

# CONSTRAINTS AND STRATEGIES OF ISSUING MUNICIPAL SUKUK IN INDONESIA

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**Abstract:** *A The purpose of this paper is to analyze the potential of Islamic municipal bonds in Indonesia focused on its constraint and strategy using Analytic Network Process (ANP). Methodology proceeded by literature research to construct a model and in-depth interview with practitioners and regulators both on government and sharia perspective to fully understand and develop an appropriate ANP Network. The experts are divided into two categories as direct relation and non-direct relation experts. The constraints are divided into five nodes, they are political risk, trust between stakeholders, lack of sharia knowledge, law constraint and risk of municipal loan. While the strategies contain of building trust, sharia education, comprehensive law basis, market strategy, and strategy of product innovation. Islamic municipal bonds may be developed by implementing comprehensive law basis as primary strategy to provide the need of law basis as main constraint. Both main constraint and strategy are agreed by all experts except BPK which is more concern in risk of municipal loan.*

**Keywords:** *Islamic municipal bonds, strategy, constraint, ANP.*

## INTRODUCTION

Sharia financial development is getting more dynamic. Innovation and unique of sharia financial instrument have been accepted globally, both in moslem country or non moslem (Endri 2009). It was begun by developing formal sharia bank in Egypt known as Nasir Social Bank (an interest-free commercial bank) year 1971 then spread through North Africa, Middle East, and Southeast Asia (Perry and Rehman 2011).

Currently, Islamic financial market have spread evenly all over the world. Its development needs a reference from international sharia financial standard, so other supporting institutions were established such as Accounting and Auditing Organization for Islamic Institution (AAOIFI), International Financial Service Board (IFSB), International Islamic Financial Market (IIFM) and Islamic Research and Training Institute (IRTI).

One of developing sharia financial instrument is Islamic bonds or known as sukuk. In capital market, sukuk is divided into 3 categories based on its issuer; sovereign, corporate and municipal. However, the last kind of instrument has not been used optimally by local government yet as a source of financial needs. Nevertheless, sukuk development is still limited to sovereign and corporate issuer. Only have Germany and Malaysia issued Islamic municipal bonds, known as Saxony-anhalt in Germany and Pasir Gudang Johor in Malaysia (Shodiq 2014). This issue becomes challenge and opportunity for Indonesia as developing country which majority population is Moslem with decentralization fiscal policy to issue Islamic municipal bonds as a source of local income to build municipal infrastructure. Moreover, the balancing fund from central government is decreasing from 2011 to 2015 (Kemendagri 2016). Sukuk may become new independent source of income for provincial government with participation from its local society.

Study about Islamic municipal bonds has been discussed in Financial Service Authority (OJK) since 2015 (Tasdemir 2015). However, the study about Islamic municipal bonds can't be separated from conventional municipal bonds which its regulations has been available since 1999 but its practice is still going nowhere. Until now, there are no region that has issued municipal bonds. Among its obstacles are local financial accountability and approval from DPRD (Utami 2015) along with utilization of current year financing budget surplus (SILPA). Despite based on its stage, regulation of municipal bonds have been completed among them are Ministry

of Finance Regulation (PMK) number 180 year 2015, PP number 30 year 2011 about municipal loan. Flux and reflux of issuing municipal bonds have begun since the launching of UU number 22 year 1999 about local government and UU number 25 year 1999 about Balancing Fund between central and local government, along with digging up local potency resources includes financial through issuing bonds. Indeed this issue has been written on National Medium Term Development Plan (RPJMN) 2015-2019 which made municipal bonds as a source of municipal finance except public private partnership, banking loan and municipal development fund through direct investment (Nazara 2016).

In spite of zero records of issuing conventional municipal bonds, it becomes an opportunity to develop Islamic municipal bonds as the pioneer in issuing municipal loans on basis of capital market financial instrument. Since dual banking system has been legalized in Indonesia, sharia financial product is always following conventional product with small market share, and with this opportunity, sukuk may become leader in municipal financial market. This assumption supported by majority moslem population and certain provinces with high sense of religious such as Jawa Barat and Nusa Tenggara Barat which are enthusiastic to implement sharia law in their social daily life.

In International market, municipal bonds is one of the tradable financial instrument in capital market, more known as Munis (Municipal Bonds). Munis has been issued by developed countries such as United States, Japan and Malaysia (Indriani 2013). Generally, Munis is issued to

build local infrastructure, school construction, public facilities moreover current trend of Munis is directed to finance green energy infrastructure. The unique point from Munis are its majority investors from individual (local society) with tax-exempt facility, then followed by banking, insurance company, mutual funds and pension funds (Fabozzi 2004). dikembangkan.

### **Sukuk Daerah**

Sukuk (plural of Sakk, "legal instrument, deed, check") is the Arabic name for financial certificates, but commonly referred to as "sharia compliant" bonds (Ayub 2007). Sukuk is defined by the AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) as securities of equal denomination representing individual ownership interests in a portfolio of eligible existing or future assets. Based on chief decision of Capital Market Supervisory Agency and Financial Institution

(Bapepam-LK) number KEP-181/BL/2009. Sukuk is defined as Sharia effect in form of certificate or securities of equal denomination and representing not separated ownership or divided as:

1. Ownership of certain intangible assets
2. Beneficial value and services on certain project assets
3. Ownership of certain project asset or investment activity

According to Fatwa DSN MUI namely, the fatwa No.32 / DSN-MUI / IX / 2002 on Sharia and fatwa Bonds No.33 / DSN-MUI / IX / 2002 on Sharia Mudharabah Bonds. Islamic bonds is a long-term security based on sharia principles issued by the issuer to the holders of Islamic bonds, which obligates the issuer to pay income to the holders of Islamic bonds in the form of profit sharing and repay the bond at maturity. Different between Islamic bonds and conventional are:

**Table 1. Different between Islamic bonds and conventional**

	<b>Sharia Bond</b>	<b>Conventional Bond</b>
Basic Principle	Free of ghoror, maysir and riba) and Sukuk indicates ownership of an asset	Bonds indicate a debt obligation.
Underlying Asset	The assets that back sukuk are compliant with Shariah.	Assets backing bonds may include products or services that are against Islam or no underlying assets
Price	Sukuk is priced according to the value of the assets backing them	Bond pricing is based on credit rating.
Value	Sukuk can increase in value when the assets increase in value	Profits from bonds correspond to fixed interest, making them Riba.
Selling concept	When you sell sukuk, you are selling ownership in the assets backing them	The sale of bonds is the sale of debt.

Source: Naveed 2014

Islamic Municipal bonds is securities based on sharia principles issued by local government or institution owned by local government in order to finance municipal construction (Walidi 2009). Practically, Islamic municipal bonds

implementation can be seen at Saxony-Anhalt Municipal Islamic Bonds in Germany and Sukuk Pasir Gudang Johor in Malaysia. Since it was issued in year 2004, Saxony-Anhalt as one of federal states in East Germany has made sukuk

as diversification financial source of its finance municipal expenditure estimation. By using ijara contract and financial mechanism with real underlying asset made this instrument attractive enough for sharia investor or conventional (Stimpfle 2011). Gunawan (2012) in his thesis under title Influence Factors of Local Governments Readiness; case study in Special Region Yogyakarta to issue municipal bonds. The results of the his research show that there are five factors that explain the readiness of local governments in Yogyakarta to issue municipal bonds, namely: project readiness factor, human resource capacity factor, management principles factor, mechanism, requirement and sanction factor, and the capability of the local financial factor. The results of the qualitative descriptive analysis indicate that the projects that are undertaken are generally social and service as well as projects that have been programmed by the Government that is not profit-oriented. Endri (2009) in his paper analyzed the problem of developing corporate sukuk in Indonesia using Analytic Network Process (ANP) method. The results found that the cause of this problem could be grouped into four aspects, namely 1) market player; 2) product characteristic; 3) regulation; and 4) government. Those problems could be summed up into two main causes from market player and regulation aspects, namely the lack of market player understanding and quality of human resource which involved in Islamic capital market, and also the uncertainty of tax regulations. Moreover, the most effective policy strategy to overcome those problems was by implementing market driven strategy, where policies were

intended to make market mechanism runs well.

Sanjay et al (2013) did research on constraints and prospect of financing via municipal bonds in India using case studies approach to analyzing efficient of infrastructure finance and managing bonds. Their study reveals constraints on municipal financing in both places emerge due to poor debt capacity resulting from incomplete devolution of power, an inadequate collection of revenues and multitude presence of decision making bodies that often lead to project delays and cost over runs. The prospects may be suggested by reformation based on incentive schemes, appropriate of uses of technology and charging of fees based on bundling of municipal services in specific areas like property taxes and parking fees.

## RESEARCH METHOD

Data Analysis using primary data then processed using Analytic Network Process (ANP) is a decision making tool which is perfection from Analytic Hierarchy Process (AHP). Both AHP and ANP are developed by Prof. Dr. Thomas L Saaty, a lecturer in Pittsburg University, United States. According to Saaty (1999) ANP is a general theory of relative measurement used to derive composite priority ratio scales from individual ratio scales that represent relative measurements of the influence of elements that interact with respect to control criteria. Many decision problems cannot be structured hierarchically because they involve the interaction and dependence of higher-level elements in a hierarchy of lower-level elements. Therefore, ANP is represented by a network, rather than a hierarchy.

While Aziz (2003) defines ANP as the application of mathematical theory that may treat dependence and feedback systemically in order to find and combine tangible and intangible factors. Different point from AHP is that AHP focused on preference while ANP focused on influence. The construction of ANP may be seen in figure 1.

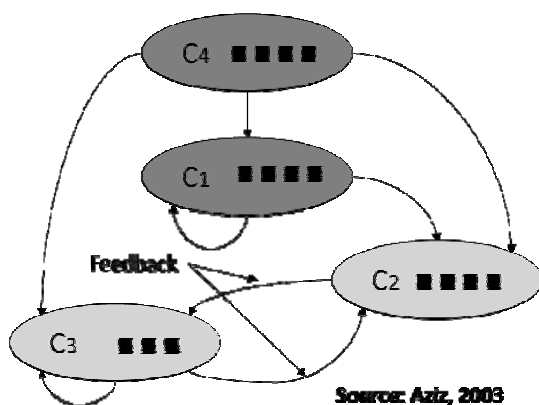


Figure 1. ANP Network

Figure 1 shows AHP model using hierarchy level from criteria goal, sub-criteria and alternative which single direct model. While ANP using network model from clusters which have its criteria and feedback with two direct relations. The relation between an element in certain cluster to another element in other cluster defined as outer dependence, while the relation between elements in single cluster defined as inner dependence

The feedback structure does not have the top-to-bottom form of a hierarchy but looks more like a network, with cycles connecting its components of elements, which we can no longer call levels, and with loops that connect a component to itself. To make tradeoffs among many objectives and criteria, the judgments that are usually made in

qualitative terms are expressed numerically. To do this, rather than simply assigning a score out of a person's memory that appears reasonable, one must make reciprocal pairwise comparisons in a carefully designed scientific way.

To get priority for each alternative, comparison is calculated for every element in clusters. Pairwise comparison is calculated by matrix, with value represent of the importance of element value in row (i) toward element in column (j). for example  $a_{ij} = w_i/w_j$ . If n elemen is compared, then comparison matrix A is defined as seen below:

$$W_{ij} = \begin{bmatrix} W_{i1}^{(j_1)} & W_{i1}^{(j_2)} & \dots & W_{i1}^{(j_n)} \\ W_{i2}^{(j_1)} & W_{i2}^{(j_2)} & \dots & W_{i2}^{(j_n)} \\ \vdots & \vdots & \ddots & \vdots \\ W_{in_i}^{(j_1)} & W_{in_i}^{(j_2)} & \dots & W_{in_i}^{(j_n)} \end{bmatrix}$$

After all pairwise comparisons are done, then weight vector priority is calculated with formulae;

$$A * w = \lambda_{max} W$$

$\lambda_{max}$  = the biggest eigen value in matrix A

w = eigen vector

## RESULT AND DISCUSSION

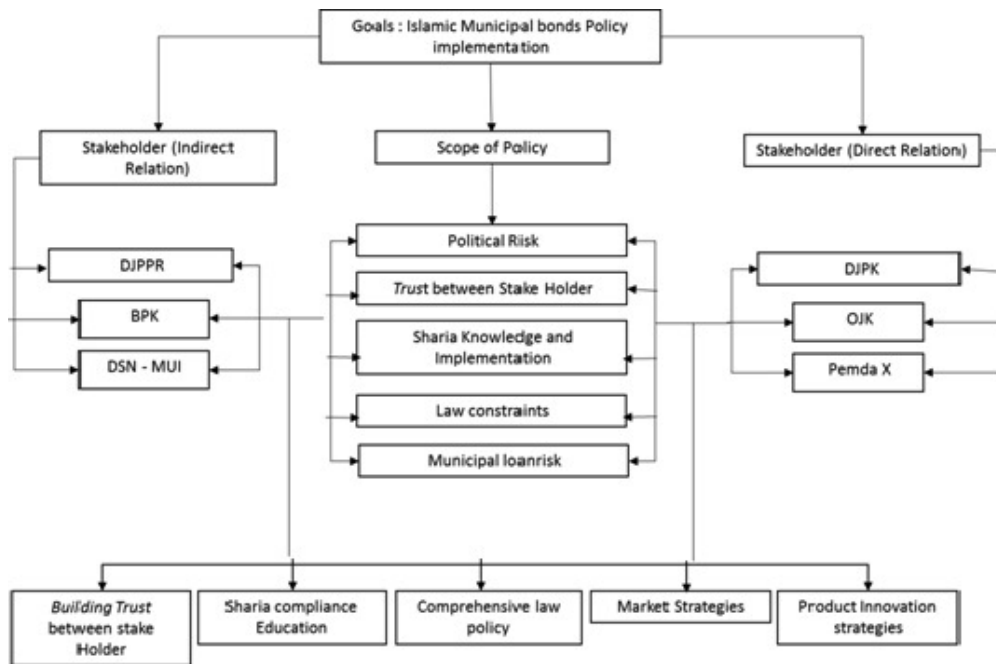
Problems decomposition process is analyzed by library research then it is confirmed and validated by expert. Confirmation and validation involve 3 direct relation expert and 3 indirect relation expert. Experts are chosen using purposive sampling. Direct relation experts are experts who have direct relation to issue Islamic municipal bonds, they are OJK (Financial Service Authority) as regulator in capital market, DJPK as supervisor, and Pemda X as issuer. Indirect relation experts are experts who don't have

direct relation to issue Islamic municipal bonds, but their contributions are needed when direct relation duties' are done. They are National Sharia

Board (DSN) as sharia compliance, BPK as auditor and DJPPR as advisor.

### Framework ANP

Figure 2. Framework of ANP



ANP's framework is divided into two sections. The first section consists of control hierarchy and network from criteria and sub criteria to control interaction. The second section is influences' network between elements and cluster.

Feedback network in figure 2 shows analysis of general framework. The network has 4 clusters, they are the goal, direct relation stakeholder, policy environment, indirect relation stakeholder and strategies. The first cluster consists of 3 elements they are (The Directorate General of Fiscal Balance) DJPK, OJK, and (Local Government) Pemda X. the Second cluster consists of 5 elements they are political risk, trust between stakeholder, sharia education, law constraints, and municipal loan risk. The third cluster consists of 3 elements they are Directorate General for financing and

risk management (DJPPR), BPK (Audit Board of Republic Indonesia) and National Sharia Board (DSN MUI). The fourth cluster consists of 5 elements they are building trust, sharia education, comprehensive law regulation, directed market driven strategy and product innovation product.

### Constraints Priority

#### Political Risk

Political risk constraints is constraints that born from change of political season in region consist of (1) risk of leadership and policy change (2) risk of area unfoldment (3) forming local government unit (SKPD) that issued based on only for certain political party (4) region political stability (different point of view between legislative and executive (5) corruption.

### ***Trust between Stakeholder***

These constraints come from lack of trust between stakeholder especially central government and investors toward the availability and capability of the human resource of local government, and local government toward central government to provide comprehensive law. These constraints consist of (1) Readiness of human resource management from local government to manage Islamic municipal bonds (2) Professional culture from local government human resource isn't seem like corporate culture (3) augmentation of load work that will cause lateness of region financial report (4) General fund allocation (DAU) projects central government doesn't seem optimal to be managed (5) Management of SILPA funds is not optimal yet (6) local government commitment (7) lack of trust of central government toward local government to propose loan through capital market (8) investor toward local capability (9) lack of open information between stakeholders that causes misperception.

### ***Sharia Aspect***

These constraints come from lack of sharia knowledge from government stakeholders and local society toward sharia economic especially about Islamic bonds, along with sharia compliance problems in sharia financial instrument implementation. These constraints consist of (1) stakeholders insight toward Islamic bonds (2) lack of society's knowledge in sharia economic (3) fundraising through sukuk still unpopular among public society (4) bai 'inah issue in Ijarah contract (5) penalty treatment

doesn't seem compatible with sharia compliance (6) Yield determination is still on conventional basis method (7) Ministry of Home Affairs doesn't seem to support toward sharia economic.

### ***Law Constraints***

Law constraints consist of (1) PMK 180 year 2015 is not considered proper yet as benchmarking rule to municipal sukuk (2) there is no law basis that rules connection between SKPD and Ministry of empowerment and the state apparatus (Kemenpan) (3) there is no any law basis that is mentioned clearly about Islamic municipal bonds (4) UU number 23/ 2014 and PP number 38/2007 are not considered support local government to manage strategic infrastructure (5) mismatch rule between local and central government especially about fee capital market supporting institute on fee that based on market (6) rule of financial feasibility that only support rich provinces, not support provinces which really need of development (7) there is no clear regulation technically decrease (Special allocation fund) DAK and DAU in default state (8) there is no rule that concerns on forming SPV by local government (9) audit authority between OJK and BPK.

### ***Municipal Loans Risk***

This risk comes from economic activity through municipal bonds that consist of (1) inflation risk (2) low demand in the market (3) weak management on risk mitigation and default (4) loan ratio that will increase APBD burden.

Table 2. Constraints priority based on ANP analysis

Jenis Hambatan	Normal	Limit	%	Rank
<i>Direct Relation (nilai W = 0,556)</i>				
Hambatan Hukum	0.4478	0.2239	45 %	1
Aspek Syariah	0.1405	0.0702	14 %	3
Risiko Pinjaman Daerah	0.1514	0.0757	15 %	2
Risiko Politik	0.1373	0.0687	14 %	4
Trust antar Stakeholder	0.1230	0.0615	12 %	5
<i>Indirect Relation (W = 0,667)</i>				
Hambatan Hukum	0.2881	0.1440	29 %	1
Aspek Syariah	0.1006	0.0503	10 %	5
Risiko Pinjaman Daerah	0.2578	0.1289	26 %	2
Risiko Politik	0.2357	0.1179	23 %	3
Trust antar Stakeholder	0.1177	0.0589	12 %	4
<i>Prioritas Hambatan (W = 0,4)</i>				
Hambatan Hukum	0.3680	0.1840	37 %	1
Pengetahuan dan Penerapan Aspek Syariah	0.1206	0.0603	12 %	4
Risiko Pinjaman Daerah	0.2046	0.1023	20 %	2
Risiko Politik	0.1865	0.0933	17 %	3
Trust antar Stakeholder	0.1204	0.0602	12 %	5

### **Strategic Priority of issuing Islamic municipal bonds**

Based on literature study, validation and expert interview is concluded 35 strategies of issuing Islamic municipal bonds that classified into five nodes, they are:

#### **3.4.1. Building Trust**

Purpose of this strategy is to build trust between central government, local government and others stakeholder. In short, it may called as an answer to trust the human resource capability of local government and central government for supporting decentralization. It consist of (1) focus development on province with high level of religious, creativity and financial feasibility (2) measured and directed human resource training (capability standard of human resource for local government) (3) focused on project financing that isn't funded by DAU (4) assurance from APBD to increase investor trust (5) obligation to buy

sovereign sukuk through credit DAU with small margin if province is considered has over SILPA funds and isn't optimal in DAU management (6) sharing knowledge between stakeholders for open information and avoid misperception (7) focused on province with excellent political stability, it can be measured by harmony relation between legislative and executive (8) coordination by ministry of economic coordination and sharia economic committee that are formed by president to keep bonds issuing process on track.

#### **3.4.2. Socialization and Sharia Education**

Purpose of this strategy is to increase understanding of sharia economic especially about sukuk from local public and stakeholders from the government. Include evaluation toward sharia implementation with academic research involvement. This strategy consists of (1) socialization and sharia education toward society about sharia economic



especially sukuk (2) local society involvement to invest their fund in sukuk (3) socialization sukuk toward local government on suggest basis not mandatory (4) cooperation between DSN and OJK toward religious forum on term of sharia economic (5) communication between local government and branch of local MUI toward knowledge of muamalah Islamiyah (6) recommendation from sharia international financial institution such as IDB (7) discussion and public hearing that involve academicians towards different perception on sharia law (8) cooperation local MUI with university and consultant corporate toward sharia feasibility analysis on certain asset.

#### **3.4.3. Comprehensive law basis**

This strategy is recommendation and evaluation toward existing law basis that regulated about municipal bonds so that can issue strong and comprehensive law from A to Z about issuing Islamic municipal bonds. The provided recommendation based on obstacles that founded during issuing conventional municipal bonds. This strategy consist of (1) issuing law basis that regulated clearly mentions municipal sukuk at PP (Law Government) level then completed technically based on PMK (2) evaluation in Permendagri (Ministry of Domestic State law) toward budgets flexibility and municipal loan supervision (3) simple requirements of issuing municipal sukuk (4) revision UU number 38 year 2007 about authority distribution between central and local government toward municipal strategic project infrastructure (5) clear legal framework system regulates local government obligation during bonds period including at time of leadership change (6) law policy in Islamic municipal bonds must involve Kemenpan in Formation of SKPD

(7) regulation mechanism of DAK and DAU toward default management (8) Momerandum of understanding toward BPK's authority to appoint KAP OJK about region audit authority.

#### **3.4.4. Market Strategy**

Technical strategy toward supply-demand municipal sukuk to avoid loan municipal risk that consist of (1) coordination between directorate general of state credit and directorate general of balancing funds (2) demand is based on market needs (3) mapping of expectant investors from local, national and international society (4) locking investor at initial public offering period in primary market to give a chance for local expectant investors.

#### **3.4.5. Product Innovation Strategy**

Several innovations about municipal sukuk model and contract that will be issued based on market opportunity and local wisdom consist of (1) benchmark toward template of sovereign sukuk (expenditure budget) (2) Provinces with high local investment consideration and regional minimum wage (UMP) may use ritel model to give a chance of local involvement, however if investors is civilian and have low UMP may use project based sukuk model (3) using tax-backed bond for mudhorobah contract with underlying asset based on certain tax source (most liquid source) (4) priority on asset backed not asset based (5) issuing semi-municipal Islamic bonds with return source from BUMD income and budget of APBD (6) percentage of intangible asset below 50% of total underlying asset.

**Tabel 3. Strategic Priority based on ANP analysis**

<b>Alternatif Strategi</b>	<b>Normal</b>	<b>Limit</b>	<b>Persen</b>	<b>Rank</b>
<b>Direct Relation (W = 0,911)</b>				
Building Trust	0.1876	0.0938	19 %	3
Landasan Hukum	0.4599	0.2300	46 %	1
Sosialisasi dan Edukasi Syariah	0.2128	0.1064	21 %	2
Strategi Inovasi Produk	0.0761	0.0381	8 %	4
Strategi Pasar	0.0636	0.0318	6 %	5
<b>Indirect Relation (W = 0,511)</b>				
Building Trust	0.1806	0.0903	18 %	4
Landasan Hukum	0.2602	0.1301	26 %	1
Sosialisasi dan Edukasi Syariah	0.1559	0.0779	15 %	5
Strategi Inovasi Produk	0.2020	0.1010	20 %	2
Strategi Pasar	0.2013	0.1006	20 %	3
<b>Prioritas Strategi (W = 0,259)</b>				
Building Trust	0.1841	0.0921	18 %	3
Landasan Hukum	0.3600	0.1800	36 %	1
Sosialisasi dan Edukasi Syariah	0.1843	0.0922	18 %	2
Strategi Inovasi Produk	0.1391	0.0695	14 %	4
Strategi Pasar	0.1324	0.0662	13 %	5

These strategies have different scale priority between each cluster. The cluster of direct relation stakeholder sees clear and comprehensive law basis to regulate municipal sukuk including revision toward others supporting laws such as audit policy, municipal authority to manage strategic project, coordination in forming SKPD between local government and Kemenpan, rules of fee for capital market supporting institution and policy in default state. For indirect relation cluster, the priority is building trust between stakeholder and implement directed market driven strategy and product innovation.

## CONCLUSION

Prioritas Strategic and constraints priority of issuing municipal sukuk are law. It was agreed almost by all respondents except BPK that sees loan municipal risk as main priority. Issuing municipal sukuk needs law basis at least at PP level which may be issued 5 years. OJK provide UU, however in

view of DJPK, DJPPR and Pemda that will consume long time maximum 20 years. The materials of law basis may be benchmarked from existing law basis on conventional municipal bonds such as PMK number 180/2015, PP number 30/2011, UU number 38/2007, and UU number 23/2014 including obstacles that appear since beginning of its discourse in the first 2000. Recommendation for mentioned regulation is clear purpose finance, DSN, technical ministry, and Kemenpan involvement, provinces authority in strategic project, audit authority etc. for financial feasibility regulation, needs for firmness of central government toward province which don't report their local financial completely especially for emergency and reforestation fund as basis calculation for debt service coverage ratio.

The second constraint is loan municipal risk such as default management and market risk. This is duty for DJPK and DJPPR to make measured training standard toward human resource of

local government about loan management to avoid default. Training also must be standardized too create trust between central and local government.

Socialization and sharia education are needed not only for civilian as expectant investors but also government stakeholders mainly BPK, DJPK, Kemendagri and Pemda. This point needed to give consideration of sharia investment advantage include decreasing obstacles that will appear from sharia aspect in the future toward interest and implementation. The first sukuk default in Indonesia is caused by violation of sharia compliance in penalty treatment that still based on conventional formulae. Several other technical cases such as stating yield and sharia contract must be socialized in order to implement muamalah rule perfectly

### Suggestion

Strategy and constraints of issuing municipal sukuk are internally oriented they are internal correlation between stakeholder and comprehensive law basis. Therefore coordination between stake holders must have involvement of Ministry of economic coordination and sharia economic committee formed by the president. Lessons that taken from obstacles of conventional municipal bonds is misperception between government stakeholders, the implication is to incomprehensive law basis revision, because every stake holder has its own target that may be opposite others institution target. Coordinator role is needed here, to keep stakeholder policy inline.

The unique of municipal bonds compared to the others capital market instrument is tax treatment. Municipal bonds is specialized as tax-exempt instrument. it is interest point of investors toward municipal bonds. Similar to Islamic municipal bonds. In Indonesia, tax to sukuk return is rather expensive, for saving sovereign sukuk ST-001, the cheapest sovereign sukuk (2 million) with fixed return 6,9%, has tax charge 15% (Kemenkeu 2016). For ideal percentage to Islamic law basis, it may use percentage of zakah 2,5% from return which its allocation focused on 8 asnaf in zakah

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