the repurchase undertaking which contains guarantee rise much controversy from Syariah perspective and off course needs to refresh in an effort to address them. The syariah scholar role is absolutely urgent in giving the recommendation of the rating process that seems to be important in the Islamic financial industry development in general and the sukuk market in particular.⁵⁸

AAOIFI has encouraged that the repurchase undertaking should be calculated based on an exercise price, instead of based on the net asset value, cash equivalent value, market value, or as is price agreed for the first time. The obligor or manager can only be allowed to guarantee of capital payment to sukuk holders at face value in the event of violation or negligence.⁵⁹

⁵⁷Prof. Dr. Zainal Azam Abd. Rahman, *What Makes Sukuk Globally Shariah Compliant?*, Dr. Zainal Azam's blog, February 17 2008, <https://drzainalazam.wordpress.com/2008/02/17/sukuk-and-repurchase-undertaking/>

⁵⁸Muhammad Al-Bashir Muhammad Al-Amine, *Sukuk Market: Innovations and Challenges*, Islamic Economic Studies Vol. 15 No. 2, January 12, 2008, <http://www.irti.org/English/Research/Documents/IES/080.pdf>

⁵⁹Farmida Bi, *AAOIFI Statement on Sukuk and its implication*, Norton Rose Fulbright, September, 2008, <http://www.irti.org/English/Research/Documents/IES/080.pdf>

According to one of purchase undertaking agreements between GOI in favour of SPV (Perusahaan Penerbit Surat Berharga Syariah Negara/PPSBSN) as issuer and an investor (it can not be mentioned here because of the confidentiality reason) as delegate that has already been in force, the GOI agrees that each of the following events or circumstances shall constitute a Republic Event for the purposes of Condition 12 (*Dissolution Events*):⁶⁰

- a. the Republic defaults in the payment of any Rental under the Lease Agreement or the Exercise Price under this Undertaking and such default is not cured within 30 days of the due date for payment;
- b. the Republic defaults in the performance of any other covenant in this Undertaking and such default continues for a period of 60 days after written notice thereof has been given to the Republic by the Delegate or to the Republic at the address of its agent for service of process in England by holders of Certificates representing at least 10% of the aggregate face amount of the Certificates outstanding;
- c. any Public External Indebtedness in a principal amount in excess of US\$50,000,000 (or the equivalent amount thereof in any other currency) is accelerated (other than by optional or mandatory prepayment or redemption);
- d. the Republic defaults in the payment of principal or interest or profit in excess of US\$50,000,000 (or the equivalent amount thereof in any other currency) payable (whether upon maturity, acceleration or otherwise) in connection with Public External Indebtedness beyond any applicable grace and waiver periods and such default shall not have been cured or waived within 30 days after written notice thereof has been given to the Republic by the Delegate or to the Republic at the address of its agent for service of process in England by any holder of Certificates; and
- e. the Republic declares a moratorium with respect to the payment of principal or interest or profit on any Public External Indebtedness.

D. How to Mitigate the Risks

Surprisingly, from 2008 to 2015, there have yet to happen ISS default/bankruptcy. It might be mainly because of good liquidity management, the creditworthiness of the obligor (GOI), and the capability of mitigating the risks.

Good liquidity management as explained above might be one of the interested reasons why investors have been interested to buy ISS. They absolutely want their money coming back to them with high and fixed return income. By providing guarantee that the payment of principal and rewards in form of coupon in the state budget, the investors feel secure and comfortable with their investment in sukuk. Moreover, GOI as a state entity get high credibility from Indonesian people as well as international community to manage their debts professionally, so it has great creditworthiness to the investors. Last but not the least, the most important thing is the capability to mitigate the risks, especially operating risk, for instance, default risk.

⁶⁰Sample of Purchase Undertaking from Directorate General of Budget Financing and Risk Management, The Republic of Indonesia

IV. LESSON LEARNED

With so many alternatives financial instruments, sukuk are absolutely the best vehicle for revenue mobilization, whether in the public or private sector, although there is still some drawbacks behind it. Sukuk holders are ideally entitled to get accurate information on the underlying assets and they should be aware of the main purpose of the asset backing is to ensure syariah compliance, not to make the sukuk senior debt. Although investors, or their legal representatives, should always consider worse case scenarios, and have a view on the worth of the underlying assets, when a default occurs there will inevitably be significant losses.

Securitization is indispensable in protecting the investors from losing their money in the case of default. For investors, the essence of investment is the analysis of the risks. We have proved that since excessive lending to risky borrowers which mostly without the underlying assets had caused global financial crisis in 2007 and a securitization system like sukuk have made financial market more stable.

As we have seen in Chapter IV B, the existence of gharar qualil do not automatically make ISS void and unenforceable as there is no party treated unfair or unjust and so far the ISS holders enjoy benefiting from ISS, unless happen ISS defaults. The default-risk mitigation provided by GOI make the investors rely on them. Moreover, GOI has been mandated by Law No.19 of 2008 on Sovereign Sukuk to provide the payment of coupon as well as principal on government budget annually until the maturity of such sukuk.

Hopefully, after this analysis, GOI will provide full protection for sukuk investors. Sukuk default might be inevitable in all types of investments, but ideally there have to be proper risk mitigation to ensure that everything is going well until the maturity of ISS.

Harmonization any laws and regulations related to the issuance of ISS is significantly required to ensue that there is no contradictory provision between each other. Syariah compliant-sukuk has to be properly maintained in order for investors to increase their investment in ISS. The implementation of asset-based sukuk is believed not fully syariah compliant sukuk, so in long run, it is expected that it would be an asset-backed sukuk to give full legal protection to sukuk's investors.

The liquidity facility provided in the government budget, on one hand, has given a guarantee that the payment of principal and coupon/award, but on other hand, is slightly violate the syariah law since it is not purely and directly coming from the generating of the underlying assets itself. So, GOI ideally seek new formula to make this kind of Islamic financial instrument complied fully with Syariah law.

Although there are still a little bit scepticism about syariah compliance and transparency, it is expected that it will be significantly growing in the future and need some stronger laws and regulations on its issuance. Indonesia has a good time enjoying more sukuk innovation to attract broader investors.

The issuance of ISS has been based on, among other things, the motive of economic development, in which for supporting Indonesian state budget in financing the government daily operations. It is not easy to formulate laws and regulations related to the issuance of it as there have been existed laws and regulations restricted to get the full syariah-compliant sukuk.

From the issuer's perspective, it has been for the moment the ideal choice to get the best results in raising fund from investors by utilising and maximizing its state assets spread all over the country without transferring the ownership of such an asset. The ministry or institution whose its assets are used to the underlying ones, still can use them for its operational purposes without worrying of the selling of its assets. The most reason of issuing ISS is to generate sustainable

national economy, so it is essential to expand various financial instruments which could mobilize as well pool public funds.

On the other hand, investors absolutely want to invest their money in a safest way, and more preferably with stable, high return and liquidity facility from a company, financial institution, even from government as an issuer/obligor. Fixed-return of investments are also the fundamental consideration in having satisfactory income of investment.

While fatwas which are required to endorse the issuance of such sukuk, the endorsements tend to result in different interpretation. If fatwas contradict with AAOIFI standards, their reliability become weak. Also, DSN-MUI fatwas seemed to plagiarize such a fatwa from the other jurisdictions without deeply analysing it. It was likely due to the fact that lacking of syariah law knowledge, specifically sukuk issuance rules. The independent decision that comply with AAOIFI standards are basically required to fulfil the syariah-compliant sukuk.

Bankruptcy/default have been the key issue of investment problem. In the globalization era, everything can change rapidly and unpredictable. To minimize risk, Indonesian government needs to make some strategies to mitigate the risk in order to avoid sukuk holders' law suit.

One thing needs to be addressed more closely and deeply: what is more powerful, Islamic laws or existed positive laws in such a country? Actually, Islamic laws are globally used and enforced around the globe, especially for the Muslim community and govern specifically about sukuk. From this statement, we can learn that Islamic laws are *lex specialis* which means that they have to be predominantly followed/obeyed in the construction of sukuk issuance rather than the existed law of such a jurisdiction. In fact, statements come up by AAOIFI have yet to be fully complied by some jurisdictions, for instance, the preferability of issuing asset-backed sukuk. The issuers prefer asset-based to asset-backed sukuk mainly because of the compatibility of the existed laws and regulations.

Who is responsible for the supervision of the compliance of syariah law, especially in issuing such sukuk, is it AAOIFI, IFI, or other organization of Islamic financial institutions? What are the main roles of those institution in enforcing the syariah-compliant sukuk all over the world? It is said that the fatwas/opinions from Islamic scholars is not legally binding in issuing such sukuk, so what is the impact on sukuk if such sukuk do not comply with fatwa/opinion from Islamic scholar? There is no intensive supervision, especially from international Islamic financial institution, for instance AAOIFI, in complying the sukuk's syariah-compliant. Non-binding atatements seem to be the most reason why some sukuk issuer do not fully comply with Syariah Laws.

As stated, the best sukuk structure and syariah-compliant sukuk are asset-backed sukuk, albeit there has been still a hindrance, for example the contradictory law underlying it. The Law No. 1 of 2004 has been incompatible with syariah-compliant sukuk since the avoidance in selling the state asset.

Citing from old problem, "*there is no perfectness in world*", we can say here that ISS, for this time being, is a temporarily good formula the Indonesian government can do to get fund from sukuk investors, apart from its drawbacks. Hopefully, there will be government good will in harmonizing the existed laws and regulations in order for the sake of investors to fully protect their investment.

So far, it also seems that the sukuk's investors enjoy this kind of investment. It is proved by no law suit taken by the sukuk's investors from 2008 to 2015. Good management of this investment might be of the reason.

Apart from those drawbacks, the Islamic financial instruments, sukuk in particular, have been the right choice for global financial institutions to raise their funds, as this kind of financial

instrument has proved that it has been stable in the past global financial crisis and has been showing the fairness in issuing them.

Moreover, the most common practices of issuing either asset-based sukuk or asset-backed sukuk, they have not reflected the real transactions, meaning theoretically in Islam they were structured to share profits and losses – if there is profit generated the underlying asset, it would be shared profit to the investors and vice versa. So, basically by providing such a liquidity facility on state budget and promising investors profits whose quantum and due dates were determined in advance have been skewing towards Shariah law. The fixed incomes and capital guarantees provided by the issuers to the investors have been replicating bonds that have a debt structure. Why profit and loss sharing securities have not been default simply as they give the investors no income and no capital guarantees. They just get them when the underlying assets yield profits. Such guarantee should be paid in case of failure to make periodic payment on time or to redeem the principal on the maturity date.

The liquidity facility has been used to attract investors at one point and to provide safe guard for the issuers at another point. Both parties wanted bond-like instruments with coupon and principal payment guarantee without true sale of the underlying assets.

There is no global standards in issuing such sukuk. Different countries have different platforms, fatwas, product, structure as well as types in issuing them. It seemed that Syariah law adapts what have been ruled by conventional law standards and in the event of differences between them, the latter laws and regulations will follow the former ones, regardless the compliance of Shariah law. Basically AAOIFI have issued a statement on sukuk in February 2008 about criticism that the majority of sukuk were structured were not strictly complying with Sharia law.

Furthermore, the role of SPV which was basically formed by the issuer would bring about independency problem when something happen like bankruptcy. Which position will it take whether on issuer side or investors side. It would be very difficult for SPV to take the right decision. Theoretically, because it is an obligor-formed entity, it tends to take the obligor side, simply because the member of SPV officially mostly derived from the obligor/company/organization. One of the reasons to form an SPV is bankruptcy remote, meaning to say if the obligor does not pay the rent, then the SPV has no obligation to pay to sukuk holders.

The choice of whether asset-based or asset-backed sukuk would more closely relates to the protection of the sukuk holders when default or bankruptcy happens than relates to the sukuk will be default/bankrupt or not. It is not so vital to choose one of them to be the basis structure of issuing such sukuk. Although they were issued with the structure of asset-backed sukuk, East Cameron Partners (ECP) sukuk for example, collapsed because of the financial crisis in 2008. But, indeed, the sukuk holders could recourse the underlying asset to pay their rights. So, by issuing asset-backed sukuk basically would increase the investors preference in investing their money, mostly because the right to recourse the underlying assets give them more confidence to get their investment back in case of default.

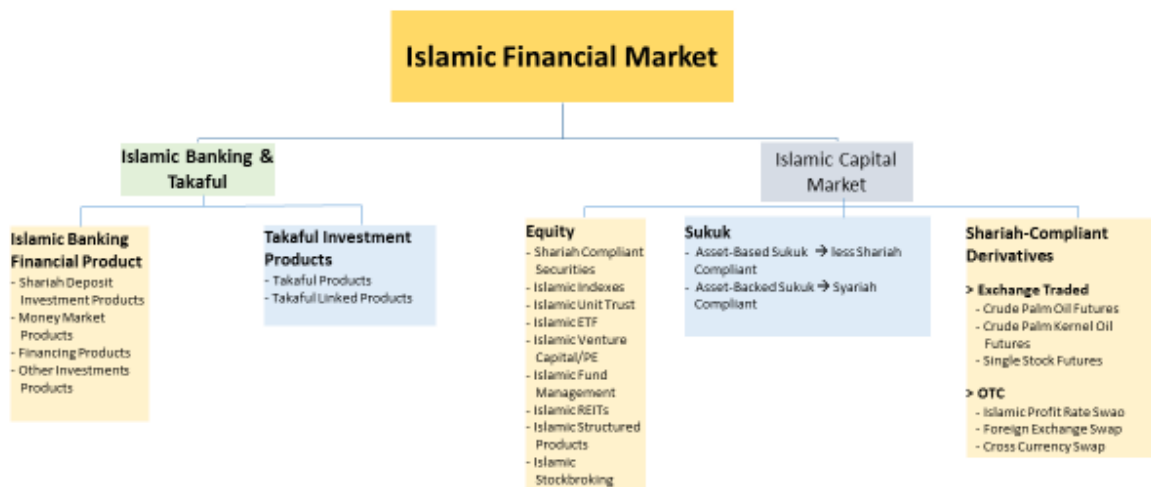
Learned from East Cameron's sovereign sukuk default, we can take a conclusion that just the asset-backed sukuk in Islamic financial history that proved that it can absolutely fully protect the investors in the event of default. This structural type of sukuk had given a right to sukukholder to be able to take the underlying asset interest and recourse it to cover their losses.

How about asset-based sukuk in the case of default? Because there is no legal transfer of ownership, the sukuk holders will have difficulty to take action on the underlying assets and there will be no asset to sell. Beneficial usufruct basically will have no benefit to the sukuk holders as it can be optimally used to generate cash.

It has been claimed by some scholars that the asset-based sukuk have much contributed to sukuk defaults. This was mainly because sukuk holders do not have right to recourse the underlying assets. The issue of whether such sukuk are asset-based or asset-backed is not a crucial factor leading to sukuk default. The creditworthiness of the originator, regulatory regime, mismatching of the portfolio and the impact of global financial crisis would be the significant factors of sukuk defaults. Nevertheless, the fact that whether sukuk are asset-based or asset-backed, is very important for sukuk holder in recouring the underlying asset in the event of defaults.

To get simple understanding that ISS are not fully Shariah-compliant sukuk and not fully protected sukuk holders as well just contain gharar qualil that do not lead to void and still can be executed, in Figure 14 we can see Islamic financial system works. And here are the main consideration why ISS are not fully or less Shariah-compliant sukuk: 1) there is no legal right to recourse the underlying asset in the case of default, so there will violate Syariah principle in fairness and be a gharar in this transaction, it is totally supported by the creditworthiness of the issuer; 2) The underlying assets are used just to Islamise the ISS' issuance, although most investors do not fully regards this action; 3) The SPV/PPSBSN is basically not independent and not self-governing entity as it is formed and accommodate the issuer's interest; 4) Repurchase undertaking is similar to debt-based instrument because it is not based on the actual performance and situation of the underlying assets.

Figure 14



Source: Adapted from SIDC, 2009

To sum up, we can argue that ISS have not fully complying with Syariah law principles as ISS are typically known as asset-based sukuk, which basically the sukuk holders could not recourse the underlying asset in case of defaults, and this situation bring about uncertainty (gharar). Because of that reason, GOI automatically has yet to fully legally protect the ISS holders. However, this gharar could be classified as gharar qualil, meaning there is just minor uncertainty which means that it still can be tolerated and be executed and donot result in void and unenforceable.

Because of that reason above, automatically Indonesian government has yet to fully protect the sukuk holders, particularly in case of defaults/bankrupcies. Sukuk holders are not able to benefit from the cashflows and the liquidity of the underlying asset.

Nevertheless, the liquidity management and facilities of ISS regulated by Law No. 19 of 2008 on Sovereign Sukuk has surely given investors certainty and enjoyment in the payment rights, both the coupon and the principle value because they have been allocating in Indonesian state budget annually until the maturity.

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