Development of Islamic Banking in Indonesia

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Agenda

- Quick introduction to Islamic Banking
- Islamic Banking Development in Indonesia
- Findings on Mini Research
- Conclusion
1. INTRODUCTION TO ISLAMIC BANKING
The Foundation of Islamic Banking

Submission to God

Qur’an and Hadits

Aqidah (faith)
Syari’ah (law)
Akhlaq (Ethics)

Theological
Economic
Political
Marital
Criminal
Military
Hygiene, etc.

Islamic Banking
Insurance, etc.
Islamic Banking Main (Commercial) Activities

Depositors fund:
- Demand Deposit (Wadia contract)
- Savings (Wadia contract)
- Savings (Mudharaba contract)
- Time Deposit (Mudharaba contract)

Trading (Cost Plus Financing):
- Murabaha Installment
- Murabaha Cash

Equity Sharing:
- Mudharaba
- Musyakara

Leasing:
- Ijara operational lease
- Hire Purchase

Customer Portion

POOLING FUND

Bank Portion

Services (100% bank income):
- Incoming/Outgoing Transfer
- Kafalah (Bank Guarantee)
- Ar Rahn (Pledge)

Profit Distribution System

* Margin
* Fee
Some Prohibited Transactions

Reasons

- The material is *haram* (*li dzatih*).
- *Haram* other than its material.

Break the principle of *An-Taraddin Minkum* (*Contentment*).

- Asymmetric information.
- Supply manipulation (*ikhtikar*).
- Demand manipulation (*Bay Najasi*).
- Incomplete Information; uncertainty to both party (*Gharar*).
- Interest (*Riba*).
2. ISLAMIC BANKING DEVELOPMENT IN INDONESIA SINCE 2000
The number of Islamic Banks has steadily grown

Data Source: Bank Indonesia 2012
Islamic Bank branches have also grown rapidly, mainly since 2007-2008.
The Islamic Banks' profit has grown at 47% annually since 2000 and the FDR has been consistently high.

Data Source: Bank Indonesia 2012
The share of Islamic Banks’ asset, depositors fund, and credit in national banking industry have also grown, yet still small.

Data Source: Bank Indonesia 2012
Question #1

• Why Islamic Banking share is very small in Indonesia, given Indonesia is the biggest Muslim-majority country in the world?
  – How to further increase its share?
The depositor’s fund has been mainly in *Mudharaba* contract (equity-sharing contract or time deposit)

Data Source: Bank Indonesia 2012
The Financing in Islamic Banking has been dominated by *Murabaha* contract (trading contract) and less *Mudharaba* contract (equity sharing contract).

Data Source: Bank Indonesia 2012
Question #2

• Why has the financing contract been dominated in *Murabaha* (trading contract) and depositors fund has been in *Mudharaba* (equity-sharing contract)?
  – What is its implications?
FINDINGS ON MINI RESEARCH
Q1: Why the Islamic Banking share is relatively very small in Indonesia?

- Islamic Banking growth is significantly determined by the dynamics of real rate of return and real interest rate (Kasri 2007)

- Other plausible reasons:
  - Regulatory aspect
  - Consumer behavior
  - Conservatism of Indonesia’s Islamic scholars
1.1 Regulatory Aspect

- Islamic Banking share is still small due to minimal support in Soeharto era (1966-1998):
  - Islamic movement was seen as threat (Venardos 2006).
  - Only minimal supports to Islamic Banking, predominantly to co-opt Muslim groups (Lindsey 2012)
  - There was no specific law on Islamic banking until 2008
  - Malaysia has it since 1983 and Middle Eastern countries since 1980s.
- Political reform in 1998 brought freedom and democracy
  - Trend towards “Islamization”
- The lack of support is still apparent as of 2013.
  - The deposit of government’s fund (ex. pilgrimage fund)
1.2 The influence of consumer behavior

- Two determining factors: value-oriented behavior and product functionality (Karim and Arif 2005)

- Thus, Two types of Islamic Banking customers:
  - Loyalist-religious
    - Individual; Price insensitive; but sensitive to physical Islamic appearance
  - Rational opportunist-swinger
    - Corporations and pension funds; price sensitive

- Things to note:
  - Lack of understanding on Islamic Banking (only for Muslim; not profitable; etc.)
  - The number of loyalist-religious is still small, (due to historical “secularism” and/or “lack of knowledge”) yet growing (with the rising Islamic trend in Indonesia, particularly among the educated youth).
  - The tighter competition between Islamic Banks will lower the bank charges thus would attract more rational opportunist customer.
1.3 Conservatism of Indonesia’s Islamic Scholar

• National Sharia Board, which has the authority to certify sharia-complied products, is another regulator in Islamic Banking industry, other than central bank.

• Conservatism leads to lack of product development

• Example:
  - As of January 2013, Indonesia (still) plan to allow Islamic Banks to use currency hedging, while Malaysia has been doing it since 2006.
  - Islamic banks in Indonesia are not doing ‘investment-bank activities’, such as seeking profit from trading Islamic securities in Islamic money market, Islamic capital market, and Islamic stock market.
Q2: Why the share of financing and deposit contract is as it is?

• Indonesian Islamic Banks are quite risk-averse, thus less Mudharaba (equity sharing) contract; while in Murabaha (trading/cost-plus) contract, there is predetermined short-term cash inflow.

• Higher deposits fund share in Mudharaba contract shows investment-manager nature of Islamic bank.

• Implication:
  – Islamic Bank will have a better liquidity condition, as the deposit is long term, while financing is short term.
Conclusion

• Small share in Indonesia’s Islamic Banking is caused by: (1) Late-comers and lack of support from government; (2) Lack of understanding on IB and also small, yet growing, number of loyalist-religious customer; (3) Conservatism of Indonesia’s National Sharia Board.

• The current composition of depositors and financing fund is caused by the risk averse nature of Islamic Bank in Indonesia.
Concluding remarks (1/2): the prospect of Islamic Banking in Indonesia

• Lack of financial inclusiveness in Indonesia
  – Only 60% of population has bank account
  – Indonesia’s domestic credit to GDP ratio in 2011 is (only) 38.5%; while Thailand 159%; Malaysia 128%; and Singapore 93%).

• The growth of Indonesia’s economy
  – As of 2012: $900 Billion economy (Nominal, 16th place) and $1.2 Trillion (PPP, 15th place)
  – Demographic bonus until 2020
  – Stable political system
  – Huge natural resources endowment.
Concluding Remarks (2/2): is (current system of) Islamic Banking the solution for financial stability?

• Yes
  – The practice of no-interest will promote real economy growth
  – The ban on speculative activity is good for financial stability.

• But it is not enough
  – Fractional Reserve Banking (FRB) and fiat money system are still practiced.
Thank You!

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Karim, Adiwarman A. and Adi Zakaria Afiff. “*Islamic Banking Consumer Behavior in Indonesia: A Qualitative Approach*”. 2005


• Islamic Bank Act No. 21 year 2008
APPENDIXES
GENERAL TRANSACTION ON ISLAMIC BANKING

**TIJARAH**
- Commercial contracts
- NCC
  - Murabahah
  - Salam & Istishna’
  - Ijarah & IMBT
- NUC
  - Mudharabah & Musyarakah
  - Get Return
  - Take Risk
  - Fixed Return
  - Certain Return
  - Islamic Financing
- Profit and Loss Sharing

**TABBARU**
- Non-commercial contracts
- Lending money
  - Qard Rahn Hiwalah
  - Must be paid
  - Islamic Financing
- Giving something’s
  - Waqf
  - For Allah
  - Hibah
  - For Everyone
  - Shadaqah
  - For Masakin
- Lending yourself
  - Wakalah
  - Wadi’ah
  - Kafalah
- Islamic Deposits
Tijarah Contracts in Islamic Banking

Natural Certainty Contract
- Murabahah
- Ijarah
- Salam
- Ishtishna

Natural Uncertainty Contract
- Mudharabah
- Musyarakah

ISLAMIC FINANCING
ISLAMIC FINANCING + ISLAMIC DEPOSIT

ISLAMIC FINANCING
Tijarah contract - Natural Certainty Contract (NCC)

- **Al-Bai’**
  - $ transfer

- **Bai’ muajjal**
  - $ $ $ $ $ transfer of title

- **Salam**
  - $ $ $ $ $ promise to sell or hibah at the beginning of period

- **Ijara**
  - no transfer of title
  - $ $ $ $ $ transfer of title at the end of period

- **Istishna’**
  - $ $ $ $ $
A typical Islamic Bank Organization Structure

- Shareholder Annual Meeting
  - Board of Commissioners
    - Audit Committee
    - Board of Directors
      - Division A
      - Division B
      - Division C
      - Division D
      - Division E
  - Sharia Supervisory Board
ISLAMIC LEGAL FRAMEWORK

Source of Believe, Law & Values
(Aqidah, Syariah, Akhlaq)

Arabic Grammar
And Lexicon

Understanding and Reasoning
Exercise of Esteemed Jurists
Towards the Twin Sources
Al-Quran and As-Sunnah

Innovation of Products to
Suit Modern Demand.

Basic Principle: Contracts & Condition are Permissible