ISLAMIC FINANCE IN INDONESIA: A QUANTUM LEAP

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ABSTRACT

Islamic finance is emerging as a rapidly growing part of the financial sector and it has become a global phenomenon. Both Muslim and western countries have accepted it into their financial portfolio. Indonesia’s Islamic banking assets have grown by 50% to US$17 billion in 2012, and are expected to continue on an upward trajectory as the Indonesian government and financial institutions show more support towards this growing sector. This research studies the development of Islamic finance in Indonesia. It analyzed the advantages, strength and benefit of Islamic banking in Indonesia such as huge domestic market, in addition to investments and economic opportunities. This research also highlights the challenges facing Islamic financial industry in Indonesia together with suggestions for improvement.

KEYWORDS: A Quantum Leap, Islamic Finance, Indonesia

JEL Classification: G21 _ G28 _ K12 _ K41

INTRODUCTION

Indonesia’s Islamic banking assets have grown by 50% to US$17 billion in 2012, and are expected to continue on an upward trajectory as the Indonesian government and financial institutions show more support towards this growing sector. In recent years, Indonesia has proven to be a strong contender against established Islamic finance jurisdictions such as Malaysia and Bahrain, with positive signs in Islamic retail banking, Islamic bond (Sukuk), project and infrastructure finance, Islamic insurance (Takaful) and Islamic microfinance. The number of banks and financial institutions offering Islamic banking services and products has also increased, while foreign investors are coming in, apprehending the growth potential of its Islamic capital markets. The newly established financial services authority, Otoritas Jasa Keuangan, is also expected to create a more regulated and transparent environment for the Indonesian Islamic capital market, and boost the volume of Islamic bond issuances in the country.

Generally, Islamic finance has been performing well, not only in Indonesia but also worldwide. Islamic finance, a model of ethical finance that rejects payment of interest or usury has been registering double-digit growth, even in the face of previous global recession. Globally, it is growing fast at a consistent rate of 15 to 20 percent a year and is estimated to have been a more than US$1.6 trillion-dollar industry in 2013. In Indonesia, the growth is even faster at 30-40 percent a year.

Islamic finance is unique as it attempts to improve the core of modern finance. One of the great debates of modern capitalism is whether or not morality matters in business. This question is often posed as: “Should the purpose of business or financing be directed to do and promote good things? Or instead, should businesses focus solely on maximizing returns, within what the law allows?”

According to the United Nations Development Project, 2.7 billion people in the world struggle to survive because of poverty. A study undertaken by the Islamic Development Bank (IDB) reveals that just five of its 56-member
countries – Indonesia, Bangladesh, Pakistan, Nigeria and Egypt – account for over half a billion of the world’s poor, with incomes below US$2 a day or below their national poverty line.

Islamic finance rejects the separation of morality and business. It aims to alleviate poverty and wealth gaps around the world using fairer business model. It promises considerable commercial and social benefits, including the encouragement of real trade and business over mere speculation, partnership relationships between capital providers and managers rather than creditor-debtor relationships and the promotion of a fair and equitable finance system. The wisdom of these principles can be seen in the aftermath of the recent global recession. Excessive speculative activities by financial institutions in the form of debt trading and subprime mortgage almost lead to the collapse of the whole system. Many countries were badly hit and some actually went bankrupt.

The rejection of gambling and other excessive speculative elements in contracts under Islamic finance make them more resilient to global financial disasters. These benefits, among others, are responsible for the dramatic growth of Islamic finance as they provide alternative to those interested. With this background, Islamic finance in gaining ground in Indonesia. There are now 11 Sharī’ah banks operating as independent business entities and another 24 Sharī’ah business units (UUS) that operate as the Islamic banking divisions of existing commercial banks. The Sharī’ah banking assets in Indonesia grew at a remarkable rate of 47 percent in 2010 to Rp 100.26 trillion (US$11.14 billion). By March 2013, the combined assets of Sharī’ah banks still accounted for just 4.6 percent or Rp 209.6 trillion (US$21.08 billion) of the total banking assets in Indonesia. Sharī’ah lending in Indonesia also increased by an average of 38 percent each year over the last five, compared with 21 percent in Malaysia (Jakarta Post 14 February 2011).

Indonesian President Susilo Bambang Yudhoyono in 2009 has called on Islamic banks to take a leadership role in the global economy, amid the financial crisis. Islamic financial institutions, he said, had not been hit as hard as their western counterparts because they did not invest in toxic assets (BBC News 2 March 2009).

ADVANTAGES, STRENGTH AND BENEFITS

Huge Domestic Market Potential

Stretching over 17,500 islands and home to around 240 million people, Indonesia is a vast, diverse nation with a rapidly growing economy, extensive natural resources and a range of sectors ripe for investment. By far the largest country in ASEAN in terms of both population and area, Indonesia is responsible for one-third of the 10-nation bloc's total GDP. With almost 50% of the population below the age of 29, the government is encouraging the growth of the creative economy to boost income levels and create jobs.

Indonesia has one of the biggest domestic markets for Islamic finance. Any financial institution that managed to seize the domestic market in Indonesia in this early stage will enjoy a great head start. However, to seize the domestic market, the products offered must be tailor-made to suit the needs of the people. Instead of trying to attract customers based on religious sentiment, it will be more commercially practical to attract them based on the strength of the products. For example, in Malaysia, many of the consumers of Islamic financial products are actually non-Muslim. The reason is because the products offered are competitive, add-value, and practical. In addition to good products, any financial institution interested to seize the domestic market in Indonesia must ensure that they have sufficient manpower and good leadership.

Due to the serious lack of experts and manpower in the Islamic finance industry in Indonesia at this stage, it will make sense to recruit some experts from overseas as well but there must be a clear framework in place to groom the local talents. In addition, the public needs to be educated about the benefits of Islamic finance. Misconception that Islamic
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finance is only for Muslims must be removed. The idea of Islamic finance is to have an alternative financial system that is fair and just to everyone because the only way forward is together.

Policy discussions around Islamic bank development in Indonesia have largely taken place in the context of increasing financial access, especially to micro, small, and medium enterprises, or MSMEs. *Shari'ah*-compliant banks appear to be more accessible and responsive to MSME financing needs, outpacing conventional bank outreach to these enterprises. (In 2012, for example, more than half of total Islamic bank financing went to MSMEs.)

**More Investments and Economic Opportunities**

Moody’s Investors Service believes that the full potential is at least US$5 trillion although currently, it only accounts for around five percent of the global financial industry (Hassan 2010). There is a huge market for Islamic finance. The first being Muslims, which compose about 20 percent of the world population. James Hume, executive vice president of the Dubai International Financial Centre, noted:

> An increasingly educated populace with growing self-assuredness and awareness of their Islamic roots is becoming alert to the shortcomings of conventional finance and more vocal in demands for alternatives (Hume 2004).

In the Middle East alone at least US$1.5 trillion in project financing is expected in the next ten years, and most of it will have strong Islamic financing aspects. Rehman’s work highlighted the following facts related to high-profile investments made by the Gulf States and Islamic institutions (Rehman 2010):

- The Gulf States control around 40 percent of the world’s known oil reserves and nearly a quarter of global natural gas reserves.
- By 2006, the foreign assets of the Gulf Cooperation Council (GCC) had already reached US$1.9 trillion.
- The net capital outflows from the Gulf States in 2006 alone were US$200 billion.
- The McKinsey Global Institute estimated that the GCC’s accumulated foreign wealth could reach US$8.3 trillion by 2020.

Indonesia will be able to attract more investment from the Middle East and the rest of the world if Islamic finance is properly included in its financial portfolio.

**MAIN CHALLENGES IN INDONESIA**

Some of the main challenges that Indonesia faces include alleviating poverty, implementing economic and financial reforms and promoting democracy and tolerance. The bigger challenges include rooting out terrorism, cultivating education, fighting rampant corruption and improving human rights. Inflation and volatile food prices are also serious concerns. Below are some of the additional challenges for Islamic finance:

**Lack of Support**

In Indonesia, Islamic banks are young compared to their conventional peers, which date back to the early 19th century. Even after the first Islamic bank—Bank Muamalat—appeared on the scene in 1992, uptake was very slow. In fact, in the ensuing 15 years, only two other *Shari'ah*-compliant banks entered the market. This is partly due to inconsistent policy on Islamic finance and lack of support from the industry and government. All that changed in July 2008, when the
Government of Indonesia issued the *Sharīʿah* Banking Law which led to a period of strong growth for the Islamic banking industry—growth that shows no sign of fading. According to data from Bank Indonesia, between 2008 and 2012, Islamic bank assets tripled, increasing by an average of 31.5% annually.

Another factor in the slower than predicted growth is the time the Indonesian government have taken to amend legislation, particularly tax rules, to level the playing field for Islamic banks. Changes that effectively remove the double taxation on Islamic financing like *murabaha* are very recent, dating to 2010. Earlier, the Islamic Banking Act No.21 of 2008 was passed by the Indonesian parliament to strengthen law enforcement in relation to Islamic banks with the expectation that it would encourage more players to support the industry.

**Lack of Manpower**

Indonesia suffers perhaps more than other countries from a shortage of skilled manpower—individuals who understand both Shari’ah and the working of the broader financial market. This is for the most part due to the rapid growth of the sector and the fact that training in Islamic finance is a relatively recent phenomenon. The number of educational institutions offering courses in Islamic finance has been steadily growing since 1999 and now includes the Tazkia Institute, Karim Business Consulting and the Indonesian Banking School/LPPI. In 2009 the University of Indonesia began to offer a Master’s degree in Islamic finance and apparently plans to offer undergraduate and doctoral programs.

Indonesia’s *Sharīʿah*-compliant banking industry currently needs 36,933 professionals, Harisman Sidi, director at the International Centre for Development in Islamic Finance at the Indonesian Banking Development Institute in Jakarta, said in an August 2012 email, citing data from the country’s monetary authority (Gulf News 20 August 2012). Bank Indonesia is encouraging Shari-compliant lenders to put more resources into staff training to help meet its objective of expanding *Sharīʿah*-compliant banking assets to 10 per cent of the total by 2020.

**THE WAY FORWARD**

**Stronger Institutional Support**

Strong institutional and regulatory support is necessary. Below are some of the major regulator and players in the Islamic finance market in Indonesia:

**The Financial Services Authority of Indonesia (Otoritas Jasa Keuangan)**

The newly established financial services authority, Otoritas Jasa Keuangan, is expected to create a more regulated and transparent environment for the Indonesian Islamic capital market. Briefly, the Financial Services Authority of Indonesia/Otoritas Jasa Keuangan (OJK) is the Indonesian government agency that regulates and supervises the financial services sector. The OJK is an autonomous agency designed to be free from interference, its functions, duties, and powers include regulation, supervision, inspection, and investigation. The agency was established in 2011 replacing the role of Bapepam-LK. The agency was created in 2011 under by Act No. 21 of 2011 which organized system of regulation and supervision of financial services. It replaces the functions of the Capital Market Supervisory Agency and Financial Institution (Badan Pengawas Pasar Modal dan Lembaga Keuangan) or Bapepam-LK for short.

**Bank Indonesia (Bank Sentral Republik Indonesia)**

Bank Sentral Republik Indonesia, Indonesia’s central bank, regulates the issuance of Indonesian currency and is responsible for the country’s banking and financial sectors. Bank Sentral Republik Indonesia also formulates and issues Islamic laws and regulations. Bank Indonesia has also been involved in a number of international initiatives including the establishment of several Islamic regulatory bodies, like Islamic Financial Services Board and the International Islamic
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Financial Market, and has been proactive by sending its experts to the groups responsible for developing a number of regulatory standards.

National Sharīʿah Council of Indonesia (Dewan Sharīʿah Nasional)

The National Sharīʿah Council of Indonesia issues guidance (fatwa) as basic laws for proposed Islamic laws and regulations to be issued by Bank Indonesia.

Sharīʿah Supervisory Council (Dewan Pengawas Sharīʿah)

The Sharīʿah Supervisory Council is required to appoint its member for each Sharīʿah financial institution and is responsible for overseeing the implementation of Sharīʿah principles and fatwa in Sharīʿah financial institutions.

Ministry of Finance

This Ministry is responsible for the formulation, determination, and implementation of policies on finance and State Assets, management of state properties, supervision and implementation of tasks within the Ministry of Finance, implementation of technical guidance and supervision over regional affairs within the Ministry of Finance, implementation of technical activities at the national scale and implementation of vertical technical activities to the regions.

In addition to strong institutional and regulatory support, it is also necessary for Indonesia to have stronger Islamic financial institution. Currently, the Indonesia government is working on an ambitious plan to establish a sizeable sharia bank to tap into the Islamic banking potential in the country, as existing sharia banks remain unable to benefit from the significant market potential.

Better Cooperation and Knowledge Sharing with other Countries

Indonesia can learn from established Islamic financial centers including Malaysia, London and Dubai. It is very important to ensure that efficient knowledge sharing and knowledge transfer are taking place. Previously, in a meeting at a joint conference in Jakarta on 18 July 2011, Governor Tan Sri Dr Zeti Akhtar Aziz of Bank Negara Malaysia and Governor Darmin Nasution of Bank Indonesia agreed on the need for joint initiatives to create an ‘enabling environment’. At the conference, headlined ‘Enhancing Financial Linkages towards Economic Prosperity’, Governor Darmin said that, “There is a strong need for Islamic banks in Malaysia and in Indonesia to improve their cooperation and develop the Islamic finance market.” Governor Zeti said, “Many of the things that Malaysia did was by trail and learning and we focused on the best. Looking at Malaysia and other countries that have developed Islamic finance, Indonesia can make the quantum leap.”

Currently, Indonesia is also assisting others in developing their Islamic financial markets. For example, The Ugandan central bank is currently struggling to address demands for the first sharia bank in the East African country. Jakarta Post reported that the Bank of Uganda, the republic’s central bank, has sent delegates to Indonesia, home to the world’s largest Muslim population, to learn more about Islamic finance.

Comprehensive Master Plan and Blueprint for Islamic Finance

Previously, lack of government support is a serious concern. However, it seems that the government has changed its approach and is now supporting the Islamic financial sector. It has been reported that Indonesia could utilize the potential of Islamic finance to fulfill its ambitious infrastructure plans, Standard & Poor’s said in a report. The poor state of infrastructure is hindering the growth of Southeast Asia’s largest economy, the report said, while noting that the government is planning to spend more than $200 billion through 2014 to upgrade and expand the infrastructure.
The previous slow progress of Islamic banking in Indonesia can be attributed to a lack of planning, the absence of a comprehensive and proper framework and instruments for supervision and regulation, a highly limited public understanding, the lack of an efficient structure to support efficient Islamic banking operations, poor support from the international community due to high level of corruption as well as operational and managerial inefficiency. In addition, the prevailing view among Indonesian scholars that banks’ interest is either not usury, or is usury but is allowed in an emergency is another reason for the slow development in Indonesia. This conceptual conflict has effectively prevented the development of Islamic finance as we understand it because a real shift will be deemed unnecessary as long as the current conventional finance is Shari'ah-compliant enough, a controversial view shared by many Indonesian scholars in the past.

For example, discussions on usury in Indonesia were conducted in 1927 by Nadhatul Ulama in Surabaya, again in Magelang in 1939 and in Cilacap in 1981 and the views expressed regarding banks’ interest were inconsistent. Some have argued that it is forbidden while others claim that it is permissible or propose that it is merely shubhah (doubtful) and therefore permissible. Research conducted by Antonio (2004) on the opinions of 45 renowned Indonesian scholars revealed that 24 out of the 45 believed that banks’ interest or usury is not forbidden (Azmi and Wan Nursofiza). For example, Kasri and Kassim (2009) explained:

In Indonesia, studies on potency, preference, and people’s behavior toward Islamic bank have also been done by the central bank in year 2000 to 2005. The study is performed with collaboration with several universities to cover at least 11 provinces in Indonesia.(8) The studies reveal that although religiosity is perceived as one of the main reasons in dealing with Islamic banks in Indonesia, the perception on interest rate is ambiguous. While most of the respondents agreed that interest rate is prohibited in Islam, they are not strongly against the interest rate application in the banking system (Bank Indonesia, 2005).

However, the attitude has now changed. There is more support from the government and from the industry. Nowadays, the Islamic banking system in Indonesia is developed within a dual-banking system framework under the Indonesia Banking Architecture (Aristektur perbankan Indonesia) Guideline. After two developmental plans namely the Blueprint of Islamic Banking Development and the Grand Strategy of Islamic Banking Market Development, the country’s commitment was followed by the enactment of the National Act No.21/2008, ratified in July 2008, which provides an adequate legal foundation for the development of Islamic banking, and hence accelerating its growth.

The Inclusion of Conventional Banks

In Malaysia, one of the main reasons for the success of Islamic finance there is due to the inclusion of the conventional banks. In Malaysia, conventional banks can also open Islamic banking products using Islamic window. This will enable the sharing and transfer of expertise into the Islamic finance sector. Furthermore, this will avoid unnecessary confrontation between Islamic financial institutions and conventional financial institutions.

One of the key problems is the prohibition towards conventional bank against entering the Islamic financial market. Dr. A. Riawan Amin, Chairman of the Indonesian Shari’ah Bank Association explained that Indonesia, the world’s most populous Muslim country, has the population to create a thriving Islamic finance industry, but first they must overcome hurdles such as infrastructure. Amin believes that, to overcome this, Islamic banking should not remain separate from conventional banking:
The retail segment needs to be developed – in retail you need a lot of outlets. There are only 1500 Islamic banking outlets, whereas there are 20,000 for conventional banks. One single gesture from the central bank, to offer Islamic banking alongside conventional banking, would solve a big problem. (CPI Financial 19 September 2012)

Indonesia is coming up with more products. For example, HSBC Amanah, the *Sharīʿah*-compliant unit of HSBC Holdings, will offer cross-currency hedging and foreign-exchange forwards after receiving central bank approval and the new rules will help Indonesia achieve 50 percent annual growth in Islamic loans through 2015 (Jakarta Globe 7 August 2012).

**Suitable Legal and Regulatory Framework**

The legal and regulatory framework in Indonesia is being revamped. In 2012, it was announced that Indonesia will let *Sharīʿah*-compliant banks hedge against exchange-rate movements to spur growth in Islamic financial assets and narrow the gap with Malaysia’s industry, which is seven times larger (Jakarta Globe 7 August 2012). The same news reported that Bank Indonesia, the National *Sharīʿah* Board and the Indonesia Institute of Accountants have approved the instruments, available in Malaysia since 2006.

Lack of clear regulation will be detrimental to the development of Islamic finance in Indonesia. For example, recent news stated that Bank Islam Malaysia Bhd is still interested in buying in an Islamic financial institution in Indonesia, but is awaiting further clarification on the country's shareholding regulations for commercial banks (The Star 9 May 2012).

Fortunately, there is much improvement in the legal framework nowadays. Bank Indonesia is accelerating reforms, including the development of liquidity instruments and capital market. Starting January 2014 all financial institutions including Islamic banks and cooperatives will come under the supervision of the Financial Services Authority (FSA). By the year 2020, Bank Indonesia expects one in five banks to be a *Sharīʿah*-compliant bank.

Indonesia’s financial goals differ from those of Malaysia. Malaysia aims to become a regional and global Islamic financial Centre. Indonesia, however, aims to focus on its own large domestic market. The population of Indonesia alone is more than 200 million and the huge majority is Muslim. An Islamic financial system that rejects corruption and focuses on the fair allocation of risk will be a competitive alternative to conventional finance in Indonesia. Venardos (2011) explained that in order to strengthen Islamic finance in Indonesia, both the legal and regulatory frameworks must be improved in addition to a reformation of the overall economic environment:

The World Bank says special care needs to be taken in Indonesia given its recent banking fiasco. The progress of Islamic banking in Indonesia is impeded by the lack of comprehensive and appropriate framework and instruments for regulation and supervision, limited market coverage, lack of knowledge and understanding by the public, lack of efficient institutional structure supporting efficient *Shariʿah* banking operations; operational inefficiency, domination of non-share base financing and limiting capability to comply with international *Shariʿah* financial standards.
In June 2008, the country took its first major step with the passing of the *sukuk* Law. This law established a body called the DSN, which is in charge of approving all *Sharīʿah* products and services issued in the country (IFR Islamic Finance Report 2009). It is reported that it is modeled on Malaysia's Sharia Advisory Council, and the DSN will not rule only on the acceptance of *sukuk* structures but on any and all Islamic instruments so its creation is an important step for the development of Islamic finance in Indonesia as a whole (IFR Islamic Finance Report 2009).

**Education and Training**

Southeast Asian universities are adding Islamic finance courses as Bank Negara Malaysia’s *Sharīʿah* Advisory Council warns a skill shortage in the industry is hampering growth. Universitas Muhammadiyah in Malang, Indonesia and Kuala Lumpur-based International Centre for Education in Islamic Finance (INCEIF) said in August 2012 they plan to start new programs. Malaysia needs 40,000 more qualified people in the industry by 2020, Dzuljastrti Abdul Razzaq, head of the International Islamic University Malaysia’s finance department, said. Indonesia will require 17,000 more over three to five years, according to a central bank survey (Gulf News 20 August 2012).

**CONCLUSIONS**

Indonesia’s strong performance during recent financial crises underpinned by increasingly positive expectation of global economic recovery since late 2010, spurs more optimism both in domestic and global market that Indonesia economy will enjoy higher growth in the incoming years. This situation will in turn boost further development of Islamic finance industry in Indonesia.

The potential of Islamic finance in Indonesia is very big. The huge domestic market potential, the possibility of getting more foreign investments and economic opportunities, and more employment opportunities are some of the benefits. It would be very wise for international financial institutions to try to penetrate the market in this early stage.

There are challenges that must be catered to as well, particularly lack of manpower and the failure to inform or educate public on Islamic finance. Despite these factors, the future of Islamic finance in Indonesia seems bright due to stronger institutional support, better cooperation and knowledge sharing with other countries, the existence of a master plan and blueprint for Islamic finance. If the conventional banks are properly included in the Islamic financial market, and suitable legal and regulatory framework are made available, there is no stopping to the growth of Islamic finance in Indonesia.

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