UNITED NATIONS
UNCTAD

MULTI-YEAR EXPERT MEETING ON SERVICES, DEVELOPMENT AND TRADE:
THE REGULATORY AND INSTITUTIONAL DIMENSION

Geneva, 6-8 April 2011

# ISLAMIC BANKING IN INDONESIA: LESSONS LEARNED

*By*

***Rifki ISMAL***
Directorate of Islamic Bankiing
Bank Indonesia
Jakarta, Indonesia

# ISLAMIC BANKING IN INDONESIA: LESSONS TO BE LEARNED[1]

Rifki Ismal
Directorate of Islamic Banking
Bank Indonesia

## Abstract

In Indonesia, Islamic banking shows a progressive performance with a robust performance of banking indicators. Its operations engage non bank financial institutions, Islamic money and capital market and *takaful* (Islamic insurance) with the ultimate target of financing the real sector and improving the economy. However, there are still some challenges to be solved in particular the small market share, lack of human resources and, lack of product development. Some recommended actions are proposed in the paper to mitigate those problems and foster the development of the Islamic banking industry.

**Keywords:** Sharia, Sukuk, FDR

[1] Paper prepared for the Annual Meeting on Trade and Development, United Nations of Conferences on Trade and Development, April 6th-8th, 2011, Geneva, Switzerland.

## 1. BACKGROUND

The same as most of the Moslem countries, Indonesia has a progressive Islamic banking industry which relies on the performance of the real sector. There are some engines of growth, which trigger the development of such industry especially the big Moslem population and, support from the government, banking regulators, parliament and Islamic scholars. However, besides the robust performance of the industry, there are some challenges that face the industry to move forward. The first challenge is the small market share which limits the operations of Islamic banks, the Islamic financial market activities and the contribution of the industry to the economy.

Secondly is the lack of human resources that may not entirely fulfill the demand for the high skilled and well-educated employees. The persistent growth of the industry has not been so far followed up by the adequate supply of human resources. Thirdly is the lack of product development to facilitate various Islamic finance transactions. The Islamic banks in Indonesia rely mostly on the classic Islamic banking contracts and needs more product innovation.

This paper explains the Indonesian Islamic banking industry. Particularly, it discusses the legal aspect, infrastructure and program of development; engines of growth; the performance of the industry and; some challenges in the industry. Some recommendations at the end of the paper are proposed to improve the condition of the industry, to improve the current practices and to further advance the prospect of the industry.

## 2. THE INDONESIAN ISLAMIC BANKING INDUSTRY

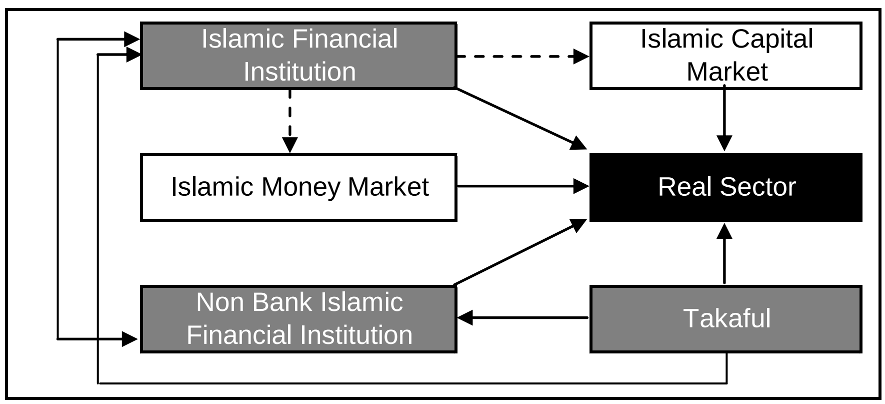
### 2. 1. Legal Aspect, Infrastructure and Program of Development

Indonesia applies double economic and banking systems. The central bank act number 23 of 1999 amended by act number 3 of 2004, stated that the country operates both Islamic and conventional monetary operations (Bank Indonesia, 1999). Also, the banking act number 7 of 1992 and amended by act number 10 of 1998 allows the implementation of Islamic banks along with the conventional ones. Finally, in mid 2008, Indonesia has had two important acts namely the Islamic banking act number 21 of 2008 and *Sukuk* act number 19 of 2008 (Bank Indonesia, 2010a and 2010b).

Hence, the application of Islamic banks, other Islamic financial institutions and non bank Islamic financial institutions has had strong legal aspect. Further, recently the parliament and government discuss and prepare *zakah* act and *takaful* act, which will further enhance the framework of Islamic finance in Indonesia.

Actually, the application of Islamic economic in Indonesia is shown by the operations of Islamic banks and, non banks Islamic financial institutions such as Islamic multi finance, BMT and *takaful*. Those institutions are equipped by the operations of Islamic money and capital markets (see figure 1). In addition, the development of Islamic banking in particular stands on the blue print of the development of Islamic banking industry 2002-2015 designed by Bank Indonesia in 2002 and the revised version in 2005-2006.

**Figure 1. Infrastructure of Islamic Finance in Indonesia**




The blue print applies six initiative programs to be implemented within 10 years (2005-2015), which are (Bank Indonesia, 2006):

a) Increasing the *Sharia* compliance;
b) Increasing the quality of prudential banking operations;
c) Increasing the operational efficiency and competitiveness;
d) Increasing the stability of banking system;
e) Increasing the expertise and quality of human resources;
f) Optimizing the social roles of Islamic banks in developing the small and medium enterprises (SME).

Such a blue print becomes guidance for banks, banking regulators, government and all related parties to determine their long term strategies and programs to expand the industry. Further, in order to boost the market share of Islamic banking, Bank Indonesia created a grand strategy of the development of Islamic banking industry which is now named as market development strategic program or simply MDSP (Markplus and Bank Indonesia, 2008). Particularly, MDSP implements the strategies:

i. to position the industry as the most attractive one and the leader among the ASEAN countries in 2009 and 2010 respectively;
ii. to create the new image of Islamic banks which are inclusive and universal;
iii. to accurately map the Islamic banking potential market;
iv. to develop the Islamic banking products;
v. to improve the banking services and;
vi. to newly communicate the position of Islamic banks as the beyond banking.

In fact, since the establishment of the first Islamic banks in 1991 and after the implementation of the blue print, the industry has developed significantly and progressively.

**2. 2. Engines of Growth**

There are at least four supporting factors which boost the development of the Islamic finance in Indonesia. The first one, of course, the big population of Moslem in Indonesia. Based on the national survey on population in 2010, there are at least 208 million Moslem people of 237 million populations. This is a potential demand for Islamic financial institutions from domestic. Further, concerning the results of banking customer surveys done by Bank Indonesia between 2000-2009, Mars company in 2008 and Markplus and Bank Indonesia in 2008, almost all of the people in Indonesia support the idea of Islamic banks and their counterparts. Hence, it depends on the ability of Islamic banks to meet the expectation of people to optimally utilize such a potential demand.

Secondly, the support from banking regulators, parliament, government and *Sharia* scholars also take part in developing the Islamic banking industry. Those parties have successfully provided underlying acts to support the operations of Islamic financial institutions. This is very important as the interaction among domestic Islamic financial institutions and with the international institutions often requires a legal basis. The approval and application of both Islamic banking act and *Sukuk* act as mentioned previously have triggered and facilitated the advancement of the industry and the Islamic financial markets as well.

In particular to Bank Indonesia as the banking authority, it has issued various banking regulations to maintain and foster the growth of the industry. The examples are channeling program in 2007, less capital required to establish a new Islamic bank and, a linkage of the placement of funds in the central bank certificate (SBIS) and reserve requirement. Moreover, to perfectly understand the verdicts of the National *Sharia* Board (DSN) and the implementation Islamic banking regulations, Bank Indonesia has set up Islamic banking committee on November 20th, 2008 (Bank Indonesia, 2008). The members are composed of Bank Indonesia's staff, Islamic scholars from Ministry of Religion and Islamic banking and finance experts.

Thirdly, the robust performance of Islamic banks in the last two decades has attracted public to deposit and become business partners. Unlike the performance of conventional banks, the Islamic banking industry has shown the optimal banking intermediary function as indicated by some banking indicators explained in the following parts. However, the strong support from the public above is identified as a rational one. They agree to be the depositors and business partners of Islamic banks mainly if the banks: (i) pay a competitive return on Islamic deposits and (ii) have a complete banking facilities and services (Ismal, 2009). These conditions require Islamic banks to perform professionally and have a comprehensive program to complete their operations with perfect services and networks.

Fourthly, the performance of the Indonesian economy backs up the business operations of Islamic banks. The economic growth of 4.5% in 2009 was declared as the third highest economic growth in the world after China and India and the impact of the global financial crisis 2008-2009 did not severely disrupt the Indonesian economy (Bank Indonesia, 2010c). These facts create conducive business environment for the banks including Islamic banks.

**2. 3. The Performance of the Islamic Banking Industry**

The Indonesian Islamic banking industry grows promisingly after the establishment of the first Islamic bank namely Bank Muamalat Indonesia (BMI), in 1992. Until the latest data of January 2011, there are eleven Islamic Commercial Banks (BUS) followed by twenty three Islamic Banking Windows/Unit (UUS) and one hundred fifty one Islamic Rural Banks (BPRS) integrating 1796 offices around the country (see table 1). In the last five years, the industry grows 46% per year which is well above the world growth of Islamic banking industry of 10%-20% per year (Eedle, 2009). The last growth of the Islamic banking industry recorded 47% (2010).

Concerning the banking intermediary function and prudential banking operations, the Islamic banking industry has shown a promising intermediary function and banking operations. The Financing to Deposit Ratio (FDR), as one of the banking indicators to indicate the banking intermediary function, has been lying on 117.12% on average from December 2000 to January 2011 and the Non Performing Financing (NPF) stands between 2%-5% of the total financing. Other indicators, such as total assets, financing and deposits grow annually between 50%-60% on average per year.

Lately, the total assets have reached Rp95.74 trillion with total financing of Rp69.72 trillion, very close with the total deposits of Rp75.81 trillion. Total capital of the industry has passed Rp100 billion in the last 2010 matching the capital requirement of the Indonesian Banking Architecture (API). The dominant contributor of the capital is the owner's funds besides retained profit. Based on the result of banking assessment in API, the fulfillment of capital requirement by Islamic banks would hopefully maintain their sustainable growth and performance.

**Table 1. Selected Islamic Banking Performance Indicators**

| BANKING INDICATORS | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Islamic banks (unit) | 2 | 2 | 2 | 2 | 3 | 3 | 3 | 3 | 5 | 6 | 11 | 11 |
| Islamic banking units (unit) | 3 | 3 | 6 | 8 | 15 | 19 | 20 | 25 | 27 | 25 | 23 | 23 |
| Islamic rural banks (unit) | 79 | 81 | 83 | 84 | 88 | 92 | 105 | 114 | 131 | 138 | 150 | 151 |
| Total offices (unit) | 146 | 182 | 229 | 337 | 443 | 550 | 567 | 683 | 951 | 1223 | 1763 | 1796 |
| Total asset (trillion Rp) | 1.79 | 2.72 | 4.05 | 7.86 | 15.33 | 20.88 | 26.72 | 36.53 | 49.55 | 66.01 | 97.51 | 95.74 |
| Total financing (trillion Rp) | 1.27 | 2.05 | 3.28 | 5.53 | 11.49 | 15.23 | 19.53 | 27.94 | 38.19 | 46.88 | 68.18 | 69.72 |
| Total deposit (trillion Rp) | 1.03 | 1.81 | 2.92 | 5.72 | 11.86 | 15.58 | 20.67 | 25.65 | 36.85 | 52.27 | 76.03 | 75.81 |

*Source : Bank Indonesia, data up to January 2011

Comparing the growth of Islamic and conventional banks, it is seen that the Islamic banking industry has a higher growth than the conventional one. Particularly between 2001-2004, both the growth of assets and financing of Islamic banks stand in a higher growth rate than conventional ones. However, between 2005-2010, the growth rate of both asset and financing of Islamic banks had slowed down although still stood in a higher position than conventional ones (see figure 2). Such a progressive growth is also implied in the upward trend of the Islamic banking market share (see figure 3). Nonetheless, the market share is still very small compared with the conventional banks.

**Figure 2. The Growth of Banks**

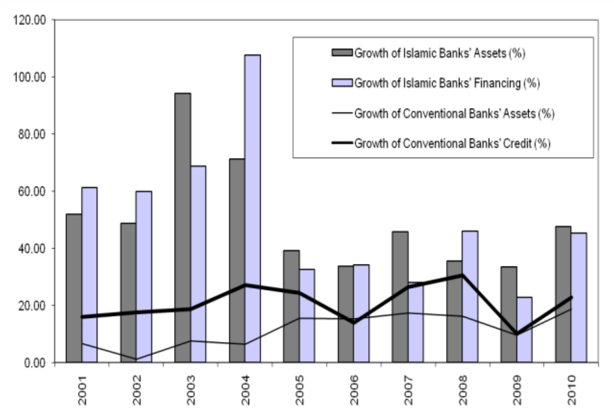
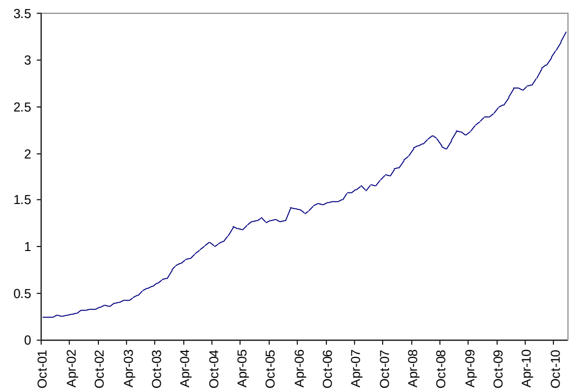



**Figure 3. Market Share of Islamic Banks**



Moreover, unlike the Islamic banking activities in other countries, the Indonesian Islamic banks consistently increase the share of investment based financing which are based on *Mudarabah* and *Musharakah* contracts. Up into December 2010, such investment based financing have captured 34% of total financing while the trade based financing which are based on *Murabahah, Salam* and *Istishna* contracts dominate 56% of total financing (see figure 4). This intention reveals that the operations of Islamic banks approach the ideal model of Islamic banking with the domination of investment based financing and the minimum of trade based financing.

**Figure 4. Breakdown of Financing**

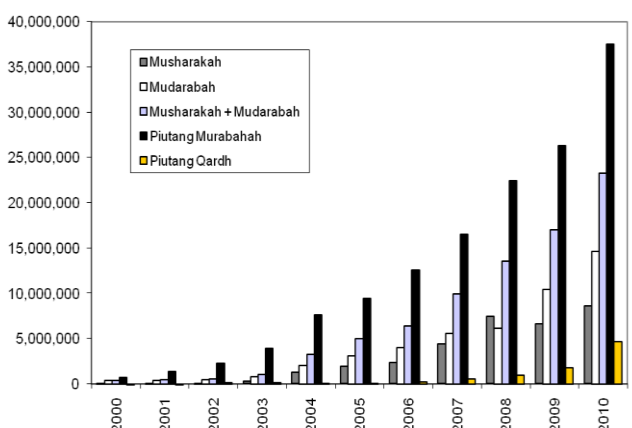
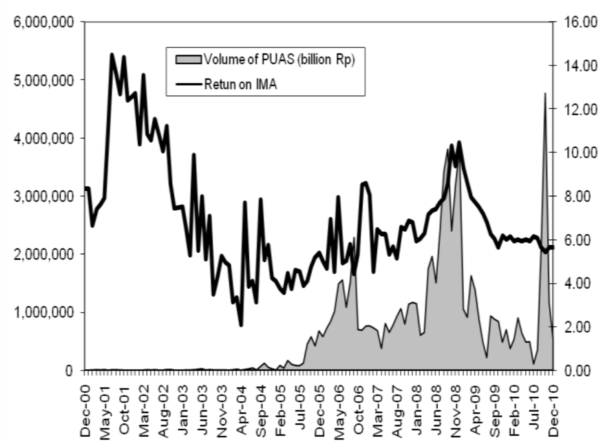



**Figure 5. Islamic Money Market Activities**




In addition, Indonesia does not apply the controversial *Sharia* contracts such as *Bay al Innah, Bay al Wafa, Tawarruq, Bay al Dayn*, which dominate the Islamic banking contracts in Malaysia and Middle Eastern countries. It means that by applying only classical contracts (non controversial contracts), the Indonesian Islamic banking industry can still perform well despite having small market share. As discussed earlier, the advancement and expansion of this industry in Indonesia depends on the performance of the Islamic banks and economic conditions, it does not rely on the application of controversial contracts.

Meanwhile, if an Islamic bank faces liquidity shortages or surpluses in their operations, they can obtain or extend liquidity from/to the Islamic money market (PUAS). However, unlike the money market activities in the conventional money markets, PUAS activities are not very active because the internal liquidity management is quite robust. The Islamic banks rarely need sudden liquidity from external sources such as PUAS (see figure 5). Another reason, why the PUAS is not so active, is because Islamic banks concentrate their financing to the real sector. They do not seek profit through trading Islamic securities in the Islamic financial market (Ismal, 2008).

**Figure 6. Islamic Monetary Instrument**

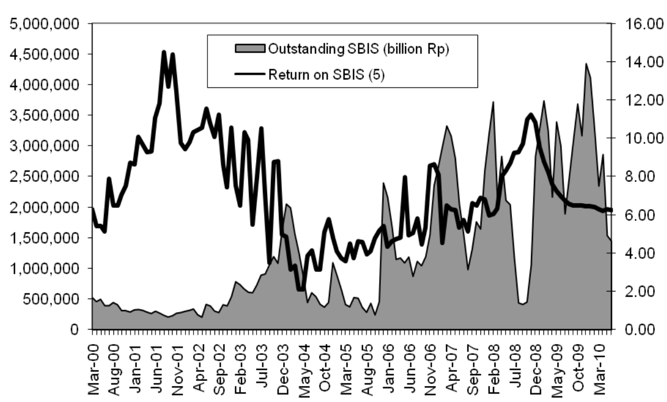
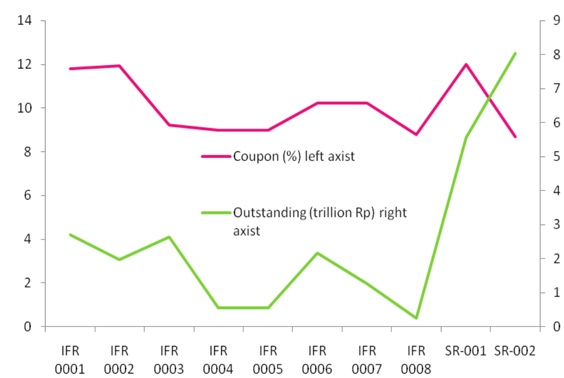



**Figure 7. Tradable Government *Sukuk***




Besides using PUAS, there is another outlet to gain or extend funds namely the central banks Islamic monetary instrument (SBIS). But the same as the placement of funds in the Islamic money market, locating funds in SBIS is not the primary target of Islamic bank financing (see figure 6). It is only 2.6% of total financing which go to this Islamic monetary instrument even when the return of SBIS is up the placement of funds does not go up as well. To one extent this shows the ineffectiveness of the Islamic monetary instrument to influence liquidity but in another extent the minimum placement in SBIS indicates the intensive bank financing to the real sector.

Furthermore, despite occupying Islamic money market and SBIS, an Islamic bank, which looks for new investment or wants to locate funds in the long term investment projects, can occupy Islamic capital market. Currently, the market is getting more active after the issuance of

*Sukuk* Act in 2008. Until the end of 2010, total government *Sukuk* was recorded Rp4.4 billion and is predicted to keep increasing in the years to come (see figure 7).

## 3. CHALLENGES OF THE INDUSTRY

However, although the industry presents remarkable performances and liquidity management, it has some challenges to be solved. Amongst others there are three main challenges. The first challenge is the market share of the Islamic banking industry. It was recorded 3% at the end of 2010. There some factors which limit the expansion of this industry. The second challenge is lack of human resources. The growth of Islamic banking is not followed by the appropriate supply of human resources which are well-*Sharia* educated employees. The third challenge is lack of product development. Compared with Islamic banking industries from Malaysia and Middle Eastern countries, the Indonesian Islamic banks have limited Islamic banking products. To some extent, this condition might discourage investors and depositors to involve in Islamic transactions with Islamic banking.

### 3. 1. Small Market Share

After two decades of its operations, Islamic banking still stands on a single digit market share. Some underlying reasons explain this problem such as: (i) the limited involvement of the government funds in the Islamic banking industry, (ii) the non comprehensive understanding of depositors, business partners and public with respect to the operations of Islamic banking and the *Sharia* principles (Bank Indonesia, 2000-2005) and, (iii) the limited number of Islamic banks and windows compared with the conventional ones.

In fact, the direction of development of the Indonesian Islamic banking industry is not really similar with other countries. While Malaysia adopts top down approach in developing the Islamic banking industry, Indonesia occupies a bottom up approach. The banking funds in the Indonesian Islamic banking industry mostly come from the public funds while the government funds are very limited. If the government can commit to realize all or some of the its funds, it could boost the Indonesian Islamic banking industry even faster and bigger than the ones in Malaysia or middle east countries.

The first funds are the hajj funds. Most of these funds are still placed in the conventional banks while they are estimated to be Rp26 trillion (USD2.6 billion) (infobanknews,com). The second funds are the funds managed by the state owned companies (BUMN). According to the statement of the minister of BUMN, total assets of BUMN are valued Rp2500 trillion (USD250 billion) (nasional.inilah.com). Reminding that the recent total assets of the Islamic banking industry was Rp100 trillion (December 2010) and if all hajj funds and only 10% of BUMN assets are deposited in Islamic banks, the total assets will be nearly three times higher than the current position.

The last potential funds is if the government could convert (at least) one of its four state owned banks from conventional banks to full fledge Islamic banks. Total assets of those four state owned banks are Rp1115 trillion (USD111.5 billion) or capture 37% market share of the banking industry (Bank Indonesia, 2010d). If at least one of them is converted to be fully Islamic banks, the total assets of the Islamic banking industry will increase further. Thus, if all three potential funds above can be realized, the operations of Islamic banks will be more active, significant and the market share of the Indonesian Islamic banking industry will absolutely jump into the level where the industry is the dominant player and determines the performance of the domestic economy.

Besides contribution of the government, the ultimate party which determines the growth of the market share is the involvement of the public (depositors, entrepreneurs, Islamic scholars, etc). Surveys of the depositors done by Bank Indonesia and universities, Mars and Markplus mentioned before reveal that most of the people support the idea of Islamic banks. But, their support is quite realistic so that the robust performance of Islamic banks is one of the key success factors to boost the market share of the industry.

Lastly, the limited number of Islamic banks restrains the industry to optimally utilize the domestic demand from Moslem population. However, almost all of Islamic banks in Indonesia are retail banks which extend financing directly to real sector. The Islamic banking industry from other countries contains some investment banks which seek profit from trading Islamic securities in Islamic money market, Islamic capital market and Islamic stock market. The ideal practices of Islamic banks should directly extend funds to the real sector and seek profit directly from the robust performance of the real sector.

### 3. 2. Lack of Human Resources

The recent growing trend of the Islamic banking industry is unfortunately not followed by the availability of human resources. Referring to the growth rate of the number of offices, from 2009 to 2010, the number of offices accelerates 44.5% and it needs additional human resources. Some underlying reasons cause this problem, such as: (i) the lack of the formal institutions giving academic degree in Islamic banking and finance, (ii) the lack of the informal institutions giving training on Islamic banking and finance, (iii) the lack of the books on Islamic banking and finance and, (iv) No Islamic banking and finance curriculum in all level of the national education system.

Ideal human resources in the field of Islamic finance are the ones who understand both the conventional finance and Islamic finance perfectly. Even, the experiences in dealing with banking activities and Islamic contracts would be advantages to successfully work in Islamic financial institutions. Almost all of the government and private universities in Indonesia do not have Islamic banking/finance program. Some master programs in Islamic finance/banking are now opened by some private and government universities but an undergraduate program in Islamic bank is rarely found in the country.

### 3. 3. Lack of Product Development

Besides lack of the human resources, the industry also has limited product development compared to Malaysian and Middle East countries. However, the Islamic contracts applied in Indonesia are all confirmed with *Sharia*. As stated before, Indonesia does not implement debatable contracts such as *bay al dayn, bay al innah, tawarruq, bay al arbun* and, *bay al wafa* which dominate Islamic banking contracts in Malaysia and Middle east countries. Hence, the performance of the Indonesian Islamic banking industry reflects the condition if a country occupies only classical contracts.

In addition, the solution to solve this problem should link with the efforts to educate public with the Islamic banking operations. Even though the industry has had a variety of Islamic banking products, if the public does not fully understand the concepts and practices of Islamic banks, it would be useless.

## 4. RECOMMENDATIONS

To solve the problem of small market share, one strategic action is to keep continuing intensive and integrated efforts to socialize Islamic banking to the public. These can be done through a mutual cooperation among market players (Islamic banks, etc), banking regulator, government, Islamic scholars and all related parties. The successfulness of such efforts would encourage the government and the public (existing and potential depositors) to place more funds in the Islamic banking industry and investors to established new Islamic banks.

To mitigate the problem of lack of human resources, it is recommended that: (i) the government provides incentives for the establishment of formal and informal institutions which provide education in Islamic banking and finance, (ii) the government includes the Islamic banking and finance in the national curriculum and, (iii) Islamic scholar and academic actively write and publish text books on Islamic economics, banking and finance.

Finally, to solve the problem of lack of product development, the Indonesian Islamic banks needs to create and offer more varieties of products on both liability and asset sides. There are combinations of classical contracts which are potential to be studied and implemented. In fact, one of the depositors' and entrepreneurs considerations of depositing money and asking for funds in Islamic banks is the variety of banking products.

However, unlike the conventional banking practices, the successfulness of the product development in Islamic banking needs a strong commitment of and cooperation with the National Sharia Board (DSN), Sharia Supervisory Board, Bank Indonesia and related parties to realize this action.

## 5. CONCLUSION

Islamic banking in Indonesia develops significantly and promisingly. Its operations have been so far very robust to give a contribution in the economic performance. The engagement with the Islamic money and capital markets, *takaful* and non bank Islamic financial institutions has interlinked the operations of the industry with other institutions to cooperatively finance the real sector. Nevertheless, there are at least three challenges to be solved with some recommended actions in order to maintain and foster the development of this promising industry.

## References


Bank Indonesia. (1999). *The Central Bank Act*. Retrieved on January 10th, 2010, from: http://www.bi.go.id.

Bank Indonesia. (1998). *The Banking Act*. Retrieved on March 10th, 1999, from: http://www.bi.go.id.

Bank Indonesia. (2010a). *The Sukuk Act*. Retrieved on March 21st, 2010, from: http://www.bi.go.id.

Bank Indonesia. (2010b). *The Islamic Banking Act*. Retrieved on February 20th, 2010, from: http://www.bi.go.id.

Bank Indonesia. (2010c). *Annual Report on Indonesian Economy*. Retrieved on January 12th, 2010, from: http://www.bi.go.id.

Bank Indonesia. (2010d). *Statistic of Banking*. Retrieved on January 12th, 2010, from: http://www.bi.go.id.

Bank Indonesia. (2000-2005). *Studies of Potency, Preference and People Behaviors Towards Islamic Banks*. A joint Paper (studies) between Bank Indonesia and Jambi University, Andalas University, Diponegoro University, Brawijaya University, National Islamic University Syarif Hidayatullah, Hasanudin University and, Bogor Agricultural University. Retrieved on June 12th, 2009, from: http://www.bi.go.id.

Bank Indonesia. (2002-2008). *Monthly Statistics Report. Indonesian Islamic Banking Statistics*. Retrieved on February 10th, 2009, from: http://www.bi.go.id.

Bank Indonesia. (2006). *Blue Print of Indonesian Islamic Banking Development*. Jakarta: Islamic Banking Directorate of Bank Indonesia, revision of 2002's Blue Print. Retrieved on October 5th, 2008, from: http://www.bi.go.id.

Bank Indonesia. (2009). *Annual Report. Indonesian Islamic Banking 2009*. Retrieved on June 3rd, 2007, from: http://www.bi.go.id.

Bank Indonesia. (2008). *Islamic Banking Committee*. Bank Indonesia Banking Regulation (PBI) number 10/32/PBI/2008. Retrieved on March 23rd, 2011, from: http://www.bi.go.id.

Eedle, Simon. (2009). *A Global Bank's View of the Evolution of Islamic Finance.* Euromoney year book, Adrian Hornbrook, Essex, UK.

Ismal, Rifki. (2009), "How Do Islamic Banks Manage Liquidity Risk", *Kyoto Bulletin of Islamic Area Studies*, Kyoto University – Japan, Vol. 3, no. 2, 2010.

Ismal, Rifki. (2008), “Industrial Analysis of Liquidity Risk Management in Islamic Bank”, *Journal of Islamic Banking and Finance*, Vol. 26 No. 2, 2009.

Markplus and Bank Indonesia. (2008). *Grand Strategy Developing the Islamic Banking Market*, Publication of the Directorate of Islamic Banking, Bank Indonesia, Jakarta.

_ *Total Assset of BUMN*. Retrieved on March 25th, 2010, from: http://www.nasional.inilah.com.

_ *Hajj Funds Per Year*. Retrieved on March 25th, 2010, from: http://www.infobanknews.com.