

## Islamic Banking in Indonesia

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Indonesia has come to Islamic, or Shari'ah-compliant, banking fairly late. This is despite the fact that Indonesia, as a country, has the world's largest population of Muslims, 210 million<sup>164</sup> out of a global Muslim population of 1.254 billion<sup>165</sup> in 2004. The reasons for this are various, not least the fact that many of Indonesia's Muslim leaders do not believe that commercial interest, in its modern form, is prohibited. Such a view reflects, in part, the singular nature of Islamic belief in Indonesia. At the same time, it is also a reflection of Indonesia's secular constitution, which clearly separates religion from government. Modern Indonesians by and large subscribe to the five principles of *pancasila*, formulated by the country's first president, Sukarno, in 1945 as the basis of Indonesian public life. They are: belief in one God, national unity, humanitarianism, democracy based on consensus and representation, and social justice. Naturally, the inherent vagueness of the *pancasila* ideology has allowed for many interpretations over the years, but from the beginning, the newly independent Republic of Indonesia was conceived as a secular state despite an overwhelming Muslim majority. Which is not to say that Islam is an unimportant element in Indonesian politics, or that Islamic parties are absent from the political scene; far from it. From the very beginning of

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<sup>164</sup>*The World Factbook 2004*, Central Intelligence Agency.

<sup>165</sup>*Encyclopædia Britannica Book of the Year 2004*.

the post-war era there have been calls from Islamicists to make Indonesia an Islamic state, notably when the constitution was first drawn up; following the abortive 1965 “communist” coup; and in the wake of the collapse of the Suharto regime in 1998.

Indeed, militant Islamicists, who at various times have called for the formation of an Islamic state have always been perceived as a threat to national security, especially on the part of the Western-educated elite who have dominated Indonesian politics ever since General Sukarno’s unilateral declaration of independence in August 1945.

### 9.1 Islam and Government in Indonesia

Indonesia was one of the earliest parts of South-east Asia to receive Islam, though the actual process was sporadic and piecemeal. The earliest states in the region were Hindu-Buddhist kingdoms, with Hinduism and Buddhism having been introduced to South-east Asia by Indian merchant adventurers around the first century AD. Their conversion to Islam was a gradual one. Arab traders were doing business in various parts of the archipelago from the sixth century onwards but the actual process of Islamisation did not begin until the thirteenth century with the conversion of the ruler of Aceh in northern Sumatra. Gradually, Islam spread to other entrepôt city-states stretched out along the principle maritime trade routes of the Indonesian Archipelago, notably the northern coast of Java, . . . and the spice islands of Maluku — Ternate, Tidore and Bandar. By the early part of the sixteenth century, the process was more or less complete, leaving only the island of Bali as the last bastion of Hindu-Buddhism in the archipelago.

But just as the reception of Hinduism and Buddhism in Indonesia had been coloured by local belief systems, so too in the case of Islam, and from the outset the Muslim faith in Indonesia diverged significantly from the orthodoxies of Islam

in, say, the Arabian Peninsula. Elements of Hindu-Buddhism continued to flourish alongside more ancient animistic beliefs, while in-coming Islamic traditions were given a distinctly Indonesian spin. This is a situation that has persisted until today, particularly in Java.

The highly syncretic nature of Islam in Indonesia has meant a more than relaxed attitude towards the Shari'ah, which may be one of the reasons why Islamic banking has been so slow in coming to the region. In the past, several well-respected Indonesian intellectuals, including former Vice President Hatta, have argued that the prohibition of *riba* is not the same as interest charged or offered by modern commercial banks. Whilst Islamic jurists in Indonesia have naturally opposed this view, the greater Muslim public seems somewhat indifferent to the issue.

Another important factor has been the de-politicising of Indonesian society during successive Sukarno and Suharto regimes. Although independent Indonesia was founded along the lines of liberal democracy, with a multi-party parliamentary system, a free press and freedom of organisation including the formation of trade unions, the country's first president, General Sukarno, was very much opposed to a Western style of governance, which he saw as at variance with Indonesian cultural values of harmony and consensus. A breakdown of parliamentary democracy in the mid-1950s as a result of widespread discontent with the government's failure to deliver the revolutionary promises of 1945 — mainly prosperity for all — gave Sukarno the opportunity to implement his programme of "Guided Democracy" with a balanced political party representation in parliament whose representatives were drawn from various "functional groups", which included peasants, workers, Muslim scholars and the military, as well as numerous minority groups. Perhaps inevitably, the armed forces group, known as Golka, quickly rose to the top — the

army had always played a significant role in Indonesian political life from the earliest days of independence, riding high on its popular acclaim as a people's revolutionary army, which had ousted the Dutch colonialists from power.

The army's put down of the attempted communist coup of 1965 and the replacement of President Sukarno's "Old Order" regime by President Suharto's "New Order" government only served to strengthen the position of Golka in the scheme of things. Although regular elections were held every five years from 1971 onwards, Golka always enjoyed the benefits of government funding and the full support of Indonesia's extensive bureaucracy, while opposition parties were subject to rigorous vetting. Unsurprisingly, Golka invariably romped home with two-thirds or more of the vote in every election held between 1971 and 1997.

Having effectively disposed of the Indonesian Communist Party (PKI) in the bloodletting of 1965, Suharto's government saw militant Islam as its next-biggest threat — the 1970s and 1980s were of course a time of Islamic revival partly as a result of the Iranian revolution and partly reflecting a more general resurgence of Islam in the Middle East. Consequently, every effort was made to promote *pancasila* as the sole ideological basis for any form of political or social organisation in the country. The Golka-led political consensus was hailed as *pancasila* democracy, and school and university students were obliged to pass exams in *pancasila*, as did civil servants and members of the armed forces. Although the more fervent Islamicists never abandoned their hope for an Islamic state, the vast majority of Indonesians accepted the status quo vis-à-vis their religious beliefs, acknowledging the fact that Indonesia could never become one because of the religious diversity from one end of the archipelago to the other, and not least within the Muslim community.

The collapse of the Suharto regime in 1998 brought a possibility that things might change, especially with the success of that Party of National Awakening, a modernist Islamic party led by Abdurrahman Wahid, which was runner-up to the Indonesian Democratic Struggle party, led by Megawati Sukarnoputri, daughter of former president Sukarno (Golka finished a poor third). The subsequent election of Wahid as president in October that year further raised the profile of Islam-based parties in post-Suharto Indonesian politics — Wahid was a Muslim cleric, who was educated in Indonesia, Egypt, Iraq and Canada and had a reputation for religious tolerance and moderate politics. Unfortunately, after twenty months of weak and indecisive rule he was removed from office by the People's Consultative Assembly and Vice-President Megawati Sukarnoputri became the new president in his place.

After years of upheaval following the overthrow of former President Suharto, President Megawati presided over a period of relative stability. However late 2004, she was replaced by Dr. Susilo Bambang Yudhoyono, the senior minister in charge of political and security affairs then. Corruption is still rife, problems associated with separatist movements in Aceh and Papua persist, and there is the ever-present threat of further terrorist violence.

## **9.2 Traditional Islamic Financial Institutions in Indonesia**

After some false starts, Islamic financial institutions are developing rapidly and have the enthusiastic support of many young people and intellectuals. The work of the Shari'ah Bureau of Bank Indonesia demonstrates that Indonesia, especially in particular parts of the country, has considerable unmet demand for Islamic banking.

There are interest-free financial institutions operating in Indonesia. One form of traditional interest-free borrowing is the still widely prevalent form of informal rural credit known as *ijon*<sup>166</sup> because the loan is secured on the standing crop.<sup>167</sup> Another is the *arisan* system practised among consumers and small craftsmen and traders. In this system, each member contributes regularly a certain sum and obtains interest-free loans from the pool by drawing lots.

### 9.3 Introduction of Measures to Permit Islamic Banking in Indonesia

The present government in Indonesia seems to associate Islamic banking with Islamic fundamentalism to which the regime is not at all sympathetic.

In order to accommodate the public demand for the existence of a new banking system, the Indonesian Government has implicitly allowed the Shari'ah banking operations in the Act No. 7 of 1992 concerning banking which is elucidated in the Government Decree No. 72 of 1992 concerning Bank Applying Share Base Principles. The set of regulations have served as legal foundations for Shari'ah banking operations in Indonesia (the new era of dual banking system).

In 1998, the Act No. 10 of 1998 on the amendment of the Act No. 7 of 1992 concerning banking came into force to give stronger legal foundation for the existence of Shari'ah banking system. The new Act No. 23 of 1999 concerning Bank Indonesia

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<sup>166</sup>This is the unjust system of sharecropping at plantations. Farmers grew food crops on unused land in the plantations, but were forced to sell the harvest to the plantation company cheaply before it was ready.

<sup>167</sup>See Partadireja, Ace, 1974, for a description.

gives an authority to Bank Indonesia to also conduct its task according to Shari'ah principles.<sup>168</sup>

#### 9.4 Contemporary Indonesian Islamic Financial Institutions

Indonesia has a small market and loyal customers of Islamic banks. Bank Indonesia ideally wants Islamic banks to reach a 5 per cent market share over the next ten years. Currently there are two fully Islamic banks and about eight Shari'ah branches of conventional banks. The trend of conventional banks opening Shari'ah branches started with the enactment of dual system banking by the government in 1998.<sup>169</sup>

Islamic financial institutions in Indonesia include: the Bank Muamalat Indonesia which has been functioning since 1992, several new Islamic branches of regular commercial banks and at least one bank just converted from the interest system, eighty Bank Perkreditan Rakyat Shariyah (BPRS — smaller banks limited to borrowing and lending in limited areas), and 2470 Bait Maal Wat Tamwil (BMT — Islamic Savings and Loan Cooperatives of which about 200 are reported to be registered with the Ministry of Cooperatives and Small Business). The Islamic commercial banks and BPRS file frequent and detailed reports with Bank Indonesia and thus produce reliable and current statistics. This is not yet the case with BMT.<sup>170</sup>

Bank Indonesia has established an Islamic Banking Development Committee comprising Oversight Committee, Expert

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<sup>168</sup>“The blueprint of Islamic banking development in Indonesia”, *Bank Indonesia*, September 2002.

<sup>169</sup>Aurora, Leony, “Shari'ah banks should invite foreign investors or go public” (2004), *Jakarta Post* (<http://www.thejakartapost.com/>), 17 June 2004.

<sup>170</sup>Timberg, Thomas A., “Small scale credit advisor”, *Partnership for Economic Growth*, Bank Indonesia, June 1991.

Committee and Working Committee. It has also recorded and assessed the existing regulatory instruments in order to develop a more comprehensive set of rules and regulations. These measures are intended to foster a conducive environment for the development of Islamic banking.

Other than that, Bank Indonesia has also issued or currently developing the issuance of decrees by the Board of Managing Directors concerning Islamic commercial and rural banks which have provided legal framework in developing and expanding the network of Islamic banks. In addition, there is the issuance of regulations on operational guidance for Islamic banks and conducting assessment on the development of prudential banking regulations and developing accounting standards for Islamic banks. Lastly, Bank Indonesia has been active in educating the public in the Islamic banking concept as an alternative interest-free system which is becoming popular around the world.

The response of the public has been overwhelming and with this, the industry is seeing some significant changes in the fate of the Islamic banking industry. Further research is taking place on the voice of the public to help in the further growth of Islamic banking in Indonesia. Recent surveys show that the public has a better understanding now and is in favour of the *riba*-free, Shari'ah-compliant system.<sup>171</sup>

## 9.5 The Introduction of Standard Accounting Procedures

As of today, there are a number of banks delivering Shari'ah banking in Indonesia, namely Bank Mandiri, Bank Danamon,

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<sup>171</sup>"Islamic banking: The Indonesian experience", [www.halah.com.my](http://www.halah.com.my), 15 December 2000.

Bank Muamalat Malaysia Berhad and Bank IFI. The Islamic banking sector continues to provide similar banking and finance facilities which conventional banks have been providing but in accordance with Shari'ah law.

PT Sigma Cipta Caraka (SCC) and Association Syariah Banks in Indonesia (ASBISINDO) is collaborating to support the application of Standard Accounting Procedure for Shari'ah Banking 59 (PSAK 59).

According to the chairman of ASBISINDO, Wahyu Dwi Agung, PSAK 59 stems from the development of Shari'ah banking in Indonesia. It is built on the principles of AAOIFI. PSAK is an interesting issue in Shari'ah banking, as it integrates the principles of accounting with the unique features of Shari'ah banking.

As previously discussed, absence of accounting (and auditing) standards pertinent to Islamic banks, causes uncertainty in accounting principles which involve revenue realisation, disclosures of accounting information, accounting bases, valuation, revenue and expense matching, etc. Thus the results of Islamic banking schemes may not be adequately defined, particularly in the profit and loss shares attributed to depositors.

Those Islamic banks which are audited by public accountants tend to disclose considerable information, but, not enough. For instance, due to the negative posture towards interest income, alternative sources of revenue probably should be disclosed, but may not be.<sup>172</sup>

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<sup>172</sup>Haqiqi, Abdul Wassay and Pomeranz, Felix, "Accounting needs of Islamic banking" (2000), *IBFNet* (<http://islamic-finance.net/islamic-ethics/article-12.html>), 17 June 2004.

## 9.6 Forms of Lending and Borrowing in Indonesia

The Indonesian Islamic institutions take a variety of funds from depositors on which they pay various sums connected with their profits. They lend on various bases in ways that involve sharing risks with their clients. The following list details the various borrowing and lending instruments used by Bank Muamallat (Indonesia), Indonesia's first Shari'ah commercial bank, as summarized in its 1998 Annual Report.

### 9.6.1 Lending Forms

#### *Advance Purchase Forms*

- **Cost Plus Financing — *Murabaha***  
*Murabaha* is a sales contract made between the bank and the customer for the sale of goods at a price which includes a profit margin agreed to by both parties. As a financing technique it involves the purchase of goods by the bank as requested by the customer. Repayment is conducted by instalments within a specified period.
- **Purchase with Specification — *Istishna***  
*Istishna* is a sales contract between the bank and the customer where the customer specifies goods to be made. After the goods are made or shipped the bank sells them to the customer according to a pre-agreed arrangement.
- **Purchase with Deferred Delivery — *Bai al Salam***  
*Bai al Salam* is a sales contract where the price is paid in advance by the bank and the goods delivered later by the customer to a designee.
- **Lease and Hire Purchase — *Ijarah Mutahia Bittamlik***  
*Ijarah Mutahia Bittamlik* is a contract under which the bank leases equipment to a customer for a rental fee. It is pre-agreed that at the end of the lease period the customer will

buy the equipment at an agreed price from the bank, with the rental fees already paid being part of the price.

### 9.6.2 Profit-Sharing Forms

- Trust Financing/Trustee Profit Sharing — *Mudharabah/Mudharabah Muqayyadah*  
In this instance, the bank provides the capital (*shahibul maal*) and the customer manages (*mudharib*) the project. The profit from the project is split according to a pre-agreed ratio.
- Partnership/Participation Financing — *Musyarakah*  
This is a partnership between a bank and its customer in which profits are shared on a pre-agreed basis, but losses are shared on the basis of equity contribution. Management of the partnership may be done either by the bank, the customer, jointly or by a third party.
- Benevolent Loan — *Qard al Hasan*  
These are interest-free loans, generally with a charitable motivation.
- Collateral Agreement — *Rahn*  
In this instance an agreement is made to provide collateral to the bank, either in the bank's or the customer's custody as appropriate. This is connected with some other form of lending.
- Agency/Trust — *Wakalah*  
This is an agreement authorising another party to be an agent to conduct some business — in this case, an authorisation to the bank to conduct some business on the customer's behalf.
- Agency — *Havalah*  
This is an agreement made by the bank to undertake some of the liabilities of the customer. When the liabilities mature, the customer pays back the bank. The bank is paid a fee for undertaking the liabilities concerned.

### 9.6.3 *Borrowing Forms*

- *Ummat Savings — Tabungan Ummat*  
This comprises a savings account from which money can be withdrawn any time at any *muamalat temiz* or ATM. Customers share in the bank's revenue. The *Ummat Savings* customers also receive life insurance and the opportunity to win a free *Umrah* (pilgrimage) to Mecca.
- *Trendi Savings — Tabungan Trendi*  
These are savings accounts for teenagers and students. Besides accident insurance coverage, it offers special prizes for high-ranked students and one-year scholarships for fifty students.
- *Ukhuwah Savings — Tabungan Ukhuwah*  
This is a savings account which is conducted in cooperation with Dompot Dhuafa Republika for convenience in making regular and automatic *zakat*, *infaq* and *shadaqat* payments by means of a choice of three packages: Rp. 25 000, Rp. 50 000 and Rp. 100 000. This saving can also give the depositor an ATM, shopping discounts at certain shops and accident insurance coverage.
- *Arafah Savings — Tabungan Arafah*  
This is a savings account specifically designed for the Haj pilgrimage. The saving scheme helps customers to plan their Haj in accordance with their financial capability and intended Haj date. Life insurance is also provided. The depositors are also eligible for various prizes.
- *Fulinvoes Deposits — Deposito Fulinvoes*  
This is a time deposit with a revenue-sharing package. It is available for various terms and with a chance for various prizes. Life insurance is provided to those with long-term deposits.
- *Wadi'ah Current Account — Giro Wadi'ah*  
This is a current account which provides cheque facilities, whilst allowing some profit-sharing.

- Muamallat Financial Institution Pension Fund — Dana Pensiun Lembaga Keuangan

This is a pension fund for those who make regular deposits. Bank Muamallat Indonesia soon intends to add a variant which will offer life insurance.

## 9.7 Conclusion

Shari'ah banking only became available in Indonesia in the mid-1990s. Previously former Presidents Sukarno and Suharto had been unwilling to support the introduction of Islamic law for banking, on the basis of the country's racial and religious diversity.

Whilst it is now a relatively small percentage of overall banking, it is growing rapidly as Indonesian Muslims embrace Islamic principles. In just the last year, demand for Shari'ah banking grew by 85 per cent to seven and a half billion Rupia, or \$200 billion. Not to be left out, some established banks are now also offering Islamic financial products, with the emphasis on investments only being made in *Halal* goods and services.

The World Bank says special care needs to be taken in Indonesia given its recent banking fiascos.<sup>173</sup> 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 Shari'ah banking operations; operational inefficiency, domination of non-share

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<sup>173</sup>Robertson, Hamish, "Shari'ah banking grows in Indonesia" (2004), *ABC Online Home* (<http://www.abc.net.au/am/content/2004/s1130581.htm>), 17 June 2004.

base financing and limiting capability to comply with international Shari'ah financial standards.<sup>174</sup> However, according to some observers, Indonesia is the sleeping giant, where Islamic banking will reach a marketshare of 5 per cent by 2010.

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<sup>174</sup>"The blueprint of Islamic banking development in Indonesia", *Bank Indonesia*, September 2002.