

Recent Developments in Islamic Banking in Indonesia

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ABSTRACT

In 1998 Indonesia decided to convert from a conventional to a dual banking system, to accommodate both types of financial institutions. The dual banking system is based on the 1998 Legal Act 10, which allows commercial banks to operate on *shari'ah* principles. Furthermore, the 1999 Act 23 makes it possible for Bank Indonesia, as the central bank, to conduct monetary operations based on *shari'ah*. Based on these acts, Bank Indonesia has a mandate to develop *shari'ah* banking in the country. However, many obstacles remain. By identifying the important issues strategies can be developed to facilitate *shari'ah*-based banking. This paper explores the strategies for Bank Indonesia to further develop *shari'ah* banking.

I. INTRODUCTION

In 1997, the banking crisis in Indonesia created a challenging environment from which the country has still not fully recovered. The issues include high interest rates, which attract deposits, but banks are still reluctant to channel credit because of a high rate of Non-Performing Loans (NPLs) and slow sector restructuring. In such conditions, however, Islamic banks have maintained their performance. Their NPL level is lower, and they are improving faster than conventional banks. Moreover, conventional banks' Loan to Deposit Ratio (LDR) has declined to below 50%, while Islamic banks' Financing to Deposit Ratio (FDR) stays at around 100%.

The Islamic banking system possesses several benefits not found in conventional banking. For example, Islamic banks offer products with interest-free mechanisms. This is especially beneficial in the current macroeconomic conditions. With a high interest rate, banking and other sectors are faced with managing high cost of funds, and hence a negative margin. The introduction of a non-interest-based system can, to some extent, alleviate this problem. Additionally, Islamic banking eliminates unproductive speculation, and introduces a system of partnership with a high level of moral principles. While some argue that the growth of Islamic banking will pose a threat to the viability of conventional banking, on the contrary, this development will improve the quality of the overall system on at least two counts. First, an orderly development of both the conventional and Islamic systems will promote healthy competition, which, in turn, will promote market discipline, improve customer service and create value for customers. Second, a parallel systematic, regulated Islamic banking system as an alternative to conventional banking will achieve a better spread of financial risk across the economy. This will, in turn, reduce the systemic effects of widespread financial failures.

In 1992, the development of modern Islamic banking in Indonesia was formally initiated in line with Banking Act 7. This Act has provisions to create opportunities to develop interest-free banking. Business transactions in accordance with Islamic principles have long been practiced among Indonesian Muslims, who constitute over 85% of the population. The profit-and-loss sharing (PLS) system between landowners and tenants has been used for a long time in the agricultural sector. Formal Islamic banking in Indonesia, however, is still in its early stages. In the last three years Indonesia has shown a rapid development of financial institutions offering services in accordance with *shari'ah* principles. Non-Bank Financial Institutions (NBFIs), including Islamic insurance (*takaful*) and Islamic funds management, have also been offering financial services. In 2000, the Jakarta Stock Exchange introduced Jakarta Islamic Index providing opportunity for *halal* investment in the stock market. This index can be a benchmark for investment for *halal* mutual funds. Also, there are more than 400 *bayt al-mal wa al-tamwil* (BMT) entities that operate all over the country to serve at the grassroots.

In Indonesia, the development of Islamic banking is based on two considerations. Firstly, there is a large niche market in Indonesia, which refuses to be serviced and catered by conventional banks, because of Islamic principles. The introduction of an Islamic banking system will assist the banking system as a whole to effectively mobilize funds in this market. Secondly, the Islamic banking is an alternative system, which could be implemented as one of the banking-restructuring programs initiated by the Indonesian government.

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II. HISTORICAL MILESTONES AND CURRENT CONDITIONS

In 1990 the Indonesian ‘Ulama’ Council (MUI) held its first symposium on “Issues in Interest and Banking.” While the participants were divided on the acceptability of interest, they did realize that some Muslim communities in Indonesia would simply not use conventional banking services. As a result they formed a taskforce, and recommended that the government create the conditions for establishing Islamic banks.

In 1992, in a plan to amend the Banking Act 14 (1967), the government and parliament enacted the Banking Act 7, providing opportunities to develop Islamic banks. Based on this Act, Indonesia recognized the existence of a dual banking system, where conventional and Islamic banking could grow in parallel to serve the economy. During the same year the first Islamic bank, PT Bank Muamalat Indonesia, was established in Jakarta. Some rural Islamic banks were also established in Java. During the early years, Bank Muamalat, as the only Islamic bank, faced some obstacles, particularly due to no market instrument and no alternative for liquidity management. Additionally, the central bank did not provide special central bank facilities (e.g., for open market operations, discount windows or central bank credit facilities) complying with Islamic principles.

In 1998, to overcome these problems and to encourage network expansion, the government amended the Banking Act with a new Act 10, providing a wider opportunity and a stronger legal foundation for Islamic banking. A notable change in this act is the opportunity for conventional banks to open Islamic banking units. Furthermore, in 1999 through the amendment of Central Bank Act by Act 23, the central bank allowed monetary control with instruments based on Islamic principles. Since then the industry has steadily progressed and expanded. As of 2001, there were two main Islamic banks, three conventional banks with Islamic banking units (three others in the licensing process) and 81 rural Islamic banks. Table 1 below shows the statistics of Islamic bank in the countries, and Table 2 shows the share of Islamic banks.

Islamic banking assets increased from 0.03% in 1992 to 0.06% in 1998 and 0.25% in 2001. Between 1990-2001 the growth of asset was 54%. Despite the rapid growth, Islamic banks in Indonesia still need to improve competitiveness especially in term of economic benefits such as return on equity, service quality, efficiency and *shari’ah* compliance assurance. Surveys conducted show that customers consider Islamic banks’ service quality and product information inferior to those of conventional banks’. Also, given their current size and legal lending limits, Islamic banks faced difficulties in serving corporations, except through syndication financing. Other problems include the lack of proactive approach by Islamic bankers to promote their product and services to corporate customers. Still, due to the relatively early stages and lack of supportive infrastructure, Islamic banks in Indonesia are focusing more on debt financing (i.e., *murabaha*), which formed 69.3% of all Islamic banks financing portfolios at end-2001, with Profit-and-loss sharing (PLS) forming only 22.2% (*musharaka*: 2.6% and *mudaraba*: 19.6%).

TABLE 1: ISLAMIC BANKING IN INDONESIA (DECEMBER 2001)

Bank	Number of Islamic Bank Offices
A. Full Islamic Banks	
1. Bank Muamalat Indonesia	1 head office 12 branches 4 sub branches 38 cash offices
2. Bank Syariah Mandiri*	1 head office 23 branches 6 sub branches
B. Conventional Banks with Islamic Banking Full-Branches	
1. Bank IFI	1 SBU** 1 SFB***
2. Bank BNI	1 SBU** 10 SFBs***
3. Bank Jabar (BPD Jawa Barat)	1 SBU** 1 SFB***
C. Islamic Rural Banks (BPRS)	
Number of banks	81 BPRS

* Fully converted from conventional bank into Islamic bank per November 1999

** *Shari’ah Business Unit*

*** *Shari’ah Full-Fledged Branches*

TABLE 2: SHARE OF ISLAMIC BANKS (DEC 2001)

Rupee Trillion	Islamic Banks		All Banks
	Nominal	Share	
Deposits	1.81	0.23%	797.40
Total Asset	2.72	0.25%	1 099.70
Financing/Credit	2.05	0.57%	358.60
FDR/LDR	113.50%		44.97%
NPLs	7.41%		12.10%

The problems faced in developing Islamic banking in Indonesia are both operational and macroeconomic in nature. Primarily, the major problems have been associated with the low level of development of Islamic banks, namely:

- The concept of modern Islamic banking is relatively new and the majority of people still lack a clear concept of the Islamic banking system and its products. As such, the benefits offered by the Islamic banking system have not been fully recognized.
- Inadequate Islamic banking infrastructure. For example, the lack of special regulations for Islamic banking activities.
- Lack of human resource expertise in Islamic banking. The development of expertise among the Islamic bankers have been on an ad-hoc basis relying more on practical experience rather than any formal training. A more structured approach to human resource development in Islamic banking and Islamic economics is required.

III. DEVELOPMENT FRAMEWORK: ACHIEVING OBJECTIVES

Islamic banking is promoted by the central bank to create a competitive, efficient and prudent industry that can support the economy through equity-based financing. To achieve this objective, the central bank of Indonesia identified the following tasks:

- Create a favorable environment for Islamic banking, with a commitment to *shari'ah*, and contributing to real sector covering.
- Research the conditions, opportunities and requirements for Islamic banking.
- Establish regulations to enable efficient operations.
- Supervise and audit Islamic banking operations.
- Market Islamic banking to the public, as well as conduct training for the development of human resources, with a high standard of professionalism, integrity, prudence, teamwork and innovation.
- Actively be involved in establishing a strong international Islamic finance community and necessary international institutions and infrastructure.

To develop Islamic banking, the central bank of Indonesia adopted some approaches in shaping policy. These are:

- Market-driven approach in network and product development.
- Fair treatment between conventional and Islamic banks.
- Step-by-step, gradual and sustainable development of regulation and infrastructure.
- Paying attention to *shari'ah*-compliance, applying Islamic universal values in regulation design and development initiatives.

These clear guidelines help Bank Indonesia, as a regulator, maintain objectivity in designing regulations and infrastructure for Islamic banking, and to resist moves to make it a political vehicle.

Since 1998, the foundation for growth has been reinforced in forming regulations for network development. The central bank, through its licensing procedures, allows alternatives for investors and/or banks to operate Islamic banking business, which includes:

- Establishing new (full) Islamic banks (domestic or foreign owned, commercial or rural Islamic banks).
- Converting conventional banks fully into Islamic banks (commercial or rural banks).
- Establishing Islamic banking units within conventional banks (dual system) as alternatives to founding Islamic banking branches.
- Opening new branches that operate as Islamic banking branches.
- Converting conventional branches to Islamic banking branches (with all its sub-branches).
- Converting and upgrading the status of conventional sub-branches to that of Islamic banking branches.

Additionally, the central bank has promulgated basic regulations to overcome liquidity management problems. In the event of over-liquidity, the banks can use Bank Indonesia *Wadi'ah* Certificate (SWBI) and when facing short-term liquidity problems they may use an Islamic-based Interbank Money Market (PUAS) with instrument *Modaraba* Interbank Investment (MII or IMA) Certificate. The salient features of four basic regulations for Islamic banks issued by Bank Indonesia are listed in the Appendix.

The central bank has established:

- The Islamic Banking Bureau in May 2001 (directly under the supervision of the Board of Governors) which regulates, supervises and licenses Islamic banks. The bureau is an extension of the Research and Development of Islamic Banking Team established in 1999.
- In 1999, the Expert Panel Committee was formed. The committee consists of '*ulama*', scholars and former Islamic bankers, who advise Bank Indonesia in all aspects.
- The National *Shari'ah* Board (NSB) is the only body that may issue *fatawa* concerning new products and services, and recommends the membership of the *Shari'ah* Supervisory Boards (SSB) within each bank.
- The Muamalat Arbitrageur Agency, which acts as a dispute settlement agency operating according to Islamic law.
- Indonesian Accountant Institute has also played a significant role in setting up standards for Islamic banks. These are mainly accounting and auditing standards adopted from AAOIFI's guidance which have been modified and adjusted to harmonize with national accounting and auditing standard and local differences.

IV. PROSPECTS AND TASKS AHEAD

The prospects for Islamic banking can be explored from both the demand and the supply side. Surveys have shown that many prefer it over conventional banking, since many owners of smaller businesses believe interest is akin to *riba*. These surveys were based upon empirical research conducted in 2000-01, which explored the demand for Islamic banking in the country. The study covered six provinces in Java and Sumatra (about 5,500 respondents), and was conducted by Bank Indonesia, with the assistance of several universities. It showed that, on average, 40% of respondents believed that interest is contrary to Islamic principles and preferred to use Islamic banking if available close by, while 68% agreed with the profit-sharing system and considered it beneficial. In West Java, 42% preferred and felt comfortable with Islamic banking, because it complies with Islamic law.

People are increasingly developing a better understanding of Islamic banking. This awareness is due to the socialization program conducted by Bank Indonesia and other institutions. They advocate Islamic banking as a moral obligation, and also explore Islamic economics and banking as a science. The target is the '*ulama*', practitioners, academics, students and the Muslim community in general. Through this socialization program, it is possible that in the near future non-Muslims will also use Islamic banking.

As we know from surveys, there is a demand for Islamic banking product and services. However, because of rigid networking regulations, the *shari'ah* business units of conventional banks find it difficult to expand their networks. In 2002, therefore, Bank Indonesia issued regulations on network expansion allowing:

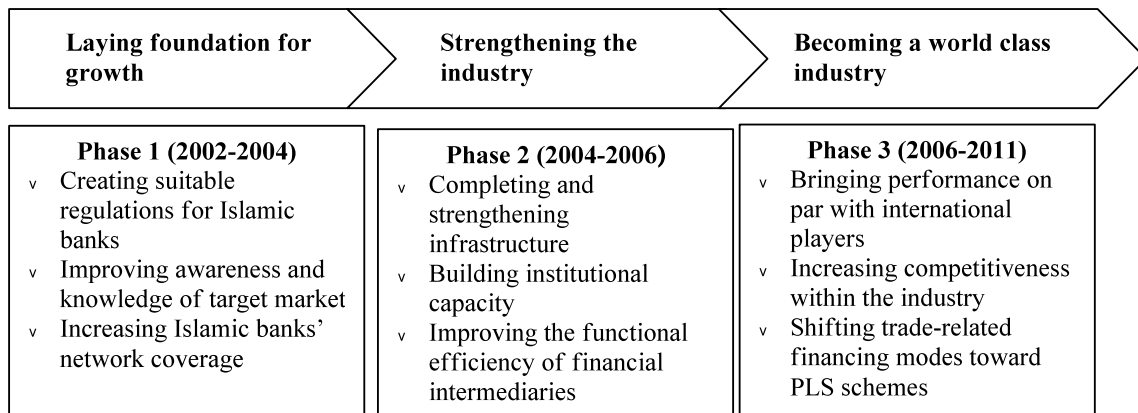
- Islamic banking sub-branches within conventional branches.
- Islamic banking services units within a conventional branch, to transition toward a full Islamic branch.

Hopefully, the new regulations will encourage growth, so that people in other regions will be served. Measures to regulate and support these initiatives are needed to develop the dual banking project in Indonesia. It is necessary to ensure that such institutions have sound management, adopt healthy practices and do not indulge in speculation. Such institutions should be regularly inspected and audited by the central bank. Bank Indonesia, as the authority, has a responsibility to consistently formulate, improve and regulate the legal framework, to provide a conducive environment for the development of efficient and competitive Islamic banking. Cooperation and

involvement by other government bodies are also necessary, for tasks such as reforming the tax system, nurturing non-bank financial institutions, and creating specialized legal institutions.

The development of Islamic banks in Indonesia has showed significant progress, but their role in the economy is still small. It is envisioned that the industry could achieve a significant contribution and play a greater role in national economy. To support these efforts, the central bank has devised a long-term plan for the next decade, based upon three phases of implementation (Figure 1). This plan will be very important in accelerating the growth of Islamic banking, enlarging its share in the national banking system, and driving the industry toward greater equity-based financing. It considers the international progress of Islamic financial infrastructures, such as the establishment of the International Islamic Financial Market (IIFM) and Islamic Financial Services Board. The first phase involves laying the foundation for growth so that Islamic banks can provide an alternative for the Indonesian people. The second phase is strengthening the industry so that it can play a bigger role in the economy. Finally, the third phase is becoming a world industry by improving performance, increasing competitiveness, and shifting trade-related financing toward PLS schemes.

FIGURE 1: PROCESS OF IMPLEMENTATION TO ACHIEVE OBJECTIVES



V. CONCLUSION

Act 10 (1998) has become the legal foundation for Islamic banks, as it provides assurance to investors, bankers, and the general public. The Act 23 (1999) strengthens the legal foundations further. As a consequence, while Islamic banking still has only a small share, its growth is significant. With the national banking system changed to a dual system, different regulations are needed for Islamic and conventional banks. This does not mean that Islamic banking is protected or privileged, but its development, as a different system, is assisted. Islamic banking development policy should not be based on the infant industry argument, but upon factors such as market, fair treatment, gradual approach and *shari'a*-compliance. In the long term this should allow Islamic banking to be competitive, efficient, prudent and significantly supporting the real sector through equity-based financing.

The success of Islamic banking development policy in Indonesia depends on more than regulations and infrastructure, social and training programs and participation in the international Islamic finance community. It is also dependent upon Islamic bankers, customers, investors and other regulatory bodies viewing Islamic banking as a financial system: a science and not just a religious obligation.

Finally, as Islamic banking continues to grow, the involvement of regulatory and other institutions will increase. We may learn from the experience of one country, and adopt suitably modified policies to continue to independently yet jointly progress in Islamic finance.

APPENDIX: SALIENT FEATURES OF BANK INDONESIA REGULATIONS ON THE OPERATIONS OF COMMERCIAL ISLAMIC BANKS

TABLE 3: RESERVE REQUIREMENTS FOR FULL ISLAMIC BANK AND ISLAMIC BANKING UNIT OF CONVENTIONAL BANK

Directive Pointers	Full Islamic Bank	Conventional Bank with Islamic Banking Unit
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Bank Account at the Central Bank:		
Non-Foreign Exchange Bank	<ul style="list-style-type: none"> ▪ One rupiah account. 	<ul style="list-style-type: none"> ▪ Two rupiah accounts, one for conventional and another for Islamic based business.
Foreign Exchange Bank	<ul style="list-style-type: none"> ▪ One rupiah account and one foreign exchange account. 	<ul style="list-style-type: none"> ▪ Four accounts, i.e.: ▪ Two rupiah accounts for conventional and Islamic based business, and ▪ Two foreign exchange accounts for conventional and Islamic based business.
RR Calculation	<ul style="list-style-type: none"> ▪ Proportion of bank's account in Bank Indonesia compared to public deposits in bank. 	<ul style="list-style-type: none"> ▪ Two RR calculations; one for conventional and another for Islamic business, i.e., proportion of bank balance in Bank Indonesia compared to balance of public deposits in bank.
Penalty of RR insufficiency	<ul style="list-style-type: none"> ▪ $RR \text{ Insufficiency} \times 125\% \times \text{PUAS Return Indication Rate recorded in PIPU (BI) on the day of violation} \times 1 \text{ day} : 360.$ 	<ul style="list-style-type: none"> ▪ Bank's head office: conventional bank provisions concerning the penalty of RR insufficiency. ▪ Islamic Banking Unit: provisions as apply to full Islamic bank (penalty calculated separately).
Penalty for Negative Balance Account	<ul style="list-style-type: none"> ▪ $\text{Negative Balance Account} \times 150\% \times \text{PUAS Return Indication Rate recorded in PIPU (BI) on the violation date} \times 1 \text{ day} : 360.$ 	<ul style="list-style-type: none"> ▪ Bank's head office: conventional bank provisions concerning the penalty of RR insufficiency. ▪ Islamic Banking Unit: provisions as apply to full Islamic bank (penalty calculated separately).

TABLE 4: CONDUCT OF LOCAL CLEARANCE PROCESS AND FINAL INTERBANK SETTLEMENT FOR ISLAMIC BANKS

Directive Pointers	Full Islamic Bank	Conventional Bank with Islamic Banking Unit
Determining Negative Balance Account for suspending on interbank clearance system membership	<ul style="list-style-type: none"> ▪ The end of day balance of rupiah account of each bank in Bank Indonesia. 	<ul style="list-style-type: none"> ▪ The calculation of balance account applying by summing-up the end of day balance of rupiah account of conventional business and Islamic Banking Units of each bank in Bank Indonesia
Suspension from interbank clearance system membership	<ul style="list-style-type: none"> ▪ Applies to all bank business. 	<ul style="list-style-type: none"> ▪ If the sum of account balance of the conventional business (+/-) and Islamic Banking Units (-/+) is positive, then both bank businesses will not be suspended from clearance system membership. ▪ If the sum of account balance of the conventional business (+/-) and Islamic Banking Units (-/+) is negative, then both bank businesses will be suspended from clearance system membership. ▪ Bank offices with a negative account balance are penalized.

TABLE 5: ISLAMIC-BASED INTERBANK MONEY MARKET (PUAS)

Directive Pointers	Full Islamic Bank & Conventional Bank with Islamic Banking Unit
Market	▪ Islamic-based Interbank Money Market (PUAS).
Principle	▪ Investment activities based on <i>mudaraba</i> .
Instruments	▪ Interbank Mudaraba Investment Agreement (IMA) Certificate.
Information intermediary	▪ Money Market Information Center (PIPU) of Bank Indonesia.
Participants:	
▪ Endorser:	▪ Head offices of full Islamic bank, and the Islamic Banking Units of conventional banks.
▪ Buyer/investor:	▪ Any commercial bank.
Payment of principal and return)	▪ Profit sharing return is paid at the end of every month, and the principle is paid back at the maturity.
Reselling of IMA certificate	▪ Can be re-sold once in the secondary market
Reimbursement of investment fund	▪ Endorser bank is obliged to pay back the principal on the due date of IMA Certificate. If the endorser used a profit-sharing method, instead of revenue-sharing, and experienced loss, then: ▪ Investor/buyer bank will not get profit/return. ▪ As long as the loss is not a result of endorser negligence/fraud then the investor/buyer will share the loss with maximum of IMA nominal amount.
Disagreement/dispute	▪ Parties may use Muamalat Arbitrageur Board (Islamic Dispute Settlement Agency)

TABLE 6: BANK INDONESIA WADI^cA CERTIFICATE (SWBI)

Directive Pointers	SWBI
Purpose	▪ Monetary instrument in accordance with Islamic principles. ▪ Instrument of short-term fund placement by a commercial bank according to the <i>wadi^ca</i> principle.
Maturity	▪ 1 week, 2 weeks ▪ 1 month ▪ stated on number of days Bank may get the deposit back before maturity, but will not receive bonus, and will incur administrative costs.
Amount and denomination of entrusted fund	No less than Rp 500,000,000. In multiples of Rp 50,000,000.
Time of transaction	Every working day from 8:00 p.m. to 2:00 p.m. Jakarta Time.
Procedure for application	Bank shall apply for placement of fund using RMDS/fax/telephone to Bank Indonesia with clear notification of nominal value, term and maturity.
Procedure for transaction settlement	Settlement of transaction for placement of funds shall be executed on the same working days. Bank Indonesia shall execute the transaction by debiting the demand deposit account of the bank at Bank Indonesia in the amount of the placement. In the case of insufficient balance in a demand deposit account, the transaction for placement of funds shall be cancelled. In respect of cancellation, the bank shall liable to administrative sanctions in the form of a letter of warning. If cancellation due to insufficient balance occurs more than twice within a period of six months, the bank shall be penalized 0.1% of the shortfall.
Settlement procedure upon maturity	Upon maturity Bank Indonesia shall credit the demand deposit account of the bank in the amount of the placement of funds
Bonus	If Bank Indonesia provides a bonus to a bank, the amount of bonus calculated with reference to the indicated rate of return for the PUAS, comprising the weighted average indicated rate of return on IMA certificate formed in the PUAS at the date of placement of funds. In the event the above data is not available for the day of placement of funds, the amount of bonus calculated with reference to the most recent indicator of rate of return formed on the PUAS or average rate of return on <i>mudaraba</i> investment time deposits prior to distribution during the preceding month for all banks conducting business based on Islamic principles.

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