Indonesian Islamic Banking and Finance: Performance and Challenges

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Indonesian Islamic Banking and Finance: Performances and Challenges Ahead

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Dr. Rifki Ismail discussed in his talk the latest developments and unique features of Islamic finance in Indonesia, at the Center for Islamic Economic and Finance at QFIS. His lecture was divided into five main sections. The first part focused upon the unique values and characteristics of Indonesian Islamic finance, which was later followed by a discussion regarding the linkages among the institutions themselves. He later examined the performance of Islamic finance and its supporting factors, as well as reviewing the legal support available for Islamic finance in Indonesia. Dr. Ismail concluded the lecture by mentioning some promising factors for the growth and development of Islamic finance in Indonesia.

There are many characteristics and values which are unique to Indonesian Islamic finance. The first unique feature that Dr. Ismail identified is that Islamic finance in Indonesia is *sharia* based and uses mainly classic *sharia* compliant contracts such as, *mudaraba*, *musharaka*, *wakala*, *salam* and *istisna'*. All other debatable contracts such as *tawaraq* and *i'na*, although they may be used in Malaysia, they are not allowed in Indonesia. Dr. Ismail argued that these restrictions come with its own advantages and disadvantages.

In the Indonesian case, Dr. Ismail finds that 80% of the financing is directed towards the SME's, as the Islamic banks do not extend money to the financial markets and this may explain why the financial markets are still under developed in Indonesia.

He also argued that the experience of Islamic finance in Indonesia is unique, as it is domestically oriented, with only one international bank in Malaysia. Dr. Ismail added that the national *sharia* board is independent in regards to issuing fatwas, which is rather unique to Islamic finance. This is due to the fact that the *sharia* board is under the Majlis Ulama in Indonesia, which is an independent institution. In addition, due to the Indonesian government not providing the support, Islamic finance in Indonesia is supported by the 200 million Muslims; hence, Islamic finance in Indonesia is socially driven, as opposed to being state-driven. Dr. Ismail recalled that the government does not present interest in developing the Islamic banks; for instance, the government continues to allocate the hajj funds to conventional banks rather than Islamic banks.

Despite the lack of government support to Islamic banks, the Islamic banks experience an "annual growth rate of 40%, and an average of 101% financing to deposit ratio in the last two decades". This could be attributed to the robust domestic economy in Indonesia, as they experience greater support from the society.

In the second part of the lecture, Dr. Ismail focused upon the institutions that have links with Islamic banking. He mentioned that Islamic windows, Islamic banks, Baytul Mal and Islamic rural banks, are the main players in Islamic finance in Indonesia. He also said that Islamic windows extend, allocate and invest funds through Baytul Mal, and then Baytul Mal deals directly with SMEs; while Islamic banks can take the same aforementioned route or invest directly to the SMEs.

He finds that banks favor investing through Baytul Mal, because they offer higher returns, despite Baytul Mal demanding a lock on the deposit for a certain period of time, for them to give a higher return. There is also a concern that Dr. Ismail discussed, which is regarding the absence of a management authority overseeing Baytul Mal and their ability to prevent risks from occurring.

Despite the concerns regarding the management of Baytul Mal, Dr. Ismail argued that there are three ways in which they manage their risk. The first method is through building a strong mutual and emotional relationship with the beneficiaries, this builds trust and a strong mutual relationship. The second technique is, that when the borrower is experiencing difficulties, the bank takes the collateral to cover the default. The third way is through penalties; hence, when the borrower gains the ability to pay back, the penalty is given back. The last method is to resort to the ulama, who are well respected by the borrowers, such that the borrowers are compelled to pay back so that they do not visit again.

In the third part of the lecture, Dr. Ismail discussed the performance of the Islamic banks in Indonesia, as well as the existing supporting factors. For instance, he noted that the market share for Islamic banks in Indonesia is 4.8%, which is considered to be rather low, however, it still has the potential to improve. In addition, the takaful and sukuk market shares are also low; nonetheless, the Islamic stock market is relatively higher. Dr. Ismail argued that the low figures can be attributed to the low support and the lack of commitment from the Indonesian government. Islamic banks are also experiencing downturns, due to core depositors downsizing during the global financial crises.

When the Islamic banks realized that they were surviving the crises they wanted to adjust the liability side of the balance sheet to lower costs. As a result, they downsized the core depositors by lowering the rate of return. Then they attracted more retail depositors; however, in 2012/2013, external economic conditions impacted the Indonesian economy, which led banks to struggle. As the banks had fewer core depositors, and the banks had to face the cost of expanding branches, such as information technology development, as well as staff recruitment. The case was made worse because the holding companies were not willing to take part in sharing these costs with the Islamic banks.

Dr. Ismail argued that despite external economic conditions impacting the banks, Islamic banking in Indonesia has a good legal framework supporting its operations. These include the central bank act, Islamic banking act, the sukuk government law for income tax, tax neutrality in government law, microfinance act, waqf act and the Otoritas Jasa Keuangan (OJK) act. In addition, the authorities and supporters include the central bank, national sharia board, accounting association and consulting companies.

One of the major positive factors is that the Indonesian government is planning to establish state owned Islamic banks, which are going to act as anchor banks for Islamic finance. Dr. Ismail also discussed a move by the government to have the hajj funds be allocated to Islamic banks, which will be a huge boost for the sector. Furthermore, the ministry of religion has the intention to establish an awqaf fund with the support of the Jordanian government. In addition, Dr. Ismail elaborated on the topic, by discussing the possibility of establishing an awqaf bank as suggested by the Jordanian government. However, he raised several concerns and questions that would need to be resolved prior to establishing an awqaf bank. For instance, Dr. Ismail recalled that banks use an ijarah contract, while awqafs use a tabarru' contract. Thus, he argued that they would need to review the contracts, in order to operate an awqaf bank.

Dr. Ismail also presented that there is a policy coordination for the banking industry, non-banking industry and financial markets under the OJK –Indonesian financial services authority –, which will mean that the Baytul Mal that lacked management authority is now under the authority of OJK. The government is also targeting more project based sukuk as opposed to ijarah sukuk. There are plans also to establish a directorate of Islamic finance in the ministry of finance together with a construction of an Islamic deposit scheme. There is a huge boost for the Islamic banks as there is stronger commitment from the parent companies.

Another interesting point that Dr. Ismail drew the audience towards was the market expansion of the Asian economy in relation to Islamic finance. As Asian countries plan to open the market and allow the expansion of banks in the Asian countries. However, he finds that Indonesia did not sign the Memorandum of

Understanding (MOU) for the open Asian economic community 2015-2020. This is due to the Indonesian government calling for a need to change some of the policies contained in the MOU, as it gave advantages to advanced economies like Malaysia. Therefore, the governor of Indonesia suggested some changes to the MOU and until these changes are implemented, Indonesia will not commit to the Asian economic community.

In brief, Dr. Ismail gave a thorough account of Islamic finance in Indonesia, while discussing the unique characteristics of Islamic finance, as well as the future prospects and developments of the field.

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Speaker Bio: Dr Rifki Ismal, Assistent Director of Macro-prudential Policy of Central Bank of Indonesia, was born on November 6, 1973. Before he join in Macro-Prudential Policy, he joined in Islamic Banking Department. Besides Assisten Director, he is a lecturer at various universities such as University of Indonesia, Trisakti University, Yarsi, and also he was a visiting lecturer in Strasbourg School of Management, France. I met him when I was meeting in Central Bank of Indonesia. He is kind, humble and smart person. Out of academic and official activities in Indonesia, he was a visiting researcher at Bank for International Settlements (BIS) in Hong Kong representative office. His educational background, he finished BA at Unversity of Indonesia (1997). After three years later, he continued to take MA at University of Michigan, USA (2003). After he finished his MA degree, he continued to take Ph.D at Durham University in 2010, UK. One of his achievements is his papers have been published on 30 International Journals. He is a special person for me because he has a great experience in academic and honestly, I want to be like him.