

# THE GROWTH OF ISLAMIC BANKING IN INDONESIA

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## ***Abstract***

*This article describes the growth of Islamic banking industry in Indonesia. Islamic banking to perform progressive and strong performance from the banking indicators. Bank Indonesia estimates that the Islamic banking industry will achieve a growth higher than the national banking system in general. In the development of Islamic banking there are still some challenges to be solved especially for a small market share, lack of human resources, and the lack of product development.*

***Keywords:*** Bank, Sharia, Growth

## ***Abstrak***

*Artikel ini menjelaskan pertumbuhan industri perbankan syariah di Indonesia. Perbankan syariah menunjukkan kinerja yang progresif dan kuat dari indikator perbankan. Bank Indonesia memperkirakan bahwa industri perbankan syariah akan mencapai pertumbuhan yang lebih tinggi dibandingkan dengan sistem perbankan nasional secara umum. Dalam perkembangannya, perbankan syariah masih menghadapi beberapa tantangan yang harus diselesaikan terutama mengenai pangsa pasar yang kecil, kurangnya sumber daya manusia, dan kurangnya pengembangan produk.*

***Kata Kunci:*** Bank, Syari'ah, Pertumbuhan

Islam is a religion that unites both spiritual and temporal aspects of life. It regulates not only an individual's relationship with God, but also human relationships in social and financial settings. Thus, the Sharia, or the Islamic Law, is part of every Muslim's cultural, social, and behavioral identity. Islamic banks are commercial banks which tend to

comply with the religious injunctions of Islam. The functions of Islamic banks are and will remain essentially that of financial intermediaries (Kahf, 1999).

Islamic banks, however, are different from conventional banks. The guiding principles for an Islamic bank, in particular and Islamic financial system, in general is a set

of rules and laws, collectively referred to as Sharia, governing economic, social, political and cultural aspects of Islamic societies. Sharia originates from the teachings of the Quran and its explanations rendered by the Prophet Muhammad, more commonly known as *Sunnah*. The Sharia prohibits interest or usury, gambling and *gharar* (undue risk taking), involvement in trading in such goods and services that are unlawful in themselves (El-Gamal, 2001). It also encourages risk and profit sharing in the sphere of financial activities as ‘the essential principle of interest free banking is profit/loss sharing’ (Metwally, 1997).

Bank according to central bank of Indonesia is a business entity which collects funds from the public in savings and share to the public in loans or other forms in order to improve the standard of living of the majority. In this decade, Indonesian finance launch Islamic financial system in order to accommodate the Indonesian people that majority is *moslem*. Kusuma (2006) and Wijaya (2008) explain that Islamic system in Indonesia has expanded into the capital markets, insurance, mortgage, savings and loan institutions, banks, etc. It enriches the Islamic system over the conventional system was used that interesting to compare the performance and future prospects especially.

Historical progress of Islamic banking in Indonesia according to Rais (2002) and Rohendi (2010) formally began with the Workshop MUI on banking in 1990, which was subsequently followed by the issuance of Banking Act No. 7/1992 about banking which accommodate banks activities with profit-sharing principle. However, during the period 1992-1998 Aziz (2009) criticize there was only one Islamic Commercial

Bank (BUS) and several Islamic Rural Bank (BPRS) as the perpetrators of Islamic banking industry. This is due during the six years of operation there is practically no other regulator that supports the system of Islamic Banking operation. The absence of these legal tools to support of Islamic Banking products to conform such as conventional product, as a result the characteristics of *Sharia* (Islamic law) be disguised like conventional banks. The government made a strategic step development of Islamic banking that is granting permission to the conventional commercial banks to open branches Islamic Business Unit (UUS) namely a conversion of conventional banks into Islamic banks (Antonio 2001).

This strategy is also a response and initiative from the changes in the Banking Act No.10/1998 as the successor Act No.7/1992, which expressly Islamic Banking Systems positioned as part of the national banking system. In 2008 the Government issued Islamic Banking Law No.21/2008, that expected to provide a more solid legal basis and greater opportunities in the development of Islamic Banking in Indonesia so that equal and parallel to the conventional banks. The impact of Islamic Banking Act provides a positive thing, the progress of Islamic banking branch until the end of 2009, among others 6 BUS, 25 UUS and 139 BPRS, if compare 2005 BUS grew 100%, UUS grew 86%, and BPRS grew 51% (Agustianto 2010). The institutional side of the spread of Islamic banking branch network also experienced rapid growth. In 2009, adding service outlets have as many as 199 branch become 1,223 branch office and 1,742 office channeling (service Islamic bank in the conventional banks).

Islamic banking in Indonesia hits significant growth when compared to the same industry in other countries. The assets of Indonesia's Islamic banks have grown four times higher than other competing countries. The total average growth of Islamic banking assets is 40% within the last five years. Other countries only book 10-15%. Indonesia's Islamic banking is currently ranked fourth behind Iran, Malaysia, and Saudi Arabia, a better achievement compared to Bahrain and United Arab Emirates. (www.bi.go.id, 2012).

### **Islamic Banking: Sharia Concepts**

Islam is a *deen* (Way of Life) practically, which teaches all things good and beneficial to mankind, regardless of time, place or stages of its development. Islam is a *fitriah* religion, which according to human nature. Financial and banking activities can be viewed as a place for modern society to bring them to two kinds of *Sharia* of the Al Quran, namely: 1) Principle of Al Ta'awun, namely mutual assistance and cooperation among members of society for good, as stated in the Al Qur'an: "And please to help each other among of you in doing goodness and piety, and not helping in sin and offense." (QS 5:2). 2) The principle of avoiding Al Iktinaz, which is holding the money (fund) and let it idle and does not rotate in transactions that the benefit for publics, as stated in the Al Qur'an: "*The peoples who trust to Allah, do not take each other neighbor's property by way of vanity, except by way of commerce that applies that applies with deals among of you*" (QS. An Nisaa:29) (National Islamic Council / Dewan Syariah Nasional, 2003).

Just like other financial intermediary institutions, Antonio (2001) and Muhammad (2005) explain the basic mechanism of Islamic bank is to receive funds from customers and channel money to other customers in need. He said that the difference in the provision of benefits received both of customers and banks, which is conducted with appropriate financing schemes in Islamic law that free of *riba*-free.

In principle there are five concepts in its operations (Swandani 2010), as follows: 1). Contract (*Akad*); all transactions must use *wa'ad ala wa'ad* (promise over promise) where there are two clauses promise. The first clause of what promises associated with itself and the second clause dealing with the consequences if the promise is ignored. 2). Profit-Sharing; used the concept of Islamic bank is profit sharing. Customer funds channelled by the bank in financing the scheme. The revenue of the financing will be divided according to contract between customer and bank. 3). Financing Targets; bank was restricted of Islamic principles in distribute the funding. Financing should not be distributed on business sectors that opposed or forbidden the Islamic law, such as gambling business, beverages and foods that are forbidden. 4). Customers are Partners; for Islamic banking customers are business partners, not a customer who require funds and who save their funds in the banks, so that business can be run based on mutual need. 5). Profit Oriented and Prosperity; for business continuity, operational Islamic bank needs funds to hire and conduct its business, for that the bank needs funds drawn from the operations revenue. While the rest of the other businesses provided to customers in the form of profit-sharing for their welfare.

The operating system of Islamic bank (Kamal 2008) in Figure 1. illustrates that Islamic bank in operate their business get started with capital from the founders, in addition get funds from a depositor funds, the profit-sharing will be given to the founders and customers over the invested funds to banks, from the profit-sharing of each set aside sharing into *zakat*. Funds are distributed to customers require, bank share their operations in two terms of distribution of these funds (1) the financing in *Ba'i bithaman Ajil, Murabahah, and Ijarah* (2) Equity Financing in *Musharakah and Mudharabah*. Profit-sharing for debtors and creditors in financing is done by contract containing an agreement margin of gains/losses on the business and equity financing in profit-sharing for each. In addition to distribution of funds by 2 mechanisms above, Islamic banks also have a mechanism for channeling other funds namely *Al Qard al Hasan* was the provision of funds in order to realize a social responsibility to debtors who deserve it, the Islamic debtor is obliged to repay only the loan principal only.

### The Performance Of The Islamic Banking

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

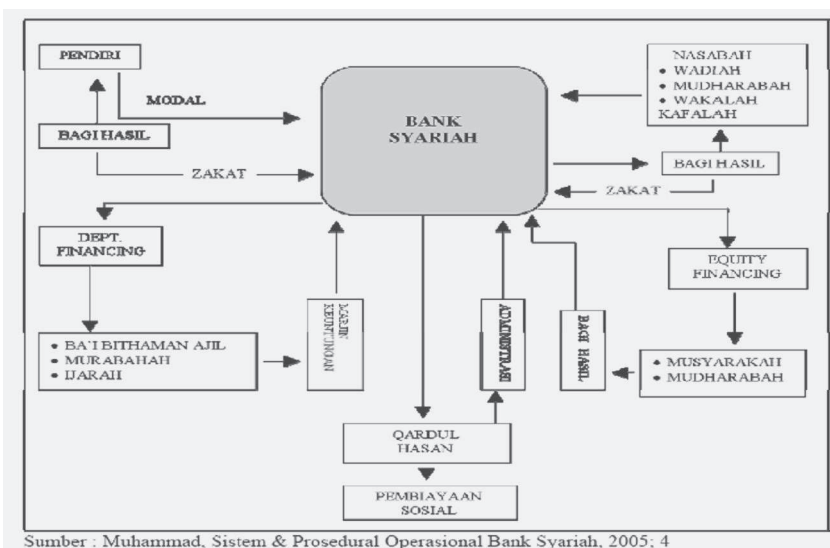


Figure 1. Islamic Banking Operational System

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.

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).

### The Growth Acceleration Programme Of Islamic Banking

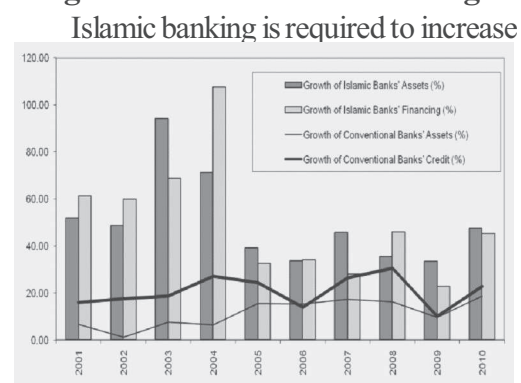


Figure 2. The Growth of Banks

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

more its effort in socialization, instrumental innovation, and bank product. Islamic banking functions as not only a financial and commercial institution but also a social-finance institution because its involvement in social activity leads to a positive sentiment in every aspect. It is very beneficial as the first step to formulate a strategic and comprehensive package in order to develop Islamic banking. Bank of Indonesia estimates that Islamic banking industry will enjoy a high growth compared to conventional banking in general. This estimation is based on the more conducive macroeconomic and microeconomic factors which affect the fastness of Islamic banking industry development. It is supported also by a plan to open new Islamic business units or new Islamic commercial banking, and by optimization of the business capacity of Islamic banking and by support of national Islamic financial environment (Sharing, 2008).

The fast growth of Islamic banking number is followed by the increase of Islamic banking indicator values such as asset, Third Party's Fund (Dana Pihak Ketiga/DPK), and The Distributed Financing (Pembiayaan Yang Disalurkan/ PYD). The growth of Islamic banking asset tends to constantly increase. The growth of Islamic banking asset increases because of the dual banking system. The same condition is also experienced by Islamic banking in Malaysia. When the Islamic Banking Act was introduced in 1983, the first Malaysian Islamic banking began to operate. However, up to 1993, there was no significant growth. By releasing the Introduction of Windows System, Malaysian Islamic banking has grown fast.

The fast growth has been triggered by some factors. They are the increasing number of branch offices and the Islamic

banking work and the profit sharing offered which are more stable toward acroeconomic fluctuations. When interests of conventional banks go down, the profit sharing margin increases. It happens because the profit sharing system is based on accorded beneficial rate (*nisbah*).

There are three strategies of acceleration of Islamic banking industry. They are permission for conventional banking branches to be converted to Islamic banking branches, spinning off Islamic banking unit to Islamic Commercial banking and converting conventional banking to Islamic Commercial banking. The strategy of penetration to Islamic banking market includes an office channeling policy which opens opportunity to offer *sharia* services for conventional banking branches and therefore supports Islamic banking penetration through increment of people's acceptability in receiving *sharia* services. Another strategy of penetration is the adjustment of communicative strategy, advertising activity and innovative product. If these strategies are optimized, the hoped growth acceleration will come true.

By the acceleration programme, it is projected that the volume asset of Islamic banking will reach Rp. 91.6 quintillion, the DPK will reach Rp. 71.3 quintillion, and the financing will reach Rp. 68.9 quintillion. (Sharing, 2008). The hard work to realize the market share target of national banking asset is the implementation of the blue print vision of Indonesian Islamic banking development. This very optimizing prediction is based on the solving of some obstacles which hampers the improvement that is by the issuance of the Law on State's Islamic Document (Surat Berharga Syariah Negara/ SBSN), the Law on Islamic banking (Undang-Undang Perbankan Syariah/

UUPS) and the completion of Taxation Law (www.republika.co.id, 2008).

Furthermore, the target can be reached if Bank of Indonesia provides Islamic Indonesian Banking Certificate (Sertifikat Bank Indonesia Syariah/ SBIS) as an instrument to absorb the liquidity of Islamic financing market. The existence of Islamic SBI with the return level which is equivalent or close to the interest level of conventional SBI will be an interesting choice of investment instrument. The existence of the Islamic SBI and another competitive investment instrument will motivate Islamic banking to collect the DPK which in turn will enhance the development of Islamic banking asset.

The necessity of liquidity is an unavoidable aspect in every monetary institution. The instrument of liquidity is required to enhance the operation efficiency, not only individually but also industrially. Some Islamic monetary instruments are potential to be developed to the instrument of liquidity in Islamic banking system. For examples, the Islamic capital market, the Islamic obligation (*sukuk*) or the Islamic stock can be the monetary instruments which are dealt in the exchange (Direktorat Perbankan Syariah, 2006).

The instrument of Islamic obligation (*sukuk*) can be used as an alternative of investment. It will be an engine to move the Islamic financial economy. Therefore, it will influence the growth of investment which in turn will affect the Islamic banking development (Suherilbs, 2008).

By the issuance of the Law on SBSN, the growth of Islamic monetary market will be more liquid. It makes Islamic banking possible to put its fund larger in the form of *sukuk* or other Islamic capital markets. The issuance of SBSN and SBIS is the instru-

ment of investment which is required to enhance the development of Islamic banking. The development of Islamic banking will also be followed by the development of other financial sectors which is represented by the good development of Islamic capital markets and Islamic insurances. By so doing, every Islamic monetary institution, especially Islamic banking, must be able to make a business strategy in order to positively contribute to the acceleration programme of the Bank of Indonesia and be ready to face the tight competition among actors of Islamic banking.

Today's Islamic banking condition has had various potencies in its product kinds, the government's supports, and a huge market segment where the majority of Indonesian people are Moslems. Now, Islamic banking is not considered as only a complement to national banking. It is because the Islamic banking works and its significant contribution to Indonesian economy in the last fifteen years (Sunarsip, 2008).

However the fast growth of Islamic banking is still cynically viewed by some groups, even by some Moslems. It can be seen from Moslems' low trust and low participation in the investment and the capital roll of Islamic banking. Now, the number of Islamic banking costumers is still 5 million people. Whereas, the number of Moslems who potent to be consumers are more than 100 million people. As the biggest Moslem populated country, Indonesia has the biggest potential market in developing monetary and Islamic banking industry. This tendency is shown by the high growth of the Industry, moreover, it is the highest compared to other nations that has the industry. However, the high growth is still considered small once it is compared to the huge market which is available (Bank Indonesia,

2007).

Since there are some differences in operational implementation between Islamic banking and conventional banking, the banking rules should be appropriated to Islamic rules so Islamic banking can effectively and efficiently operate. The rules are some aspects which organize the required instrument in order to resolve liquidity, accounting standard and audited account. The rules are so required in making Islamic banking as an element of monetary system which plays its roles well (Arifin, 2005). By the implementation of the Law on Islamic banking, many rules of Bank of Indonesia related to Islamic banking should be revised. The issuance of the Law and the rules of Bank of Indonesia which supported by commitment of interest holders will enhance the fast, healthy and trusted Islamic banking.

### **Challenges Of Islamic Banking**

Islamic Banks has some challenges to be solved. Amongst others there are three main challenges. 1) The first challenge is the market share of the Islamic banking industry. There some factors which limit the expansion of this industry. 2) 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. 3) 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 Is-

lamic banking.

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

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 (USD 2.6 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 fledged 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, 2010). 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.

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 ([www.bi.go.id](http://www.bi.go.id), 2012).

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: (a) the lack of the formal institutions giving academic degree in Islamic banking and finance, (b) the lack of the informal institutions giving training on Islamic banking and finance, (c) the lack of the books on Islamic banking and finance and, (d) 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 ([www.bi.go.id](http://www.bi.go.id), 2012).

Islamic banking 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 ([www.bi.go.id](http://www.bi.go.id), 2012).

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: (a) the government provides incentives for the establishment of formal and informal institutions which provide education in Islamic banking and finance, (b) the government includes the Islamic banking and finance in the national curriculum and, (c) 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 ([www.bi.go.id](http://www.bi.go.id), 2012).

### **Conclusion**

The development of Islamic banking in Indonesia represents people's necessity on an alternative banking system which provides healthy financial services and fulfills Islamic principles. Its development is either in its operational quality or in kinds of products and services which are offered. The Bank of Indonesia's policies on the widening of networks of Islamic banking services, significantly affects the increment of Islamic banking works. The development and the growth of Islamic banking in Indonesia are quantitatively fast and satisfying. However, they are less in quality. Therefore, Islamic banking should improve its services. All elements should take into their consideration that Islamic banking will significantly contribute to the national economy.

The developing of Islamic banking should not be burdened only to Bank of Indonesia and the government but also to all elements of society who should be familiar with and understand the Islamic banking system. By doing so, there will be a synergy among institutions in developing today's and future's Islamic banking.

Islamic banking in Indonesia develops significantly and promisingly. Its operations have been so far very robust to give a con-