DOCTORAL DISSERTATION

Possibility of Intensifying and Socializing the Islamic Banks in Indonesia: Supporting the Indonesian Financial System Stabilization and Searching for Social Significance in the Islamic Banks in Indonesia

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2016

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Chapter 1. Introduction

In this introductory chapter, following some reviews of previous researches and an explanation of the theme and component of this doctoral dissertation, will be stated an academic contribution to the Indonesian Islamic banks study that I will attempt to make in this thesis. What I would like to appeal as an academic contribution here is that, through all the chapters, I will be able to construct an approach which synthesizes a way of intensifying Islamic banks in Indonesia in an economic and commercial point of view on the one hand and a way of searching for socializing them in a moral and ethical point of view on the other hand. It should be admitted that Islamic banks originally have been expected to be such financial institutions as these since they appeared in 1960s in the Middle East. If Islamic banks are not large enough to be competitive with conventional banks, they do not expand and provide their services satisfactorily for a lot of potential Muslim users in the world. Meanwhile, if Islamic banks are not solidly based on the moral principle, they lose their social significance. However, there are few researchers who search for both two possibilities. Some exclusively stress religious and moral property of Islamic banks and other are more concerned with how to develop them commercially in the national or the international financial system, including Indonesian one. An important factor linking these two possibilities is the stability of Islamic banks since they are thought to be more stable just because of their strict observance of Islamic law (*Sharia*). With regard to it too, there are remarkable researches demonstrating the stability of Islamic banks.

Taking into consideration what I mentioned above, and after reviewing some previous researches in the Chapters 1.1, 1.2, and 1.3 below, I will reveal an academic contribution of the thesis.

1.1. Review of Previous Theoretical Researches

To begin with, we will clarify the standing position of Islamic economics and Islamic finance based on the principle of Islamic economics. According to Khurshid Ahmed, Islamic economics is not value-neutral. Although it is not "an aspect of theology", nor "an aspect of law", it has "its own set of values" whereby it operates. A distinctive feature of Islamic economics is, he mentions, that it does not conceal its values in contrast with western economics. Islamic economics deals not only with how human beings behave, but also "how they should behave". Islamic economics directs human beings "towards the achievement and actualization of justice (*'adl*) in human relations" through a set of regularizations "known as *halal* and *haram*, that is, what is permitted and what is forbidden" (Ahmed, 2000a).

Ahmed, in another article, also asserts that Islamic economics calls for a change from interest-based banking and financial system to an equity-based, stake-taking system where money is used primarily as a means and a measure, where money is a servant not a master, and where money does not beget money but money is used directly as a facilitator for production of goods and services (Ahmed, 2000b). Hasanuzzaman also observes that Islamic economics has a prerequisite that "economic activity is not governed only by human desire and experience" but also by "injunctions of the *Shari'ah*". While it is a ramification of the social science, he continues, "Islamic economics is not independent of social requirements and moral values" (Hasanuzzaman, 2010) [1].

One of the reasons why Islamic banks are propagated with eagerness in the recent years can be understood by such a fundamental "framework of a value system" of Islamic economics that delineates "the boundaries of the free area" of economic action (Abdul-Rauf, 2010). It is not measured simply by their compatibility with conventional banks, but by the contributions made by Islamic banks towards the betterment, justice, equity and fairness of the whole Islamic community[2]. Islamic banks are responsible for promoting establishment and growth of business enterprises soundly so that activities of these enterprises are able to be permitted by the Islamic law (Haroon, 2000).

One of the most strictly prohibited financial behaviors in Islamic economics is taking interest (*riba*). It is just because people living in the Islamic society should help each other in times of need by supplying money without extra charge. "Prohibition against *riba* means

[1] With regard to the ethics, Vatican's official newspaper, *Observatory Romano*, stated that the ethical principle on which Islamic banks bases themselves may bring them closer to their clients and to the true spirit which every financial product and service should assume originally as their mission (Totaro, 2009). The article was also delivered by Temporal with additional remark that strength of Islamic finance lies in the *Sharia*-compliant and ethical banking transactions (Temporal, 2011).

[2] As Ali Basah and Yusuf argue, "*Sharia* acts as an internal control over Islamic banks alongside secular legislation. Such internal control should make Islamic banks more sensitive towards CSR [Corporate Social Responsibility] and environmental risk management than conventional banks". They continue that "In [in] economic activities, in order to achieve social justice, Islam provides a foundation for establishing socio-economic justice and therefore social responsibility. For example, Islam imposes obligatory payment of income and wealth (*zakat*), philanthropic trusts (*waqf*), alms and charity (*sadaqah*), and interest free loans (Q*ard al Hassan*). To ensure socio-economic justice, *zakat* is compulsory in Islam and is one of its five pillars. Non-fulfilment of this requirement is a sin and results in punishment in the Hereafter. Economic competition is encouraged as long as it is healthy, raises efficiency, and helps promote human well-being" (Basah and Yusuf, 2013: 201).

that one cannot passively invest one's money in bonds and collect interest; if one wishes to increase one's wealth, this wealth must be directly invested to yield a profit"[3]. This thought leads us immediately to the principle of profit and loss sharing principle (Pryor, 2010). Provision of financial resources to business undertakings for productive purposes is permissible only on the basis of profit and loss sharing principle. Islam allows a return on capital on the condition that "provider of capital shares also the risks of the business" (Ahmed, Z., 2000).

El-Galfy and Khiyar assert that money has no intrinsic value in itself in Islamic finance. "A Muslim cannot lend money to, or receive money from someone and expect to benefit. This means that interest is not allowed and making money from money is forbidden. Money must be used in a productive way, by which wealth can only be generated through legitimate trade and investment in assets. The principal means of Islamic finance are based on trading. Any gains relating to the trading are shared between the party providing the capital and the party providing the expertise. As a result, the Islamic banks have developed four main

[3] According to a research of Elmawazini and the other (2015) about Islamic finance development in GCC Countries, Islamic finance has positive and significant impacts on economic growth in GCC countries. Firstly a main principle of Islamic banking (e.g. zero nominal interest rate) results in efficient allocation of resources. It is in line with Nobel Prize Laureate, Milton Friedman (See Friedman and Bordo, 2005). Secondly, the use of *zakat* funds and interest-free loans (*qard hassan*) can reduce the income gap between the poor and the rich and improve socio-economic development in the society. *Zakat* funds are imposed on wealth and income of the rich that exceed their personal spending and normal customs, and they are distributed to the poor for their private consumption of "consumer goods" (Hassan and Khan, 2007). While *zakat* and *qard hassan* are derived from a kind of charity, they differ from each other in usage: The former are for consumption and the latter for productive activity in the micro business. At any rate, it is evident that these two points make the possibility of Islamic banks to develop well in the countries.

Islamic financing techniques, which are: *Mudharabah, Musharakah, Ijara* and *Murabaha*[4]". Since Islamic banks make social investment, such as support of the low-income classes, social works, and sustainable development, these are not in contradiction with rational allocation of resources because they contribute to the long-term development (El-Galfy and Khiyar, 2012).

Then, are there any factors of conventional finance which are similar to Islamic finance? According to a Malaysian leading scholar in the field of Islamic finance, Abbas Mirakhor, there are some basic similarities between modern economics and Islamic economics. Mirakhor and Bao argue that Adam Smith's "major contribution in his *Theory of Moral Sentiments* is to envision a coherent moral-ethical social system" and to show how each member of society would enforce need for "an organic coevolution of individual and society". They also argue that there are some theoretical works which, reflexing such Smith's thoughts, seek for optimal risk sharing in "a decentralized market economy". For example, a model of Arrow-Debreu-Hahn shows general equilibrium in a decentralized market economy, where risk is allocated to those who can best bear it and where "securities represent contingent financial claims on the real sector" (Mirakhor and Bao, 2013). Whereas risk sharing is one of the most crucially important factors in Islamic finance, in conventional

[4] These four transactional forms will be explained in detail in the second chapter. Here it is suffice to point out, as Haneef and Smolo list up, that they share the four common features: (1) Asset which is being sold or leased are real, and "not imaginary or notional"; (2) Seller "owns and possesses" the goods being sold or leased; (3) Transaction is "a genuine trade transaction with full intention of giving and taking delivery", and; (4) "Debt cannot be sold, and thus, the risk associated with it cannot be transferred to someone else", being borne by the creditor himself (Haneef and Smolo, 2014: 29).

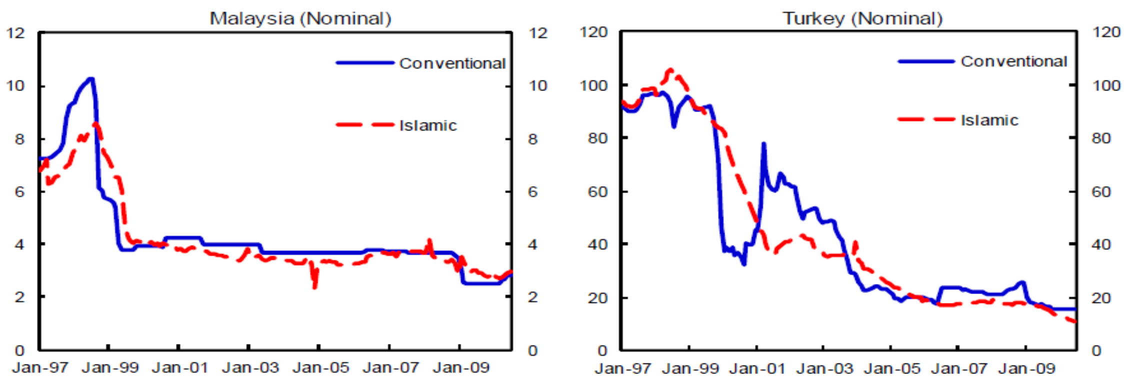
economic theory is also mentioned that risk should be allocated among market participant rather than allowing it to be concentrated among borrowers.

Following the arguments of Mirakhor and Bao, Sheng and Singh also point out some similarities between modern (conventional) finance and Islamic finance. Their concerns are rather focused on similarities with regard to prohibition or permissibility of *riba* (interest). "(This) rate of discount, which is normally taken to be the market interest rate, is supposed to reflect society's preference between consumption or utility today and consumption and utility tomorrow. If the two are equally valued, this may be regarded, as the case of Islamic finance, with a zero discount rate or interest rate". Sheng and Singh find, following the statement cited above, an ethical justification of a zero interest rate in the classic work of Pigou and Ramsey who argued that the time preference should be zero for "the achievement of intergenerational fairness". A positive discount rate would "greatly favor the current generation at the expense of the future generations" (Sheng and Singh, 2013).

Shen and Singh also cite a doctrine which was referred to by John Maynard Keynes in *the General Theory of Employment, Interest, and Money*, "the rate of interest is not self-adjusting at a level best suited to the social advantage but consistently tends to rise too high, so that a wise Government is concerned to curb it by statute and custom and even by invoking the sanctions of the moral law". Keynes criticized the classical school for the reason that it repudiated this doctrine cited above as "childish" and he insisted that the doctrine, far from being repudiated, deserved "rehabilitation and honour" (Sheng and Singh, 2013).

As discussed above, although the fundamental approaches and concepts of modern economics and those of Islamic economics are quite different from each other, they are sometimes likely to be approximate to each other, since modern economics, like Islamic economics, cannot neglect entirely the moral or ethical side of financial activity of human kinds[5].

Figure 1.1. Rate of Return Earned in Banks in Malaysia and in Turkey in the Years 1997 to 2010 (in Percentage)



Source: Cevik and Charap, 2011

Then, we will focus on an analytical issue concerning competition of conventional banking institution and Islamic banking institution. A recent IMF study by Cevik and Charap which compares the rate of return from the two kinds of banking institutions in Malaysia and Turkey in the years 1997 to 2010 confirms that there is not much difference in the rate of return earned by the two groups as a result of competition between them (See the Figure 1.1).

[5] Blitz and Long, reviewing historical discourses on regulation of usury, observe that there have been three kinds of objectives of usury legislation: "protecting the small borrower" in need of consumption loans; "curbing the monopoly power of the creditor", and; "regulating the allocation of resources" (Blitz and Long, 2010). Levy, citing from Smith a statement that "the legal rate, it is to be observed, though it ought to be somewhat above, ought not to be much above, the lowest market rate. If the legal rate of interest in Great Britain, for example, was fixed so high as eight or ten percent, the greater part of the money which was to be lent, would be lent to prodigals and projectors, who along would be willing to give this high interest", mentions that usury laws, according to Smith, can benefit society by reducing the riskiness of society's investments (Levy, 2010).

While the analysis of Cevik and Charap belongs to empirical researches which will be reviewed in the next section, it makes, in a sense, a theoretical demonstration that, whether it may be Islamic or conventional banking institution, the question of optimality is considered only from a perspective of an *individual* banking firm and not from the perspective of a *whole* banking institution (Cevik and Charap, 2011).

Competition of conventional banks and Islamic banks may put the latter even into disadvantageous position. Clement M. Henry observes that, although Islamic economics recommend the long-term and risk sharing financing methods, such as *Mudharabah* and *Musharakah*, they cannot entirely evade risk like the long-term lending of conventional banks. Risk sharing methods like *Mudarabah* or *Musharakah* "presuppose a high degree of trust between business partners, whereas conventional banks can maintain hands-off relationships with the clients" owing to risk transfer. It means that, without "the mutual trust" in depth, Islamic financiers would need much higher monitoring costs (Henry, 2004). Moral hazard of clients is likely to arise more probably in Islamic banks than in conventional banks, for borrower may manipulate its profits and losses at the expense of bank. If these issues are resolved, as will be stated later in the second chapter, Islamic banks probably diminish the credit risk. However, it requires much cost and, in the last analysis, impedes their competitiveness. As with funding, the substantial Muslims apparently prefer to "put their saving in Islamic banks" than in conventional banks. Even if the return of funds (deposits) in Islamic banks may be less than the interest expensed by conventional banks, the faithful Muslims convince themselves with depositing their money into Islamic banks. It enables Islamic banks to keep up with conventional banks in overall profitability (Henry, 2004). However, even the faithful Muslims would be not always willing to deposit their money into

Islamic banks in case that opportunity cost of not depositing their money into conventional banks which also accept Muslims' money would be relatively high. In short, as Çizakça asserts, "the desire to run the Islamic banking industry in compliance with *Shari'ah* conflicts with the need to compete with the conventional system and the instinct to act like them" (Çizakça, 2011).

From what we argued so far is concluded that Islamic economics, Islamic finance and Islamic banks are based on the solid value system, although morality are also identified in the conventional counterparts in some degree, that competitiveness is fundamentally dependent on individual banks, whether they may be Islamic banks or conventional banks, and that Islamic banks do not always have advantages over conventional banks since advantages depend, for instance, on monitoring cost to borrowers or on attractiveness to depositors.

Here should we proceed the other positive aspects of Islamic banking than moral value. It is financial stability which is naturally related with moral value. With regard to financial stability, Askari, Iqbal, Krichene, and Mirakhor stress the inherent stability of Islamic financial system. Islamic financial system can be modeled as "nonspeculative equity ownership that is intimately linked to the real sector and where demand for new shares is determined by real savings in the economy". Islamic banks directly own real assets and operate like "an equity holding system". Profitability in Islamic financial system is fully secured by real economic growth, while profitability in conventional financial system is not driven by real sector. As Askari and the others point out, Islamic banks are likely to be immune to the unbacked expansion of credit, firstly because they are assumed to "match deposit maturities with investment maturities": Short-term deposits may principally finance short-term trade operations, and long-term deposits are used usually for long-term investments, and secondly because these long-term investments are to finance real activities in the production of goods and services, not to finance non real activities with a fixed or floating interest rate (Askari et als, 2011).

Askari and the others continue to argue that in Islamic financial system the sectors of firms and households are likely to evaluate the rate of return, not in comparison to interest rate as in conventional financial system, but in comparison to the average rate of return "determined by real factors given by consumers' preferences and marginal productivity of capital". Consequently, savings and real investment plans, rather than credit, determine not only long-term investment by Islamic banks but also equity prices in Islamic stock markets, which eventually decrease "systemic risk caused by credit booms, speculative bubbles, and debt trading" (Askari et al, 2011).

Based on the argument of Askari and the others, the rest of this paper will adopt profitability, liquidity, and solvency (less riskiness) as main indicators of bank stability, implying that when a bank is more profitable, liquid, and solvent, it is more stable. In case of Islamic banks, owing to their moral conservatism, avoidance of speculation, and their tendency to link themselves to the real economic sector, they are intrinsically profitable, liquid, and solvent.

The argument of Askari and the others also leads us to a question: Whether is the business cycle in Islamic economy more moderate than that in conventional economy? With regard to this question, Pryor mentions that most of Islamic economists consider that business cycles are likely to be dampened from the several reasons: There is no movement of interest rate to induce procyclical investment; Since savings are "tied more closely to investment”, there is less chance that these two aggregates get out of alignment; Destabilizing speculation is less probable because banks are “less willing to participate in such schemes than individuals”, and; There is “less incentive to pyramid the financial assets” that are easily subject to liquidity risks (Pryor, 2010). However, it should be noted that, as Islamic modes of financing are strongly linked to real and physical transactions, it is susceptible sooner or later to the fluctuations of asset prices which are originated in the conventional financial sector and transmit to the Islamic financial sector.

If we are given a theorem that Islamic banks are more stable and, however, are subject to an influence of conventional banks, here we will move to an empirical discussion in order to answer a following question: Are Islamic banks actually more stable than conventional banks and how are they actually susceptible to conventional financial movements?

1.2. Review of Previous Empirical Researches

In considering such question as shown above, it is important, first of all, to ascertain whether or not direct impact of the global financial crisis in the years 2008-2009 on the Islamic banking sector was more limited due to the principles intrinsic to Islamic banking. Then I will survey here some previous researches which will be followed by an argument in the second chapter.

According to Kayed, Mahlknecht and Hassan, Islamic banks were reluctant to CDS (credit default swaps) or CDOs (collateralized debt obligations) because risk sharing should be observed and risk shifting as implemented in these products was prohibited. It enabled most Islamic banks to stand aloof from the global financial crisis. Islamic banks are conservative in banking management, are cautious against the structured products and “sophisticated financial instruments”. Kayed and the others mention that, differently from PLS contracts where both parties are exposed to gain and loss, risk shifting in conventional banking “assures only one party” to gain while the losses are incurred by the other parties. High-risk speculation brought by excessive optimism was clearly limited by prohibition of “excessive uncertainty risk” (*gharar*) and leverage risk which are thought to be avoidable in Islamic finance (Kayed et als, 2011). According to the Islamic Finance and Global Stability Report (2010), “Islamic banks in the Gulf area witnessed 38.2 percent asset growth rate and 20.1 percent profit growth rate compared to 16.3 percent and -6.1 percent, respectively, for their conventional counterparts” in the year 2007-2008 (Salem and Badreldin, 2014).

However, Islamic banking could not escape thoroughly from influences of the global financial crisis whose origins were not in Islamic banking. An IMF report in 2009 states that “Islamic banks and conventional banks faced similar risks in the global financial crisis in that (a) the risk profile of *Sharia*-compliant and conventional contracts are comparable; and (b) credit risk is the main risk for both types of banks. Unlike conventional banks, however, Islamic banks are not permitted to have any direct exposure to financial derivatives or conventional financial institutions’ securities—which were hit hardest during the global crisis” (IMF, 2009: 10). According to the report, it should be also noted in the same page that, while “Islamic banks were less affected by the initial impact of the global crisis, potentially reflecting a stronger first-round effect on conventional banks through mark-to-market valuations on securities in 2008”, “for the first half of 2009, data indicate slightly larger declines in profitability for Islamic banks compared to conventional banks, which could be linked to the second-round effect of the crisis on the real economy, especially real estate”. “In particular, the weaker performance of Islamic banks in 2009 was largely driven by the United Arab Emirates and Qatar, where they had a considerably higher exposure to the real estate and construction sectors” (IMF, 2009: 11).

Likewise, Hasan and Dridi (2010) point out the difference of performance of Islamic banks and conventional banks during the financial crisis, using bank-level data covering 2007-2010 for about 120 Islamic and conventional banks in eight countries, of which about one-fourth are Islamic. With regard to Islamic banks, their data “covers over eighty percent of Islamic banks globally if Iran is excluded”. As a result, Islamic banks could limit the adverse impact to profitability caused by the crisis better than conventional banks, yet, at the same time, “weakness in risk management practices in some Islamic banks” emerged clearly by the fact that their profitability declined in 2009 compared to conventional banks: Whereas change in profitability in 2007-2008 was -8.3% in Islamic banks and -34.1% in conventional banks, it was -47.9% and -13.4% respectively in 2007-2009. It is evident that the crisis gave worse damage to Islamic banks in the single year 2009. Therefore, Islamic banks are judged to have shown more stability during the initial stage of the global financial crisis and, however, it was less stable in the subsequent stage. In spite of that, Hasan and Dridi assume that the performances, such as lower leverage and higher solvency, were, over all, contributing factors for financial stability of Islamic banks.

Additionally, in terms of growth in credit and assets, Islamic banks kept better performance than conventional banks. Islamic banks’ credit and asset growth were “at least twice higher than that of conventional banks during the crisis” (Growth in credit in 2007-2009: 40.7% in Islamic banks and 19% in conventional banks; Growth in assets in 2007-2009: 31.8% in Islamic banks and 12.6% in conventional banks) (Hasan and Dridi, 2010).

If we take longer-terms after the crisis, as indicated in the Table 1.1, a statistical report in 2013 on competitiveness of Islamic banks published by Ernst and Young, an internationally reputable Islamic finance research institution which declares that their data sources come from central banks in the world, company financial reports, and interviews with banking executives and industry observers, also reveals that Islamic banks obviously grew much faster than conventional banks after the demise of the global financial crisis in the six countries which are called QISMUT (See the Footnote 6).

Table 1.1. The 5 Year CAGR (Compound Annual Growth Rate), Assets, and Market Share of Islamic Banks in Six RGM[6] : 2008-2012

Six RGM	CAGR of Islamic Banks	Compared with CAGR of Conventional Banks	Islamic Bank Assets (US$)	Market Share (%)
Qatar	31%	1.8 Faster	54b	24%
Indonesia	42%	3.1 Faster	20b	4.6%
Saudi Arabia	11%	3.6 Faster	245b	53%
Malaysia	20%	2.1 Faster	125b	20%
UAE	14%	3.0 Faster	83b	17%
Turkey	29%	1.6 Faster	39b	5.6%

Source: Ernst and Young, 2014 (Edited)

In addition, Amba and Almukharreq (2013) investigated impact of the financial crisis on performance of Islamic and conventional banks with analysis of 92 banks in GCC countries: 27 Islamic banks (IB) and 65 conventional banks (CB) in the years 2006 to 2009.

[6] RGM (Rapid Growth Market) is a group of 25 selective countries that have a good forecast in market growth with economies and populations over a certain size, and are strategically important for business. In particular, six countries of RGM, Qatar, Indonesia, Saudi Arabia, Malaysia, UAE, and Turkey are called QISMUT where Islamic banks are prospected to grow the fastest in the world.

First, ROE (return on equity) and ROA (return on asset), indicators of bank profitability declined by 41.33% and 67.60% respectively in Islamic banks (IB), while by 62.72% and 106.83% respectively in conventional banks (CB). However, decline in profitability was not significantly different between IB and CB during the crisis. Second, in respect of capital structure, ratio of equity and ratio of tangible equity decreased in IB by 8.49% and 13.19% respectively and in CB by 9.34% and 25.71% respectively. It is found that tangible equity ratio had statistically significant difference between IB and CB. Third, ratio of liquid assets to total assets, indicators of liquidity declined by 8.55% in IB and by 13.33% in CB during the crisis from which the authors conclude that there was no significant difference in liquidity between IB and CB during the crisis. Lastly, liabilities are measured based on deposit ratio (ratio of deposits to total assets) and overhead ratio (ratio of overhead costs to total assets). During the crisis, deposits ratio increased by 7.95% in IB and 6.36% in CB and overhead ratio also increased by 19.40% in IB and 31.83% in CB, meaning that ratio of overhead cost was significantly different between IB and CB during the crisis.

As initial conditions, Islamic banks have higher capital adequacy, are less leveraged, that is, have higher capital-to-assets ratio, and have smaller investment portfolios, all of which indicate the degree of stability, discretion and conservativeness of Islamic banks. While these financial performances are required to observe the Islamic banking principle, such as risk sharing (profit and loss sharing), not risk transfer as in conventional banks, and equity-based financing, not debt-based financing as in conventional banks, these performances have also effect of alleviating damages of any financial crises. This is the reason why the degrees of profitability and growth in credit and assets of Islamic banks were higher or maintained better and why Islamic banks were less affected by deleveraging than in the case of conventional banks when the financial crisis occurred, even if it hit Islamic banks harsher in the single year 2009 (Hasan and Dridi, 2010).

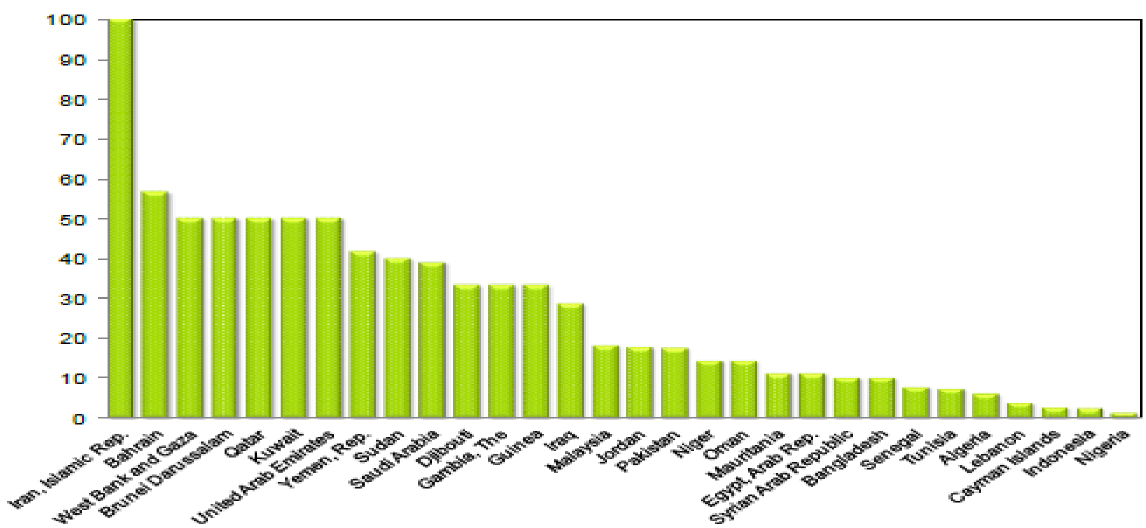
However, as initial conditions, Islamic banks have also some feeble factors: Managing liquidity in Islamic banking is difficult because infrastructure and tools for liquidity risk management by Islamic banks are still weak; *Sharia*-compliant interbank money markets led by an interbank rate are insufficient; less reliance on wholesale banks deposits; absence of lender-of-last-resort, and; underdevelopment of Islamic bond markets (*sukuk*) when compared to conventional counterparts. These factors which will be considered in detail in the second chapter were one of the reasons why, once the impact of the global financial crisis moved to the real economy, Islamic banks in some countries faced the larger losses especially in terms of profitability than their conventional counterparts in 2009 (Hasan and Dridi, 2010).

Here again, we should note that Islamic banks are in competition with conventional banks[7]. Imam and Kpodar attempt to identify the factors that are linked to the development of Islamic banking. Using various econometric estimation techniques, and with the sample data of 117 countries for 1992-2006, they concluded that income per capita, share of the Muslims in the population, status as an oil producer (oil prices), economic integration with

[7] Beck and the other (2010) found that the number of Islamic banks increased during twelve years from 1995 to 2007 by 300 percent. Sole (2007) also points out that the growth of Islamic banking is observed in the world, especially in GCC countries, South East Asia, and in the western countries where conventional bank are still competitive, being confronted with growth of Islamic banks. In accordance with their research and perspective, Srairi and Kouki (2015) found that Islamic banking is viewed as competitive and alternative to the conventional banking in many states of the world, particularly in GCC countries as well as in some Asian countries, which can be proved by the fact that Islamic banking assets have been growing at a faster pace (an average annual growth of 20%) compared with the overall banking assets during the last decade, with the expectation that Islamic banks will play a growing role in the succeeding years.

Middle Eastern countries (share of trade with these countries) and proximity to two Islamic financial centers, Bahrain and Malaysia, are meaningfully and positively linked to the diffusion of Islamic banks. The diffusion itself is supposed to be indicated by the share of Islamic bank numbers and the share of Islamic bank assets in total banking system. The Figure 1.2 and 1.3 show the share of Islamic bank numbers and the share of Islamic bank assets with recent data respectively. However, whereas most of these factors are formed into Islamic banks' internal relationships, the analysis cannot fully demonstrate the relationships of Islamic banks to conventional banks (Imam and Kpodar, 2010).

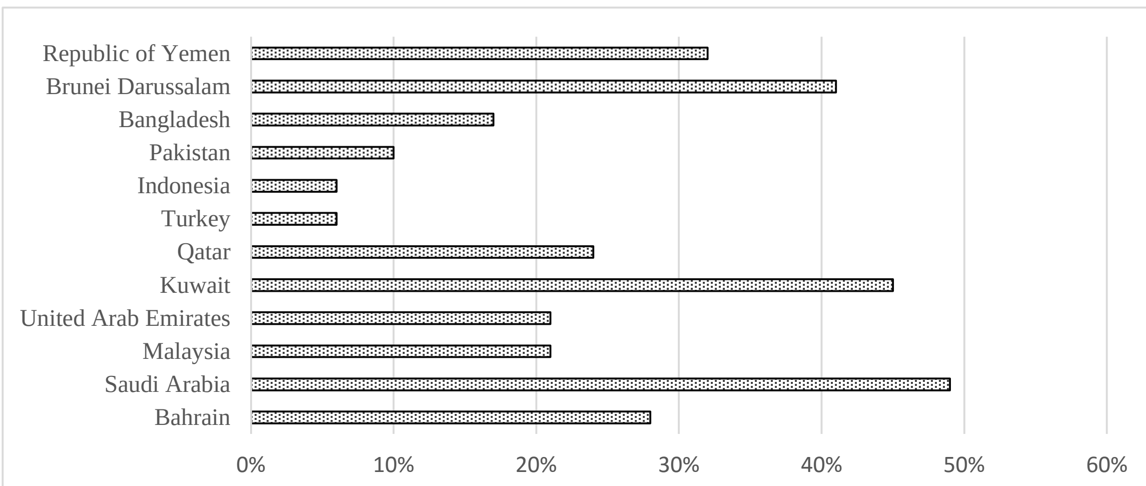
Figure 1.2. Share of Islamic Bank Numbers in Total Banking System in the Selected Islamic Countries, 2006 (in Percentage)



Source: Imam and Kpodar, 2010

However, more importantly, Imam and Kpodar point out that the interest rates of conventional banks have a negative impact on Islamic banks, which illuminates an aspect of competition between Islamic banks and conventional banks. If the interest rate of conventional banks is low, less devout Muslims and non-Muslims consider it as the lowering of opportunity cost of depositing their money with Islamic banks and are likely to increase them, and vice versa. Interestingly, a threshold value of interest rate is estimated to be 3.5 percent by Imam and Kpodar. On the other hand, the existence of a developed banking system is a positive factor on Islamic banks, as the dominance of sophisticated and competitive conventional banking system and their products is also accommodative to Islamic banks and stimulates their growth. Islamic banks "acts as a complement to, rather than a substitute for", conventional banks (Imam and Kpodar, 2010).

Figure 1.3. Share of Islamic Bank Assets in Total Banking System in the Selected Islamic Countries, 2013[8] (in Percentage)



Source: Ernst and Young, 2014 (Edited)

[8] The data are collected from publicly available data of 70 Islamic banks and 44 conventional banks in the sixteen countries: Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirates, Turkey, Bahrain, Kuwait, Pakistan, Bangladesh, Egypt, Jordan, South Africa, Sudan, United Kingdom, and Brunei. The Figure 1.3 consists of the best nine of these sixteen countries which are prospective countries of Islamic banking in the world. They are estimated to cover approximately 80% of total banking assets in those sixteen countries. While the research has some limitations in that it excludes Iran market because of its singular character and in that it does not cover all data of Islamic windows in conventional banks and subsidiary operations and offshore business in both Islamic and conventional banks, the Figure 1.3 reveals that Islamic bank is going in mainstream more and more in each national market: in Saudi Arabia, Kuwait, and Bahrain by 48.9%, 44.6%, and 27.7% respectively, probably owing to their increasing competitiveness.

At an initial stage, Islamic finance institutions (IFI) in GCC countries tended to emulate their conventional counterparts in terms of financial products offering, which can be observed in 2011 by the fact that the number of IFI which offer "general investment services" amounts to 13, compared with 16 conventional counterparts[9]. IFI entered into the financial market in GCC countries with a purpose of supplying these general investment services for Muslims customers. However, as competition with conventional banks in the investment banking services intensified, IFI tended to supply original financial products "on asset based in line with *Sharia* based principles" (Tawari, 2015). Thus, in the last analysis, emulation in the early stage of market entry might be thought as a good step for the early infiltration of Islamic banks into the market where conventional banks were dominant.

At the end of the arguments which reviews the previous theoretical and empirical researches, two remarkable qualities of Islamic banks are clarified: 1) Islamic banks have the solid base of moral and ethical values, and are obliged to comply with *Sharia*, although conventional banks cannot entirely neglect morality and ethics, too; 2) Performances which indicate banking stability were better in Islamic banks than in conventional banks when the severe global financial crisis erupted and in a several years before and after the crisis, which were due to their fundamental discreet and conservative principles, although they could not escape from spillover of crises whose origins were found in conventional finance.

[9] As already stated above, each national Islamic real estate and capital market in GCC region by and large dropped down drastically about one year after the global financial crisis which erupted in 2007. Related to this failure, Aksak and Asutay cast a doubt on expansion of Islamic financial institutions, saying that they have become too integrated with the means of conventional finance, to the extent that they have been mimicking the conventional finance markets, "causing asset bubbles, speculation, and divergence from the real economy" together with conventional counterparts (Aksak and Asutay, 2015).

Additionally, it is easily recognized from these considerations that Islamic banks have always close relationship with conventional banks, and that they are always confronted with influences of conventional banks whose scales are much larger than those of Islamic banks.

1.3. Review of Previous Research of Islamic Banks in Indonesia

Islamic Banking in Indonesia: New perspectives on Monetary and Financial Issues in 2013 (Wiley Publishing) is the first English book on the theme of the Indonesian Islamic banking industry that was published internationally (Ismal, 2013). It was elaborated by an author, Rifki Ismal, and he identifies in the book some challenges of Islamic banks in Indonesia and advocates some propositions to solve them. This doctoral dissertation refers to him a number of times. I appreciate Ismal for his pioneering study of the Indonesian Islamic bank study. There were few scientific publications on Indonesian Islamic bank at the international scale before his book. An interview with him conducted by me in August 2014 is also beneficial to my research.

Ismal sees that the Islamic bank in Indonesia mainly has two challenges: (a) a small market share, and (b) a lack of human resources. Ismal provides solutions to a small market share: (a-1) *Hajj* funds should be transferred principally to the management of Islamic banks; (a-2) Conventional banks owned by the government should be converted into Islamic banks (It was proposed in the context of how to reform the state owned banks); (a-3) Islamic banks, in order to attract customers, should improve performance such as returns, and; (a-4) Motivation to use Islamic banks should be increased, motivation not only of material remuneration in the secular world, but also of Islamic practice for the hereafter.

However, (a-1) and (a-2) must resort, if they are truly realized, to some forcible methods in a wider context of politics which are out of consideration in my doctoral dissertation. Instead, the dissertation, being based on (a-3) and empirical analysis of the current financing and funding structure of Islamic banks in Indonesia, presents a few solutions to solve a small market share as follows: (a-3-1) Target of financial market segmentation of Islamic bank in Indonesia should be changed and be focused more on medium and large companies; (a-3-2) Composition of short-term deposits should be also converted into long-term ones, and; (a-3-3) Finance (investment) and funds themselves should be diversified in the other areas than direct financing and deposits, such as investment in securities, equity participation, and raising funds in the *sukuk* market. Furthermore, (a-4) is also so suggestive that I design tentatively (a-4-1): an approach of socializing Islamic banks which ought to be considered by the Indonesian public as socially and morally significant existence. In particular, I propose an educational program of Islamic banks which starts from the bottom level to the highest education which will create well-educated Indonesian citizens who understand Islamic banks well and save their money there as a practice of their mission for the religion.

With regard to the second challenge, (b) a lack of human resources, Ismal recommends that: (b-1) The government provides incentives for establishment of formal and informal institutions which provide educational curriculum of Islamic banking and finance, and; (b-2) Islamic scholar and academic professionals write and publish text books on Islamic economics, banking and finance.

However, these suggestions may be too simple and therefore, may be more materialized as follows: (b-1-1) Socializing the public in a nationwide scale and at a grass root level should be promoted in order to let the public embrace widely and profoundly consciousness of Islamic banks; (b-2-1) Professionals and experts should be brought up in the higher educational institutions. The first solution (b-1-1), that is, Islamic bank socialization, is connected to the fourth solution of a small market share of Islamic banks by enhancing customers' motivation to use them.

The dissertation explains the second suggestion, that is (b-2-1), for resolving insufficient human resources by bringing up professional employees (roughly corresponding to those who have been educated in curriculum or program of Islamic economics, banking and finance in undergraduate schools) and experts (roughly corresponding to those who have been more profoundly educated and trained in master and doctoral courses in graduate schools). Professionals are expected to support the operations of Islamic banks, help the banking system to function better, and increase and maintain credibility of the Islamic banking to the public. Islamic bank experts are expected to participate in what is called think tanks of Islamic banks. They can produce some new discoveries through research, training, articles, and the others.

Next to Rifki Ismal, it is worth here referring to Angelo M. Venardos who describes, in *Islamic Banking and Finance in South-East Asia: Its Development and Future*, Islamic banks in each country in East Asia from a comparative view point and gives the future perspective of the development of Islamic banks in the region and in each country (Venardos, 2012). I especially remark the eighth and the ninth chapters where he explains and compares Islamic banks in Malaysia and Indonesia.

Venardos explains that Indonesia has a market-based economy in which the government also plays a significant role, meanwhile Malaysia is described as a country where, high levels of foreign and domestic investment, rather than governmental elements, play a significant role which has changed the Malaysian economy into diversified and modernized one. However, as he argues, the differences of national economy delineated above cannot be applied straightforwardly to comparison of Islamic banks in Malaysia and in Indonesia.

For example, the central bank of Malaysia (Bank Negara Malaysia) has led liberalization of Islamic banking sector since 2004 and issued three new licenses to Islamic financial institutions from the Middle East from the year 2007. Here we admittedly find a dependency on foreign Islamic investment. However, he also remarks an initiative of Malaysian government in founding the Malaysia International Islamic Financial Center (MIFC) in 2006 to promote Malaysia as a major hub for International Islamic finance. MIFC has actually played an important role in accelerating a process of bridging and strengthening relationships between international and Malaysian Islamic financial market by offering a well-established hub for enhancement of knowledge, research, and intellectual discourses in the specialized training program of Islamic finance and banking in the universities and the other institutions. In addition to these policies, the government has continually amended tax and accommodated regulations to facilitate Islamic finance in Malaysia. It is obvious from these actions that Malaysian government plays an initiative role to develop Islamic banks in the country.

Being suggested by the comparative study of Venardos, my doctoral dissertation attempts to find whether there are aspects in Islamic banks in Indonesia that are different from the types delineated by Venardos. As a result, I found that the government is not always a leader of growing the Islamic banks as in Malaysia: While *Sharia* compliance system in

Malaysia can be characterized to take rather a top-down approach under the leadership of the central bank and the government which have motivation of bringing up the international Islamic financial center in the country, *Sharia* compliance center in Indonesia can be said to take a bottom-up approach owing to an influence of MUI, a Muslim religious and intellectual association which is an substantial organizer of *Sharia* compliance system.

1.4. Theme and Component of the Doctoral Dissertation

Taking into consideration the theoretical properties and empirical performances of Islamic banks and their relationship to conventional banks which were clarified in the first and the second sections, and following the study of Rifki Ismal and Angelo Venardos in the third section, here I will show the theme and the components of the doctoral dissertation. "Possibility of Intensifying and Socializing the Islamic Banks in Indonesia: Supporting the Indonesian Financial System Stabilization and Searching for Social Significance in the Islamic Banks in Indonesia" implies two things as follows: 1) If it can be generally assumed that Islamic banking is more stable for their good performance against fluctuations of the international finance than conventional banking in the long term, it may also make the Indonesian financial system which already introduced the dual banking system (coexistence of conventional banking and Islamic banking which will be explained in the next chapter) more robust and stable, and; 2) At the same time, Islamic banks not only should pursue scale of economy, but also should keep its solid base of moral and ethical values. Concerning to the latter, as a matter of fact, as discussed later in the fourth chapter, Indonesian Islamic banks have so far maintained well its *Sharia* compliance system. Hence, I will consider in the following chapters a possibility of intensifying the Islamic banking in Indonesia which, at the same time, should not lose the fundamental course of Islamic moral and ethics in the country.

In the Chapter 2, I will overview the current national banking systems in the world which are roughly categorized into three: the first (conventional), the second (Islamic), and the third (mixed) banking system. The global financial system where most of the countries adopt the conventional banking system has a weakness in that it often propagates economic crises. Meanwhile, the Islamic banking system, although it has several intrinsic advantages, such as discrete and nonspeculative management, and the less probability that it causes the financial turmoil, and so on because of, for example, the profit and loss sharing (PLS) system in banking operations, is comprised by few countries. Lastly, in the third (mixed) banking system, conventional banks and Islamic banks coexist. PLS system is principally more secure and stable against exogenous financial risks and fluctuations in interest rates and foreign exchange rates, if not perfectly. Previous empirical researches on stability of Islamic banks and conventional banks will be surveyed again in the second chapter.

We can now prospect a high-potential international market in the world for the Islamic banks. Such remarkable growth has been possible by several factors: Islamic banks are latecomers in the banking industry; Development of middle Muslim classes especially in Asia is considerable, and; ongoing transformation from a conventional bank to an Islamic bank is relatively smooth. These factors are backgrounds on which, even if the second (purely Islamic) banking system is not likely to increase from the various reasons, the third banking system (coexistence of conventional and Islamic banks) is prospected to develop.

In the Chapter 3, I will focus on the current third (mixed) banking system in Indonesia and, after overviewing Islamic bank legislation and regulatory system, *Sharia* compliance system, and constellation of conventional and Islamic banks in the third banking system in the country, I ascertain that, in spite of a few reforms after the Asian currency crisis in the years 1997 to 1998, and their noticeable outcomes, Indonesia where 95% of banking assets pertain to conventional banks, still has the potentially vulnerable financial system and is susceptible to the serious market risk.

In such a circumstance, Islamic banks in Indonesia have been growing in recent years alongside the global trend, although the degree of development in Indonesia is still low. Here again, following the first and the second chapters, previous empirical researches on stability of Islamic banks and conventional banks before, during and after the financial crises in Indonesia are surveyed. Considering a role of Islamic banks, if not sufficient, supportive for stabilization in the Indonesian financial system, it would be desirable to intensify Islamic banks for stabilization of the overall financial system in Indonesia. If Islamic banks in Indonesia have any potentiality of stabilizing the national financial system in the long term, they are objectively needed to be intensified in the country which holds the most Muslim population in the world.

The Chapter 4 will consider how to intensify Islamic banks in Indonesia. There are some problems to be overcome: shortage of human resources and suboptimal financing and funding structure. Therefore the following measures should be taken for developing Islamic banks in Indonesia: bringing up professionals and experts in Islamic banks; optimization of financing and funding structure and diversification of financing and funding contracts and products, and; utilization of *sukuk* as one of the prospective contracts in the Islamic investment market.

Sufficient supply of qualified professionals and experts can be ensured through higher education in the graduate and undergraduate schools of the universities. Current market segmentation of Islamic banks in Indonesia should be changed from enterprises of micro and small scale to those of medium and large scale. In tandem with this, composition of main funding should be converted from short-term deposits to long-term savings funds. Furthermore, placement of funds itself could be more various from financing to the other areas, such as investments in *sukuk*, Islamic equity participation, and the others. Funding also should be less concentrating into deposits and saving and be more diversified. Extension of the *sukuk* market in Indonesia as an instrument of financing and funding should be activated by Islamic banks.

I will also attempt to compare Indonesian and Malaysian Islamic banks in some aspects in the Chapter 4. While Malaysia and Indonesia are growing rapidly in Southeast Asia and have also great potentialities for developing Islamic banking in the world, assets, deposits, and capital of Islamic banks are all much larger in Malaysia. The first Islamic banks established in Malaysia and in Indonesia are Bank Islam Malaysia Berhad and Bank Muamalat Indonesia respectively and they are still the largest Islamic banks in each country. The chapter reviews some differences of Islamic banks in the two countries concerning financial contracts, Islamic interbank money market, compliance of *Sharia* (Islamic law) system and the government role.

Findings of the comparative analysis that I attempt in the Chapter 4 are as follows: Malaysia uses a top down and market-oriented approach for growing Islamic banking and, with the leadership of the government and the central bank, has an ambition to be an international hub of Islamic banking in the world. However, Malaysia tends to be generous in *Sharia* interpretation and compliance one of whose symbolic results is a few financial products of Islamic banks that are permissible in Malaysia but are prohibited in the other most Islamic countries. On the other hand, Indonesia has long adopted a bottom up approach for promoting Islamic banks. While Indonesia is stricter in observing *Sharia* rule, it does not tend to be more aggressive to expand Islamic bank market with a simple commercial motivation as seen in Malaysia. Implications for Indonesian Islamic banking deduced from the comparative analysis are: Firstly, the Indonesian government, just as the Malaysian government does, should be more active in funding and capitalizing Islamic banks and in supporting them to be larger scale for the sake of realizing high level of efficiency, and; secondly, however, Indonesian Islamic banks should keep *Sharia* standard consistently in terms of their social significance.

From the second implication mentioned above, I will remark in the Chapter 4, importance of Islamic banking and finance in not only higher education, but also through the national education system which can be started from kindergarten school, to elementary school, junior high school, high school, and university, to facilitate understanding of Islamic banking and finance in the Indonesian citizen, potential customers of Islamic banks. It gives an orientation of argument in the Chapter 5 where I will refer to the national education in Indonesia again. However, here is it not simply for intensifying the Islamic banking sector, but for socializing Islamic banks, taking into consideration that Islamic banks have the solid base of moral and ethical values.

Therefore, I will limit my focus on an issue of how Islamic banks in Indonesia can be socialized. After distinguishing concept of socialization from marketing in the second section next to the introductory section in the Chapter 5, I will overview the ongoing performances of socialization of Indonesian Islamic banking in the third section and point out, in the fourth section, some problems of the ongoing socialization and remark an Islamic popular institution, MUI (*Majelis Ulama Indonesia*: Indonesian Ulama Council) which is highly esteemed both from the Indonesian society widely and from the government as an important facilitating element for proceeding more continuous and better organized socialization. In the next fifth section, I will attempt to design a tentative sketch of "the Organized, and Continuous [OC]" socialization program conducted mainly by MUI. Lastly, as a conclusion, it will be stated that as far as Islamic banks in Indonesia have a willingness to be based on *Sharia* compliance, socialization program is well worth consideration. Indonesian Islamic banks should keep *Sharia* standard in consistent with their social significance.

As I mentioned at the beginning in this introductory chapter, I hope that the thesis will be able to contribute academically to the study of the Indonesian Islamic banks in that it will succeed in making an approach which synthesizes a way of intensifying Islamic banks in Indonesia in an economic and commercial point of view on the one hand and a way of searching for socializing them in a moral and ethical point of view on the other hand.

Chapter 2. An Overview of Current Banking Systems in the World: Comparison between Conventional and Islamic Banks

2.1. Introduction

Based on dichotomy of conventional banks and Islamic banks, national banking systems in the world are divided into three categories: 1) interest-bearing banking system [conventional banking system] where there is no special laws regulating usury-free banking; 2) Islamic banking system where all banks are subject to the laws regulating usury-free banking, and; 3) mixed banking system [dual conventional and Islamic banking system] where special laws regulating usury-free banking are supplied beside the laws governing usury-taking banking (Wilson, 2012).

Currently, the countries which adopt conventional banking system are much more than the countries which belong to the other two categories. Therefore, interest-bearing banking system is dominant in the world[10]. The country that adopts Islamic banking system is said to be one, that is, Iran. Pakistan and Sudan, although they had once introduced Islamic banking system, chose the mixed banking system later. Mixed banking system is adopted by, for example, Malaysia, Indonesia, and Kuwait.

Islamic banks have so far traced three historical stages: 1). The early Islamic finance for specific practices, but not equipped with modern banking management methods, such as Mit Graham bank, the first Islamic bank in the world in 1963 in Egypt and Tabung Haji in Malaysia in 1960s (Venardos, 2012); 2). Modern Islamic banks, such as Dubai Islamic Bank,

[10] Although Saudi Arabia is "the heartland of Islam and its ruler is designated as custodian of the two holy shrines, there is no legal provision for Islamic banking and there was no religious scrutiny of the Banking Control Law of 1996" (Wilson, 2012).

that began to be introduced in 1975 (Asutay and Turkistani, 2015), and; 3). Internationalization of Islamic banks and financial institutions since 1990s. Model of Islamic banking and financing has been well received by a lot of new comers in the world and, as a result, Islamic banks and financial institutions are now located in more than 75 countries, whether they are Muslims or non-Muslims, where knowledge and concept of Islamic banking and financing are being accepted steadily.

I will firstly demonstrate in the second section that the global financial system in which most countries adopt conventional banking system has a tendency of being fluctuated by the exogenous factors. Then I will explain in the third section that Islamic banks have the financial contracts and products different from conventional ones and point out that the various international institutions supporting and governing Islamic banks are now developing. Then I observe in the fourth section that we can find mixed banking system in some countries and discuss that, whichever banking system a country may choose, it cannot easily escape financial risks which both banks should be faced with. Lastly, however, in the fifth section, I review, following the first chapter, some researches which compare financial performance of Islamic banks and conventional counterparts in the world and draw from them a conclusion that Islamic banks performed better than conventional banks before, during and immediately after the turmoil of the global financial crisis.

2.2. Volatility of the Global Financial System

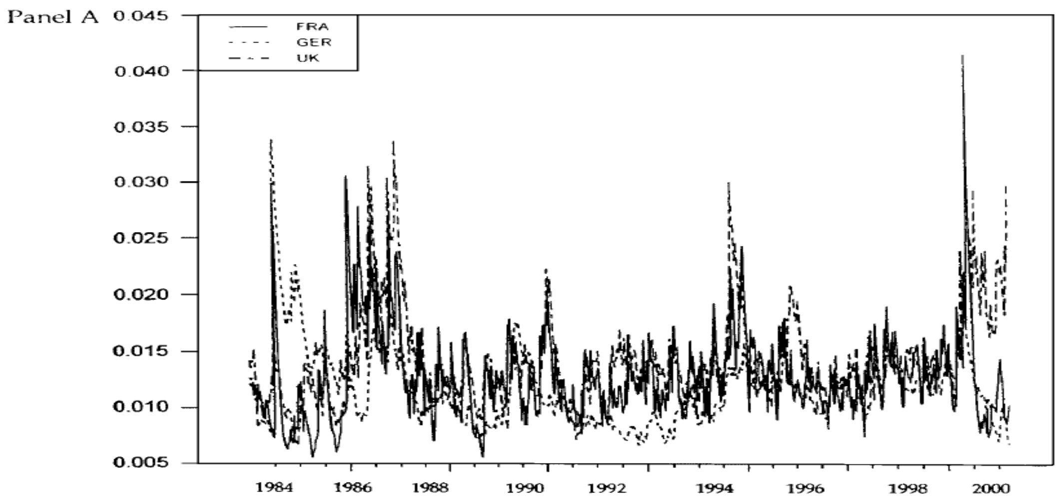
Conventional banks usually take interests as an important part of their banking activities. Interest rates are the key factors for them. However, interest rates are potent in causing bank loss, leading to bankruptcy. For example, in the serious Asian currency crisis in 1997, bank interest rates in Indonesia were increased sharply up to 60 percent. Consequently, at that time, bank had to disburse high amounts of interests to their depositors, causing them to suffer from unexpected high expenditures. As a result, more than 65 conventional banks in Indonesia were forced to be closed (Fane and McLeod, 2002).

On the other hand, at the first glimpse, depositors seemed to gain a towering sum of money from their deposits with those elevated interest rates, which was nominally profitable. However, this condition is probably accompanied with considerably increasing price of goods and services. Overall, this meant that the high interest rates which occurred in Indonesia in 1997 did not provide a significant advantage for depositors, too.

Interest rates change in one country is likely to influence interest rates in the other countries, causing them to move up and down with high volatility. The volatility is caused not only by investors' decision on their global portfolio, but also by market efficiency. This is consistent with a research of Laopodis (2003) who traced weekly five-year long-term interest rates in the specific eight countries, namely Belgium, Canada, France, Germany, Japan, Netherland, the United Kingdom, and the United States of America.

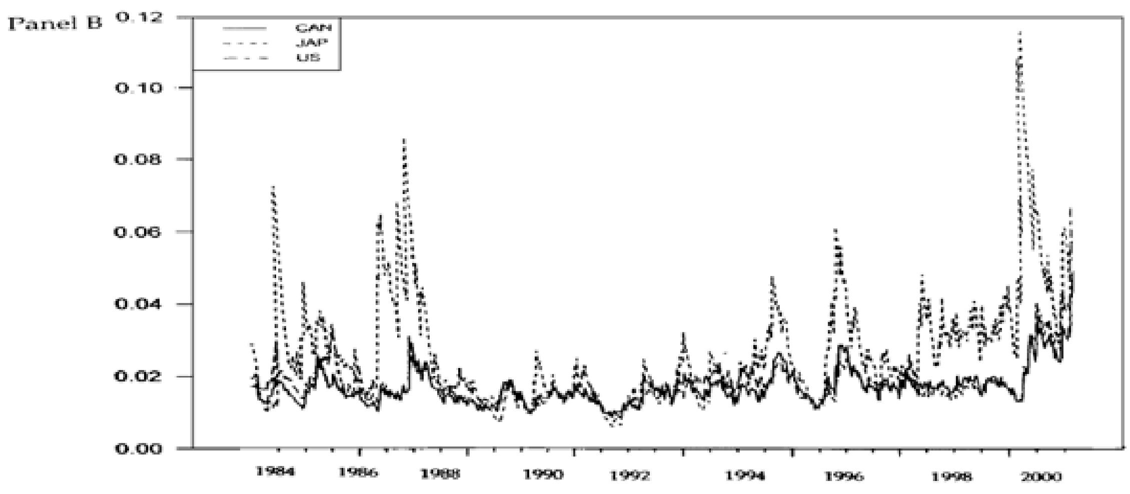
Prior to it, Laopodis (2002) also revealed volatility linkages among bank interest rates. Citing past shocks such as the stock market crash of October 1987, the turbulence of the early 1990s in the European Monetary System (EMS), the financial problems in the Asian markets in the late 1990s, and the collapse of the Argentine economy in 2001, he succeeded in visualizing a velocity of domino effects from the shocks in the integrated financial markets. As domestic and international markets are increasingly synchronized, and as the volumes of international trades and investments increase, the cross-border disturbances are more and more expanded and recurrent (Ibid., 231).

Figure 2.1. Volatility Linkage among Bank Interest Rates (France, German, and UK) in the Years 1984 to 2000



Source: Laopodis, 2002

Figure 2.2. Volatility Linkage among Bank Interest Rates (Canada, Japan, and USA) in the Years 1984 to 2000



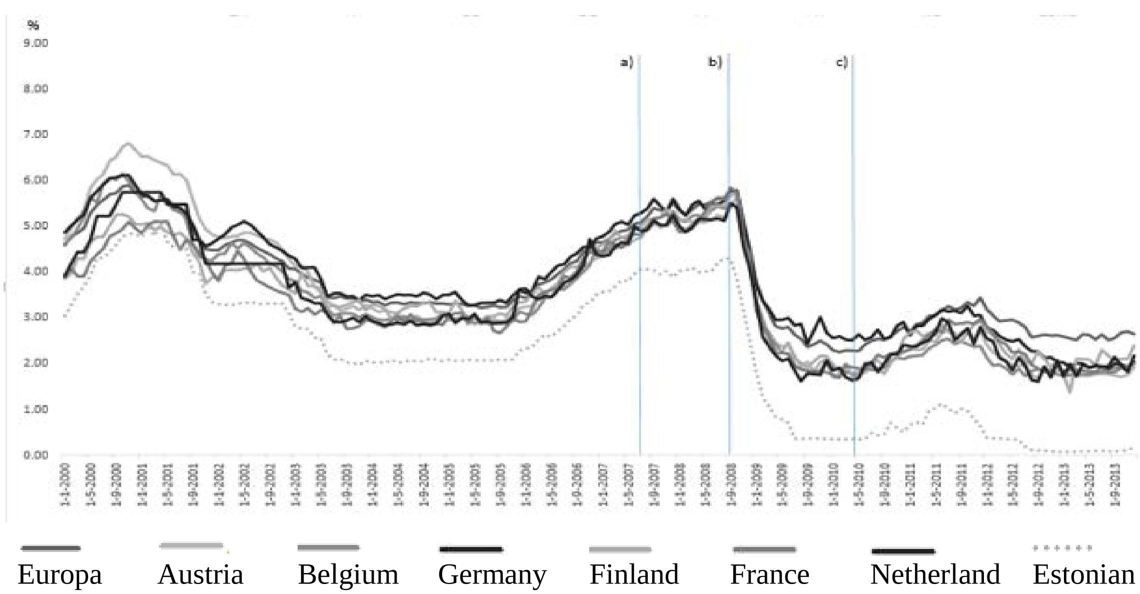
Source: Laopodis, 2002

The Figure 2.1 and 2.2 indicate that both the fluctuations of long-term interest rates in France, German and UK in the Figure 2.1 and those in Canada, Japan and USA in the Figure 2.2 are recurrent and simultaneous respectively. The peaks of fluctuations are discerned in

1984, 1987, 1991, 1995, and 1999. These movements of interest rates indicate instability in the global financial system where fluctuations of interest rate are also likely to make the volumes of assets, loans, and the other transactions unsecure.

We can discern the international volatile movements in interest rate in recent years, too. Borstel and the others show us the Figure 2.3 below, revealing that, while interest rate in each member of the Euro area naturally tends to converge due to a common monetary system, the short-term lending rates from 2000 to 2013 in the Euro area were fluctuated so often: They were in slight slowdown trend from 2000 to 2005, after an erupt in the latter half of the year 2000. An uptrend occurred in 2006 and it continued to 2008, the year when the global financial crisis took place. Afterwards, it dropped dramatically into a relatively low level from 2009 to 2011 before a mild cycle with a peak in the beginning in 2012 (Borstel et al, 2015).

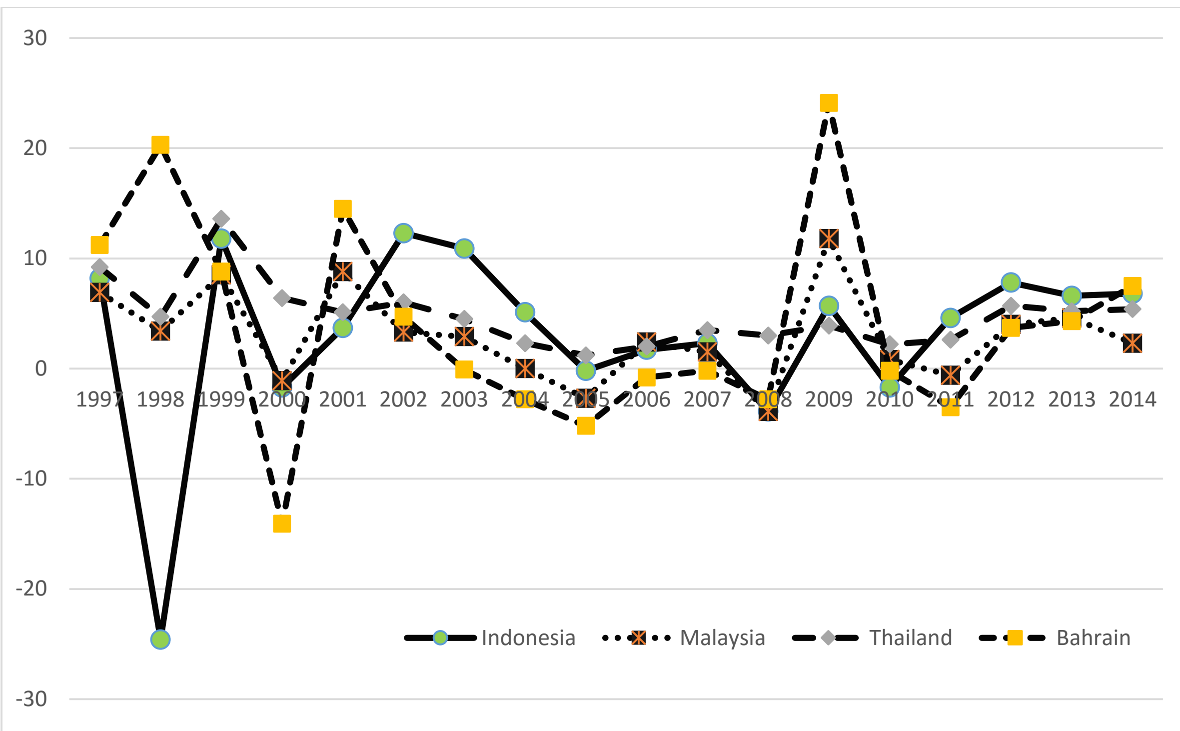
Figure2.3. Short-term Lending Rates in the Euro Area and the Selected Core Countries: 2000-2013



Source: Borstel et al, 2015

Furthermore, with regard to some countries including Indonesia as well as Malaysia, Thailand, and Bahrain, real interest rates (lending interest rate adjusted for inflation as measured by the GDP deflator) have also fluctuated frequently and simultaneously, as shown in the Figure 2.4. High volatility occurred several times in all four countries, in particular, in the financial crisis with a global scale, such as in 1998 and in 2009, with an exception of Bahrain in 1998.

Figure 2.4 Real Interest Rates in Indonesia, Malaysia, Thailand, and Bahrain: 1997-2014 (in Percentage)



Source: World Bank, 2015 (Edited)

Although Indonesia, Malaysia, and Bahrain that appeared in the Figure 2.4 have adopted the mixed banking system and have introduced the Islamic bank regulatory system in tandem with the conventional bank regulatory system, it is evident that the current global financial system where the conventional banks are overwhelmingly dominant has a weakness. It may propagate immediately, with many probabilities, financial crises that erupted in one country to the other countries under the same system. At the same time, more importantly, it raises necessity to argue an alternative banking system that is more resistible to the complexity of the current conventional banking system.

International inflow and outflow of capital is one of the main factors of fluctuation of interest rates. On the contrary, change of interest rates often causes international capital movements. Under the current complex system of the international finance[11], foreign capital inflow and outflow from one country to the other countries is easy to manipulate. When huge capital outflow from a country occurs suddenly, it leads to depreciation of currency rate of the country and increase of interest rate consequently (Rajan, 2007). Government may also prefer to increase interest rates to make capital comeback to the country, especially if capital continues to outflow from the country. This makes condition of banking and financial system unstable[12].

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[11] Rickards (2011) warns that complex financial systems have a benign organizing principle and, absorbing all available energies, will end in destroying the system itself. Capital and currency markets are such complex that it will collapse in the end unless they are contained, compartmentalized and descaled. The dollar today is more and more being destabilized due to derivatives and leverage. As a consequence, he argues that the "currency wars" will cause the next global crisis through the complex systems. Eichengreen points out financial regulatory system cannot control investment banks effectively. Investment banks gamble their and their partners' money largely outside the regulatory network (Eichengreen, 2011). From these arguments it cannot be denied that conventional banking cause instability in the international financial system.

[12] Kaufman justifies it from the standpoint of investors as follows: "International portfolio investors may prefer to reduce their risk exposures by diversifying geographically in foreign currency securities across a number of countries. If one of their countries experiences difficulties that reduce the value of its securities, the value of the entire portfolio declines and the investors will need to sell securities of other countries in order to rebalance their portfolios to the original mix. Such sales will exert downward pressure on the exchange rates of these countries. This

2.3. Development of Islamic Banks

2.3.1 Profit and Loss Sharing (PLS) System

Islamic banks are mainly controlled by profit and loss sharing (PLS) system where profit and loss is to be shared between Islamic banks and customers. Generally speaking, banks conduct two main activities: collecting deposits (funding) and distributing them (financing). Indeed, Islamic banks also have these two functions as well as conventional banks. However, Islamic banks are different from conventional counterparts in the regard that they have PLS system. In relation to this, Islamic banks do not charge bank interest because it is believed that bank interest, *riba*, should be prohibited. *Riba* means "additional". *Riba* in the banking terminology is extra money charged from customers who borrow money from banks. Islamic banks can be called Free Riba (FR) banks[13].

Theoretically, PLS system is pointed out to be more secure and stable against fluctuations in interest rates and foreign exchange rates in the market. In PLS system, profit is divided on an agreement between Islamic banks and customers (depositors and

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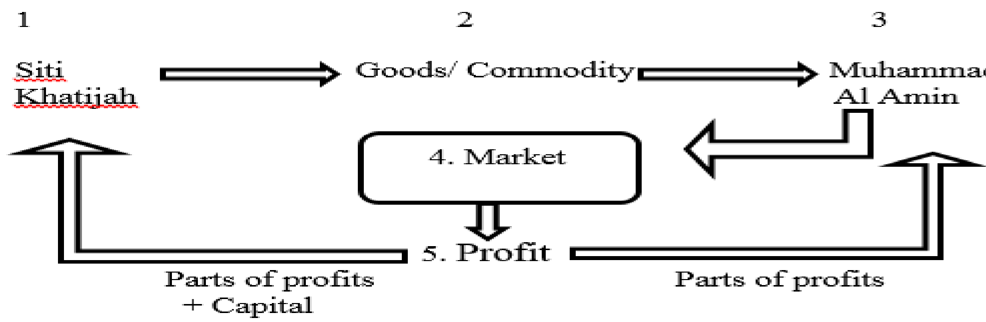
channel has been used by some analysts to explain the contagion that transmitted downward pressure on exchange rates to Latin America, particularly Brazil and Argentina, from Russia following its devaluation and debt default in the summer and fall of 1998" (Kaufman, 2000).

[13] It is needless to say that Islamic finance is as rational in economic terms as conventional finance and that Islamic bankers search for rationality in every activities and efficiency and competitiveness in the financial market. However, as we argued in the first chapter, Islamic banks are also religiously obliged to seek to keep "a balance between profit and social responsibility" (Rudnyckyj, 2014).

entrepreneurs)[14]. Entrepreneurs should return the capital and a part of profit to Islamic banks. Loss is treated in the same way[15].

Figure 2.5. Concept of Profit Sharing



Source: PKES (Pusat Komunikasi Ekonomi Syariah: Islamic Economic Communication Center), 2008 (Edited)

[14] As Islamic banks avoid interest and interest-based assets and restrict speculations, it can secure itself as "nonspeculative equity ownership" that is linked to the real sector and "where demand for new shares is determined by real savings in the economy". Savings are employed into productive investment with no money creation from nothing. Hence, demand for and supply of shares tends to be stable. As Islamic banks with profit-sharing basis own real assets and participate directly in production and trade activities, an overall rate of return of them is determined by the economic growth rate (Askari et al, 2011).

[15] According to Z. Ahmed, "it is generally agreed that there is nothing objectionable, from the Sharia point of view, in the deposits of an Islamic bank having different maturities". Therefore, deposits of Islamic banks are said to have each counterpart of conventional banks. Demand deposits which in conventional banks are fully repayable on demand continue to maintain the same function in Islamic banks. However, in contrast with demand deposits, saving deposits and time deposits which in conventional banks usually bear a fixed return by way of interest do not bear any contractually fixed interest. Returns of these types of deposits "fluctuate with the profits of Islamic banks". If the banks incur a net loss in the operations, depositors are to share the loss with the banks. Due to this profit-loss sharing system, time deposits in Islamic banks are called investment accounts or investment deposits. Ahmed explains that "Islamic banks can also have specific investment accounts in which deposits are made for investment in particular projects" (Ahmed, Z., 2000).

In the Figure 2.5 shown above, Prophet Muhammad ruled from God and began to teach Islam in the early 7th century. Pre-defined as prophet, Muhammad showed excellent behaviors, one of which was to behave as a trustworthy person, and that is why Muhammad was reputable as an honest person or, in Arabic, as "*Al-Amiin*". Siti Khatijah was a female entrepreneur who provided capital (goods/commodity) to trustworthy Muhammad (*Al-Amiin*). Muhammad brought it to the market. Transaction resulted in some profit. It was divided on a pre-defined agreement between Siti Khadijah and Muhammad. Adding to this dealing, Muhammad returned capital to her and Siti Khadijah gained it.

a. Deposit

Islamic banks offer saving account, current account, and time deposit that follow the rules of Islam law.

a-1) Saving account

Saving account is divided into *Wadiah* and *Mudharabah*. *Wadiah* is placement of funds in the form of storage, for example, *Hajj* savings. In this instance, Islamic banks merely offer an opportunity of *Hajj* fund storage. Meanwhile, *Mudharabah* deposit takes a form of savings under profit and loss sharing (PLS) system based on an agreement between Islamic banks and customers where the former give bonus to the latter if there is profit (minus bonus, if loss). In contrast, in *Wadiah*, Islamic banks are not mandated to give a bonus to customers.

a-2) Current Account

Likewise, current account is also divided into two types, *Wadiah* and *Mudharabah*. A difference between saving account and current account is in the regard that the latter is used usually by corporate customers which often withdraw a large amount of money through checks.

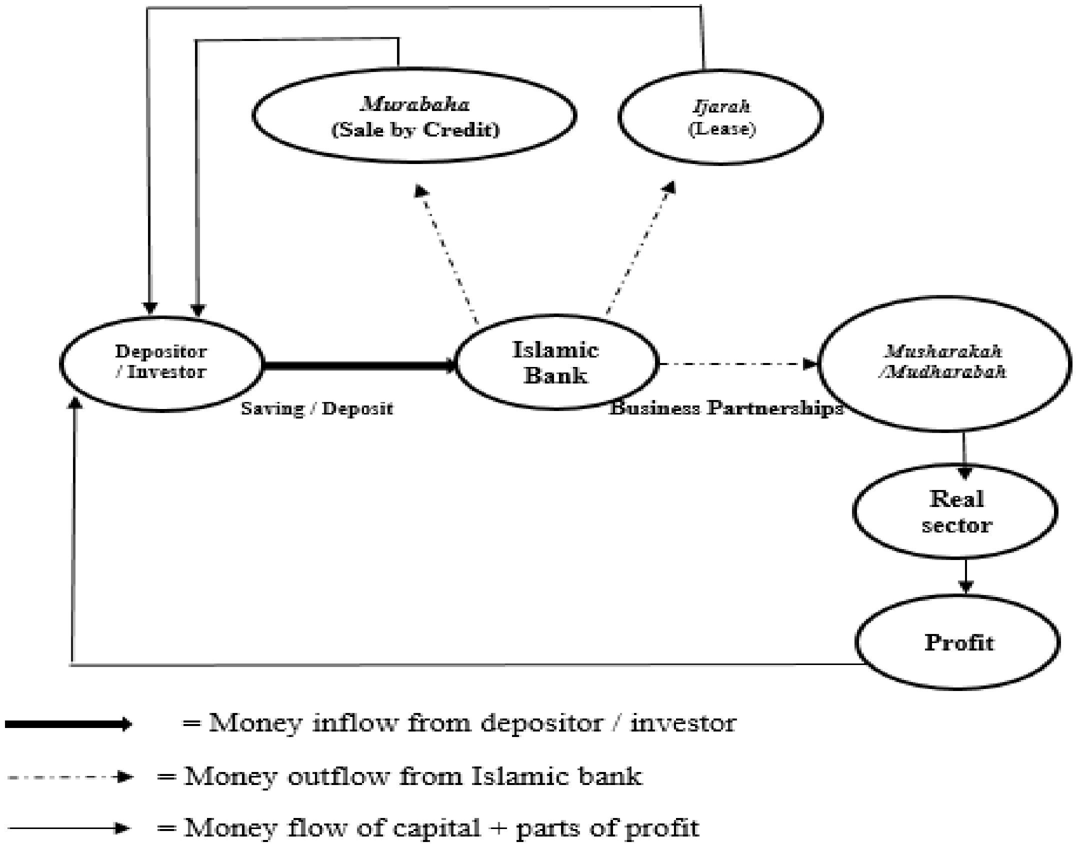
a-3) Time Deposit

Time deposit is invested into Islamic banks based on the principle of *Mudharabah* which is withdrawn after certain terms, such as 1, 3, 6, and 12 months, and in some cases, time deposit offers longer terms than 12 months, such as 24, 36, and 60 months.

b. Financing

Islamic banks offer loan or financing in several types: In addition to PLS contracts, *Musharakah* and *Mudharabah*, there are two other main contracts used by Islamic banks: *Ijarah* (lease) and *Murabaha* (selling in installments). The concept of these four main contracts, *Musharakah*, *Mudharabah*, *Ijarah*, and *Murabaha*, may be explained concisely in the Figure 2.6 shown below. Depositors or investors save money in Islamic banks. Islamic banks can process the trusted money following the procedures based on these contracts. Simply speaking, the results of processes through the bank managements are profits. Islamic banks, in turn, are to give some of their profit plus capital to depositors or investors.

Figure 2.6. Concept of Mechanism and Operational System of Islamic Bank



Source: PKES (Pusat Komunikasi Ekonomi Syariah: Islamic Economic Communication Center), 2008

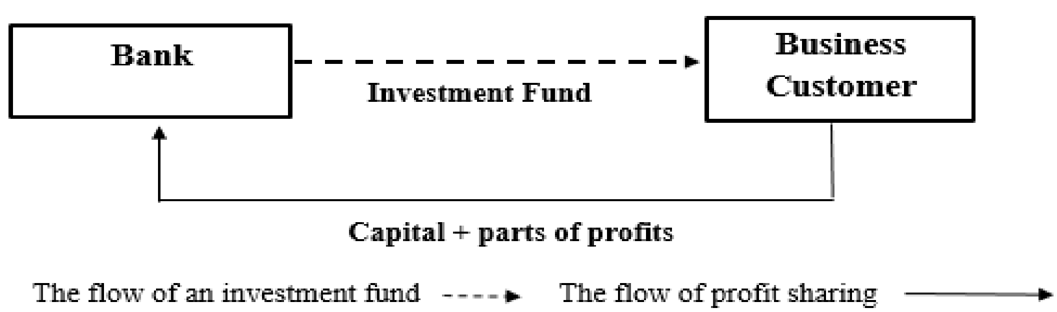
b-1) PLS (Profit and Loss Sharing)

The general principle of PLS in Islamic banks actually takes the form of *Mudharabah* (or *Al-Mudharobah*) (trust financing and investment trust) and *Musharakah* (or *Al-Musyarokah*) (equity participation). PLS based on *Mudharabah* is financing where customer as manager (*mudharib*) and Islamic bank as capital owner (*shahibul maal*) share profit or loss on an agreement of proportion (*nisbah*) such as X percent for customer and Y percent for Islamic bank respectively. PLS based on *Musharakah* is financing where customer and Islamic bank provide fund for one project, after which profit or loss is shared on the agreement between customer and Islamic bank, with their derivative financial contracts, *Al-Muzara'ah* (harvest yield profit-sharing), and *Al-Musyaqah* (plantation management fee based on certain portion of yields). Concisely, they are said to be the financial partnerships[16].

b-1-1) *Mudharabah*

In *Mudharabah,* an Islamic bank provides capital to an entrepreneur. Islamic bank and entrepreneur make a deal agreement on which the result of operations, whether profit or loss, is shared together (based on ratio). For example, 60 percent of profit is divided to entrepreneur, and 40 percent to Islamic bank. 100 percent of capital must be returned to Islamic bank[17].

Figure 2.7. Concept of Mechanism of Financial Partnerships (*Mudharabah*)



Source: PKES (Pusat Komunikasi Ekonomi Syariah: Islamic Economic Communication Center), 2008 (Edited)

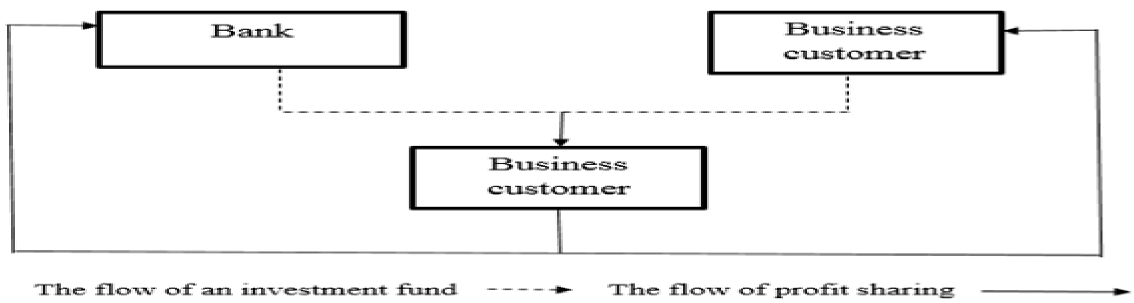
[16] *Musharakah* and *Mudharabah* have widely been used in the Islamic banking system and in the mixed banking system (Antonio, 1999). For example, a great increase of the PLS in the Sudanese banking industry was seen and *Musharakah* was almost one-third of the total funds which was financed in the years 1999 to 2004 (Ahmed, 2008).

[17] In *Mudharabah,* client (depositor) invests one's capital and Islamic bank takes on the role of a *mudharib*. "As a *mudharib* the Islamic bank then invests the funds which have been entrusted to its care in business". At this point, entrepreneur becomes a *mudharib* and bank itself provider of capital. "The money is not loaned to entrepreneurs", but invested in them (Qayum, 2000: 80).

b-1-2) *Musharakah*

In *Musharakah*, an Islamic bank provides capital to an entrepreneur, and the latter also supplies some capital jointly. Islamic bank and business customer make a deal agreement on which to share the result of operations (based on ratio). For example, 70 percent of profit is divided to entrepreneur, and 30 percent to Islamic bank. 100 percent of capital must be returned to Islamic bank[18].

Figure 2.8. Concept of Mechanism of Financial Partnerships (*Musharakah*)



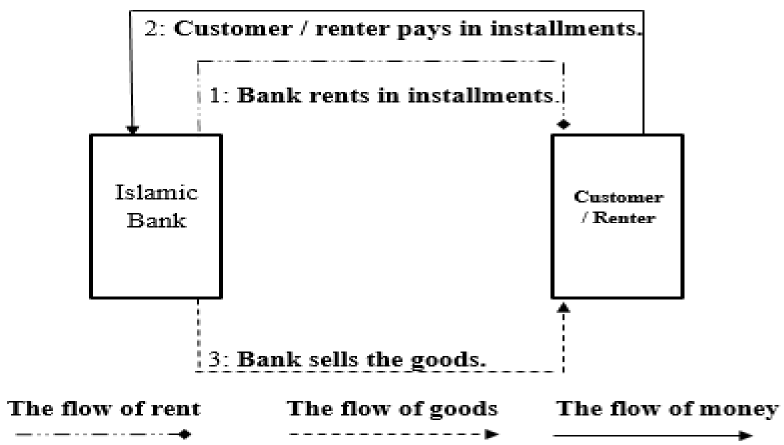
Source: PKES (Pusat Komunikasi Ekonomi Syariah: Islamic Economic Communication Center), 2008 (Edited)

[18] PLS transactions, such as *Mudharabah* and *Musharakah* are to be core of Islamic banking. However, non-PLS transactions, such as *Murabaha* and *Ijarah*, are more dominant practically. PLS transactions are unsecured equity financing and are much riskier compared to non-PLS transactions. Such a discrepancy between concept and practice is due to the following factors which feature *Mudharabah* and *Musharakah* contracts: Vulnerability to agency problems (Probability of moral hazard on the side of business customers who manage the financed project in these contracts and difficulty of monitoring them by the side of Islamic banks); Absence of well-defined property right; Restrictive role of investors for participatory decision-making; Questionable feasibility of PLS instruments for funding short-term projects; and Non-existence of secondary markets for PLS financial instruments (Noibi, 2004). With respect to agency problems, particularly in *Mudharabah*, Islamic banks have no legal means to control agent-entrepreneur or business customer. These have sometimes complete freedom to run the enterprise according to their judgments. In *Musharakah*, banks have relatively better opportunities to monitor the business they invest in, because partners can exercise voting rights (Sundararajan and Errico, 2002). In order to overcome such agency problem, Islamic banks must attempt to improve PLS such as *Musharakah* contract by monitoring customers more carefully to ensure that their investment is secured.

b-2) Lease

Lease contract takes the form of *Ijarah* and lease purchase contract takes the form of *Ijarah Muntahiya Bit Tamlik* (IMB). *Ijarah* is a contract where firstly an Islamic bank purchases the goods desired by a customer in place of him or her, and in the next step, bank rents it to customer in installments. Meanwhile, IMB is a transaction where customer uses product that is leased from Islamic bank and at the termination of contract customer becomes owner of the product (Antonio, 1999).

Figure 2.9. Concept of Mechanism of Leasing Transactions in Installment (*Ijarah*)



Source: PKES (Pusat Komunikasi Ekonomi Syariah: Islamic Economic Communication Center), 2008 (Edited)

Ijarah has a legitimate Islamic rule or resource in Al-Qur'an, verse 2, ayah 233:

ءَاتَيْتُم بِٱلْمَعْرُوفِ ۗ وَٱتَّقُوا۟ ٱللَّهَ وَٱعْلَمُوٓا۟ أَنَّ ٱللَّهَ بِمَا تَعْمَلُونَ بَصِيرٌ

وَإِنْ أَرَدتُّمْ أَن تَسْتَرْضِعُوٓا۟ أَوْلَٰدَكُمْ فَلَا جُنَاحَ عَلَيْكُمْ إِذَا سَلَّمْتُم مَّآ

"And if you wish to have your children nursed by a substitute, there is no blame upon you as long as you give payment according to what is acceptable. And fear Allah and know that Allah is seeing of what you do." (Al-Qur'an, 2007).

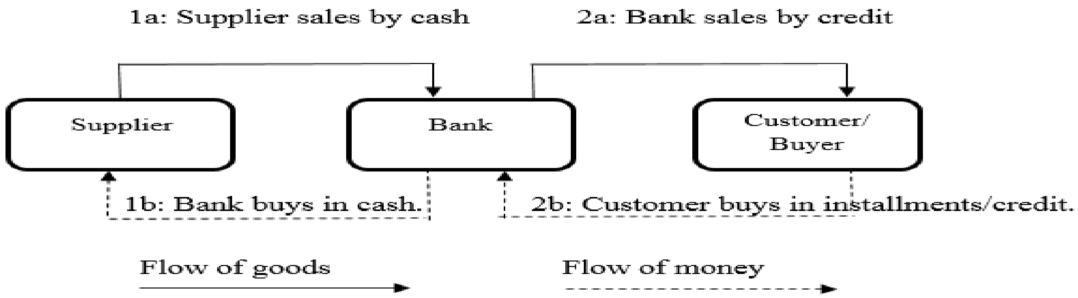
A sentence *"as long as you give payment according to what is acceptable"* indicates that, for example, services of purchasing and leasing real assets which are rendered by bank are due to the obligation to pay fee by customer. It is different from getting interests from the money lent to borrowers. Even if bank gets some profits in the dealing, it is legitimate if it is based on a solid agreement. This is a fundamental rule of *Ijarah* contract in Islamic law (Antonio, 1999)[19].

b-3) Sale and Purchase

Sale and purchase contract takes the form of *Murabaha* (Deferred Payment Sale), *Bai' Bithaman Ajil* (BBA), *Salam, Istishna* and *Tawarruq*. *Murabaha* is a transaction where firstly certain product is requested by a customer to a bank, secondly bank purchases it, and thirdly bank sells it to customer with original price added by cost and profit for Islamic bank on an agreement between customer and Islamic bank, with a short-term installment.

[19] However, according to Azma, we must note that *Ijarah Muntahiya Bit Tamlik* (IMB) which is called *Ijarah Thumma al Bai'* (AITAB) in Malaysia raises some criticism due to its dealings which seem to be lack in explicit *Sharia* regulatory framework. AITAB "has an additional agreement which is the sale contract after the leasing period is over", which means that until the leasing is completed, bank continues to be owner of the asset. Accordingly, even if AITAB is not accompanied with actual procedure of transaction between bank and customer, it would be probable to substitute it for another procedure of transaction between customer and goods vendor, enabling transaction between Islamic bank and customer to be virtual (Azma et al, 2014).

Figure 2.10. Concept of Mechanism of Selling in Installment / Credit (*Murabaha*)



Source: PKES (Pusat Komunikasi Ekonomi Syariah: Islamic Economic Communication Center), 2008 (Edited)

Murabaha has legitimate Islamic rule or resource in: Al-Qur'an, verse 2, ayah 275:

وَأَحَلَّ ٱللَّهُ ٱلْبَيْعَ وَحَرَّمَ ٱلرِّبَوٰا۟

"Allah has permitted trade and has forbidden interest." (Al-Qur'an, 2007).

This *ayah* says that Muslims should be permitted trading, but forbidden to take *riba*. 'Trading' in this term covers bank activities to buy a product and to sell it to the consumer. Bank is permitted to get profit if it is based on an agreement of getting difference of price between customer and bank. Even if bank gets some profit in the dealing, if it is based on a solid agreement, it is legitimate like *Ijarah*[20]. Regarding to the profit in *Murabaha*, Islamic

[20] Al-Omar and Iqbal explain that fixed-return modes of finance should be distinguished from interest-based modes of finance. Dealings of the former modes are done "through real commodities", while in the latter they are carried out "through … exchange of money" (Al-Omar and Iqbal, 2010). Ariff and Rosly also state that although *Ijara* and *Murabaha* are the contracts where Islamic banks get fixed profits, they are permissible and *Sharia*-compliant since the facility offered by Islamic banks are "not based on loan contracts" (Ariff and Rosly, 2011). Ariff explains that *Murabaha* is legitimate because "bank first acquires the asset and in the process it assumes certain risks between purchase and resale" (Ariff, 1988).

banks often use conventional, interest-based benchmarks such as LIBOR (the London Interbank Offered Rate) to determine what profit rate to charge. However, *Murabaha* is justifiable as *Sharia*-compliant contract since: 1) Financing is linked to a real asset purchased on behalf of client; 2) Markup of the asset does not increase even if client defaults, and; 3) Economic activity is generated when the asset is traded.

Bai' Bithaman Ajil (BBA) is similar with *Murabaha*, but it is different from *Murabaha* in the regard that BBA involves long-term installment payment from a customer to an Islamic bank, for example, when customer purchases houses or automobiles (Abdullah and Chee, 2012)[21]. Additionally, the difference of *Murabaha* and BBA on the one hand and *Ijarah* on the other hand is in the fact that the former is trading contract and the latter is leasing contract. In each contract, Islamic banks may get profit which is likely to be influenced by interest rates of conventional banks. In this regard, Islamic banks are surely connected to interest-bearing banks. However, as will be discussed later, the former is inherently less risky than the latter.

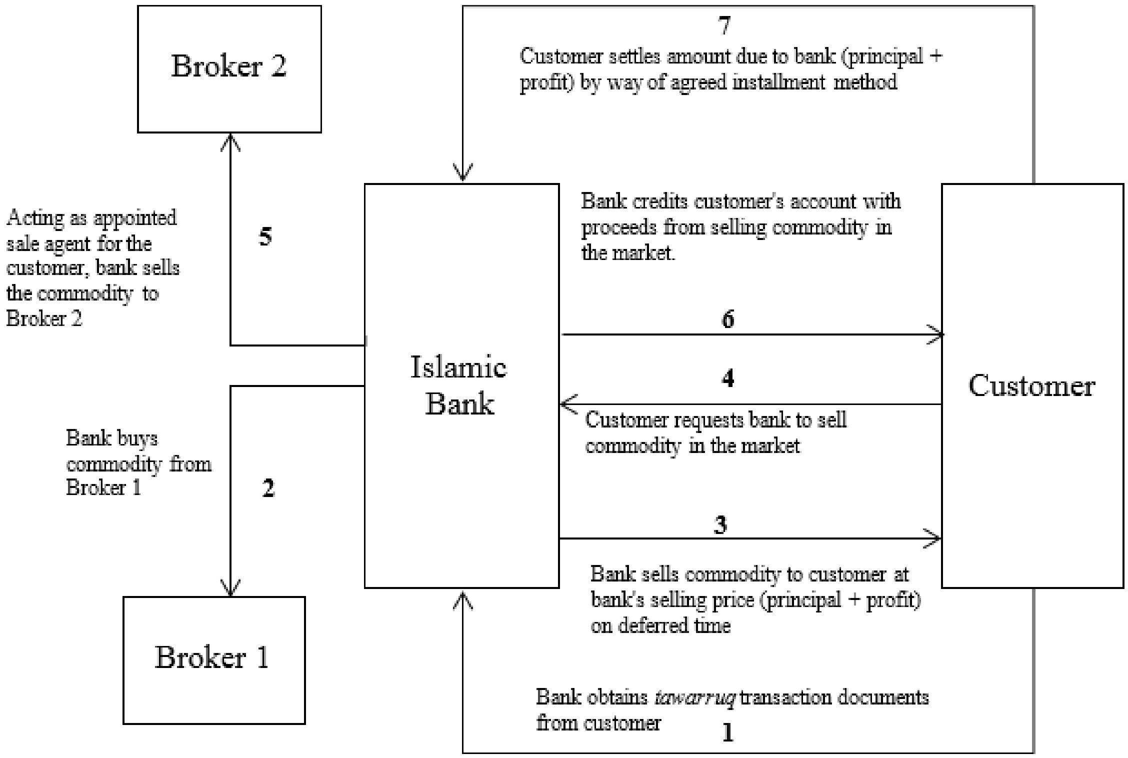
Salam (Purchase with Payment in Advance) is a transaction where an Islamic bank buys a commodity by making an advance payment to a supplier and by fixing the date of delivery as desired by its client. Islamic bank can then sell the commodity to client on an instalment sale base, for example, *Murabaha* or BBA (Iqbal, 2014). In a similar way, *Istishna* (Purchase by Order in Manufacturing) is a transaction where two contracts between

[21] The difference between conventional and Islamic long-term finance for, for example, a house or car, is "subtle yet very important". *Sharia* principles require that a house or a car under Islamic finance contracts "must be owned by the Islamic institution for the duration of the transaction" (Mardam-Bey, 2005). *Murabaha* and *BBA* are justifiable since they get profit by buying and selling directly certain product that customer truly wants, and since bank holds ownership risk in the procedure (Rosly, 2005: 94).

a buyer and a producer are formed through mediation of an Islamic bank as a third party before actual manufacturing. “The first is concluded between beneficiary bank, in which the price is payable by purchaser in future in agreed instalments and bank undertakes to deliver the requested manufactured commodity at an agreed time”. The second contract is between bank and contractor “to manufacture the product according to prescribed specifications. Islamic bank would normally pay the price in advance or during the manufacturing process in instalments to manufacturer”. *Istishna* contract must remove “any ambiguity regarding its specifications” and “the price of the goods to be manufactured must be fixed in absolute and unambiguous terms” (Iqbal, 2014).

Lastly, *Tawarruq* is a financing contract between a bank and a customer where seller and buyer of certain goods mediate financing. Although bank arranges a pair of purchase and sell of goods in detour, what is needed actually by customer is not commodity which the third party trades, but money. The contract is completed just on paper. A concept of *Tawarruq* transaction is illustrated in the Figure 2.11.

Figure 2.11. *Tawarruq* Concept



Source: BIMB (Bank Islam Malaysia Berhad), 2015 (Edited)

An example of *Tawarruq* is as follows: Customer needs 300,000 RM. Bank buys a commodity through Broker 1 and sells it to customer on deferred payment of 400,000 RM. Customer requests bank to sell it to Broker 2 with 300,000 RM. After customer obtains 300,000 RM, bank credits customer's account with 400,000 RM by way of an agreed instalment method. Whereas *Murabaha* is based on real commodity which customer needs actually, *Tawarruq* is only on paper. Since buy and sell transactions are done instantly, they are interpreted to be accompanied with unfair value at non-market price (Hosen and Nahrawi, 2012). As discussed later, in the fourth chapter, *Tawarruq* contract has caused much controversy among *Sharia* scholars.

b-4) Borrowing and Lending Services

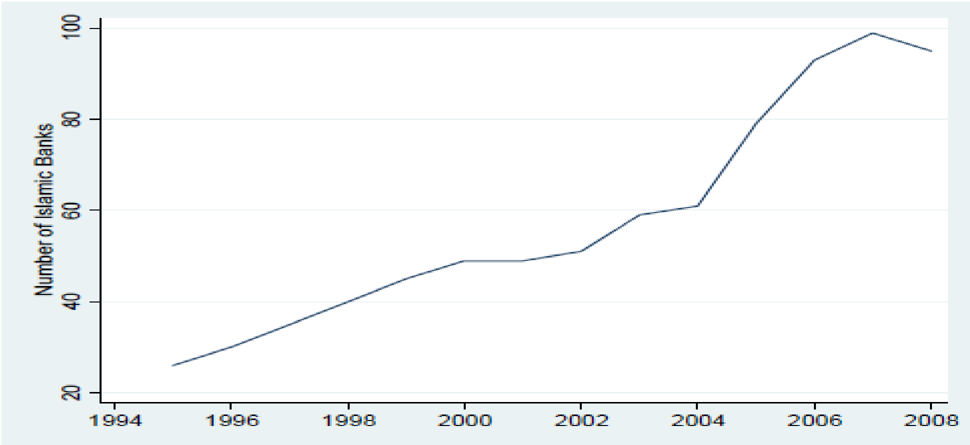
Borrowing and lending contracts are justified if bank and customer take care of evading interest by using the form of *Qard* or *Rahnu*. *Qard* is a way of lending money to customer just for help: Customer returns the same amount of money. *Rahnu* is a financial contract of short-term loan whereby customers, most of whom are low income people or micro enterprises, keep gold or other items to bank as collateral and buy it back again with payment of money. Although *Rahnu* is similar with mortgage in conventional banking, Islamic bank does not charge interest but take a charitable low storage fee under Islamic law (BIMB, 2014a).

Bai Inah is another contract of borrowing and lending service where a customer buys an item (it is a fictitious item in all most cases) from a bank firstly and bank buys back it from customer immediately with fewer prices than in the first trade, from which customer is obliged to repay the difference of the prices to bank (Abdullah and Chee, 2012). *Bai Inah*, as well as *Tawarruq*, is a questionable financial contract, as will be explained in the fourth chapter.

2.3.2 Development of Islamic Banks in the World

The number of Islamic banks in the world tends to increase rapidly. From the Figure 2.12 which indicates transition of the number of Islamic banks in the world in the years 1995 to 2007, we can confirm that it increased significantly by about 300%.

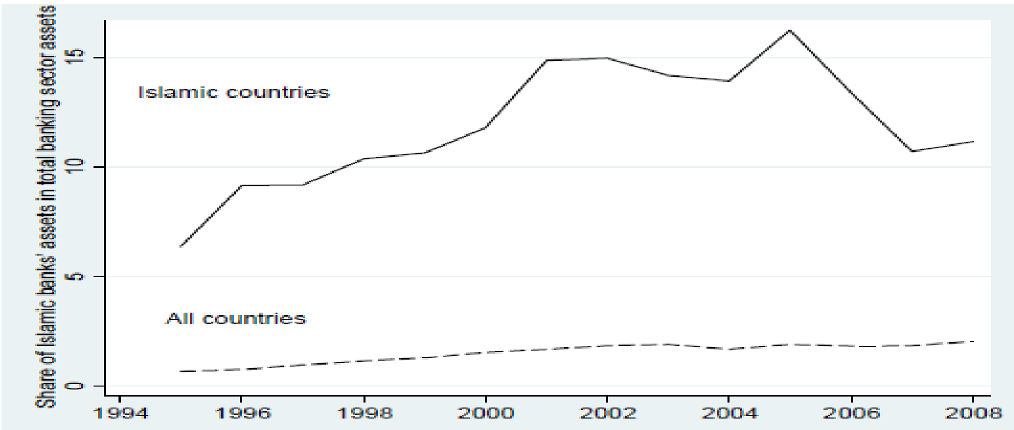
Figure 2.12. The Number of Islamic Banks in the World: 1994-2008



Source: Beck et al, 2010. Note: Information usage by Beck et al. is explained in the page 65.

In addition to a remarkable growth of the number of Islamic banks in the world, a share of Islamic bank assets in total bank assets in the world is also increasing, as revealed in the Figure 2.13. However, it should be noted that, while the trend in all countries increased slightly from 1995 to 2005, the trend in Islamic countries increased significantly during the same years.

Figure 2.13. A Share of Islamic Bank Assets in the World: 1994-2008



Source: Beck et al, 2010. Note: Information usage by Beck et al. is explained in the page 65.

According to Ernst and Young, also in the succeeding years, assets of Islamic commercial banks in the world continued to grow and attained to 1.3 trillion USD in 2011, suggesting an average annual growth of 19% over the past four years before it recorded 24% in 2011. The share of assets of the top four countries (Saudi Arabia, Kuwait, United Arab Emirate, and Malaysia) accounted for 84%. Islamic banking growth is expected to continue also in the next decade, growing fifty percent faster than the overall banking sectors[22]. Overviewing these trends, while each Islamic bank is in a different stage of development, and therefore, pursues a different strategy, we cannot deny high-potentiality of Islamic banks in the world. In respect to Asia, Singapore and Malaysia declare separately that they are the major centers of Islamic banks in the region (Ernst and Young, 2012). Sole (2007) also observes that growth of Islamic banks still continues in the world and especially in the GCC countries and in South East Asia to a degree that conventional banks in the western advanced countries keep on competing with each other "to attract international investors" against the rise of Islamic banks.

Practice of Islamic banking is now not limited into the Arab and Muslim developing countries but is spreading either towards the non-Muslim West developed countries in Europe and the United States of America, or towards the Far East including Indonesia and Malaysia (Chachi, 2006). Thus, as World Bank points out, rapid growth development of Islamic banks plays significant role and enhances their financial presence not only among Muslim populations, but Islamic banks, beyond it, also raise their popularity in non-Muslim

[22] Afterwards Ernst and Young reported that total assets of Islamic banks in South East Asia, GCC, and the rest of the world are 89, 131, and 257 billion USD respectively and total assets of all Islamic banks in the world are 1,811 billion USD in 2013 (Ernst and Young, 2013).

countries. An Islamic banking database of World Bank compiles the names of about 400 Islamic financial institutions from 58 countries (World Bank, 2014).

In August 2004, Islamic Bank of Britain (IBB) became the first fully fledged Islamic bank that was established in a country where Muslim population is a minority (Pollard and Samers, 2007). In the United States, too, we can see LARIBA since 1987 as a representative case among the most successful American Islamic finance houses (Abdul-Rahman, 2010) [23]. As a case of Muslim developing country, Islamic banking sector in Pakistan is prospected to get a market share of 12 percent in 2012. In Malaysia too, Islamic bank market share reached 29 per cent in 2011 (BNM, 2011). But, in contrast with Pakistan and Malaysia, Islamic bank market share in Indonesia was still 3.8 per cent in the same year (BI, 2011). Based on the definition of national banking system explained in the first section, Malaysia and Indonesia belong to the third banking system (mixed banking system). In contrast, the United Kingdom adopts the first banking system (conventional banking system) where Islamic banks are exceptionally introduced [24], and Pakistan converted itself from the second to the third banking system. While we must be conscious of these important distinctions among national banking systems, here we remark simply the conspicuous development of Islamic banks all over the world.

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[23] Almost 25 % of Islamic financial institutions now operate in the countries that do not have Muslim majorities. In a case of Malaysia where the majority is Muslims, "non-Muslims have gradually become the major users" of Islamic banks: For example, the Hong Long Islamic Bank, Oversea-Chinese Banking Corporation and the Malaysian Cooperative Bank (Bank Rakyat) have reported that a 70 % of Islamic financial products have been purchased by the Chinese customers (Nawi, 2013).

[24] In the United Kingdom, there is no special legislation concerning the Islamic banking and all deposit-taking institutions, including Islamic banks, "are required to comply with broadly the same set of regulations", except some minor requirements and allowances for institutions offering Islamic products (Sole, 2007).

Remarkable growth of Islamic banking sectors that can be observed in the world is due to some factors such as: 1) Islamic banking sector is a latecomer (Venardos 2012) meaning that Islamic banking sector in the world has worked for only 51 years with the rapid growth of Muslim population; 2) Islamic banking system is relatively more stable than conventional banking system as demonstrated in the fifth section where performance of Islamic banks and their conventional counterparts before, during, and after the last global financial crisis are compared and; 3) Islamic bank business is more ethical in the sense that, as discussed in the chapter one, they only invest in the projects that are permitted in Islamic law. For instance, Islamic banks are forbidden to fund any gambling projects or prostitution[25].

Organizations of Islamic banks in the world are also growing rapidly to support the development of Islamic banks. As Islamic banks were expanded recently in the world and as they are now prospected to be developing more and more, the development of organization related to Islamic banking has been growing up as well. There are many organizations which are related with Islamic banks: Islamic Development Bank (IDB), an institution that can help development of economy and society of the Muslim member countries and communities in accordance with the principles of *Sharia* (IDB, 2014); Islamic Research and Training

[25] Tawari (2015) also attempts to identify some factors driving growth of Islamic banks in the world. Firstly, in the retailing sector, Muslims had looked to financial products and services under *Shariah* law for a long time. It caused a wave for development of Islamic retail commercial banks, such as Dubai Islamic Bank and Kuwait Finance House in the late 1970s and 1980s (Wilson, 2009). Secondly, practitioners and scholars developed Islamic bank products that could be accepted not only by Muslims but also by non-Muslims. It made the next wave of Islamic banks in the Islamic debt market (*sukuk*) which grown rapidly in South East Asia and in the Gulf region (El Qorchi, 2005). Thirdly, increase of petrodollar and wealth especially in GCC countries extended Islamic investment which made a climb of development of Islamic banks in the early 1990s offering the services of asset development management, private equity, investment advisory and merchant banking, such as The International Investor, Arcapita Bank and Gulf Finance House.

Institutes (IRTI) which was established in 1981 in Saudi Arabia, an affiliate of IDB, whose responsibility is to lead development and sustenance of Islamic financial services industry that supports socio-economic development in the member countries (IRTI, 2014); Bahrain Institute of Banking and Finance (BIBF) in 1981 which provides education in junior colleges, undergraduates schools, and graduates schools (master degrees); Institute of Islamic Baking and Insurance (IIBI) in London in 1991, an organization which provides education of graduates schools (master and doctorate degree) accredited by the British Accreditation Council (BAC) (IIBI, 2014); Islamic Corporation for the Development of the Private Sector in 1999, an affiliate of IDB for development and promotion of Islamic private sectors (ICD, 2014); Islamic Banking and Financial Network (IBFNET) in 1999, which is a global network organization of education, training, research and publication in the field of Islamic finance and business (IBFNET, 2014); Islamic Banking and Finance Institute Malaysia (IBFIM) in 2001 which conducts as training center of Islamic banking, *takaful* (Islamic insurance) and Islamic capital market, and also as adviser for *Sharia* advisory boards, audits, knowledge management, and other business problems (IBFIM, 2014); Islamic Financial Services Board (IFSB) in 2002 in Kuala Lumpur, Malaysia, which conducts as an international standard of regulatory and supervisory agency of Islamic banks, capital markets and insurances (IFSB, 2014) and; International Central for Education in Islamic Finance (INCEIF) in 2006 in Malaysia, an organization of bringing up Islamic finance human resources in four categories such as certified Islamic finance professional, master in Islamic finance practice, master of science in Islamic finance, and doctor of philosophy in Islamic finance (INCEIF, 2014).

2.4. Mixed Banking System [Conventional and Islamic Banking System]

As explained in the first section, differently from the first and second banking systems, conventional banks and Islamic banks are coexistent under each jurisdiction and regulatory system in the third banking system. The third banking system is adopted when the legal framework governing the licensing of banks is designed for conventional banks and when the nation also introduces Islamic banks not by accommodating them into the existing legal provision, or not by amending the legal provision simply, but by enacting the necessary provision initially (Wilson, 2012). Under the mixed banking system, not only Islamic banks are introduced for the first time, but also existing conventional banks have option to continue to act based on interests, to open Islamic windows or units (subsidiaries) through which to act on Islamic banking principle separately, or to convert themselves into Islamic banks as a whole[26].

The third banking system has certain advantage as follows: Muslims and non-Muslims need the almost same banking services for various purposes such as finance of new business, houses, facilities, capital investment, trading activities, and safe custody for assets. The mixed banking system stimulates competition between conventional and Islamic banks, and, in such a situation, the latter have got a huge appreciation for their prospects. As Brown and the others (2007) point out, Islamic banks are increasingly competitive with conventional banks. Further, Billah (2007) asserts that the operations of Islamic banks provide "a different

[26] For banks to operate with Islamic banking principle, the operations must be arranged by the two major preparations: first, the legal settings of Islamic contracts, and second, the regulatory settings of Islamic financial transactions. As with conventional banks, they need to "establish different capital funds, accounts, and reporting systems" for segregating money which should be transacted under Islamic windows, units of conventional banks, or full-fledged Islamic banks converted entirely from conventional ones (Sole, 2007).

perspective to banks and financial practices". Nowadays, conventional financial institutions are realizing values of Islamic finance techniques and necessity to cooperate with them, not only in their Islamic separate departments or Islamic windows, but also through conversion to full-fledged Islamic banks.

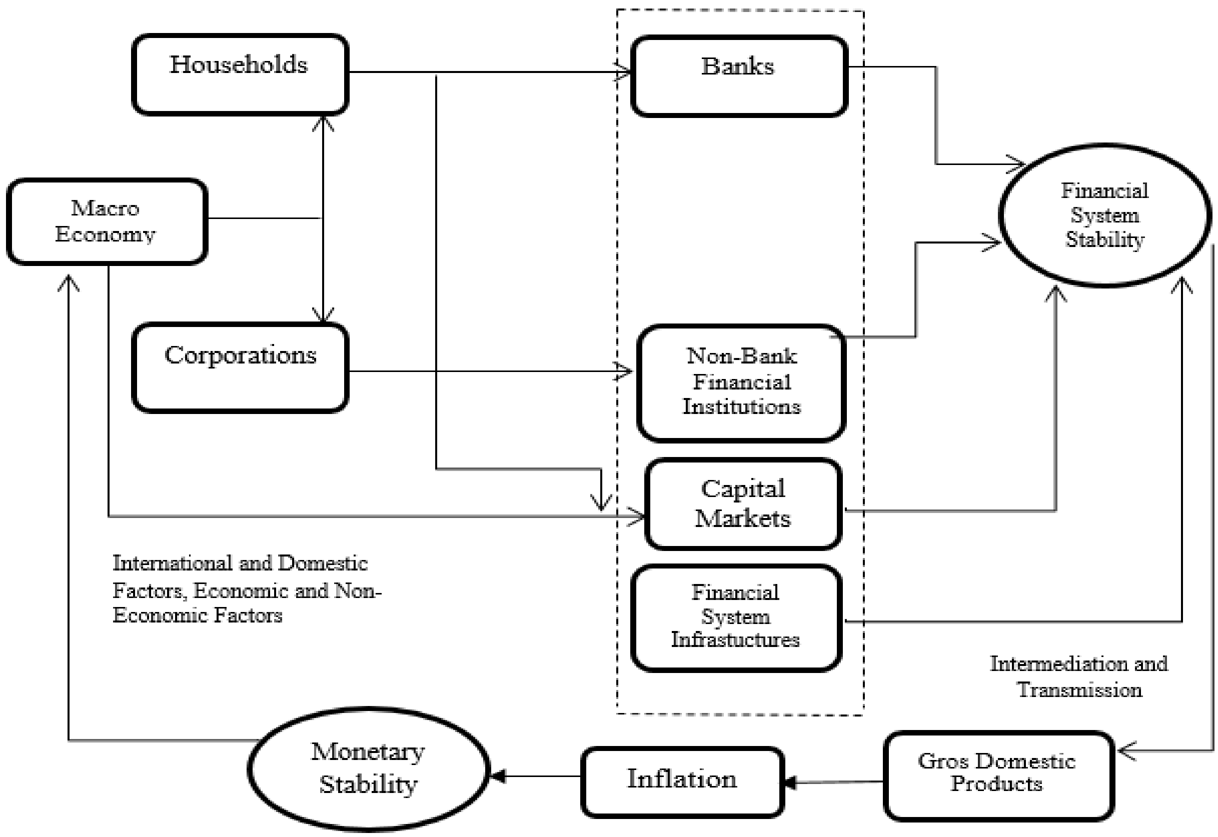
Malaysia claims to be the only country that implements the highly mixed banking system where full-fledged Islamic banks operate on equal basis with full-fledged conventional ones. Not only do the two types of banks work on equal basis, but also they essentially utilize the same sets of banking infrastructure (Yakcop, 2003). However, such claim is not relevant to the current situation. Indonesia, for example, has now twelve full-fledged Islamic banks, too, as will be discussed in the next chapter. In any case, Malaysian government has supported energetically Islamic banking and finance in the country since the mixed banking system was introduced in the early 1980s which was more government-sponsored outcome than a result of private sector initiative (Ariff, 1988; and see also the fourth chapter).

Principally, each country can choose any national banking system. If a country is populated by Muslims almost exclusively, the second PLS system may be adopted. On the contrary, if there is no Muslim population in a country, then the first conventional banking system may be more suitable. As an alternative to these two systems, any country can use the third banking system where Islamic banks and conventional banks are running simultaneously or where conventional banks may have Islamic windows[27]. At any rate,

[27] However, in the mixed banking system, Islamic banks are not likely to be "on par with conventional banks in terms of ease of access, product variety and competitive pricing". Although we generally can point out that Islamic banks become more competitive, they face "a huge scale of disadvantage" against their counterparts "in terms of economies of scale and scope", particularly

whichever system may be adopted, it is with no doubt expected to be managed safe and sound.

Figure 2.14. The Link between Financial System Stability and Monetary Stability



Source: BI (Bank Indonesia), 2014a (Edited)

The Figure 2.14 above explains that financial stability which contains banks, non-bank financial institutions, capital markets and financial system infrastructures is a part of the

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if they are in confronted with conventional banks in the mixed banking system. If they will have a strategy of imitation of conventional banks without differentiation policy of *Sharia* compliance, they have little prospect of surpassing their counterparts (Ariff, 2014). At the same time, as Ariff (2014) continues, "conventional banks can do what Islamic banks can through their Islamic bank subsidiaries, but Islamic banks will not do what conventional banks do due to their *Shari'ah* commitments".

national economic structure stabilization as a whole, where financial stability is expected to affect the macro-economic factors in the country in a stabilizing way, such as gross domestic products, degrees of inflation and money market, which, in turn, stabilize micro-economic factors, such as households, corporations and the banking sector which is a part of financial system. However, financial system is growing very fast and complexly owing to the fact that various types of financial products are always evolving either in domestic or global dimension. Besides, information technology continuously makes one financial system to another system beyond the national borders. As a result, changes in financial systems often cause not stabilizing, but destabilizing effect on the economic structure in each country. In such circumstance, banks are obliged to control and evade three potential financial risks: credit risk, liquidity risk, and market risk (Ismal, 2013).

2.4.1. Credit Risk

Hubbard and O'Brien (2013) suggest that credit risk is due to asymmetric information between borrower and bank. It implies that credit risk is a potential risk of losing income incurred as a result of delays or cancel of borrower of full payment which is agreed upon contract (Ahmed and Khan, 2007). For most banks, credit risk occurs in bank loans and investments. Borrower knows actual usages of the borrowed money and their financial health degree more than lender. Whereas banks may supply loans that are in the risk of being bad credit risk, borrower is likely to be induced to use the loan funds for the other purposes than in agreement. That is why one way of reducing credit risk is dispersing finance among various borrowers and industries and in various regions and industrial sectors as possible.

Conventional bank transfers risk to customer unilaterally, without amending information asymmetry in most cases. On the other hand, Islamic banks are intrinsically less risky than conventional banks because of sharing information and risk between banks with customers on PLS system which reduces information asymmetry and, therefore, credit risk. For example, *Mudarabah* contract, a kind of Islamic PLS system, enables both bank and customer to share and reduce risk of instability of production or consumption and earnings and to improve welfare of both parties (Askari et al, 2012).

However, we should also regard that, as already suggested in the first chapter, there is a potential operational risk that can be considered as a kind of credit risk in Islamic banking, such as an agency problem in PLS system including *Mudharabah* and *Musharakah*, and that due to it, Islamic banks actually have tendency to rely more on non-PLS contracts such as *Murabaha* or *Ijara* to evade operational risk.

2.4.2. Liquidity Risk

Liquidity risk is a risk resulting from incapacity and unsoundness of financial organizations to undertake its contractual obligations. According to Ismal (2013), bank liquidity is maintained by both internal and external management. While internal management can be realized by keeping balance between assets and liabilities of the bank, external management can be realized by good communication, coordination, complete information and credit monitoring with stakeholders, such as depositors, regulators, employers and other banks.

If there are liquidity pressures, bank needs to utilize instruments, such as liquid cash reserves, the central bank funds, funds in other banks and money market instruments, or emergency liquidity facility from the central bank or the government. The factors that are mostly likely to increase liquidity risk, according to Pervez (2000: 176), are erosion of confidence in a country’s banking system as a whole or in an individual bank, lack of diversification of the deposit base, and excessive mismatch of liabilities and assets in the bank.

With respect to Islamic banks, they need to minimize liquidity risk as well as conventional banks. Azam and the others (2013) state that Islamic banks also need to keep balance between their financing policies on the one hand and goal and objective of the loan applications of customers on the other hand, which is a way of avoiding problems in the future. Islamic banks manage their liquidity through deposits with the central bank that earn no return, by holding inter-bank deposits, and by accepting time deposits with longer-term than saving accounts and current accounts from which there is expected to be few or no unpredictable withdrawals.

However, there is no denying that Islamic banking has a defect in the interbank money market. Islamic interbank money market (IIMM) is expected to have the same function as a counterpart of conventional banks: function of managing liquidity, stabilizing individual Islamic banks, providing short-term fund in the money market where one Islamic bank needs the fund and another has the surplus, and transmitting the monetary policy of the central bank (BNM, 2015a) [28]. In spite of such crucial function required to IIMM, *Sharia* in most

[28] IDB (Islamic Development Bank) (2013) reported that "the IIBR (Islamic interbank benchmark rate) was launched in November 2011, as the world's first Islamic finance benchmark rate, to provide an objective and dedicated indicator for the average expected return on Sharia'a-compliant short-term interbank funding. IIBR was established by Thomson Reuters in cooperation with IDB, AAOIFI, … and a number of major Islamic banks. IIBR is calculated by using data from Sharia'a compliant US dollar funding in reasonable market size each business day by a panel of 16 Islamic banks / fully segregated Islamic banking windows. IIBR tenors range from overnight up to 12 months. In terms of corporate governance, IIBR setting mechanism is governed by an Islamic Benchmark Committee and a Sharia'a Committee, both comprising leading market participants and Sharia'a experts" (IDB, 2013: 49).

countries prohibits a transaction method of *Bai al-Dayn*, a kind of trading of debts which are negotiable and discounted in the money market. The Islamic Fiqh Council of the Organization of Islamic Cooperation (OIC) in 1998 agrees that this contract is not permitted since return on debt is evidently usury or *riba* because *Bai al-Dayn* is a simple exchange of securities, bills, or certificates and money through which profit is generated[29]. The concept of loan in Islam must be philanthropic and generous with no return and be mediated by real goods (Hosen and Nahrawi, 2012).

Generally speaking, most of IIMMs are not easily admitted to introduce short-term interest-bearing borrowing, discounting and tradable secondary market, which is likely to bring disadvantage to Islamic banking compared with conventional banking and to make it difficult for the central bank to manage liquidity smoothly in the Islamic monetary market (Tiby, 2011: 37). However, as will be overviewed later, liquidity indicators empirically show that Islamic banks are more liquid than conventional banks, and furthermore, as will be also explained in the fourth chapter where IIMMs in Indonesia and Malaysia will be compared, some *Sharia*-compliant financial products different from *Bai al-Dayn* in IIMM have been developed and are actually utilized.

2.4.3. Market Risk

Market risk is a risk of financial disadvantages arising from sudden various movements in the markets. Financial losses are caused by changes external to bank transactions

[29] *Sharia* allows *Bai al-Dayn* if it is traded at par value. What is prohibited in most of Islamic countries is trading of *Bai al-Dayn* in arbitrage, that is, through buying it with low price and selling with high price. However, as will be stated in the fourth chapter, SAC (*Sharia* Advisory Council) in Malaysia permits the debt trading at a discount or premium as *halal* (Rosly, 2005: 438).

themselves, such as changes in interest rates, foreign exchange rates, commodity prices, or securities prices (FRB, 2014), all of which cause change of balance sheets positions and administrative accounts (off-balance sheets) positions of banking books and trading books, and ultimately bank assets that can be traded or leased (Ahmed and Khan, 2007). Market risk arises: (1) When bank buys a bond with a fixed coupon and afterwards its price goes down because of increase of the yields in the bond market, or; (2) When bank buys foreign currency and afterwards its value declines in the foreign exchange market (BI, 2014a), and so on[30].

With regard to Islamic banks, the Islamic Financial Services Board (IFSB) makes the definition of market risk in December 2005. Market risk of Islamic banks is not different from that of conventional banks, and therefore, it is fundamentally defined as the risk of losses in both on balance sheet positions and off balance sheet positions of individual portfolios arising from fluctuations in market prices of assets. The risk, in particular, relates to current and future volatility of market values of Islamic specific assets, such as *Salam* asset, *sukuk* (Islamic bonds) asset, and *Murabaha* asset which are purchased to be delivered over a specific period (IFSB, 2005). Therefore, it can be assumed that Islamic banks are susceptible to market risk to the same degree as conventional banks.

[30] To the contrary, Ho and Yeh states that "firms that have borrowed from overseas may no longer be able to do so after a currency crisis because a devaluation of domestic currency raises the real burden of their existing external liabilities". These difficulties are likely to cause serious damages to domestic macro economy in developing countries. Besides such currency crisis may also undermine the solvency of domestic banks that borrow from overseas and lessen the function of financial intermediary of the banks (Ho and Yeh, 2014: 627).

2.4.4. Interconnection of Risks

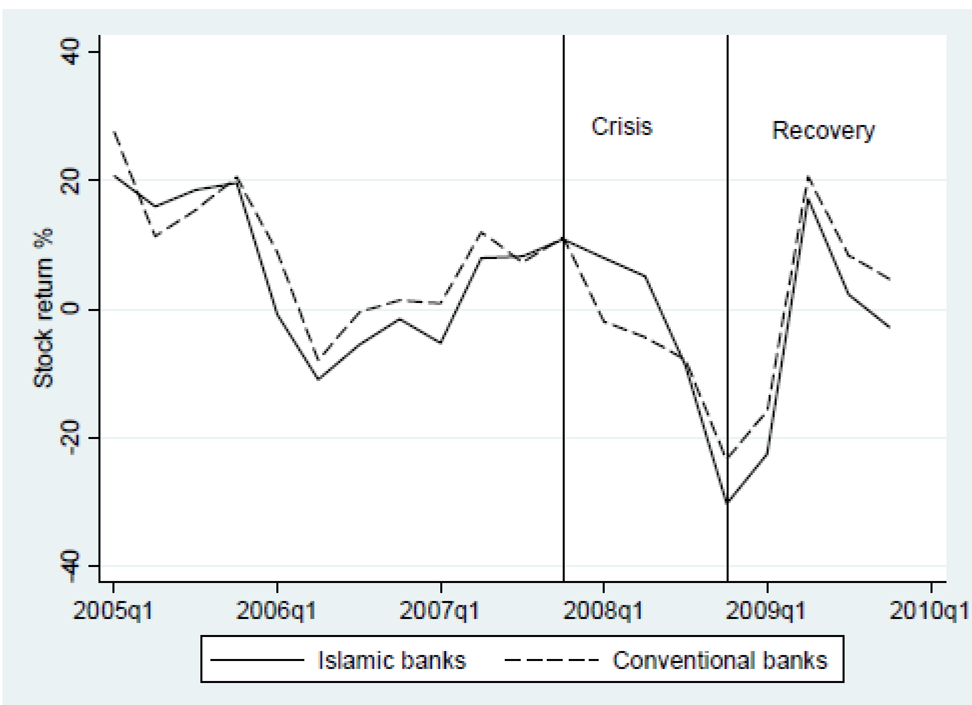
These three potential risks, credit risk, liquidity risk, and market risk, are interconnected to each other. While we can consider whichever risk may occur first, here we assume that market risk begins first which often occurs actually owing to the external factors (from overseas) as well as to the internal factors. For example, conventional banks using bank interests in day-to-day operations, in the event of sharp rise in interest rates in the market, are highly subject to credit risk: Bank interest rates rise; Burden of the credit on commercial bank customers (both household and corporation sector) increases proportionally, and; When they cannot to borrow additional funds from banks, the matters will be worse. In the next stage, if credit risk continues, banks are likely to be faced with liquidity risk. Thus these risks lead to instability of the whole financial system (systemic risk).

When we take into consideration of various risk factors which are argued above, we cannot find any clear answer to a question: Which banking system is resistible to financial risks. While Islamic banks may reduce credit risk in PLS system, the system itself contains potential agency problem which may increase credit risk; Islamic banks need interbank monetary market as well as conventional banks, but financial products in interbank monetary market are restricted by *Sharia*; Lastly, Islamic banks and conventional banks are susceptible to market risk to a same degree. Both of them can be influenced by exogenous risks such as exchange rate, interest rates, inflation and other factors, such as mismanagement of domestic macroeconomic policies, and increase of non-performing loans[31].

[31] The dual banking system is likely to tighten relationships between conventional banking and Islamic banking directly. For example, behaviors of depositors in Islamic banks are influenced by

It is natural that Islamic banks are not immune to the various risks stated above, because exogenous shocks inevitably arise from macro-economic policies, exchange rate and terms-of-trade shocks, and international commodity inflation. The Figure 2.15 is cited from a research of Beck and the others (2013) which, using data of 88 Islamic banks and 442 conventional banks in 21 countries, attempts to compare bank stock returns of Islamic banks with those of conventional banks. The figure indicates that quarterly transition of stock returns in Islamic banks and conventional banks in these years trace almost the same trend.

Figure 2.15. Average Bank Stock Return by Bank Type: 2005–2009



Source: Beck et al, 2013

the interest offered by conventional banks in the same country. As we argued in the first chapter, we always should note that there is much or less competition between Islamic banks and conventional ones.

Note: The graph shows the average stock return of Islamic and conventional banks across 21 countries hosting both types of banks over the period 2005–2009.

It should be also recognized that harsh fluctuations in interest rates in conventional banks influence Islamic banks, as is exemplified in Malaysian in the Table 2.1 below (Kaleem and Isa, 2003). The table presents the granger causality relationships of time deposit returns (TDRs) in Islamic banks and conventional banks. The research covers the years from 1994 to 2002, with a result suggesting that conventional TDRs have strong impact on Islamic TDRs unsymmetrically. The result makes Kaleem and Isa conclude that Islamic banking must consider conventional interest rates before adjusting its deposits returns.

Table 2.1. Results of Granger Causality Test for Islamic and Conventional TDRs (Time Deposit Returns) Offered under Commercial Banks

TDRS Periods	Conventional TDRs do not Cause Islamic TDRs (P- Value)	Islamic TDRs do not Cause Conventional TDRs (P- Value)
1-Month	0.00	0.12
3-Months	0.00	0.54
6-Months	0.00	0.49
9-Months	0.00	0.59
12-Months	0.00	0.30

Source: Kaleem and Isa, 2003 (Edited)
* Significant at 1 % level.

However, we can assume that conventional banks will be more quickly exposed to market risk, especially to fluctuations in interest rates. On the other hand, Islamic banks that do not take interests will certainly be relatively safe against bank interest rate fluctuations.

Islamic banks are not significantly affected by foreign-currency fluctuation, too. This is because foreign currencies are not commodities to be traded in order to gain profits by speculation. Islamic banks are prohibited from making any transactions that have an element of gambling. These result in maintaining stability of Islamic banks against conventional banks in financing and investment in the midst of crisis. It is partially true to the countries that use the dual banking system. It can be repeatedly pointed out that conventional banks are intrinsically more vulnerable to the financial turmoil, and that Islamic banks are intrinsically more stable, because Islamic banks must share risk together with investors and customers on real asset-base, and accordingly they should be required of discreet behaviors[32].

Exogenous shocks are not likely to originate from the Islamic banking system itself as Islamic banks exclude "endogenous systemic risks such as credit booms, speculative bubbles in asset prices, and debt trading" (Askari et al, 2011). Chapra asserts that an equity-based economy tends to remove daily destabilizing influence of fluctuating interest rates. Exchange rates tends to be relatively more stable too, if we neglect exogenous factors, because all the fundamentals that influence exchange rates, such as structural imbalances and differences in growth rates, are of a medium or long-term nature and do not normally change erratically (Chapra, 2000). In contrast with Islamic banks, "since interest-bearing loans have no specific relation" with production, they create "a serious mismatch" between goods and services

[32] Based on a statement of Kayed and Hassan, we can say that in the United States, epicenter of the financial crisis of 2007-2009, long-lasting lower interest rates enabled real estates to be more "affordable". Banks, "driven by a sense of invulnerability", adopted "an easy approach" to securitize mortgages and sell them to a lot of investors as asset-backed securities. But as interest rates began to rise, the ability to repay existing loans has "sharply plummeted" and prices of the asset-backed securities lowered without limits. In the Islamic banking system, it could hardly have happened. For "it is against *Sharia* principles to sell a debt against a debt": They cannot sell or lease unless they possess real assets (Kayed and Hassan, 2011: 554, 558).

which are actually produced. Since Islamic finance is based on the real production, it has substantially curtailed inflation (Memon, 2010).

2.5. Survey of Comparative Researches on Stability of Islamic Banks and of Conventional Banks

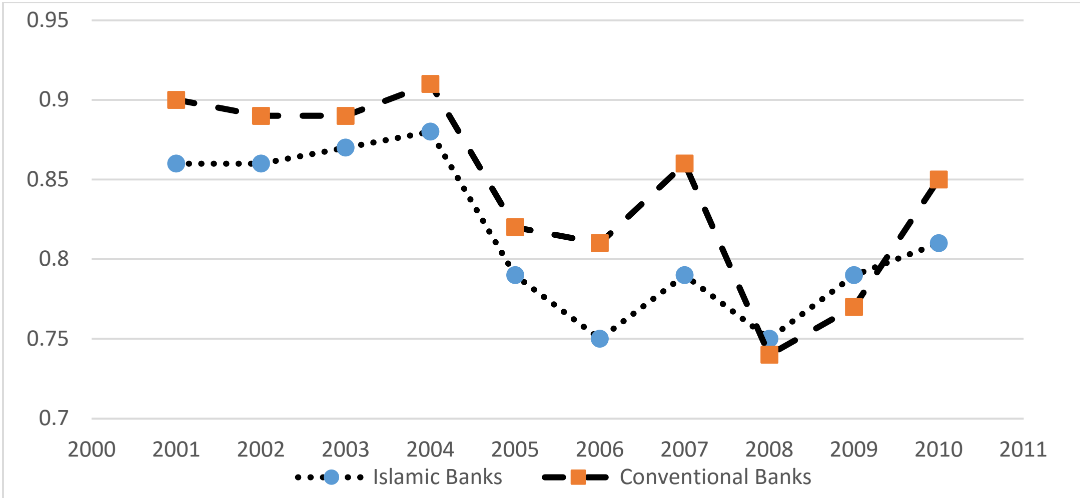
We argued in the previous section that while both Islamic banks and conventional banks are susceptible to various financial risks to almost the same degree, Islamic banks are likely to be less susceptible to risks than conventional banks. Then in this section, with regard to some bank performance in several years before and after the latest financial crisis in 2008 and 2009, I cite several previous researches to reconfirm the argument in the first chapter in which we already reviewed several empirical researches and confirmed better performance of Islamic banks compared with conventional banks (the Chapter 1.1). Also in the first chapter, profitability, liquidity, and solvency are defined as main indicators of banking stability (the Chapter 1.2).

First of all, we shall overview Islamic bank performance in the GCC regions in the long term of 2003-2011 including the crisis period. Overall, Islamic banks were less efficient, but more profitable, more liquid, and more solvent (less risky) than conventional banks. (1) When assets utilization (AU: total revenue/total assets) is used as efficiency ratio, an average AU of Islamic banks was 4.70% and that of conventional banks was 6.91%. (2) On the other hand, profitability may be indicated by ROA (return on assets: net profit after tax/total assets. According to Bucci (2014), ROA shows how much profit is generated from the assets of the company, in other words, how profitably the company uses its assets to generate income for the business. In 2003-2011, an average ROA of Islamic banks was 2.42% and that of conventional banks was 1.72%. The result that Islamic banks are less efficient, but are more profitable is able to be explained by the fact that Islamic banks are inferior in managing overall costs due to their less scale, but that their asset qualities are better than in conventional banks. (3) LAR (ratio of total loans or financing to total assets) is an indicator of liquidity. An average LAR of Islamic banks was 50.82%, while that of conventional banks was 59.39%, which means that Islamic banks were more liquid. (4) Lastly, DER (Debt-Equity Ratio: total debt/owners' equity), average solvency ratio, in Islamic banks was 596.50% on average compared with 693.04% on average in conventional banks which suggests that Islamic banks are less insolvent (Al-Hares et al, 2013). These comparisons are all statistically significant.

As a complementing data of banking efficiency, a research of Alam (2015) can be cited, an attempt to estimate bank technical efficiency score by DEA (Data Envelopment Analysis) in the five GCC countries (Bahrain, Kuwait, Qatar, Saudi Arabia and UAE) where the dual banking system is introduced, over the period from 2001 to 2010 covering the crisis period. Alam examines personnel experience, fixed assets, deposits, and short term funding as inputs and total amount in loan disbursement and total earning assets as outputs. The result shown in the Figure 2.16 below reveals that an average of technical efficiency scores for 35 Islamic banks were less than that for 41 conventional banks, which means that conventional banks were more efficient probably due to the larger size effect of conventional banks and that it is in accordance with the result of Al-Hares and the others' research (2013)[33].

[33] However, with regard to the comparison of Islamic and conventional bank technical efficiency, Alam analyses a correlation between the efficiency on the one hand and the regulatory and supervisory structure on the other hand by using seemingly unrelated regression (SUR) approach, with results that: (a) "Higher supervisory power increases the technical efficiency of Islamic banks

Figure 2.16. Technical Efficiency Scores by Year and Bank Type: 2001-2010



Source: Alam, 2015 (Edited)

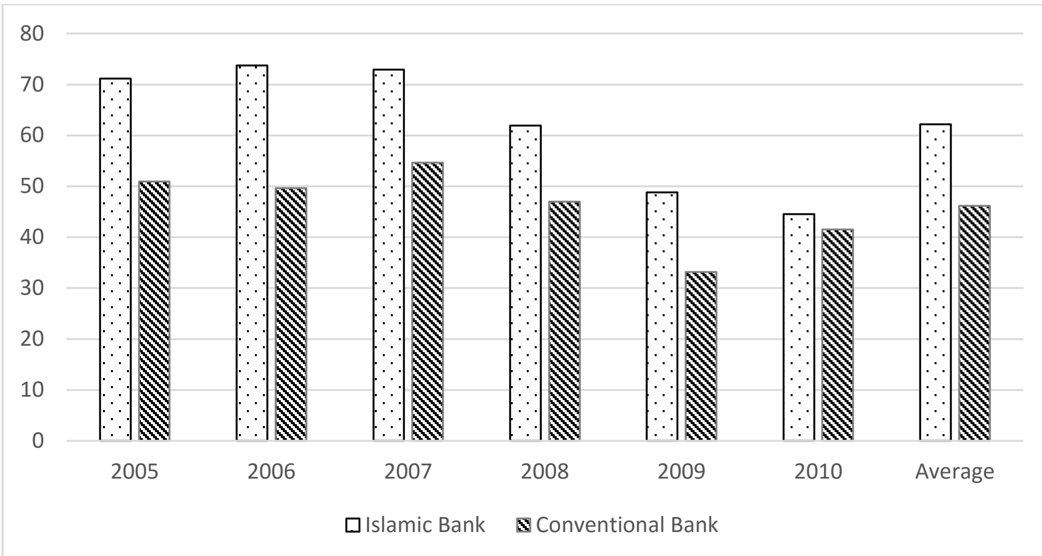
Note: IB means Islamic banks and CB means conventional banks

As a research which focuses narrowly on the short period in the same region, we can cite a study of Siraj and Pillai (2012) who investigate performance of representative six conventional and six Islamic banks in the GCC countries in the years 2005 to 2010. The authors select these Islamic banks in all six countries except Oman where Islamic banking operation started only recently. Firstly, they calculate operating profit ratio (OPR) of these total twelve banks by dividing operating profit by total income generated. The Figure 2.17 shown reveals that the average value of OPR of Islamic bank is 62% during the 6 years,

but reduces the efficiency of conventional banks", highly probably due to the fact that Islamic banks are governed not only by national banking laws and higher regulatory bodies but also by *Sharia* laws and each bank *Sharia* committee which restrain some undesired activities of them, and reduce corruption and ambiguity in bank lending, and; (b) There is a positive relationship between loss reserve (an indicator of risk-taking) and inefficiency for conventional banks and an inverse relationship for Islamic banks which implies that "an inefficient conventional bank takes on more risk than its Islamic counterpart", suggesting a reason why Islamic banks "suffered less damage and experienced no banking failures" immediately after the financial crisis.

while that of conventional banks is 46%. This statistically significant ratio means that Islamic banks are totally more profitable than conventional banks, though tracing diminishing trend, are totally more profitable than conventional banks in the long term.

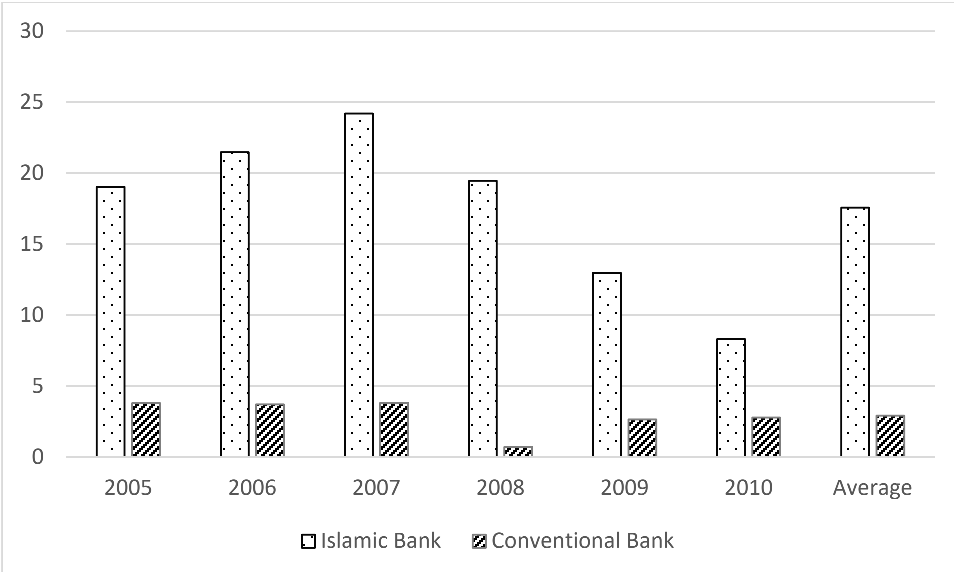
Figure 2.17. Average Operating Profit Ratio: 2005-2010 (in Percentage)



Source: Siraj and Pillai, 2012

According to the authors, another statistically significant performance which is indicative of stability of Islamic banks (although it is not defined as an indicator of banking stability in the first chapter) is its efficiency in managing customer deposits and converting it into investments which generate more revenue. Banks pay for the return of customer deposit, which in conventional banking is denoted as interest expense, whereas in Islamic banking it is represented as a share of profit. Profit as a percentage of customer deposits is calculated by dividing the profit after taxes by total customer deposits. It can be observed from the analysis that the Islamic banks, despite downward, totally provide more benefits on customer deposits than conventional banks as shown in the Figure 2.18 below.

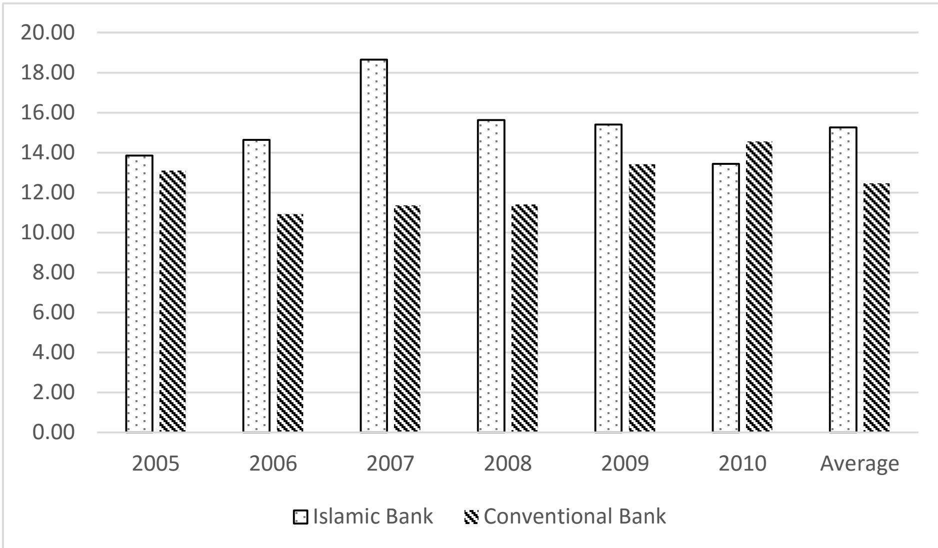
Figure 2.18. Profit Ratio to Customer Deposits: 2005-2010 (in Percentage)



Source: Siraj and Pillai, 2012

The third performance of proving better performance of Islamic banks is a ratio of equity to assets which shows a relative percentage of total equity (shareholder funds) in total assets of the company, a solvency indicator. A higher ratio is preferable as it indicates presence of less external funds in total assets of the company. From the Figure 2.19 shown below, on annual average, total equity as a percentage of total assets is calculated as 15.26% in Islamic banks during the years from 2005 to 2010, while it stands 12.46% in conventional banks during the same period. There exists statistically significant relationship among movements of total equity as a percentage of total assets of Islamic banks and conventional banks. It may be observed from the analysis that Islamic banks utilize more equity funds in total assets compared to conventional banks, which implies that Islamic banks, though being more damaged by the crisis, are totally more equity financed on average.

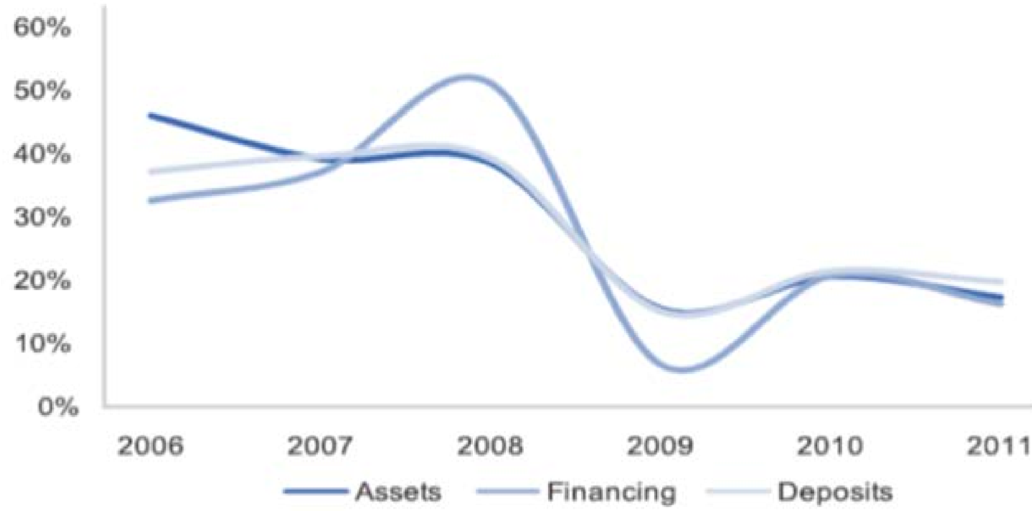
Figure 2.19. Ratio of Equity to Assets: 2005-2010 (in Percentage)



Source: Siraj and Pillai, 2012

However, while the study of Siraj and Pillai demonstrate the better performance of Islamic banks than conventional banks in the GCC countries before and after the financial crisis period, which can be observed in operating profit ratio, profit ratio to customer deposits, and equity ratio to total assets, both banks had almost the same downward trend in these years. As a matter of fact, as is revealed in the Figure 2.20 below, and as was already examined in the first chapter, Islamic banks could never escape from the global financial crisis in 2008-2009, sometimes more damaged than conventional banks. Even if so, however, overall, Islamic banks can be said to have performed better than conventional banks from the middle to the end of 2000s in the GCC countries.

Figure 2.20. Islamic Banking Global Average Growth Trends (in Percentage): 2006-2011



Source: IFSB, 2013 (Edited)

With regard to a specific country in GCC region, Ghassan and Taher (2013), for example, concludes that Saudi Islamic banking sector has successfully absorbed the shock of the international financial crisis, increased customers' confidence and contributed to avoid a local financial crisis and its detrimental repercussions on real economy, which are demonstrated by a fact that during the first nine months of 2009, profitability of Saudi Islamic banks indicated a small decline by 2.6% (18.86 billion Riyals in 2009 against 19.37 billion Riyals in 2008) and contrastingly, Al Bilad Bank and Saud British bank (conventional banks) recorded losses by 66% and 11% respectively.

However, it cannot be clearly concluded that performance of profitability of Islamic banks was better than that of conventional banks in the other regions. For example, K. M. A. Islam observes that conventional banks in Bangladesh were more profitable than Islamic ones after the financial crisis in 2008-2009: In 2009-2011, a mean ROA in 11 conventional banks, 1.91% with standard deviation of 0.61%, was higher than a mean ROA in 4 Islamic banks, 1.56% with standard deviation of 0.77%; as with ROE (return on equity: net profit after tax/equity capital), another profitability ratio[34], 11 conventional banks have a higher mean ROE, 20.76% with standard deviation of 6.63%, compared to 4 Islamic banks a mean ROE, 17.15% with standard deviation of 5.82% (Islam et als, 2014).

Likewise, according to Hazzi and Kilani who analyzed some financial performance of a group of Islamic banks and a group of conventional banks in Malaysia in the years 2007-2011 (in the long period covering the financial crisis), there are some meaningful differences in performances of them. Pre-tax profit on asset ratio of Islamic banks group and pre-tax profit on shareholders' funds ratio were 1.18% and 14.28% and those of conventional banks groups were 1.52% and 18.12% respectively, which means that conventional banks are more profitable (Hazzi and Kilani, 2013).

However, in respect to liquidity and risk performance, a study of Hazzi and Kilani (2013) has the same results as the study of Al-Hares and the others in the case of the GCC countries which was reviewed above in this section: in the years 2007-2011, with regard to liquidity, total loans (total financing) to total deposits ratio of Islamic banks is 74.68% and that of conventional banks is 79.94%; as with risk-weighted capital ratio, a framework set by BIS, the numerical values of Islamic banks and conventional banks are 15.54% and 13.38% respectively. They reflect that Islamic banks are more liquid and less risky than conventional banks (Hazzi and Kilani, 2013).

Furthermore, Kamaruddin and Mohd collect the data of financial performance of BIMB, one of the largest Malaysian Islamic bank and Maybank, a large Malaysian

[34] ROE is a ratio which indicates how a company can generate returns from a unit of equity, in other words, how profitable a company is in terms of its equity (Bucci, 2014).

conventional bank, over the period from 2007 to 2011. As results, with regard to the liquidity, the mean ratio of liquid assets to total assets for BIMB is 31% while for Maybank it is only 15%, which reveals that BIMB has more potential ability to pay off its liabilities. Another indicator of liquidity, the ratio of liquid assets to total deposits which reflects ability to cover unanticipated deposit drains, the mean ratio of BIMB is 35% and that of Maybank is only 23%. As with the ratio of total capital as a share of total assets, an indicator of capital adequacy and solvency risk, about 22% of the assets of BIMB are financed by its capital while for Maybank only 17% of its assets are financed by its capital, which means that BIMB is more resistible to unanticipated losses. (Kamaruddin and Mohd, 2013).

A study of Thim and the others find almost the same trends. They collect the data of five representative Islamic banks and five representative conventional banks in Malaysia in the period of 2006-2010 which shows the following results: Annual averages of ROA, ROE, LDR (net loan to deposit ratio), LAR (net loan to asset ratio), CAR (capital adequacy ratio) and DER (debt equity ratio) of Islamic banks groups are 0.45%, 8.38%, 50.61%, 38.91%, 33.89%, and 1,081.32% respectively and those of conventional banks groups are 1.12%, 17.1%, 77.61%, 57.24%, 13.72% and 1,265.7% respectively. These indicate that Islamic banks are less profitable, more liquid and less risky (Thim et al., 2014). Hazzi and Kilani (2013) also demonstrate that an average LDR of Islamic banks was 74.68% and that of conventional banks was 79.94% in Malaysia in 2007-2011, which means that Islamic banks are more liquid. Another indicator of bank liquidity, a ratio of liquid assets to liabilities of the six Islamic banks in Malaysia moved from 0.35 to 0.35 and 0.32 in the years 2006-8, which also means that liquidity of Islamic bank was stable during the harsh financial crisis (Ariffin and Kassim, 2014).

With respect to the international comparative researches, though I will cite three researches (Ariss, 2010; Beck et al., 2013; Cihak and Hesse, 2008), they do not cover the period of the global financial crisis, or if so, the selected terms are too long to focus on the crisis.

Ariss traces performances of 58 Islamic banks and 192 conventional banks operating in 13 different countries in the years 2000-2006, with the results that average ROA and ROE, indicators of profitability, were 2.04% and 14.19%, while the corresponding figures for conventional banks were 1.85% and 14.04% respectively. Although the differences were small, the results are in accordance with the example of GCC countries. As with liquidity, an average of LAR of each segment was 52.78% and 43.96% respectively. Although the data results in higher liquidity risk in Islamic banks, equity to asset ratios for the two banking segments were 14.01% and 12.42% respectively. It means that Islamic banks are more robust due to relatively better capitalization which is likely to diminish solvency risk of Islamic banks in the last resort (Ariss, 2010).

Beck and the others (2013), computing banking performances over the period 1995-2009 of 88 Islamic banks and 422 conventional banks across 21 countries, showed that cost income ratio of Islamic banks and conventional banks were 62.86% and 56.30% which implies that the former were less efficiency than the latter, but that ROA of Islamic banks was 1.88% and that of conventional banks was 1.16% which implies that the former were more profitable. Additionally, non-performing loans of Islamic banks was 6.34% and those of conventional banks was as high as 9.58%; equity assets ratio of the former and the latter were 16.10% and 11.34% respectively which implies that Islamic banks were more stable and less insolvent (Beck et al, 2013)[35]. Concerning one of the founding of Beck and the others that high quality asset is not always congruous with cost effectiveness, they also suggest that "smaller Islamic banks might be more affected by the higher cost inefficiency of Islamic banks as the design of *Sharia*-compliant products" and by the scale economies, while smaller banks are less risky for the same reasons (Beck et al, 2013)[36].

Directly in respect to the recent global financial crisis and the aftermath, Beck and the others concluded that "while Islamic banks yield lower stock returns for their investors in general, the reverse held during the crisis" owing to higher capitalization, higher asset quality,

[35] These results are all statistically meaningful. However, since there are much differences within countries and years, Beck and the others, furthermore, compare Islamic and conventional banks by which they can control country-year specific effects, but not other bank-level characteristics such as differences in size and asset structure, with a relevant result that Islamic banks still show lower cost efficiency, lower non-performing loans and higher capitalization. The magnitude of these differences is also meaningful, with Islamic banks having 9.9 point higher cost-income ratio, 0.3 points higher overhead costs, 2.2 points lower non-performing loans, and 2.9 point higher capital-asset ratio. With regard to efficiency, according to Al-Omar and Iqbal (2010), Islamic banks, most of which remain small scale, "have not reached an optimum size to achieve efficiency". In addition to efficiency, larger size is also important for "positive credit rating", "shareholders' commitment to their business", raising more capital, and diversification of portfolio to minimize risk.

[36] Said (2012), measuring efficiency through Date Envelopment Analysis and t-test, finds that the efficiency score ("the maximum number of outputs", namely total loans, liquid assets, and other income, that can be created "for a given number of inputs", namely labor cost, fixed assets, and total deposits) of 24 Middle Eastern or non-Middle Eastern Islamic large banks (more than $600 million of assets) in 2006, 2007, 2008 showed an increase in efficiency and a decline in 2009, while 23 Middle Eastern or non-Middle Eastern Islamic small to medium banks started (less than $600 million) at lower level of efficiency and showed an increase during these years, meaning that large Islamic banks performed more efficiently in normal periods and during the crisis (except in 2009) than small ones, and that small Islamic banks improved efficiency steadily even in the crisis period. Additionally, Said also points out that there is no difference in efficiency performance of Islamic banks operating in 26 Middle Eastern and in 21 non-Middle Eastern counties during the financial crisis.

better capitalization and lower loan loss provisions in comparison with conventional banks, all of which indicate that Islamic banks are more solvent, and hence due to the fact that Islamic banks are less subject to disintermediation and deleveraging as are often observed in conventional banks (Beck et al, 2013).

Cihak and Hesse (2008) measured stability of conventional banks and Islamic banks in the years 1993-2004, using the average z-score[37]. The results shown in the Figure 2.21 below can be summarized as follows: (1) Large conventional banks still tend to be more financially stable than large Islamic banks; (2) In contrast, small Islamic banks tend to be more financially stable than either small conventional banks or large conventional banks, and; (3) Totally, Islamic banks tend to be more financially stable than conventional banks (Cihak and Hesse, 2008). According to Cihak and Hesse, the reason of these results may be as follows: Islamic banks are able to pass through a negative shock on the asset side to investment in time deposits, because time deposits are also based on the profit loss-sharing system as well as finance of Islamic banks; and the more difficult access to liquidity because

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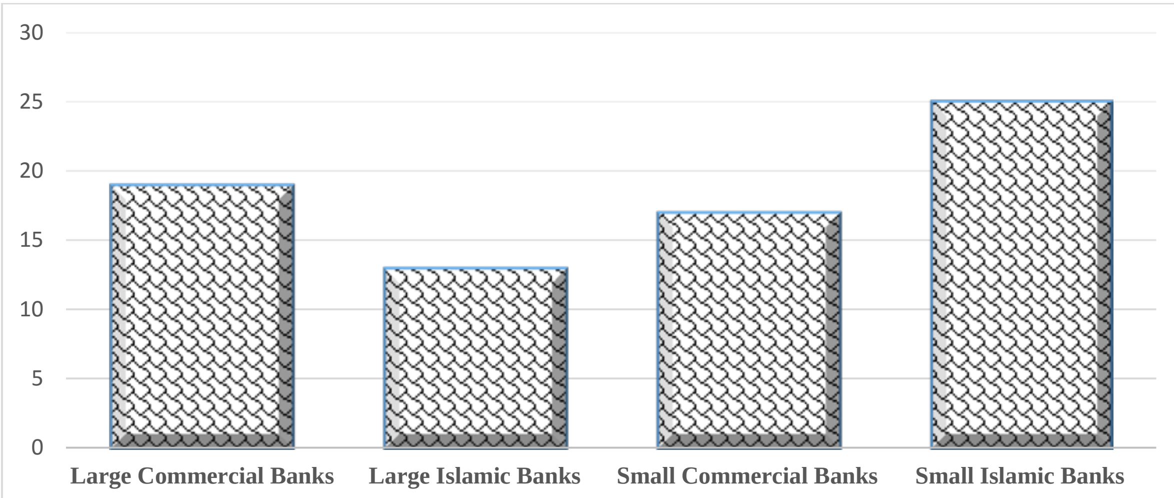
[37] The z-score can be summarized as $(k+u) / o$, where k is equity capital and reserves as percent of assets, u is average return as percent of assets, and o is standard deviation of return on assets as a proxy for return volatility. The z-score is used for measurement of a bank's soundness or its probability of insolvency, a main indicator of banking stability.

The authors' calculations are based on individual bank data drawn from the commercially available and Bank Scope database, including Islamic banks of non-negligible presence: Bahrain, Bangladesh, Brunei, Egypt, Gambia, Indonesia, Iran, Jordan, Kuwait, Lebanon, Malaysia, Mauritania, Pakistan, Qatar, Saudi Arabia, Sudan, Tunisia, United Arab Emirates, West Bank and Gaza, and Yemen (in total, 77 Islamic banks and 397 commercial banks) over the period 1993 to 2004.

of lack or insufficiency of Islamic interbank money market put pressure on Islamic banks to be more conservative and be less risk taking (Cihak and Hesse, 2008) [38].

Figure 2.21. Comparison of Average Z-Scores



Source: Cihak and Hesse, 2008

2.6. Conclusion

Most of the banking systems adopted by nations are still conventional ones where banks charge the interest rates. In the global financial system where national conventional banking system are dominant, and which is accompanied with complexity of information technology in the banking and investment activity, capital movement has been more and more turbulent, and several monetary indicators such as interest rates, inflation, and foreign

[38] Farook and Hassan (2015) also observe that smaller Islamic banks are more financially stable when compared with larger ones (See also Masood et al, 2011). Gamaginta and Rokhim (2010) found that smaller Islamic banks relatively have the same degree of stability as smaller conventional banks during the years from 2004 to 2009 in Indonesia.

exchange rates has been rising and falling more and more sharply, with a result of increased instability of the financial system in each country, each region, and the world.

In these circumstances, the world is now witnessing an emergence of Islamic banks that induces the nations to introduce the Islamic banking system or the mixed banking system where the banks which do not charge the interest and adopt the profit and loss sharing are regulated by the different banking system from the conventional one. Islamic banks are growing increasingly. Nowadays, many developing countries, especially in GCC region and in South East Asia, and also some western developed countries convert conventional banks to Islamic banks or allow conventional banks to open Islamic windows or Islamic bank units.

Such transformation as described above increases the number and transaction volumes of Islamic banks in the world, with expectation that it will be able to restrain, if partially, instability of international conventional system since not a few researches prove that Islamic banks were more stable than conventional banks, mainly measured by profitability, liquidity, and solvency, against the fluctuation in the period which covers the global financial crisis in spite of the fact that Islamic banks have some negative sides such as agency problem in PLS contracts, limited Islamic interbank money market, less efficiency, and vulnerability to the fluctuation originated in the conventional finance.

Chapter 3. An Overview of the Mixed Banking System in Indonesia: Unstable Financial Situation and Significance of Islamic Banks

3.1. Introduction

A Financial crisis often starts with volatility of a national currency which is caused by exogenous conditions. Indonesia had a serious experience of drastic decline in the Indonesian currency from 2,300 IDR (Indonesia Rupiah) per one USD (U.S. dollar) in June 1997 up to 15,000 IDR per one USD in June 1998 during which IDR had been devalued by more than 400 per cent (Delhaise, 1998). Such harsh decline of foreign exchange rate was due to drastic capital outflow. Depreciation of IDR not only burdened Indonesian economy with heavy debt service payments on loans denominated in foreign currency, but also caused another bad effect: rise of interest rate. In the Asian currency crisis in Indonesia in 1997, interest rate rose rapidly from 20 per cent to 60 per cent. Increase of interest rate with high-speed such as this case causes many banks to become insolvent because their assets decrease quickly which is, furthermore, owing to the fact that, on the one hand, its assets are used to pay interest to customers, and on the other hand, customers are urged but unable to pay their loan interest which jumped rapidly to, for example, 60 per cent in the Indonesian crisis in 1997.

In general, higher interest rates lead to increase in bank lending rates. Rising interest rates has a negative impact to ability of debtors to pay their debts to the banks. Thereby, financial position of banks becomes deteriorating because NPL (non-performing loans) is accumulated. If it occurs continually, many banks go bankrupt as happened in Indonesia in 1997. Many banks that went into bankrupt in the year disturbed the whole financial system and the national economy of Indonesia (Chowdhury and Islam, 2011). Furthermore, it provided a systemic impact to the financial system of other countries[39].

But it should be noted that insolvent banks in Indonesia were all conventional banks at that time. On the contrary, An Islamic bank that existed at that time succeeded against fluctuations in currency values and high interest rate (see 3.3.2). It was because Islamic banks do not use bank interest rate in their banking operations. Islamic banks are also forbidden to buy and sell money because transaction of money is censured as having inclination of gambling.

A purpose of the third chapter is to review the mixed banking system in Indonesia. I already explained the general mixed banking system in the world in the second chapter. Indonesia is a very interesting object of research of the mixed banking system because the country has a potential of developing Islamic banks in the world much more than at present as a country that has the largest Muslim population in the world and that has been increasingly associated with Islamic banks[40].

[39] However, as often pointed out, there was doubtlessly an indigenous cause of the Indonesian economic crisis in 1997-1998: much party lending which was related to the fact that most banks belonged to the families or to the industrial or commercial groups which gave interlocking privileges to each other; "political patronage" with a result that, before the crisis, two-thirds of all delinquent loans were carried by the state-owned banks (Delhaise, 1998).

[40] Indonesia is nowadays one of the fastest industrializing countries in the world. We should recognize that, in spite of such current situation, Islam is more and more important factor for the Muslims in Indonesia. Rudnyckyj observes that Islam is not a retreat into "mystification of resistance" "against neoliberal transformation", but a way in which economic reform is performed, intensifying it with "religious piety and spiritual virtue" in confront with the neoliberalism. Islam is "a medium through which subjects of spiritual reform are made accountable to themselves, their families, their work, and the nation at large" (Rudnyckyj, 2009).

Following this introductory section, the second section focuses on the mixed banking system in Indonesia. Bank Indonesia, the central bank of Indonesia, tried to stabilize the national financial system after the demise of the Asian currency crisis, and whereas it got some positive outcomes, it cannot yet overcome financial instability in Indonesia. The national financial system is still susceptible to financial fluctuations caused by international destabilizing factors. In the third section, I overview performances of Islamic banks in Indonesia during and after the demise of the Asian currency crisis and in the period covering the latest financial crisis, and suggest a possibility that Islamic banks play some stabilizing role in the Indonesian financial system in the long term.

3.2. Baking System in Indonesia

3.2.1. Mixed Banking System in Indonesia

Banks are, in principle, intermediary institutions that channel funds from the surplus sectors to the deficit ones. Therefore, banks run their operations that should be based on the principle of prudence. The banking structure in Indonesia consists of commercial banks and the people's credit banks (*Bank Perkreditan Rakyat*: BPR) whose operations are different from each other since BPR are prohibited from creating demand deposits, transacting foreign exchange, and trading insurance. Meanwhile, both types are similar in that they are permitted to collect and invest money as financial intermediary institutions (OJK, 2014a).

As stated in the first section, Indonesia adopts the dual (mixed) banking system where commercial banks can continue to conventional banking operations, convert themselves into full-fledged Islamic banks, or open Islamic windows or units based on the Islamic principle while keeping mainly conventional banking operations. On the other hand, BPR are separated clearly into two types: BPR which exclusively adopt the conventional business principle or BPR "Syariah" (Islamic BPR) which exclusively adopt the Islamic business principle.

In Indonesia, 'Islamic' bank is usually termed '*Sharia*' bank. It is associated with a history of establishment of the first Islamic bank in Indonesia, Bank Muamalat Indonesia. It was in 1990s that President Soeharto attempted to be close to the Islamic powers in the country (Porter, 2002) and that he agreed to establishment of a bank based on the Islamic banking principle. In this period, Soeharto favored the ICMI (*Ikatan Cendekiawan Muslim se-Indonesia*: Indonesian Association for Muslim Intellectuals) formed in 1990 by Islamic actors, intellectuals, and bureaucrats, contemplating enhancing his political influence. However, with political reasons of not stimulating the Islamic powers in the country too much, President conditioned that the name of 'Islam' should be eliminated. Hence eventually the name of 'Islamic' bank in Indonesia was replaced mildly with the name of '*Sharia*' bank (Choiruzzad, 2012)[41].

The first Islamic bank, Bank Muamalat Indonesia (BMI) started its operations on May 1, 1992, with the capital of 84 billion IDR, and with initiative of ICMI, MUI (*Majelis Ulama Indonesia*: Indonesian Ulama Council), the largest organizations of *Ulama* (Islamic scholars who understand Islamic law in depth) established in 1975[42], and the Indonesian government.

[41] The mixed banking system was easy to be accepted in Indonesia. One of the reasons was related to a basic idea of the establishment of Indonesia as a nation-state (*Pancasila* which means the Indonesian nation), idea of "*Bhineka Tunggal Ika*" which signifies a lot of diversity which include religions into a union.

[42] MUI earnestly promoted the government to establish BMI. Prior to it, there was a rise of Islamic economy movement led by ICMI which called for "Islamization of economic system" in 1980s. One of the main argument of the Islamic economy movement was concerning the issue of interest

BMI was legally based on the Banking Act of 1992, the Act No.7/1992, which stipulated for the first time the rules of Islamic finance based on the *Sharia* (Islamic law) and PLS principle (BMI, 2014a).

However, BMI was not followed by the new ones, except 78 BPR Syariah during the period from 1992 to 1998. 1998 was not only the year of Indonesia's political reformation, but also the year when the Banking Act of 1998, the Act No. 10/1998, was introduced with substantial amendment and refinement of PLS principle stipulated in 1992 Act. By the 1998 Act, furthermore, was started the dual banking system where full-fledged Islamic banks based on the Islamic law were regulated and commercial banks were allowed to open Islamic window: *Unit Usaha Syariah* (UUS) or *Sharia* Business Unit (SBU). When doing so, conventional banks must separate money and capital in SBU because money and capital in *Sharia* banking and conventional banking cannot be mixed in one accounting place. The 1998 Act is considered as a legal basis for further development of Islamic banks in Indonesia.

The Banking Act of 1999, the Act No. 23/1999, provided Indonesian Central Bank (Bank Indonesia) with complete authority of regulating Islamic banking operations. In the same year, some commercial banks opened Islamic business units and the second full-fledged Islamic bank, Bank Syariah Mandiri (BSM), was established. An initial process is as follows: On the one hand, Bank Mandiri, a new state bank, was formed after consolidation of the four state banks; On the other hand, differently from Bank Mandiri, BSM started its

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charge (Choiruzzad and Nugroho, 2013). It was MUI which undertook the argument. An idea of creating Islamic banks in Indonesia was formed in a workshop on banks and banking interests on 18-20 August in 1990 in Cisarua Bogor with a sponsorship of MUI. It was forwarded to the National Conference of MUI on 22-25 August in 1990 in Jaya Jakarta. Then MUI started a working group which made later a blueprint of the first Islamic bank (Antonio, 2001).

operation as an Islamic bank which was converted from a conventional bank. After BSM was acquired by Bank Mandiri and capitalized, it was privatized soon again in 1999 (Venardos, 2012).

In 2004, Bank Tugu was converted to the third full-fledged Islamic bank, Bank Mega Syariah. In 2006, Bank Indonesia introduced “office channeling policy” which, according to Ika and Abdulah, allowed conventional banks to start *Sharia* banking service “without establishing separate office for their Islamic banking unit”. The policy enabled conventional banks to reduce cost of setting up new Islamic banking offices which took huge initial investment. Owing to the office channeling policy, opening of Islamic bank in Indonesia became easier under the authorization of the central bank (Ika and Abdulah, 2011).

In 2008, a new inclusive act on Islamic banking, the Sharia Banking Act of 2008, the Act No. 21/2008, was passed. It defined overall types of Islamic bank business and stipulated provisions for implementing *Sharia* compliance and feasibility and prohibitions of Islamic banks. It also provided, as a further step, a clear process for conventional banks to convert their Islamic banking units into completely separated Islamic banks (full-fledged Islamic banks), by setting a deadline for existing *Sharia* banking unit to obtain licenses as full Islamic banks either (a) if 15 years had passed when the Act was endorsed or (b) when the *Sharia* unit’s assets surpass 50 percent of its parent’s asset value (Venardos, 2012)[43].

[43] Bank Indonesia has also arranged regulations of the Islamic financial market and instruments used in the market, for example, a Bank Indonesia Regulation (PBI or *Peraturan Bank Indonesia*) number 6/17/PBI/2004 on BPR Syariah (OJK, 2014b) or a Bank Indonesia Circular Letter (SEBI or *Surat Edaran Bank Indonesia*) number 15/51/SEBI/December 30, 2013 on *Sharia* Business Unit (BI, 2014b). Additionally, Bank Indonesia issued a PBI number 17/4/PBI/ 2015 on interbank money market based on *Sharia* principles, especially on Repo repurchase agreement of Islamic bonds, *sukuk*, issued by the government. In these ways, Bank Indonesia has to pay a special

Sharia compliance system in Indonesian Islamic banks can be said to have a two-tier structure, at the bottom of which is positioned Sharia Supervisory Board (*Dewan Pengawas Syariah*: DPS) which is to be formed in each Islamic bank or unit in conventional bank. DPS must be independent of the bank management, and keep itself as an internally-authoritative body for monitoring whether the bank complies with *Sharia* laws. On the top of the structure is positioned National Sharia Board (*Dewan Syariah Nasional*: DSN) organized by MUI (Ulama Council of Indonesia), a social institution which is influential over the government policy (Lindsey, 2012). The members of DSN are consisted of *Ulama* and experts and practitioners in Islamic law, economy and finance. They are appointed by MUI for the period of four years. DPS membership is limited to persons with substantial knowledge of *Sharia* laws and they are also required to consult the DSN-MUI.

DPS must follow *fatwas*, that is, Islamic religious decrees issued by DSN and obeyed by Islamic financial institutions. DSN can be said to be a kind of Islamic financial infrastructure. Islamic banks need *fatwas* of DSN that is under the control of MUI[44]. The duty of DPS is to supervise Islamic banks in their implementation of Islamic value in daily banking activities, especially in finance, insurance, and stock exchange with the criteria set

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attention to regulations that make Islamic banks have a stronger legal basis in implementing its activities. With regard to Islamic interbank money market, see 4.4.2.

[44] The latest *fatwa* (No.96/DSN-MUI/IV/2015) which was issued in 2015 is concerning *Sharia* hedging transactions on exchange rate (MUI, 2015).

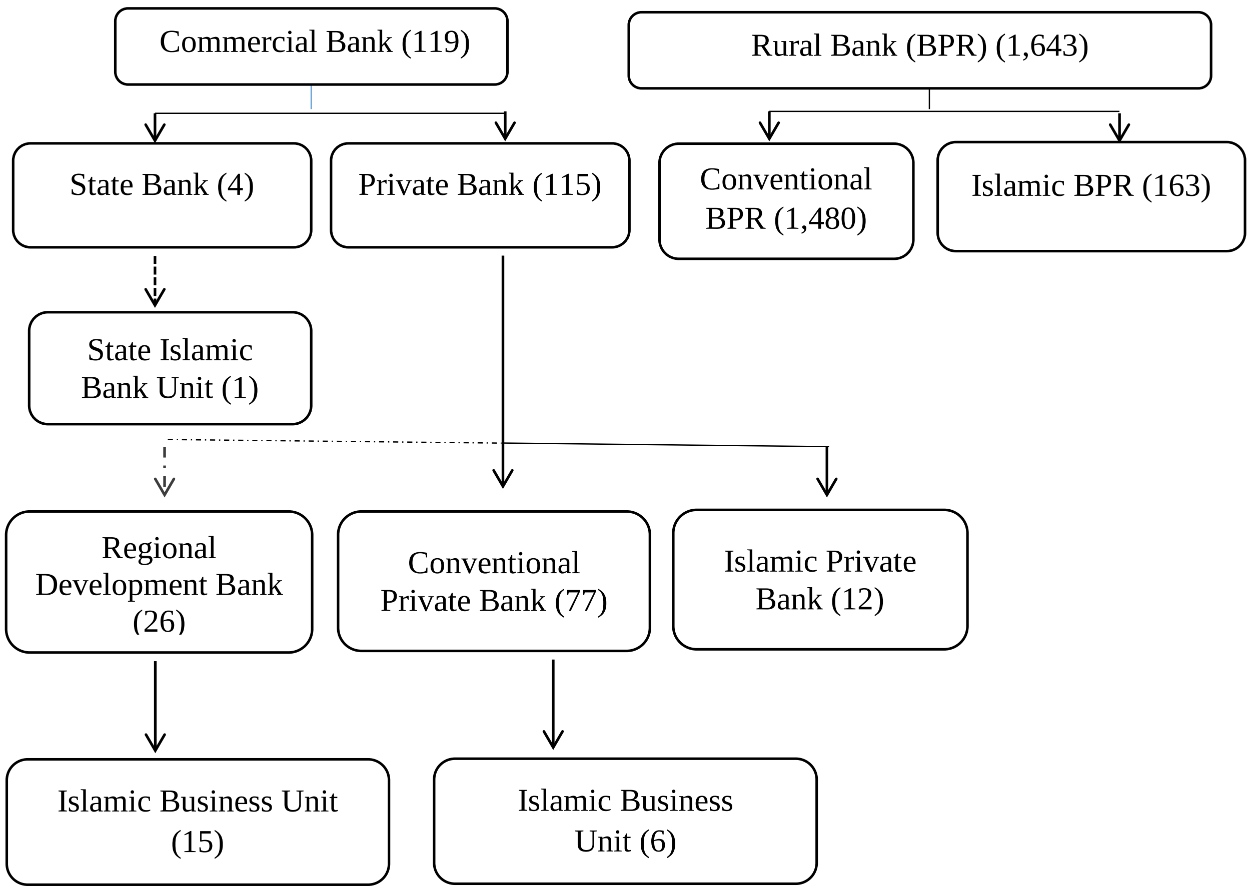
National Sharia Arbitration Board (BASYARNAS or *Badan Arbitrase Syariah Nasional*) is an institution of *Sharia* arbitration which is an autonomous and independent institution under the decree number 09/MUI/XII/2003, dated December 24, 2003 (previous name is BAMUI or *Badan Arbitrase Muamalat Indonesia*) as one of the legal instruments resolving disputes between the parties, both of which come from within Islamic banks, Islamic insurance, or other parties who need it. Actually, non-Muslims can also make use of BASYARNAS in resolving the dispute (Sula, 2004).

by *fatwas*. DSN intervenes membership of DPS, makes recommendation or rejection of their members of individual Islamic banks, obliges DPS to supervise and regulate individual banks to follow *fatwas*, gives warnings DPS and Islamic financial institutions to stop activity deviated from *fatwas*, and proposes MUI or the government to take proper actions if the warning is not obeyed (MUI, 2015; Agustianto, 2015).

As illustrated in the Figure 3.1 below, there are 119 commercial banks in Indonesia. Among them, the government owns four public commercial banks, and the rest are private commercial banks. These private commercial banks (115) consist of 26 regional development banks[45] (partially or fully owned by regional governments), 77 conventional commercial private banks, and 12 Islamic commercial banks. Besides of these commercial banks, there are 1,643 BPR which are composed by 1,480 conventional rural banks (conventional BPR) and by 163 Islamic rural banks based on *Sharia* (BPR Syariah).

[45] Regional development banks or BPD (*Bank Pembangunan Daerah*) has a purpose to provide funding for implementation of regional development efforts in the framework of National Development Planning. BPD works in provincial regions, such as BPD Jawa Tengah (BPD Jateng), or BPD Jawa Timur (BPD Jatim). The main owner of each bank is the provincial government or a local government (Indonesia, 2013a).

Figure 3.1. Recapitulation of Banking Institutions in Indonesia, December 2014[46]



Source: BI (Bank Indonesia), 2014c (Edited)

The mixed (dual) banking system in Indonesia is explained as follows. Each state bank had an Islamic business unit: Bank Rakyat Indonesia (BRI) provided not only conventional bank services, but also Islamic bank services through a state Islamic business unit (BRI

[46] State bank is owned directly by the central government and under control by the Ministry of State Owned Enterprises. Meanwhile, regional development bank is owned and controlled by local government (Ismal, 2015a). For example, Jateng Bank is owned by local government in Central Java Province and the local government in Central Java Province has majority share amounting to 58.36% (Bank Jateng, 2015). In spite of such clear classification which distinguishes state bank and regional development bank from private bank, Bank Indonesia classifies regional development bank into private bank, as shown in the Figure 3.1.

Syariah) that was, however, converted into a full-fledged Islamic private commercial bank in 2009; BNI 46 had also an Islamic window (BNI 46 Syariah) which was privatized in 2010; Bank Mandiri had an Islamic unit (Bank Syariah Mandiri) which, as stated above, was spun off into a Islamic private bank as early as in 1999; and Bank Tabungan Negara with an Islamic unit (BTN Syariah) that is still maintained as the same status.

In respect to Islamic regional development banks, we can cite an example of BPD Jawa Tengah (BPD Jateng) Syariah, an Islamic unit of Bank Jateng (See a former part of the Table 3.1, a list of Islamic banking units of regional development banks).

With regard to conventional private commercial banks, for example, Bank Central Asia has an Islamic unit (BCA Syariah) (See a latter part of the Table 3.1, a list of Islamic banking units of conventional private banks).

Islamic full-ledged private banks in Indonesia are 12, as an example of which we can cite Bank Muamalat Indonesia (See the Table 3.2, a list of full-fledged Islamic private Banks).

Table 3.1. Islamic Banking Units of Regional Development Banks and of Conventional Private Banks

No.	Islamic Banking Unit of Regional Development Bank
1	BPD (Bank Pembangunan Daerah) DKI
2	BPD Yogyakarta
3	BPD Jawa Tengah (BPD Jateng)
4	BPD Jawa Timur
5	BPD Jambi
6	BPD Aceh
7	BPD Sumatra Utara

8	BPD Sumatra Barat
9	BPD Riau
10	BPD Sumatra Selatan and Bangka Belitung
11	BPD Kalimantan Selatan
12	BPD Kalimantan Barat
13	BPD Kalimantan Timur
14	BPD Sulawesi Selatan and Sulawesi Barat
15	BPD Nusa Tenggara Barat
No.	Islamic Banking Unit of Conventional Private Bank
1	Bank Danamon Indonesia Tbk
2	Bank Permata Tbk
3	Bank International Indonesia Tbk
4	Bank Cimb Niaga Tbk
5	Bank OCB NISP Tbk
6	Bank Sinarmas

Source: BI (Bank Indonesia), 2014d (Edited)

Table 3.2. Full-fledged Islamic Private Banks in Indonesia

No.	Full-fledged Islamic Private Bank
1	Bank Muamalat Indonesia
2	Bank Victoria Syariah
3	Bank BRI Syariah
4	Bank BJB Syariah
5	Bank BNI Syariah
6	Bank Syariah Mandiri
7	Bank Mega Syariah
8	Bank Panin Syariah
9	Bank Bukopin Syariah
10	Maybank Syariah Indonesia
11	PT. BCA Syariah
12	PT. Bank Tabungan Pensiun Syariah

Source: BI (Bank Indonesia), 2014d (Edited)

Lastly, the rural banks, *Bank Perkreditan Rakyat* (BPR), are banks that carry out their business activities either conventionally or following *Sharia* principles without providing services in payment interests. As mentioned above, BPR's activities are much narrower than those of commercial banks because BPR are prohibited from demand deposit collection, foreign exchange business and insurance services. BPR's activities are: 1). To collect the funds in the forms of time deposits, savings, and other forms equivalent to those; 2). To give credit or provide financing either conventionally or following *Sharia* law, according to provisions stipulated by Bank Indonesia, and; 3). To place the funds in the form of Bank Indonesia Certificate (SBI: Bank Indonesia promissory notes), time deposit, deposit certificate, and savings in other banks either conventionally or following *Sharia* law (OJK, 2014c). One example of BPR Syariah is BPR Syariah Arta Leksana, Jawa Tengah, established in 2006, with basic capital of 1,675 million IDR and total asset of 19,061 million IDR in 2013. Another example of BPR Syariah is BPR Syariah Al Salaam, Limo Depok, with basic capital of 14,356 million IDR and total asset of 230,523 million IDR in 2013 (Alsalaam, 2015) [47].

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[47] Here I will explain micro financing institutions in Indonesia which include not only conventional ones but also Islamic ones. The largest conventional micro finance services are supplied by the rural banks (BPR: *Bank Perkreditan Rakyat*), second to the state bank, Bank Rakyat Indonesia (BRI) which has extended the nationwide network of microfinance local units since 1983. BPR, as well as BRI, have a managerial model that they distribute most of their units into the provinces whose GDPs are relatively low in contrast with commercial banks whose units are rather concentrated into urban areas. The micro finance provides small-scale loans to poor borrowers (enterprises and individuals) who are required collateral for consumption and investment loans.

There are also Islamic micro financing institutions in Indonesia, namely, BPR Syariah and Baitul Maal Wattamwil (BMT) introduced in 1998. While the former are Islamic banks, the latter are informal non-banks as they are neither under Bank Indonesia nor banking law of Indonesia but under the municipal laws. The units of BMT are located mainly in poor regions like BPR and BPR Syariah. Hamada shows that BMT had 3,038 units, 157 million IDR loans, and 209 million IDR

3.2.2. The Indonesian Banking Architecture

As stated in the first section, Indonesian financial system experienced chaos during the Asian currency crisis in 1997 and 1998. More than 20 banks were forced to be closed. After demise, a new Bank Indonesia Act was enacted in May 1999, which formalized the central bank autonomy (Hamilton-Hart, 1999; Chowdhury and Islam, 2011). The Bank Indonesia Act defined clearly the tasks of the central bank (Bank Indonesia), such as implementing monetary policy, regulating and administering banks, and maintaining "a sound and effective payment system". Since the enactment, Bank Indonesia has been able to intervene in the foreign exchange market to smooth against movements of the exchange rate with objective of rupiah stability (Ananta et al, 2011) [48].

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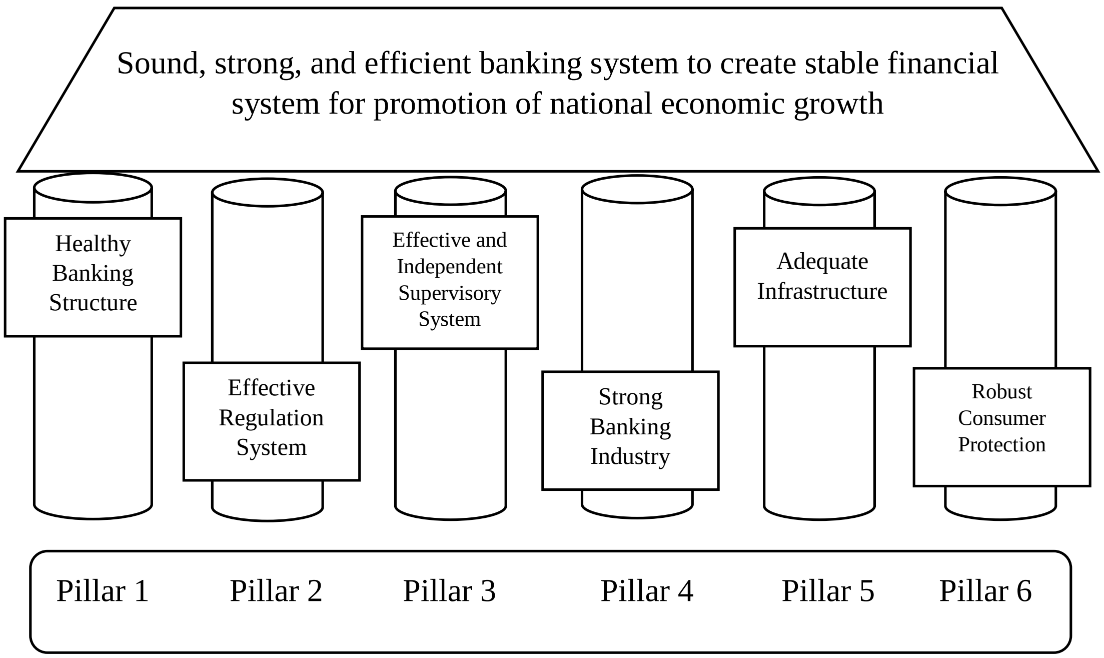
savings in the middle of 2000s, which can be compared with 2,158, 12,150 and 11,160, respectively in BPR (Hamada, 2010). Evidently the scale of BMT is much smaller than that of BPR. According to Rostiyani (2010), when BMT were established in 1998, the total capital was two million IDR, and after a dozen years, in 2010, it attained to 64 million IDR.

Activity of BMT is noticeably different from that of Islamic commercial banks or BPR Syariah in that BMT facilitate various types of free charitable services for the poor population which cannot be served by Islamic banks: for example, free ambulance car service for the people who need to go to hospital in an emergency or from hospital to home which can be seen in many regions in Indonesia; Job training program where young unemployed people who have high motivation to work or start small business can be supplied with job training gratuitously, for example, for barbers. Those who finished training for barbers can also be lent shops with all barber tools. They can return all facilities shared together with BMT every day or weekly on the agreement.

[48] With regard to the government policy after the currency crisis, "the government pledged that the state-owned banks, which carried a heavy load of bad debt, would not to be recapitalized" and, if not closed, would be privatized. An amendment of the banking law to "enable state bank mergers and privatization was submitted" in August 1998. Prior to it, the Indonesian Bank Restructuring Authority (IBRA) was established in January whose mission was to take over the private banks, absorbing their non-performing loans and corporate assets pledged by them (Hamilton-Hart, 1999). It led to rapid monetary expansion in 1998. The broad money supply (M2) increased by 60 percent in the first half of 1998. The capital injections and takeover of banks' NPLs by IBRA restored financial health on Indonesia's banks by 2001. Concerning the fiscal policy, the government managed to resolve the debt problem. From 2000, fiscal deficits were rarely greater than 2% of

Figure 3.2. The Indonesian Banking Architecture (API)



Source: BI (Bank Indonesia), 2014e

For a next step, Bank Indonesia designed an architecture for Indonesian banks, later called IBA (Indonesian Banking Architecture) or API (*Arsitektur Perbankan Indonesia*) in the Indonesian language in January, 2004. API was designed in order to prevent recurrences of such chaos that occurred in Indonesian banking and financial system in 1997, and in order to outline Indonesian banking policy for the future, with a vision of achieving healthy, strong

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GDP. To reinforce the trend, a fiscal policy law of 2003 was introduced. Public debt also "fell sharply over the decade 2000-2010, from about 100% to less than 30%" (Basri and Hill, 2011).

and efficient banking system through which to create stability and realize steady national economic growth (BI, 2014e)[49].

Once API was launched, Indonesian banking industry settled down and experienced a steady growth. General conditions of banking industry turned relatively good[50]. However, as will be emphasized later in 3.2.3, Indonesian financial market still has potential of risks and instability. It will be able to be observed in some indicators, such as fluctuations of foreign exchange rates, particularly in relation with the USD, or stock price index fluctuations.

Pillar 1 of API is healthy banking structure. It aims especially at facilitating stronger capitalization in Indonesian banks including both conventional and Islamic banks. It is a part

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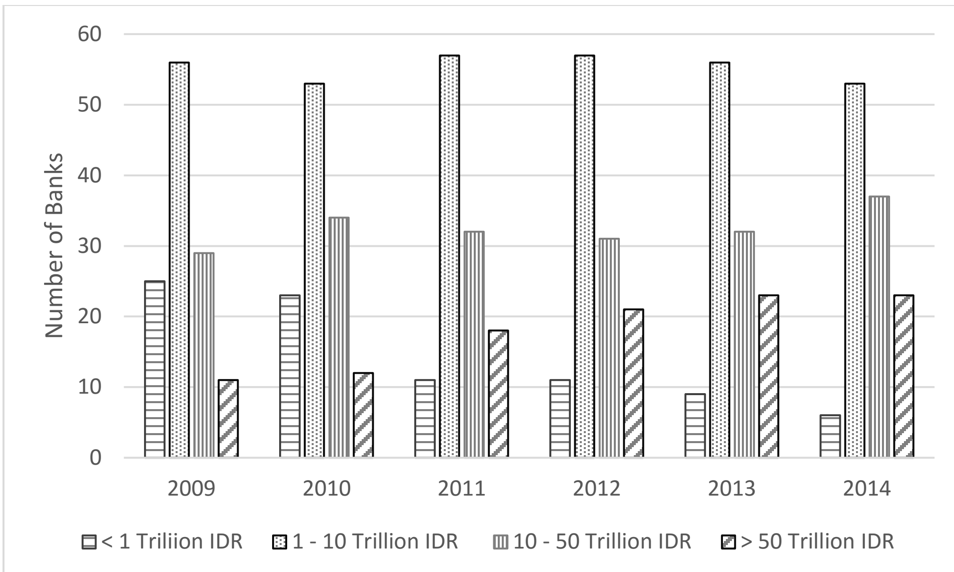
[49] In the same year as the API was launched, a regular deposit insurance scheme, Deposit Insurance Corporation, was established which covered bank deposits up to 100 million IDR. Coverage was raised to 2 billion IDR in October 2008 which covered about 90 percent of the depositors. Meanwhile, the average CAR (capital adequacy ratio) in the Indonesian commercial banking sector was boosted to 17.18 percent in 2010, nearly double the required ratio of 8 percent by Basel III (Nasution, 2015: 57, 72).

[50] Political stability is one of preconditions of financial stability. Indonesian civil society has grown since the fall of an authoritarian regime of Suharto in 1998. During these years, Islamic mass organizations have also gained more influences than before, such as Muhammadiyah and Nahdlatul Ulama (NU). These organizations will be explained in the fifth chapter. However, they have not hindered, but contributed to the growth of civil society with appreciation of values, such as "social justice, respect for human rights and modern progressive understandings of Islam". As a matter of fact, the election of 1999, 2004 and 2009 showed the degree of maturity of "Indonesia's nascent democracy" (Barton, 2010).

Parallel with such political stability, Indonesia was ranked the third fastest growing country in G20 members in 2009. Many macroeconomic policy experts suggest that the Indonesian economic growth is so prospective that it will enter into a new member of the group "BRIC" (Brazil-Russia-India-China), a leader group of the emerging markets. Indonesia was graded by Fitch and Standard & Poor as BB+ and BBB- respectively, while Moody' rating was Baa3 in December 2011. These grading mean that Indonesia is in the category of investment grade (TE, 2015). Domestic and foreign investors appreciate Indonesia as a country where micro- and macro-economic conditions are expected to keep good conditions for investment.

of measures of strengthening bank capacity for risk management, research and development of information technology, and enlargement of business scale in order to increase capacity for bank credit expansion.

Figure 3.3. The Number of Banks by Assets in Indonesia: 2009-2014

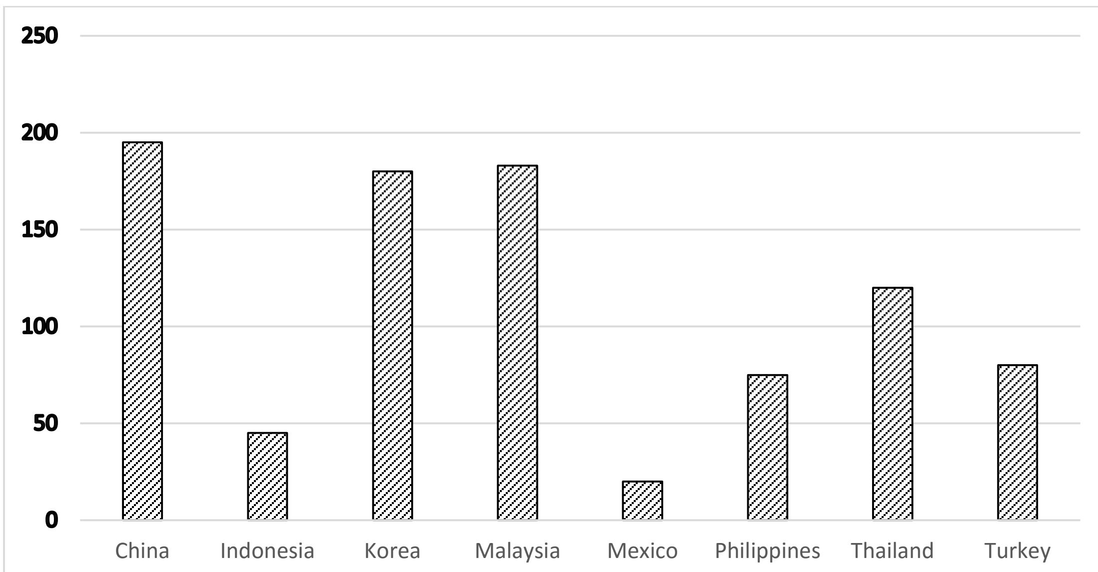


Source: BI (Bank Indonesia), 2014d

In fact, from 2004, the year when API was launched, to 2013, capital structure of Indonesian banks was remarkably intensified. All conventional banks were capitalized more than 100 billion IDR which is the minimum standard of bank capital. Afterward, an average of 119 conventional banks assets in Indonesia was 4.6 trillion IDR in 2013 (OJK, 2014c). The Figure 3.3 reveals that the number of banks whose total assets were between 10 and 50 trillion IDR increased by 28% and the number of banks whose total assets were more than 50 trillion IDR increased by 109% from 2009 to 2013. On the other hand, the number of banks whose total assets were under 1 trillion IDR decreased by 76% and the number of banks whose total assets were between 1 and 10 trillion IDR decreased 5 % during the same years.

However, as International Monetary Fund (2010) reports, financial sector assets in Indonesia including banking sector assets are still small relative to “the peer countries” in terms of a ratio to GDP (See the Figure 3.4).

Figure 3.4. Ratio of Banking Sector Assets to GDP (in Percentage)



Source: IMF (International Monetary Fund), 2010 (Edited)

Additionally, we should note a problem as follows. Bank Indonesia, since API started in 2004, has pursued to reduce the total number of banks in Indonesia to only 35-38 in ten or fifteen years, the number which is considered to be appropriate (Ariefianto, 2012). However, at present stage when ten years have passed since the start of API, commercial banks in Indonesia still numbers 119 (BI, 2014d; and See the Figure 3.1) [51]. Another blueprint of API was that Indonesia would have two or three banks of international reputation with more than 1,000 trillion IDR assets by 2019. An Asset of the largest bank in Indonesia, Mandiri Bank, is 817 trillion IDR in June 2015 (BM, 2015). The second one is BRI Bank, whose asset in June 2015 is 747 trillion IDR (BRI, 2015). Accordingly, the target of having two or three banks of international reputation in Indonesia in the next few years will be achieved.

Pillar 2 is effective regulation system to enhance effectiveness of the banking regulation in Indonesia which can be appreciated as international best practice. To improve the level of regulation, 25 Basel core principles for effective banking regulation should be implemented gradually but thoroughly in Indonesia.

Pillar 3 is effective and independent supervisory system. It aims to enhance the independence and effectiveness of supervision of Bank Indonesia and of its some regulatory agencies. The necessitated measures are to increase their competence of risk-based examinations of individual banks and the banking industry as a whole.

With respect to Pillar 2 and 3, banking regulatory and supervisory system in Indonesia is estimated to be improved very well. It is due to the establishment of IFSA (Indonesia Financial Service Authority) or OJK (*Otoritas Jasa Keuangan*), a new regulatory institution

[51] Seen from another viewpoint, the policy of reducing the number of banks is criticized as follows: From 2000 to 2008, the number of banks decreased from 151 to 124, the number of private commercial banks from 120 to 93, and the number of bank ATMs from 7,114 to 20,792. However, it should be remarked that, in accordance with the trend, the number of BPR which had intensified microfinance in rural areas and fulfilled the needs of rural small and micro enterprises and population also diminished their numbers from 2,419 to 1,772 during the same years, while pawnshops conversely increased from 692 to 1,331 (Rosengard and Prasetyantoko, 2011).

to intensify the control over all financial institutions in Indonesia. OJK is a financial agency which was newly established in 2012, under the Act, No. 21/2011, to take over functions, duties and authority of regulation and supervision of financial services activities in the sector of capital markets, insurance, pension funds, and other financial institutions from the Capital Market Supervisory Agency and the Financial Services Institute which had been under control of Ministry of Finance (OJK, 2014a). It was a first good step for Indonesian financial regulatory system to be more professional and raise its credibility. In the next step, since December 31, 2013, a part of functions, duties and authority of regulation and supervision of Bank Indonesia has been also switched to OJK. The transition continues long until now whereby micro prudential regulation, supervision, and inspection are mainly under jurisdiction of OJK whose task is to investigate bank risk, bank liquidity, and so on, enabling the central bank to concentrate into financial adjustment and macro level policies, such as IDR exchange rate, central bank interest rate, and inflation. Additionally, there are a few financial supervisory institutions other than OJK, such as Indonesian Financial Transaction Reports and Analysis Centre (IFTRAC) or *Pusat Pelaporan dan Analisis Transaksi Keuangan* (PPTATK) which was formed in 2002, for supervision, anti-money laundering with collaboration with the police and judiciary (OJK, 2014c).

Pillar 4 is strengthening internal condition of banks to improve their good corporate governance (GCG), quality of risk management and operational management capabilities.

Concerning GCG, banks must hold the following five principles: transparency, accountability, responsibility, independence and fairness, all of which are at present time based on the latest Bank Indonesia Circular Letter, Number 15/15, issued in April 2013 (BI, 2014f). Banks must also pursue following things along these principles: to clarify duties and responsibilities of the board of commissioners, to exert internal and external audit to supervise compliance, and to public transparent financial and non-financial internal reporting. Self-assessment report on implementation of GCG must be submitted to the Bank Indonesia and to the other stakeholders after adjustment to the rating assessment by the Bank Indonesia which is presented to each bank in the previous year and which rates individual banks into five ranks.

Concerning risk management, banks are required qualified human resources and their competence in risk management along professional standards and codes of conduct. Bank Indonesia launched the Risk Management Certification Program based on Bank Indonesia Regulation (PBI or *Peraturan Bank Indonesia*), Number 11/19, in 2009. The program assesses five aspects: period of employment, knowledge, skills, behavior and attitude, and experience (BI, 2014g). Bank Indonesia has authority of rejecting certificates if problems of competence and integrity are detected in the results of monitoring and inspection.

Pillar 5 is adequate infrastructure to provide banks with effective operational facilities, such as credit information bureaus or credit rating agencies[52]. First, Bank Indonesia had an idea to establish the Credit Information Bureau in 2006 (BI, 2014h) to collect, store and provide credit information. However, the idea was not implemented. Credit information that was called the Individual Debtor Information (IDI) History, was supposed to be used by the members of the Bureau to determine credibility (eligibility) of fund recipients (borrowers) and facilitate financial institutions in analysis of credit and financing and in risk management.

[52] Pillar 5 also contains Islamic financial market and *fatwa*, Islamic decree which prompts Islamic banks to comply Islamic law (*Sharia*), to be intensified as Indonesian financial infrastructure. Islamic financial market regulation and *fatwa* were already explained in 3.2.1 in this chapter.

The second infrastructure is the credit rating agency (CRA). Banks generally trust ratings calculated by CRA as reference for decision making in creditworthiness. A Bank Indonesia Circular Letter, Number 13/31/DPNP, issued in 2011 (BI, 2014i), recognized six institutions as CRA, namely Fitch Ratings, Moody's Investors Service, Standard and Poor's, PT Fitch Ratings Indonesia, PT ICRA (Information Credit Rating Agency) Indonesia, and PT Indonesian Securities Rating.

Pillar 6 is strong consumer protection. It has four main objectives: (1) customer empowerment through standardized action mechanism for customer complaints, (2) establishment of an independent mediation organization that helps bank customers to solve problems, (3) transparency of bank products, and (4) promoting information for clients. First, the law concerning consumer protection, Number 8/1999, was extended to bank customers in 2001. Second, based on PBI, Number 7/7/PBI in 2005 on "Settlement of Customer Complaints", banks must respond to every complaint of bank customers and compile them, especially those related to financial transactions (BI, 2015a). Third, PBI, Number 7/6/PBI, in 2005 which rules out transparency in bank product information and use of customer personal data (BI, 2015b) obliges banks to provide written information in the Indonesian language thoroughly on properties of each financial product, prohibits them to give misleading and unethical information, and obliges them to ask customers to write an approval document when banks provide personal data of customers to third parties for commercial purposes. Fourth, Bank Indonesia encourages banks to inform bank customers of financial products and services. The public is expected to understand benefits, risks and costs of financial products and services. However, any proposed independent mediation organization that helps bank customers to solve problems which occur in banking transactions is not still established.

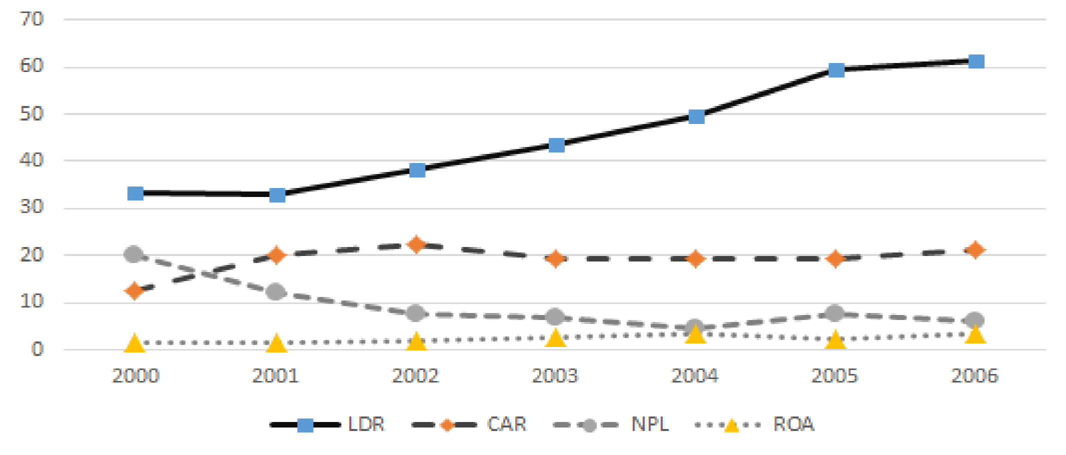
It should be admitted that Indonesia took lessons from the Asian currency crisis in 1997 and 1998, especially from the structural problems in the banking sector which were elicited at that time. One of the main actions was API, designed to restructure drastically the financial and banking system in Indonesia. Bank Indonesia expected that confusions of the banking system would not recur by implementing a series of measures related to API. Indeed, as will be overviewed at the top of the next section, too, the API program contributed to reduce instability of the Indonesian banking system against fluctuations and risks after unpleasant experience of chaos in 1997 and 1998[53].

3.2.3. Stability of the Financial System and Potential Risk

If the starting year is set in an immediate post Asian currency crisis, 1999, performances in the Indonesian banking thereafter seemed to be good, as were revealed in the Figure 3.5 shown below. LDR (loan/deposit ratio) increased from 32% in 2001 to 61% in 2006; NPL (non-performing loans) declined 20% in 2000 to 5% in 2006 drastically; CAR (capital adequacy ratio) rose 11% in 2001 to 20 % in 2001 after which, however, it was almost the same value until 2006 around 20%; ROA (return on asset) was maintained at a low level under 3.5% until 2006.

[53] It achieved excellent solutions not only for the stability of the banking and financial system, but also for economic activities by reducing risks. Indonesian banks used their funds for financing, equity, external debt, and corporate debt, whose shares were 48%, 26%, 23%, and 3% respectively in 2010. Most of financing was directed to corporations and their productive activities. Therefore, stability of the banking system can be said to contribute to support real economic activities in Indonesia (Ariefianto and Soepomo, 2011).

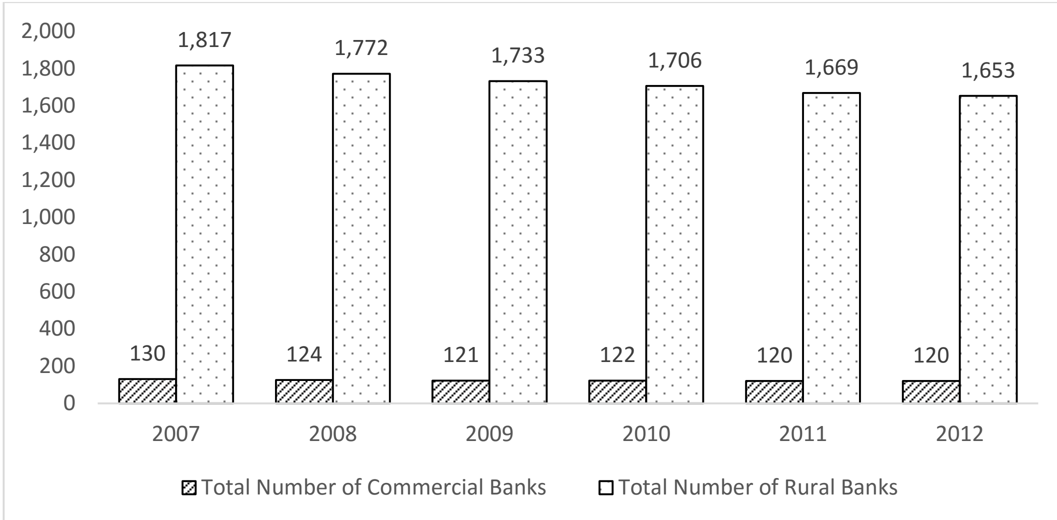
Figure 3.5. Performance of Banks in Indonesia in the Post Asian Currency Crisis: 2000-2006 (in Percentage)



Sources: BI (Bank Indonesia), 2015c (Edited) and BI (Bank Indonesia), 2015d (Edited)
Notes: LDR: loan deposit ratio; CAR: capital adequacy ratio; NPL: non-performing loan and; ROA: returns of asset

Another statistical references also reveal the good performance: With regard to Indonesian commercial banks from 1999 to 2005, LDR changed from 26.2% to 66.2%, NPL from 32.8% to 8.7%, and CAR from -8.1% to 19.6% (Adiningsih, 2007). Additionally, LDR of Indonesian commercial banks improved from about 40% in the year 2004 to about 80% in the year 2010 (Rosengard and Prasetyantoko, 2011: 278). Furthermore, for example, strong growth in bank credits in one year from 2006 to 2007 offers evidence of rising and continued economic activity: Total credits rose to 915.6 trillion IDR at the end of July 2007, compared with 832.9 trillion IDR at the end of July in 2006 (EIU, 2007).

Figure 3.6. Total Number of Commercial and Rural Banks in Indonesia: 2007-2012

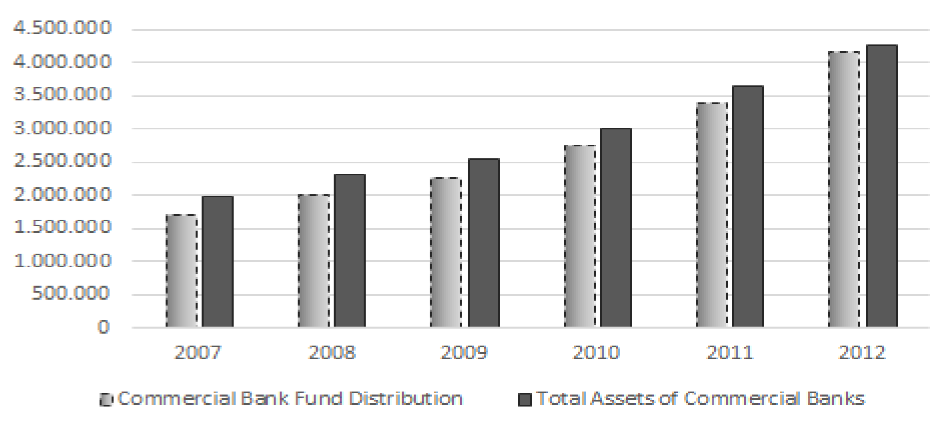


Source: BI (Bank Indonesia), 2014j (Edited)

Along a guideline of API (Pillar 1), commercial banks decreased every year from 2007 to 2012 in Indonesia (the Figure 3.6). The rural banks (BPR) were also decreasing from 1,817 to 1,653 during the same years with almost the same trend of commercial banks (See the footnote 51). There is evidently a tendency of reduction in the number of conventional banks including both commercial banks and BPR. This is due to the process of policy of restricting licenses for commercial banks or BPR in order to diminish unsounded banks with little capital, which makes establishing new conventional banks under the authorization of the central bank difficult.

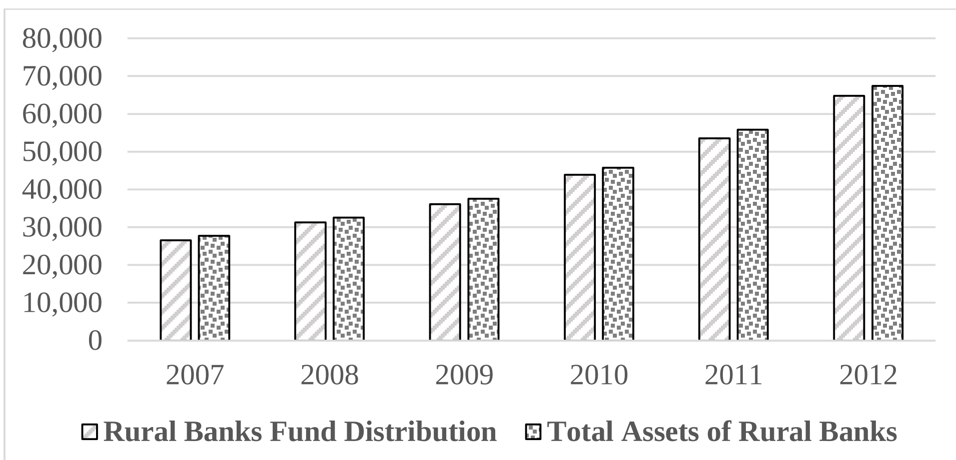
However, while the number of commercial banks decreased, total assets of commercial banks increased every year (the Figure 3.7). Assets of commercial banks were also distributed properly, as the whole value of fund distributions was always kept under the total assets. This is a desirable condition because a decent fund distribution of the assets is necessary for reducing liquidity risk.

Figure 3.7. Total Assets and Fund Distributions of Commercial Banks: 2007-2012 (in Billion IDR)



Source: BI (Bank Indonesia), 2014j (Edited)

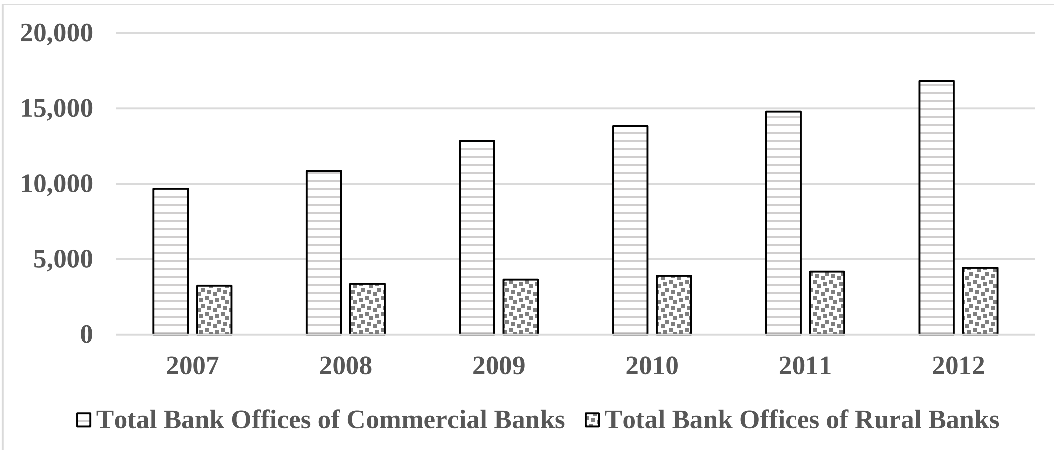
Figure 3.8. Total Assets and Fund Distributions of Rural Banks: 2007-2012 (in Billion IDR)



Source: BI (Bank Indonesia), 2014j (Edited)

As indicated in the Figure 3.8, total assets and fund distributions of BPR (the rural banks) also increased year by year. This implies that BPR as well as commercial banks increased assets and kept good performance, while the value of the assets of BPR is much less than that of commercial banks. The number of offices is also more in commercial bank than in BPR (the rural banks) (the Figure 3.9). It is in accordance with the gap of the amount of capital between commercial banks and BPR.

Figure 3.9. The Number of Total Bank Offices of Commercial Banks and Rural Banks: 2007-2012



Source: BI (Bank Indonesia), 2014j (Edited)

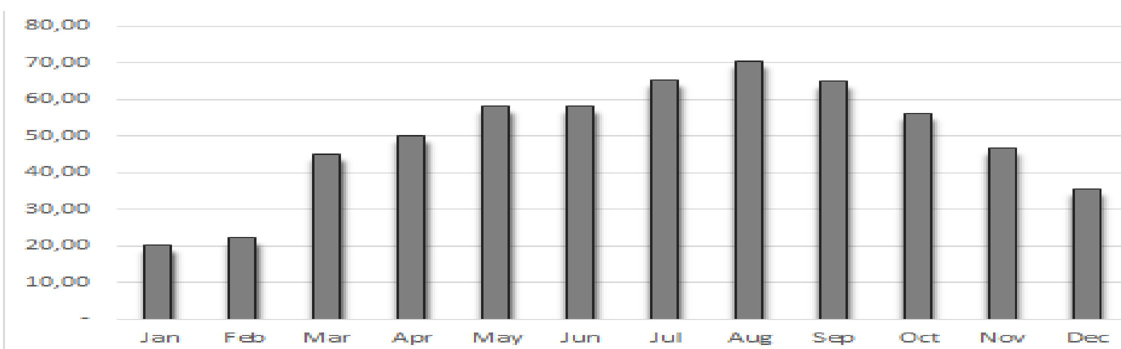
It can be concluded at this point that the financial system in Indonesia in the years 2007 to 2012 was relatively stable: Banks can channel their assets properly if judged from distributions of funds; Total assets of banks (both commercial banks and BPR) increased, and, parallel to this trend, the number of bank offices also increased steadily every year[54].

[54] In terms of macroeconomic performances, too, stability of Indonesian economy can be confirmed. Indonesia has increased the international reserves from less than 10 billion USD (6% of GDP) in the early 1990s to 120 billion USD (14.8% of GDP) in June 2011. It has contributed to reducing Indonesia's external vulnerabilities (Ruiz-Arranz and Zavadjil, 2012: 63). Adding to this, foreign exposure of Indonesian firms has been the lowest in emerging-market countries. For example, foreign assets as a percentage of total assets were below 5% on average in Indonesia compared with about 50% in Mexico and more than 25% in Korea. Furthermore, Indonesian firms have reduced their dependence on foreign borrowing and self-financing as well as expanded their

However, the Indonesian banking system still holds potential negative factors against risks which may be originated from various factors in the global or the domestic markets, such as fluctuations in interest rates, foreign exchange, or inflation. They are not negligible matters given that the level of international borrowing by the corporate sector as a proportion of reserve still remains one of the highest in the region: 46.6% in Indonesia, 8.4% in Korea, 11.0% in Malaysia, 32.1% in Philippines, and 54.6% in Thailand in May 2010 (Ruiz-Arranz, 2012: 99, Table 7.1).

The Figure 3.10 below reveals that the bank interest rates in Indonesia were very volatile in 1998. At that time, as stated in the first section, a lot of banks went into bankruptcy as a result of the high bank interests fluctuations. In the longer terms too, we can discern the same unstable trend from the Figure 3.11 which indicates that the central bank rates as a reference to the bank interest rates have often fluctuated since the Asian currency crisis in 1997 and 1998. Even after the crisis, the rates over 10% happened several times, from 1999 to 2009.

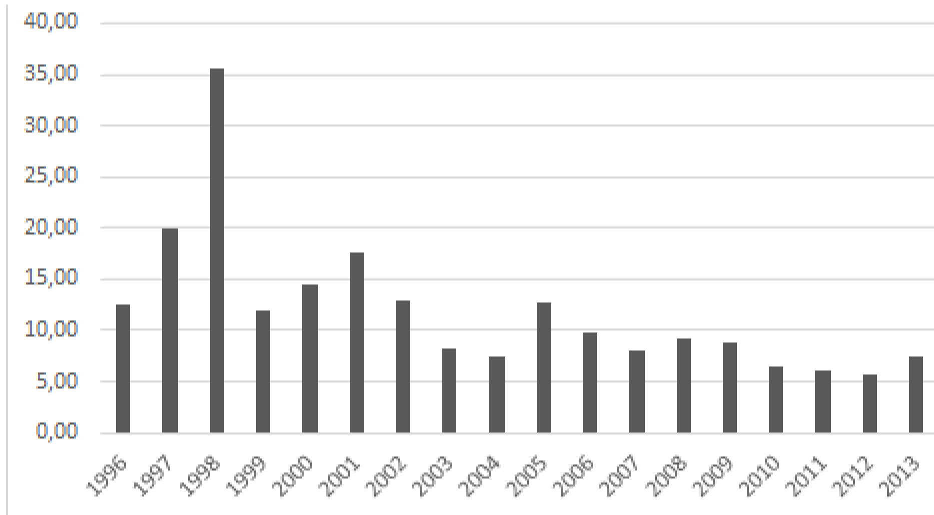
Figure 3.10. Indonesia Interest Rates in 1998 (in Percentage)



Source: BI (Bank Indonesia), 2014k

reliance on equity and bond financing. Private external debt declined from 40% of GDP in 2000 to 14% of GDP in 2008.

Figure 3.11. Interest Rates of Bank Indonesia: 1996-2013 (in Percentage)



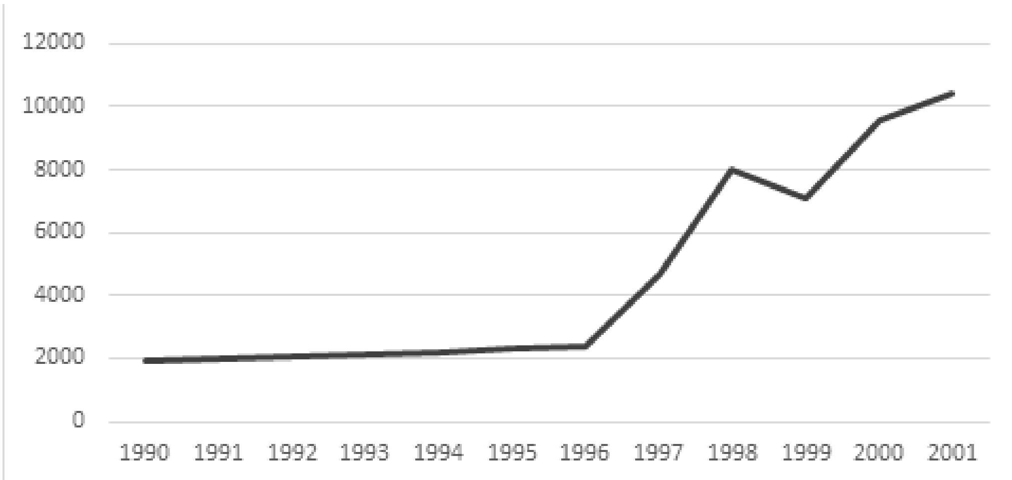
Source: BI (Bank Indonesia), 2014k

With respect to the foreign exchange rates, the Figure 3.12 describes the currency exchange rate of the Indonesian rupiah (IDR) to the United States dollar (USD) was stable from 1990 until 1996. But it rose suddenly and harshly in 1997 and again in 1999. The Figure 3.13 which traces more recent period from 2001 to 2013 also shows that the value of IDR against USD moved with high fluctuations. Keen rises (depreciation of IDR) above the average (8,000 to 10,000) often happened. Even pungent increase (over 10,000) occurred four times in 2001, 2002, 2005, and 2008. Furthermore, as the Figure 3.14 reveals, in the most recent one year, October 2014-October 2015, the exchange rate ranged from 12,000 to almost 15,000 IDR: High fluctuations occurred in November 2014, March and October in 2015.

This suggests that the exchange rate system is still vulnerable to USD. IDR was depreciated in August 2005 to the lowest level of 2002. The crisis caused the international reserves position which decreased drastically from 35 billion USD in early 2005 to 28 billion

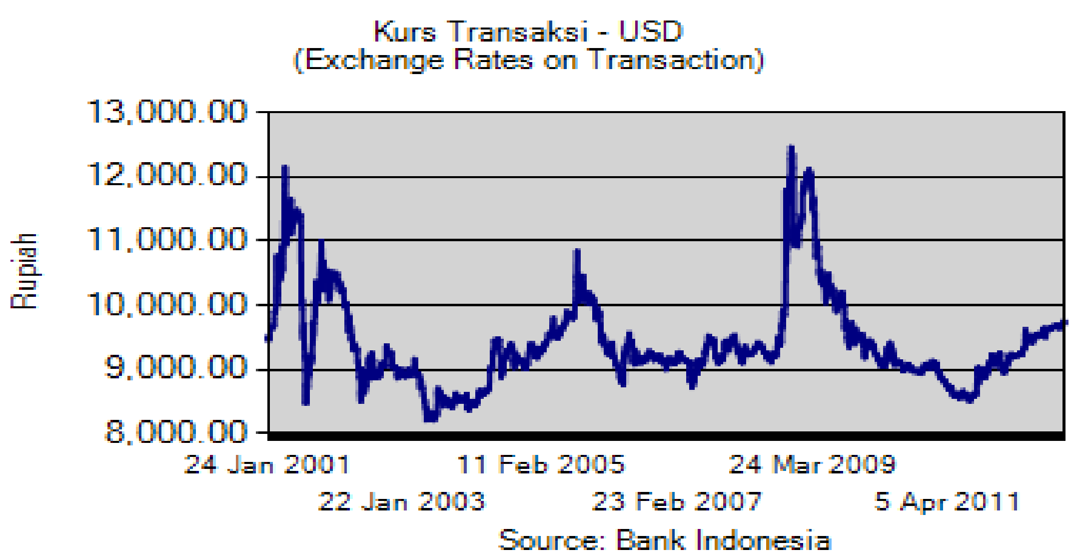
USD in September 2005. The situation forced Bank Indonesia to raise the interest rate from 8.5% in July 2005 to 12.75% in December 2005 (Adiningsih, 2007).

Figure 3.12. Exchange Rates of IDR to USD in the Years 1990 to 2001 (Indonesian Rupiah)



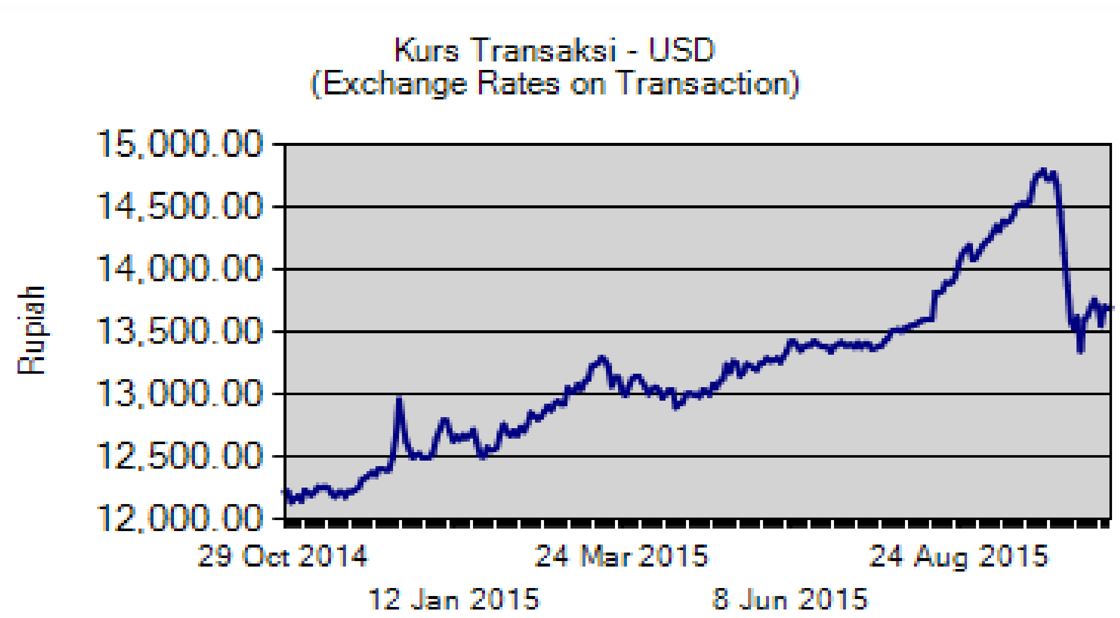
Source: BPPK (Badan Pendidikan dan Pelatihan Keuangan or Finance Training and Education. Finance Department of Indonesia), 2014

Figure 3.13. Exchange Rates of IDR to USD in the Years 2001 to 2013 (Indonesian Rupiah)



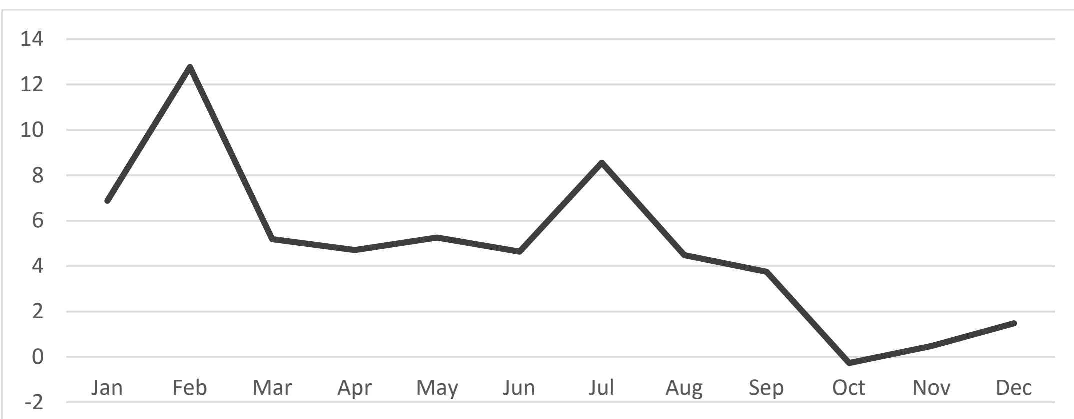
Source: BI (Bank Indonesia), 2015j

Figure 3.14. Exchange Rates of IDR to USD in One Year: October 2014-October 2015 (Indonesian Rupiah)



Source: BI (Bank Indonesia), 2015k

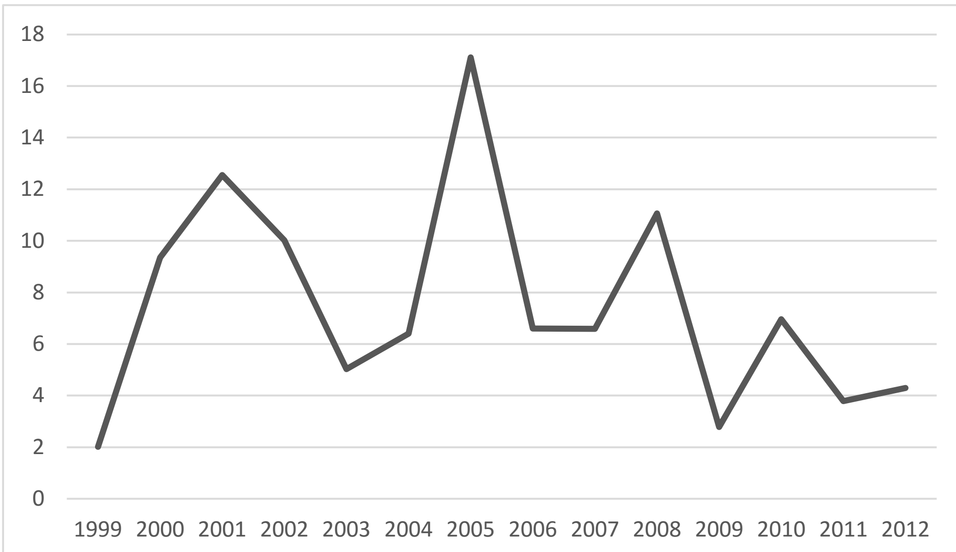
Figure 3.15. Inflation in Indonesia in 1998



Source: BPS (Biro Pusat Statistik or Statistics Indonesia), 2014a (Edited)

Concerning inflation, the Figure 3.15 demonstrates high volatility of prices in Indonesia in 1998 which was uncontrollable under the monetary authority. This was due to the rocketing interest rates during the year. However, in the longer term too, inflation rates after the Asian currency crisis, from 1999 to 2012, showed towering fluctuations (the Figure 3.16). Lofty fluctuations of prices give a signal that the banking and financial system are still unstable in Indonesia[55].

Figure 3.16. Inflation in Indonesia after Economic Crises in the Years 1999 to 2012

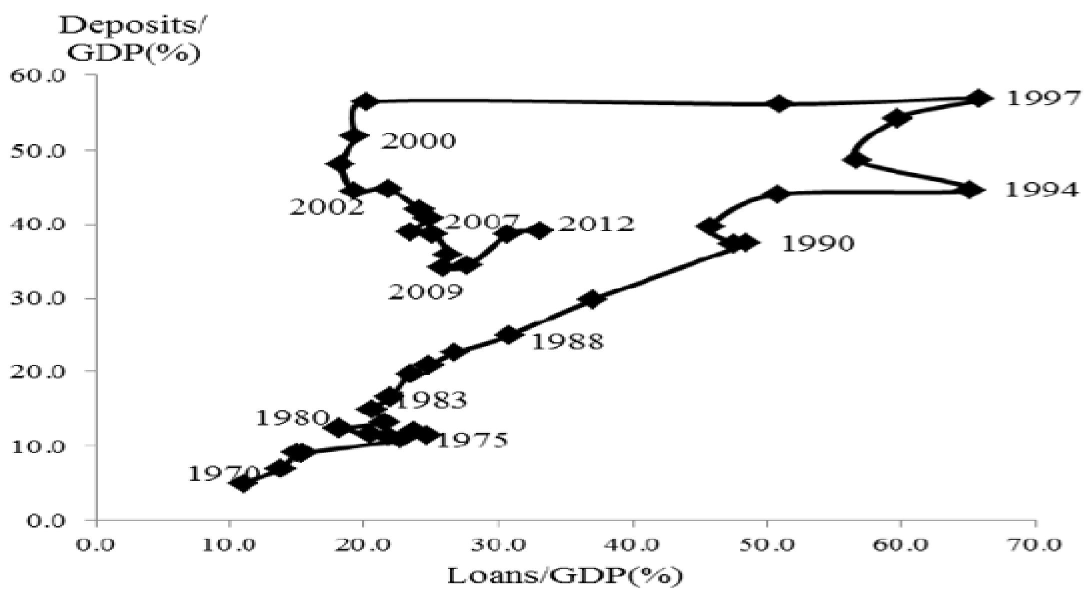


Source: BPS (Biro Pusat Statistik or Statistics Indonesia), 2014a (Edited)

[55] For example, in the second semester of 2005, external factors and global imbalances changed the macroeconomic situation of Indonesia suddenly. Sharp increase of oil prices (the highest in twenty-five years), rise of the Federal Fund rate and subsequent USD appreciation caused current account pressure, IDR depreciation and high inflation in Indonesia. As a result, IDR depreciated to almost 12,000 in August 2005 and inflation rate reached to as high as 17.1 % (Ananta et al., 2011). In the case of the financial crisis in 2007-2009, "a visible pick-up in inflation" occurred firstly and continued from the second half of 2007 to the first half of 2008. Inflation target of Indonesia was 4 to 6 % at the period, but inflation was not controlled and reached over 11 % at the peak of August 2008. Tang points out that "global financial uncertainty" caused depression of returns on bonds and equities, which "pushed investors into alternative investment classes, such as commodities". Bank Indonesia finally raised bank rate by 25 bps to 8.25 % (Tang, 2014).

All data shown in this subsection prove that the Indonesian financial system is still fragile: Inability to keep interest rates, exchange rates and inflation rates stable has negative impact on the Indonesian financial system indirectly[56]. The chart below (Figure 3.17) reflects a long tendency of fluctuation and instability of the Indonesian banking sector in terms of a ratio of deposits to GDP and a ratio of loans to GDP. The peak recorded in 1997 was deteriorated from that year to 2009 after which, however, the performance improved slightly (Hamada, 2013).

Figure 3.17. The Development of the Banking Sector in Indonesia: 1970-2012



Source: Hamada, 2013

[56] In the case of the financial crisis in 2008-2009, the Indonesian currency suffered the most in Southeast Asia. IDR depreciated over 30 percent against USD in October and November 2008, which was accelerated by huge capital flight. Besides, the stock market in Indonesia was heavily damaged: It lost “two-thirds of its value between January and September 2008” (Chowdhury and Islam, 2011). “Banking confidence also fell sharply”, as illustrated by shrink of interbank borrowing from 206 million IDR in December 2007 to 84 trillion IDR in December 2008. Banks “sought to repair their balance sheets by pushing up interest rates” (Basri and Hill, 2011).

If such a trend will continue, then another banking crisis may probably be triggered again by some market risks. As discussed in the second chapter, for the purpose of reducing potential risks in foreign interest rates, exchange rates and inflation rates as much as possible, efforts to reinforce the financial system by introducing and intensifying another banks such as Islamic banks is worth considering, especially if we consider Indonesian case where the mixed banking system was already introduced.

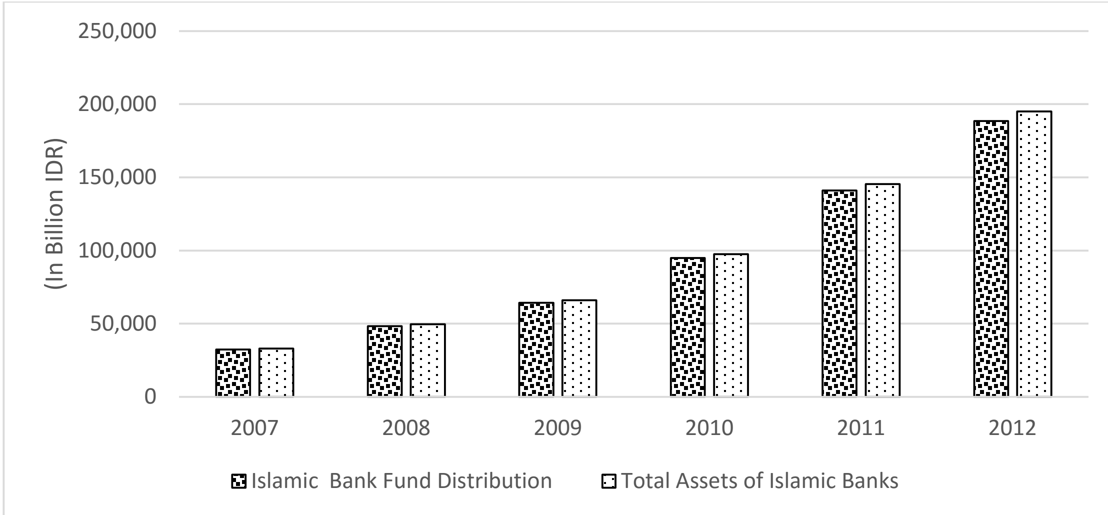
3.3. Islamic Banking Sector in Indonesia and Significance of Its Role

3.3.1 Recent Growth of Islamic Banks in Indonesia

Actually, Indonesia has much potential in advancement of Islamic banks mainly because of existence of the world's largest Muslim population whose dealing with Islamic banks will grow steadily and because of performance of Islamic banks over the past decade that were relatively promising (Ismal, 2011). How to intensify Islamic banks more than at present in Indonesia and what measures should be taken for the purpose will be considered in the next chapter. Then here in this subsection, I only mention to the outline of recent growth of Islamic banks in Indonesia.

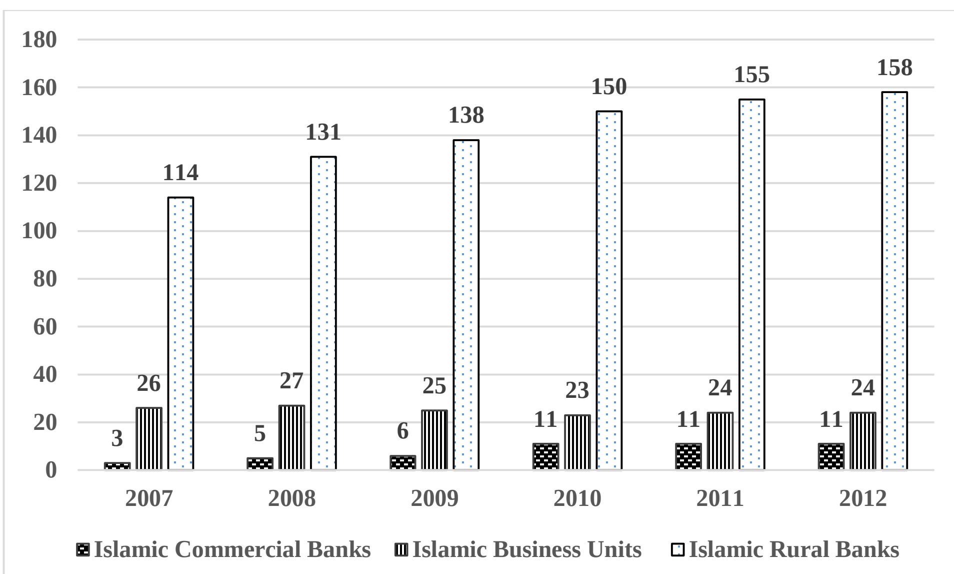
As indicated in the Figure 3.18, total assets of Islamic banks have increased sharply in recent years and fund distribution, in tandem with it, have also increased. They demonstrate an aspect of good performance of the Islamic banks in Indonesia.

Figure 3.18. Assets and Fund Distribution of Islamic Banks in Indonesia: 2007-2012



Source: BI (Bank Indonesia), 2014l

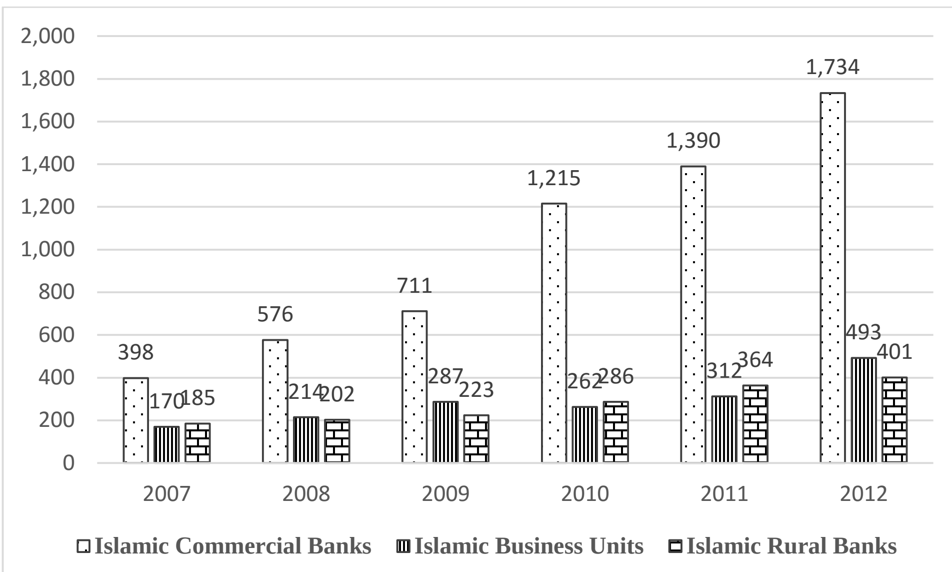
Figure 3.19. The Number of Islamic Commercial Banks, Islamic Business Units, and Islamics Rural Banks: 2007-2012



Source: BI (Bank Indonesia), 2014l

The Figure 3.19 shown above reveals that the number of commercial Islamic banks turned out to have relatively little increased over the years from 2007 to 2012: Started with 2007 to 2008 and 2009, it increased from 3 to 5 and 6 respectively; In contrast, during the three years of 2010, 2011, and 2012, it did not change in the number of 11. The number of Islamic business units in conventional banks has been volatile from 23 to 27 units between 2007 and 2012. On the other hand, the number of Islamic BPR is raised steadily from 114 units in 2007 to 158 units in 2012.

Figure 3.20. The Number of Offices of Islamic Banks in Indonesia: 2007-2012



Source: BI (Bank Indonesia), 2014l

However, while the total number of commercial Islamic banks is not remarkably increasing, it does not mean decline or stagnation of the Islamic banks in Indonesia. It is because, as stated earlier, assets and funds of Islamic banks are steadily increasing, and because Islamic bank offices have been propagated in Indonesia. The Figure 3.20 tells us that while the number of offices of commercial Islamic banks developed rapidly to 1,734 offices in 2012, the number of Islamic business unit offices also developed from 170 in 2007 to 493. Islamic BPR offices also experienced a bit of development: The office number of them was from 185 in 2007 to 401 in 2012.

Although recent quantitative development of Islamic banks in Indonesia cannot be revealed clearly, a series of the figures shown in this subsection proves that Islamic banks are surely developing in terms of the scale of assets and the number of offices.

3.3.2 Stability of Islamic Banks in Indonesia during and after the Crisis

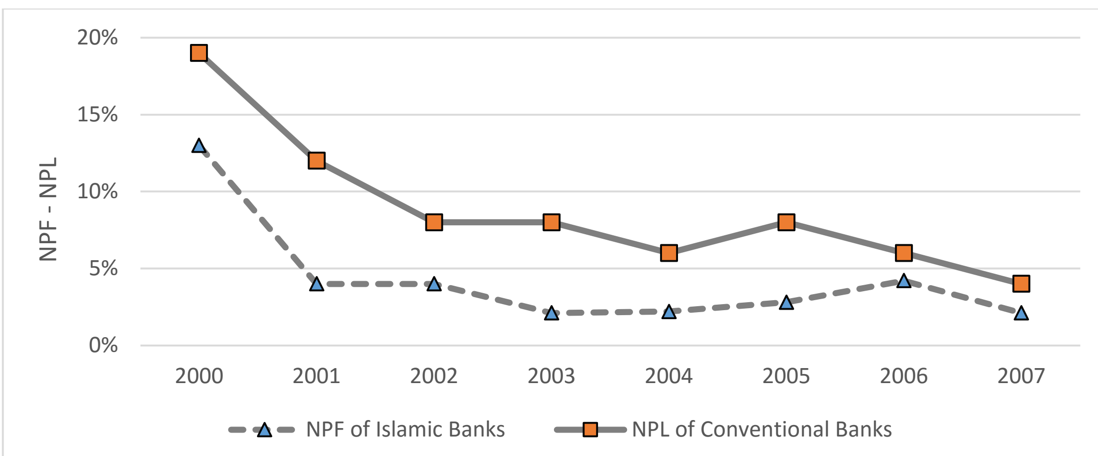
A financial crisis which frequently occurs oscillates confidence in the global financial system and increases uncertainty of future macroeconomic trends. In such an environment, as surveyed in the second chapter, not a few researchers on the period before, during and after the global financial crisis have remarked that Islamic financial activities showed better performance mainly measured by profitability, liquidity, and solvency than conventional financial activities. Theoretically, this may be due to the prohibition of interest (*riba*) and the ethics and morals in the financial practices of Islamic banks which keep them away from speculative transactions (See the first chapter). Accordingly, their behaviors can reduce risk and increase quality of assets in the long term. Indeed, knowledge, information, honesty, accountability and transparency are key ingredients for success of Islamic banks and are critical factors to the performance of market and business activities (Al-Roubaie, 2009).

In focusing on Indonesian case, we firstly know that, although there was only one Islamic commercial bank, Bank Muamalat Indonesia (BMI), when the Asian currency crisis erupted in 1997 and, lasting in the next year, gave serious damages to Indonesia, BMI was found to be robust in confrontation with the crisis: It survived in the turmoil and immediately after the demise of the Asian currency crisis, while more than 65 conventional banks bankrupted and closed (Fane and McLeod, 2002).

Mahfudz compares some financial performances of Islamic banks with those of conventional banks during the post-Asian currency crisis period in Indonesia, using the annual reports of the two Islamic banks, Bank Muamalat Indonesia and Bank Syariah Mandiri, and those of the five largest conventional banks, BCA, BNI, BRI, Bank Mandiri, and Bank Danamon. One of the proofs of stability of Islamic banks confronted with the Asia currency crisis can be seen in the performance of NPF (Non Performing Financing), equivalent to NPL (Non-Performing Loan) in conventional banks. Although NPF and NPL are not direct indicators of profitability, they can be considered as indirect ones because decrease of them probably contributes to increasing bank profits. Not only during the period of the crisis in 1997-1998 explained above, but also in the post-crisis period, Islamic banks were continuously able to perform better than conventional banking institutions in terms of NPF: NPF of Islamic banks in 2000 was only 12.96% while NPL of conventional banks was 26.77%, and in the next year, 4.04 % and 14.02 % respectively (Mahfudz, 2011). We can add to NPF performances the fact that EM (equity multiplier), an indicator of solvency risk, which is calculated as total assets divided by share capital (the higher the ratio, the more the bank is relying on debt to finance its asset base) of Islamic banks in 1999 was 15.08% and that of conventional banks was 66.00%, which means that solvency risk of Islamic banks was lower than that of conventional banks (Mahfudz, 2011).

With respect to NPF, looking at the longer term after the crisis and before the next financial crisis, Ika and Abdullah (2011) also compares NPF of six Islamic banks with NPL of six conventional banks during the assessment years of 2000 to 2007. As a result, they show in the Figure 3.21 that NPF of Islamic banks were consistently lower than NPL of conventional banks. Another good performance of Islamic banks is liquidity. Current Ratio (CR: current asset/current liability) is one of indicators of liquidity. It "indicates the capability of firm to meet the current liability with the current asset". The higher the ratio is, the more liquid the firm is. Again, according to a research of Ika and Abdullah, average CR of six Islamic banks in Indonesia during 2000-2007 was 2.50, while that of six conventional banks during the same period was 1.31 (Ika and Abdullah, 2011).

Figure 3.21. NPF (Non-performing finances) of Islamic Banks and NPL (Non-performing loans) of Conventional Banks in Indonesia: 2000-2007

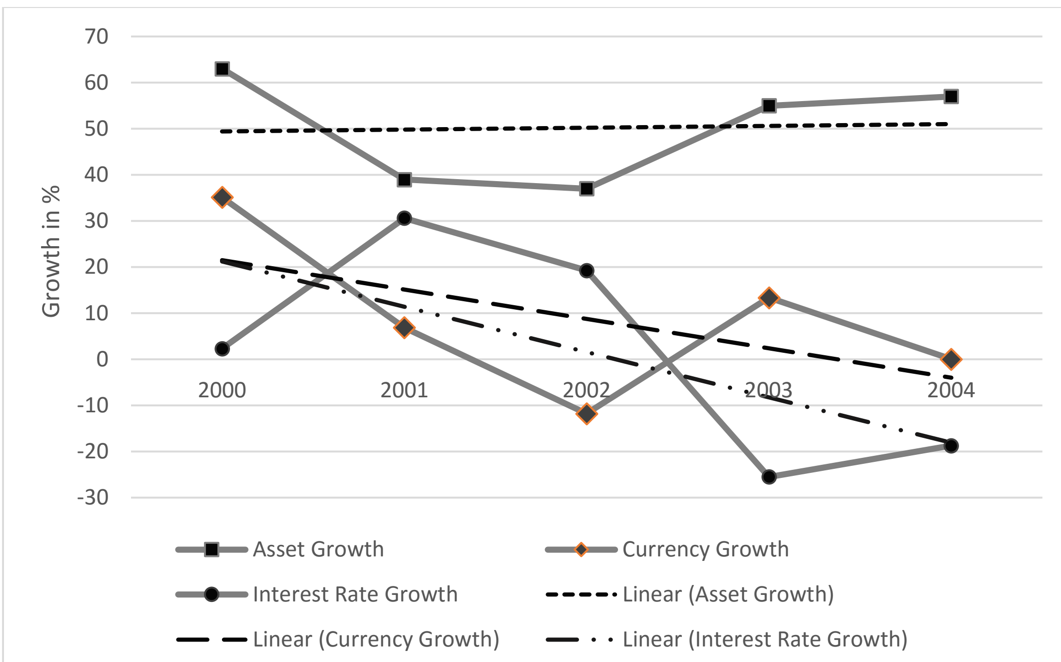


Source: Ika and Abdullah, 2011 (Edited)

Additionally, it is remarkable that, as Hutapea and Kasri (2010) point out, and as also seen in the Figure 3.22 including the research period of Ika and Abdullah, volatility of interest rate and currency growth rate do not give much influence on Islamic bank asset growth rate in Indonesia in the subsequent several years from the Asian currency crisis.

There are two reasons why Islamic banks in Indonesia are little influenced by interest rate and currency growth rate. First, Islamic bank financing still rather focuses on the domestic real economy. Second, Islamic banks do not procure highly sophisticated financial management like large conventional banks and therefore, they cannot deal speculative transactions, nor do they want to do so (BI, 2013a).

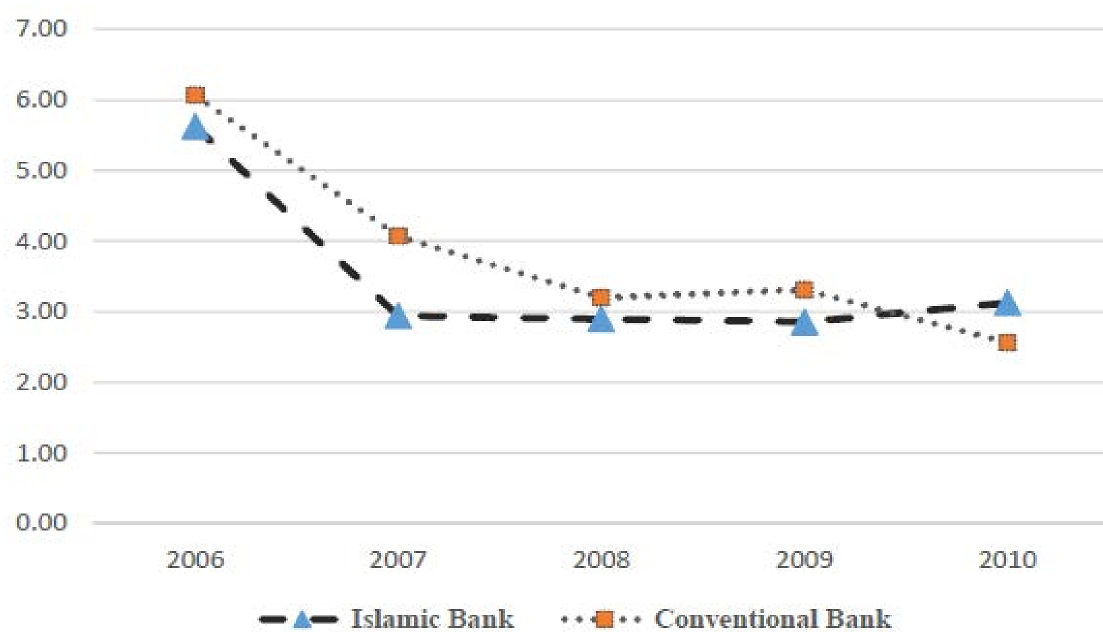
Figure 3.22. Relationship among Asset Growth Rate of Islamic Banks, Currency Growth Rate and Interest Rate Growth in Indonesia: 2000-2004



Sources: BI (Bank Indonesia), 2015f (Edited); BI (Bank Indonesia), 2015g (Edited); and BMI (Bank Muamalat Indonesia), 2015 (Edited)

Concerning the recent global financial crisis in 2008-2009, the performances reported by Bank Indonesia demonstrates that Islamic banks were not so heavily damaged. Three following statistical data (non-performing loans, capital adequacy ratio, and net interest margin) are extracted from the banks whose number is inconstant annually: the number of conventional banks in the years 2006, 2007, 2008, 2009, and 2010 are 130, 130, 124, 121, and 122 respectively. Additionally, the number of Islamic banks is just only four, because although there are twelve Islamic banks which issued annual reports during the period, the four of them are only considered to be ready to comparison with those of conventional banks.

Figure 3.23. Non-performing Loans of Islamic and Conventional Banks in Indonesia: 2006-2010 (in Percentage)

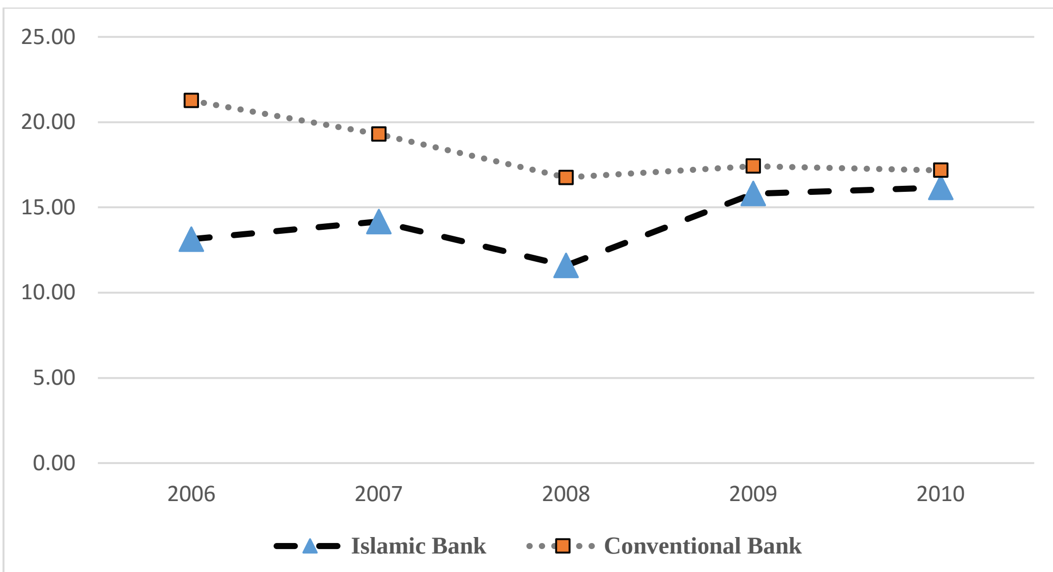


Source : BI (Bank Indonesia), 2015e (Edited)

The Figure 3.23 shows the trend of non-performance loan (NPL), a negative indirect indicator of bank profitability, of Islamic banks and conventional banks in the years 2006 to 2010 which covered the crisis period, revealing that the annual NPL percentage of Islamic banks in Indonesia did not increase but was nearly maintained during the crisis after the sharp decline in 2006-2007, and Islamic bank NPL was always under conventional bank

NPL until 2010. The biggest difference NPL was found in 2007, where the Islamic bank NPL was 3% and the conventional banks one 4%. Total assets, deposit, and financing of Islamic commercial banks and Islamic BPR (BPR Syariah) raised 33%, 42%, and 23% respectively in the years of 2008 to 2009 (Kusuma and Asif, 2012). These suggest that Islamic banks were robust against the crisis and contributed to supporting financial stability (Setiadi, 2012). However, it should be also noted that NPL of Islamic banks and conventional banks were reversed from 2009 to 2010, implying that the financial crisis originated from the conventional financial system extended to the Islamic one and exerted negative influence to it due to the strong linkage of Islamic banks to the real economic sector.

Figure 3.24. Capital Adequacy Ratio (CAR) of Islamic and Conventional Banks: 2006-2010 (in Percentage)

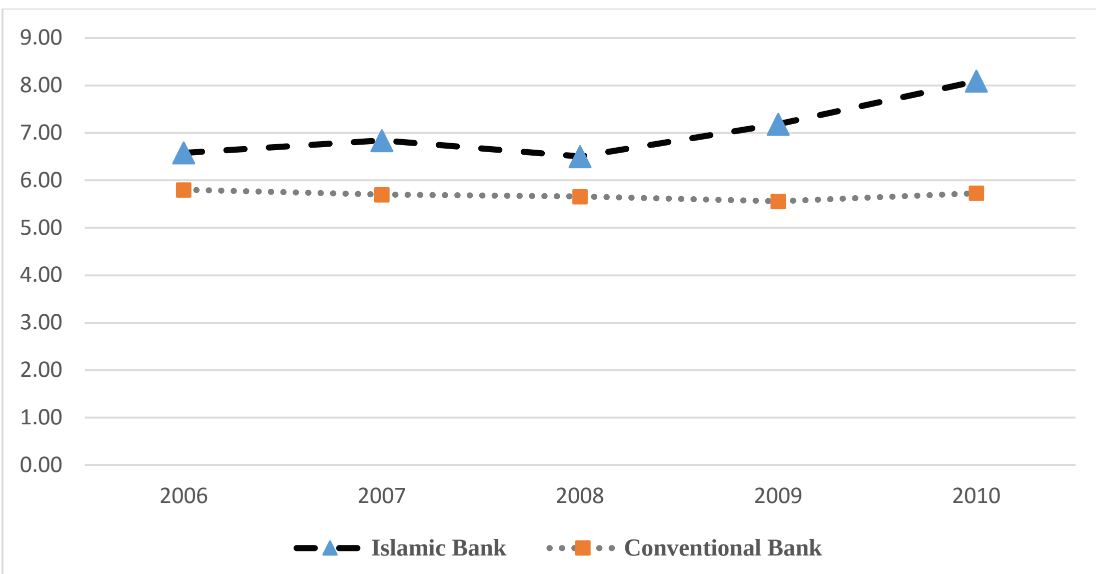


Source: BI (Bank Indonesia), 2015e (Edited)

The Figure 3.24 above indicates the trend of capital adequacy ratio (CAR) of Islamic banks and conventional banks during the years from 2006 to 2010 from which we can point put that while the trend of Islamic banks was overall upward, especially during the crisis in 2008-2009, conventional banks had the downward or stagnating trend during and after the crisis. The contrast implies that Islamic banks were more solvent in terms of capitalization.

Adding to these comparisons, the Figure 3.25 shown below illustrates a trend of net interest margin (NIM) of Islamic banks and conventional banks. It can be found that while NIM of Islamic banks during the period traced almost ascending trend except at the beginning of the crisis, the trend of conventional banks was downward or nearly downward except in 2010 when there was a slight increase. While NIM is not an indicator of banking stability, the contrast means that Islamic banks functioned as financial intermediation better than conventional banks during and after the recent global financial crisis.

Figure 3.25. Net Interest Margin of Islamic Banks and Conventional Banks: 2006 - 2010 (in Percentage)



Source: BI (Bank Indonesia), 2015e (Edited)

As a whole, Islamic banks in Indonesia can be estimated to have been more stable than conventional banks, or at least, not more unstable than conventional bank during and after the global financial crisis from the comparable data which were overviewed in this subsection, although they both traced simultaneously a same downward trend after the crisis.

3.4. Conclusion

Multi-religious countries such as Indonesia and Malaysia can adopt the mixed banking system (coexistence of conventional banks and Islamic banks which are respectively under the separated regulatory systems). Islamic banks are indeed more stable, if not completely, against complexity of the global financial system which generates various risks. Hence Indonesia which adopts the mixed banking system needs to intensify Islamic banks and its financial intermediary function of channeling funds to the public. Although the number of offices and assets of Islamic banks continue to increase year by year, as will be explained again in the next chapter, Islamic bank assets are still only 5 percent in the total bank assets in Indonesia. Therefore, Indonesia should search for intensifying Islamic banks more than at present with a perspective of its expected contributory role of stabilizing the whole financial system in Indonesia in the long run.

Chapter 4. Key Factors for Intensification of Islamic Banks in Indonesia: With Some Comparison with Malaysian Case

4.1. Introduction

Islamic banks appear to be able to grow more rapidly in Muslim-majority countries, such as Indonesia. This is due to a fact that Islamic banks are based on *Sharia*, Islamic religious law. Hence, they may be expected to develop more rapidly in the countries whose population is predominantly Muslim. Surprisingly, Islamic banks in the largest Muslim-majority country in the world, Indonesia, have not developed as fully as expected. Therefore, we should find the reason why such paradox is seen in Indonesia[57].

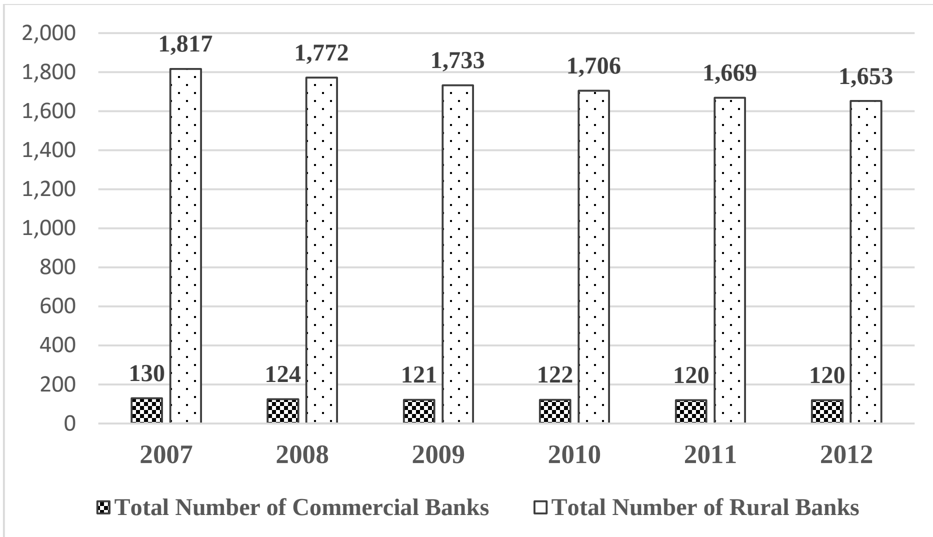
The Indonesian government has so far attempted to develop Islamic banks since the early 1990s. As stated in the third chapter, the first important measure taken by the government was to enact the Banking Act of 1992, the Act No.7/1992 (Indonesia, 2013b). Being based on the Act, the first Islamic bank in Indonesia, Bank Muamalat Indonesia, was established (BMI, 2013).

However, from the Figure 4.1 and the Figure 4.2 (same as the Figure 3.6 and the Figure 3.18 respectively in the third chapter), we can see that the total number of Islamic banks (193) is as small as about 12 per cent of the total number of banks (1,773) in Indonesia

[57] According to Ernst & Young, a consulting company, seven out of the twenty five countries which are classified into the rapid growth markets (RGMs) and affect much influence on the global economy are Muslim countries where Muslim population are the major: Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirates and Turkey, which are called QISMUT, and Bahrain. Besides, these seven countries are categorized as a group that is prospected to be the most important players in the internationalization of the Islamic banking industry in the future (Ernst and Young, 2013).

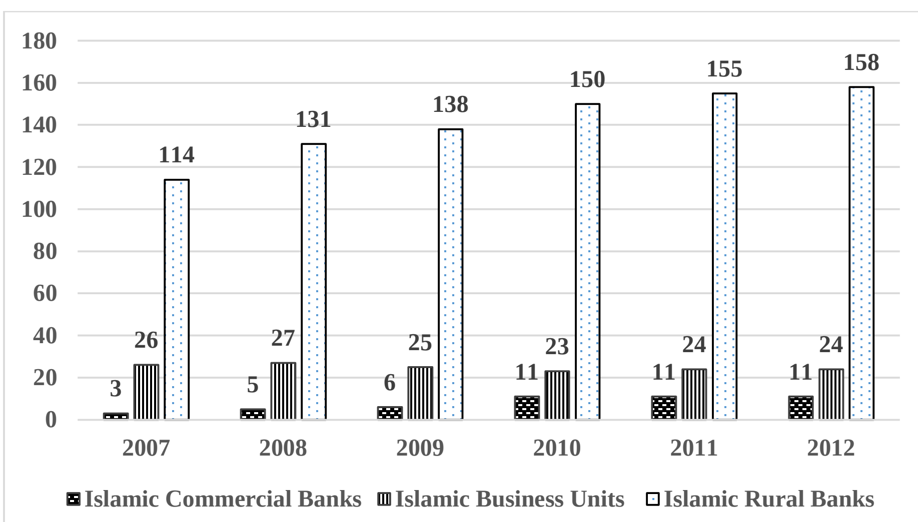
in 2012. Taking into consideration of the fact that Indonesia is the largest Muslim populated country in the world, it is a kind of paradox.

Figure 4.1. The Number of Total Commercial and Rural Banks in Indonesia: 2007-2012



Source: BI (Bank Indonesia), 2014d (Edited)

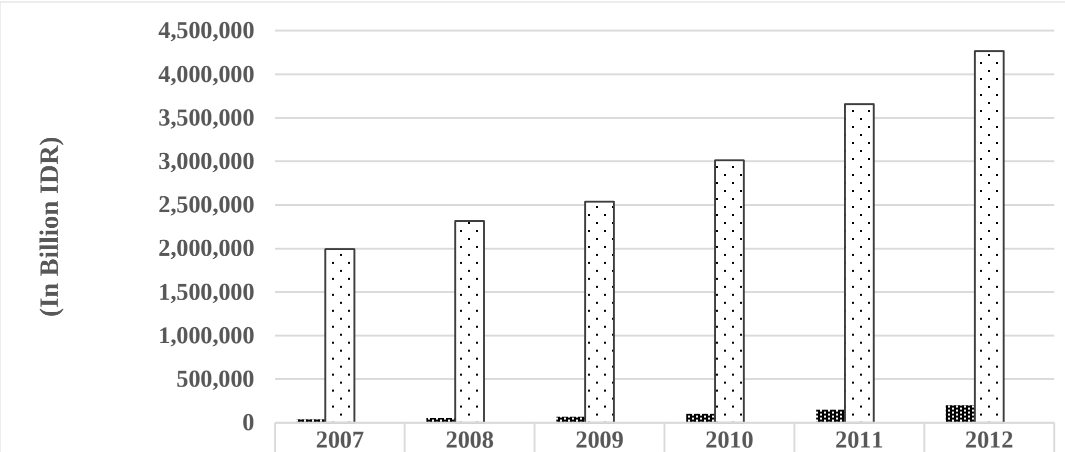
Figure 4.2. The Number of Islamic Commercial Banks, Islamic Business Units, and Islamic Rural Banks: 2007-2012



Source: BI (Bank Indonesia), 2014l (Edited)

Another issue is that an amount of Islamic bank assets is still small when it is compared with conventional banks: The former is still 5 percent of the latter in the year 2012, as indicated in the Figure 4.3.

Figure 4.3. Assets of Islamic Banks and Conventional Banks in Indonesia: 2007-2012



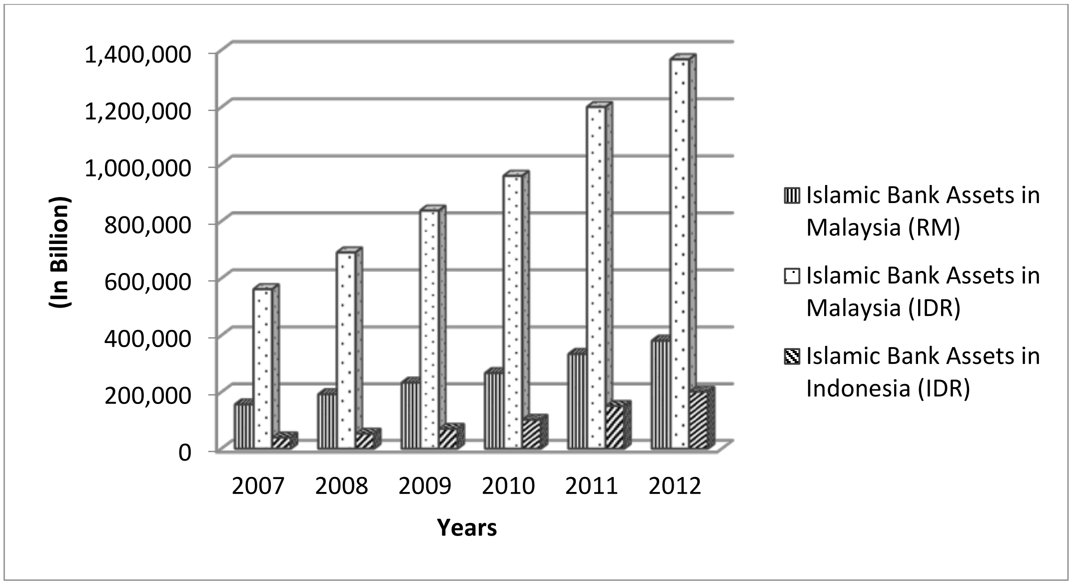
	2007	2008	2009	2010	2011	2012
Islamic Bank	39,748	53,256	70,225	102,268	150,997	201,729
Conventional Bank	1,990,325	2,314,337	2,537,848	3,012,569	3,656,512	4,266,152
Percentage (%)	0	2%	3%	3%	4%	5%

Source: BI (Bank Indonesia), 2014l (Edited)

Moreover, although the Muslim population in Indonesia is larger than in Malaysia, total assets of Islamic banks in Indonesia were only 15 percent of total assets of Islamic banks in Malaysia where assets of Islamic banks reached to 1,367,836 billion IDR (about 120 billion USD) in 2012 (the Figure 4.4) [58].

[58] Indonesia and Malaysia belong to the group located in Southeast Asia that has great potentiality of Islamic banking development, and, as explained in the third chapter, they both adopt the mixed banking system where Islamic banks and conventional banks are under the separated regulatory system. According to Venardos (2012), Islamic banks in South East Asia will be a key factor for the long-term stability of the global Islamic banking and finance. Venardos (2012) also states that

Figure 4.4. Islamic Bank Assets in Indonesia and Malaysia: 2007-2012



Sources: BNM (Bank Negara Malaysia), 2013 (Edited) and BI (Bank Indonesia), 2014l (Edited)

The Figure 4.4 also illustrates that growth of Islamic bank assets in Malaysia has been remarkable since 2007. They rose continuously every year at high rate until 2012 with a result that the ratio of Islamic bank assets to conventional bank assets in Malaysia is as much as 20 percent (Samat, 2013), whereas, as mentioned above, the ratio in Indonesia is only 5 per cent. Although it was absolutely low level, "5 per cent" had been the target set by the government at the end of 2008 (Kasri, 2010). Islamic bank assets in Indonesia had been so small that they got serious attention from the government.

Malaysia, in particular, is one of the centers of global Islamic finance, and will be a model for many countries which intend to follow Malaysian successful case. The country has a long experience of Islamic finance for more than 30 years. The first Islamic bank established in Malaysia is Bank Islam Malaysia Berhad (BIMB). BIMB has been operated since 1983 whose legislative base is Islamic Banking Act (IBA), the Act No. 276 of 1983 and, as a leading Islamic bank in Malaysia, BIMB has 131 branches and more than 1,000 nationwide self-service terminals. The bank has a list of more than 70 innovative and sophisticated Islamic banking products and services which are comparable to those offered by its conventional counterparts (BIMB, 2014a).

A series of the data shown above implies that, while the number of Islamic banks has increased, a growth rate of their assets has been relatively slower for two decades of the operations. As a result, Islamic bank assets in Indonesia are still much smaller compared with the counterparts in Malaysia. Islamic banks still held only a single-digit market share in Indonesia. However, in spite of these hardships, Islamic banks are potentially prospective in "improving performance", and "increasing competitiveness" (Siregar and Ilyas, 2011)[59].

I will argue, in the rest of the chapter, a few of underlying causes of impeding growth of Islamic banks in Indonesia: limited human resources and suboptimal financial and funding structure in Islamic banks (the second section). Afterwards, I will consider the key factors for developing Islamic banks: intensification of higher education program of Islamic economics, finance, and banking to supply the Islamic banking sector with empowered professionals and experts; diversification of finance and funding; and increase of utilization of *sukuk* (the third section). Intensification of Islamic banking education program prior to the higher education level will be mentioned only partially here. Since lack of comprehensive understanding among depositors, business partners, and the public with respect to operation of Islamic banking and the *Sharia* principles is an important issue to be resolved (Ismal, 2013), it will be argued mainly in the fifth chapter. Lastly, I will argue that Indonesia will go his proper way of developing Islamic banks, however much Malaysian

[59] In spite of the slow growth pace of Indonesian Islamic banks pointed out hitherto, in August 2013, Indonesia had 11 full-fledged Islamic banks, 23 Islamic banking units, and 160 Islamic rural banks. Office network increased rapidly up to as many as 2,663. Total asset of Islamic banks also amounted to 22.4 billion USD due to higher financing demand and financing amounted to 17.45 billion USD. CAR of Islamic banks was maintained on 14.71%, with ROA, FDR, and NPF being 2.01%, 102%, and 2.00% all of which indicate good financial performance of Islamic banks (Setiadi, 2012). However, the rest of this chapter will consider the required supporting factors which will strengthen Islamic banks in Indonesia more than at present.

case may be beneficial and suggestive as a successful predecessor. In this regard, comparisons of some aspects in Islamic banking, such as financial contracts, Islamic interbank money market, compliance of the *Sharia* system, and the government role between Indonesia and Malaysia suggest that Indonesia should bring up Islamic banks not only for a purpose of making them commercially competitive in the domestic and international financial market but also for a purpose of making them obey the *Sharia* principle to pursue solidly the social significance of Islamic banking (the fourth section).

4.2. Problems for Intensification of Islamic Banks in Indonesia

Problems for intensification of Islamic banks in Indonesia include several factors. They are:

4.2.1. Human Resources

While the number of employees (professionals and experts) in the Islamic banking sectors has been increased in recent years, supply of professionals and experts from the higher educational institutions does not catch up with the trend. Human resources for Islamic banks are divided into two categories. Firstly, professionals are needed for Islamic current banking operations. Secondly, experts are needed to develop new financial products, research new findings, and resolve issues in Islamic banking and finance.

There are 55 higher educational institutions (undergraduate and graduate schools) which supply the curriculum or program of Islamic economics, finance, and banking, under the jurisdiction of Ministry of Religion: UIN is State Islamic University that offers the curriculum or program of Islamic economics, finance and banking; IAIN and STAIN are

State Institutes of Islamic Religion that offer the same curriculum or program in higher education (the Table 4.1).

Table 4.1. Higher Educational Institutions under Ministry of Religion Which Offer the Curriculum or Program of Islamic Economics, Finance and Banking

No.	The Name of Higher Education	No.	The Name of Higher Education
1	UIN Alaudin Makassar	29	STAIN Jember
2	UIN Malang (Maulana Malik Ibrahim)	30	STAIN Jurai Siwo Metro Lampung
3	UIN Sulthan Syarif Kasim Riau Pekanbaru	31	STAIN Kediri
4	UIN Sunan Gunung Djati Bandung	32	STAIN Kendari
5	UIN Sunan Kalijaga Yogyakarta	33	STAIN Kerinci
6	UIN Syarif Hidayatullah Jakarta	34	STAIN Kudus
7	IAIN Antasari Banjarmasin	35	STAIN Malikussaleh Lhokseumawe
8	IAIN Ar-Raniry Banda Aceh	36	STAIN Manado
9	AIN Sultan Amal Gorontalo	37	STAIN Padangsidempuan
10	IAIN Imam Bonjol Padang	38	STAIN Palang Karaya
11	IAIN Mataram	39	STAIN Palopo
12	IAIN Raden Fatah Palembang	40	STAIN Pamekasan
13	IAIN Raden Intan Bandar Lampung	41	STAIN Parepare
14	IAIN Sultan Maulana Hasanuddin Serang Banten	42	STAIN Pekalongan
15	IAIN Sultan Thaha Saifuddin Jambi	43	STAIN Ponorogo
16	IAIN Sumatera Utara Medan	44	STAIN Pontianak
17	IAIN Sunan Ampel Surabaya	45	STAIN Purwokerto
18	IAIN Walisongo Semarang	46	STAIN Salatiga

19	IAIN Ambon	47	STAIN Samarinda
20	IAIN Cirebon	48	STAIN Sorong
21	STAIN Syekh Abdurrahman Siddiq Bangka Blitung	49	STAIN Surakarta
22	STAIN Al-Fatah Jayapura	50	STAIN Ternate
23	STAIN Batusangkar	51	STAIN Tulung Agung
24	STAIN Bengkulu	52	STAIN Watampone
25	STAIN Bukittinggi	53	STAIN Gajah Putih Takengong, Aceh Tengah, Aceh
26	STAIN Cot Kala Langsa	54	STAIN Bengkalis
27	STAIN Curup	55	STAI Teungku Dirundeng Meulaboh
28	STAIN Datokrama Palu		

Source: Kemenag (Kementrian Agama or Ministry of Religious), 2015

Meanwhile, as shown in the Table 4.2, there are 27 universities (undergraduate and graduate schools) which supply the curriculum or program of Islamic economics, finance, and banking under the jurisdiction of Ministry of Research-Technology and Higher Education (ex-name is Ministry of National Education).

Table 4.2. Higher Educational Institutions under Ministry of Research-Technology and Higher Education Which Offer the Curriculum or Program of Islamic Economics, Finance and Banking

No.	**The Name of Higher Education**	**No.**	**The Name of Higher Education**
1	Universitas Muhammadiyah Jakarta	15	Universitas Nahdlatul Ulama Nusa Tenggara Barat
2	Universitas Brawijaya	16	Universitas Ibn Khaldun
3	Universitas Padjadjaran	17	Universitas Darussalam Gontor

4	Sekolah Tinggi Ilmu Ekonomi AAS	18	STAI Natuna
5	Universitas Islam Nahdlatul Ulama Jepara	19	Universitas Tanjungpura
6	Universitas Negeri Surabaya	20	STEI Iqra Annisa Pekanbaru
7	Universitas Syiah Kuala	21	Universitas Islam Negeri Sunan Gunung Jati
8	Universitas Hasyim Asy'ari Tebuireng Jombang	22	Universitas Mulawarman
9	Universitas Airlangga	23	STIE Muhammadiyah Pekalongan
10	STAI Muhammadiyah Sinjai	24	Universitas Islam Negeri Walisongo Semarang
11	Universitas Malikussaleh	25	Universitas Tomakaka
12	Universitas Wahid Hasyim	26	Universitas Islam Riau
13	Universitas Indonesia	27	Institut Bisnis Muhammadiyah Bekasi
14	STAI Ihyaul Ulum Gresik		

Source: Pddikti (Pangkalan Data Pendidikan Tinggi Direktorat Jenderal Pendidikan Tinggi, Indonesia), 2015 (Edited)

Here we assume roughly that total entrance quota of the students in the two lists shown above are recruited by the Islamic banks, even if it would be actually improbable, and that professional employees come from undergraduate schools, while experts come from master and doctoral courses in graduate schools. As a result, we can get a following table where the ratio is 96% for professionals and 4% for experts and the assumed maximum number of supply for the Islamic banks from the higher educational institutions is 13,993 which is divided into 13,461 for professionals and 532 for experts (The Table 4.3).

Table 4.3. An Assumed Maximum Supply for the Islamic Banks from the Higher Educational Institutions in Indonesia

Sources of Supply	amount		%
Professionals – Diplomas of the Undergraduate under Ministry of Religion	10,263		
Professionals – Diplomas of the Undergraduate under Ministry of Research-Technology and Higher Education	3,198		
Sub Total		13,461	96%
Experts – Masters and Doctorates under the Ministry of Religion	375		
Experts – Masters and Doctorates under the Ministry of Research-Technology and Higher Education	157		
Sub Total		532	4%
Total Supply		13,993	100%

Source: Pddikti (Pangkalan Data Pendidikan Tinggi Direktorat Jenderal Pendidikan Tinggi, Indonesia), 2015 (Edited)

With regard to demand side, the Table 4.4 shows the number of employees in the full-fledged Islamic commercial banks in Indonesia in 2013 which are collected from the each annual report of the banks. The table does not include Islamic rural banks and Islamic banking units because the data are not available. However, it seems to be reasonable that the ratio of 97% for professionals and 3% for experts in Islamic full-fledged commercial banks is roughly applicable also to Islamic rural banks and Islamic banking units.

Table 4.4. The Number of Employees in the Islamic Banks in Indonesia in 2013

No.	Islamic Full-fledged Commercial Bank	Professionals	Experts
1	Bank Muamalat Indonesia	5,884	132
2	Bank Victoria Syariah	198	8
3	BRI Syariah	4,725	140
4	Bank BJB Syariah	730	32
5	Bank BNI Syariah	3,713	111
6	Bank Syariah Mandiri	903	34
7	Bank Mega Syariah	4,578	43
8	Bank Panin Syariah	197	46

9	Bank Bukopin Syariah	564	20
10	Maybank Syariah Indonesia*	0	0
11	PT.BCA Syariah*	0	0
12	PT. Bank Tabungan Pensiun Syariah*	0	0
	Total	21,492	566
	Percentage	97%	3%

Sources: BMI (Bank Muamalat Indonesia), 2014b; BVS (Bank Victoria Syariah), 2014; BRIS (Bank Rakyat Indonesia Syariah), 2014; BJBS (Bank Jabar Syariah), 2014; BNIS (Bank Negara Indonesia Syariah), 2014; BSM (Bank Syariah Mandiri), 2014; BMS (Bank Mega Syariah), 2014; BPS (Bank Panin Syariah), 2014; BBS (Bank Bukopin Syariah), 2014 (Edited)
Note: * Annual report 2013 is not available.

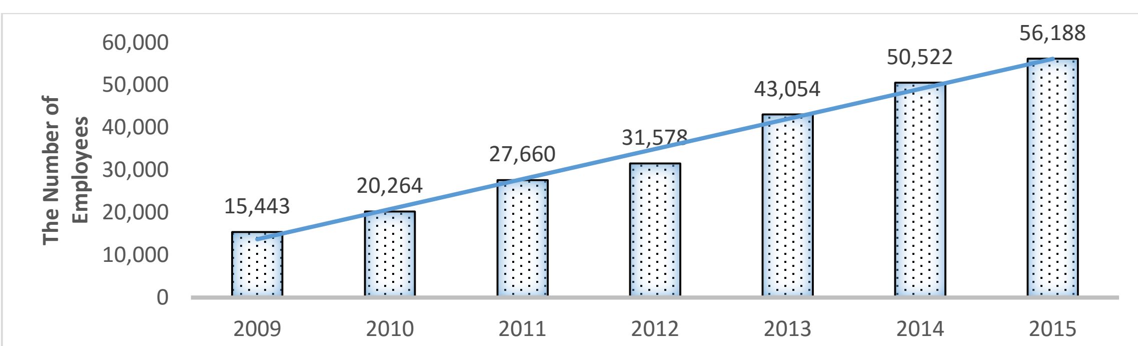
Meanwhile, we can access statistical data concerning annual average growth of employees (professionals and experts) in the whole Islamic banks, as indicated in the Table 4.5 which shows that an annual growth rate is as much as high 27 per cent (See also the Figure 4.5).

Table 4.5. Indonesian Islamic Bank Employees: 2009 to 2015

Year	2009	2010	2011	2012	2013	2014	2015*
Total	15,443	20,264	27,660	31,578	43,054	50,522	56,188
Growth		31%	36%	14%	36%	17%	
Average Growth						27%	

Source: BI (Bank Indonesia), 2014l
Note: * The number in 2015 is a forecast.

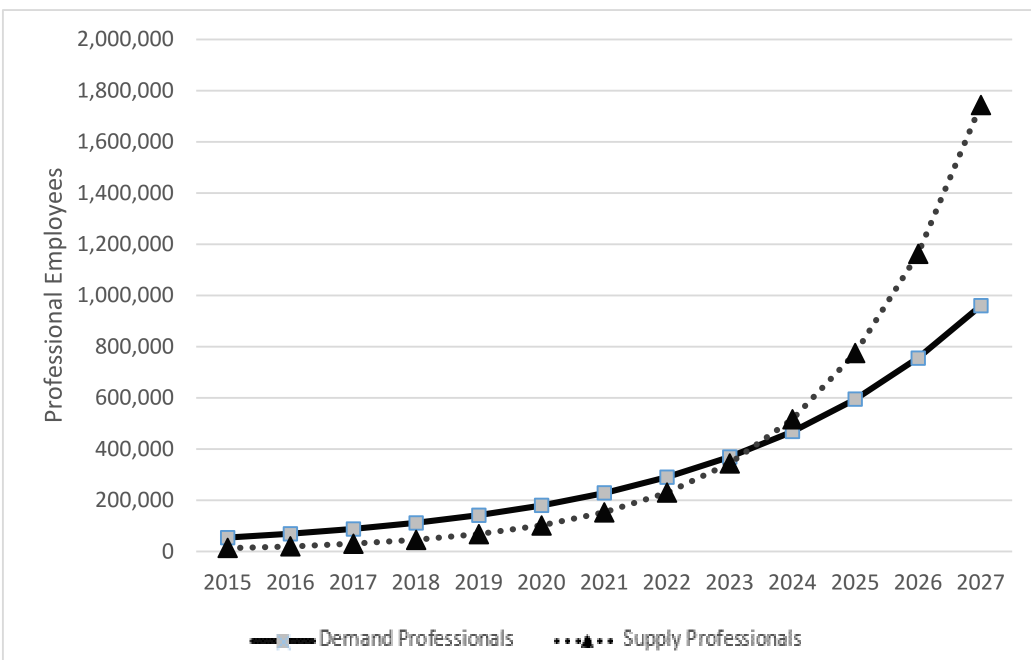
Figure 4.5. Trend Line of Indonesian Islamic Bank Employees: 2009-2015



Source: BMI (Bank Muamalat Indonesia), 2015 (Edited)

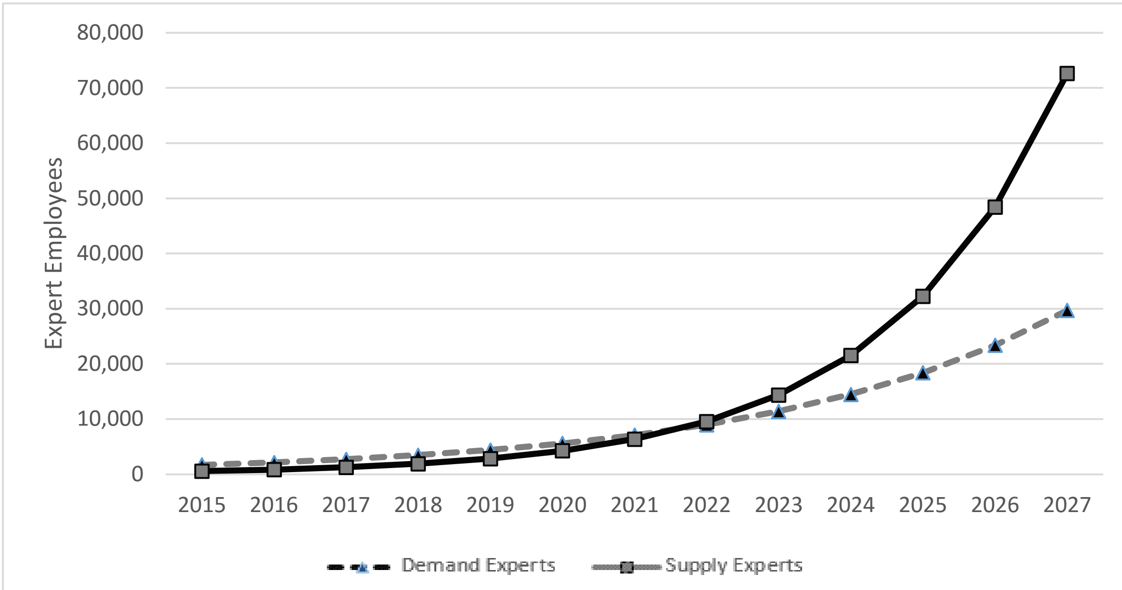
Now we can hypothesize that maximum supply of professionals and experts for the Islamic banks in 2015 will be 13,461 and 532 respectively on the ground of constant quota of student entrance (the Table 4.3) and that, on the other hand, total demand of them will be 56,188 which is divided into 54,502 for professionals and 1,686 for experts deduced from the trend of increase of the total banking sector (the Table 4.5) and from the ratio calculated from the full-fledged Islamic banks (the Table 4.4) in 2015. Then I make three scenarios where supply will grow annually by 30%, 40%, and 50% respectively. The result shows that, while the cases of annual growth of 30% or 40% take too long time to get to equilibrium with the demand line in the near future, the case of annual growth of 50% is more suitable for getting to equilibrium, as illustrated in the Figure 4.6 and the Figure 4.7.

Figure 4.6. Supply and Demand of Professional Employees of Islamic Banks: 2015-2027



Sources: Pddikti (Pangkalan Data Pendidikan Tinggi Direktorat Jenderal Pendidikan Tinggi, Indonesia), 2015 (Edited) and BI (Bank Indonesia), 2014l (Edited)

Figure 4.7. Supply and Demand of Expert Employees of Islamic Banks: 2015-2027



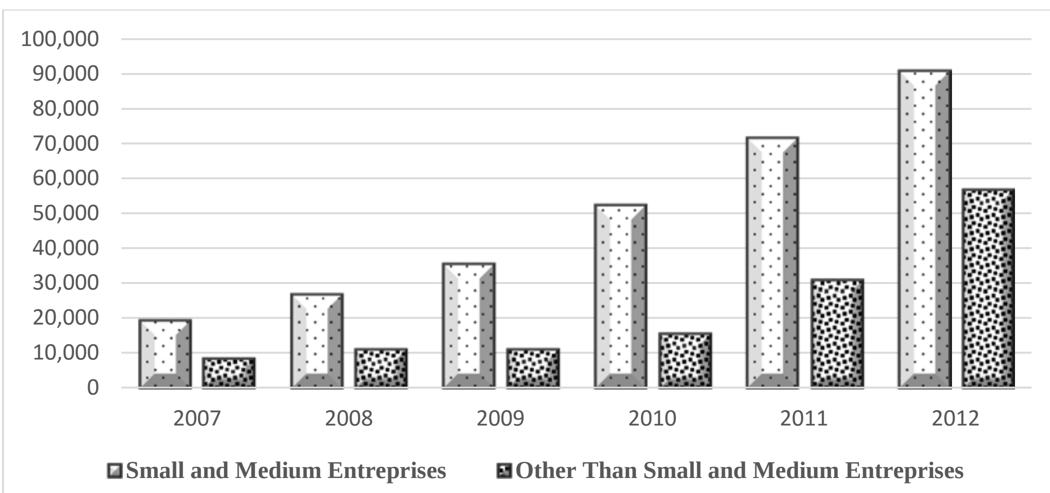
Sources: Pddikti (Pangkalan Data Pendidikan Tinggi Direktorat Jenderal Pendidikan Tinggi, Indonesia), 2015 (Edited) and BI (Bank Indonesia), 2014l (Edited)

Although simulation that I attempted so far lacks exactness, it can be said without doubt that the trend evidently implies that, while development of Islamic banks in Indonesia needs trained and competent human resources, professionals and experts are and will be in short. This is an obstacle against intensification of Islamic banks in Indonesia. Taking such disadvantageous circumstances into consideration, Islamic banks, to fulfill the gap between demand and supply, may resort to training of new employees who have not enough acknowledgements of Islamic economics, finance, and banking in a short and instant course after recruitment. However, such measures may be called ‘firefighting’ systems because they cannot respond to necessity of developing highly competitive products and management in Islamic banking.

4.2.2. Suboptimal Financing Structure

The Figure 4.8 reveals that financing of Islamic banks in Indonesia mainly focuses on small and medium companies[60], or in other words, 62 percent of Indonesian Islamic bank financing in the years 2007 to 2012 is given to small and medium enterprises. It is partly related to the fact that resources available in the majority of Islamic banks are short-term funds, as explained in the next subsection, since such funding structure makes it difficult for Islamic banks to finance more medium and large companies in the long-term. Market segmentation such as this has resulted in loss of good opportunity to obtain greater profits in the long term. Islamic banks in Indonesia cannot be attractive if the revenue continues to stagnate, which discourages depositors from their money to Islamic banks in the long-term time deposit. Here we can find a vicious circle.

Figure 4.8. Financing Groups of Islamic Banks by Enterprise Scale (in Billion IDR): 2007-2012

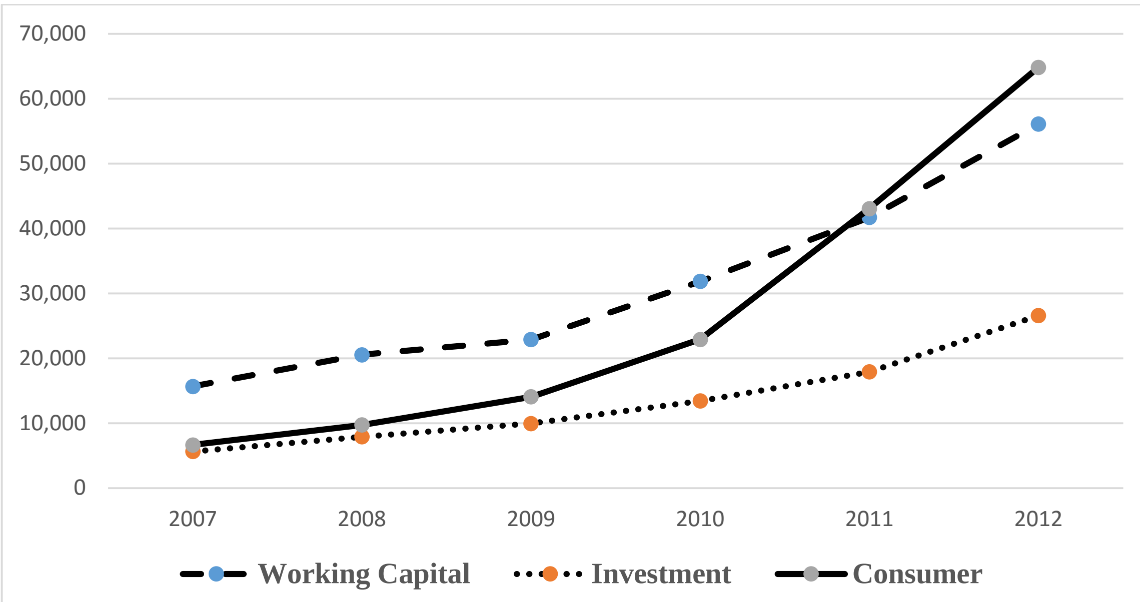


Source: BI (Bank Indonesia), 2014l (Edited)

[60] The Banking Act of 2008 (Act No. 20/2008) defines a small company as a company that has a net worth between 50 million and 500 million IDR, and a medium company between 500 million to 10 billion IDR.

It is obvious that the main target of the Islamic banks in Indonesia is still micro, small and medium enterprises[61]. More profits can be obtained from the optimal financing to firms of medium and large scale. Therefore, the target of market segmentation of Islamic bank in Indonesia should be changed so that the ratio of medium and large companies will be able to be further extended.

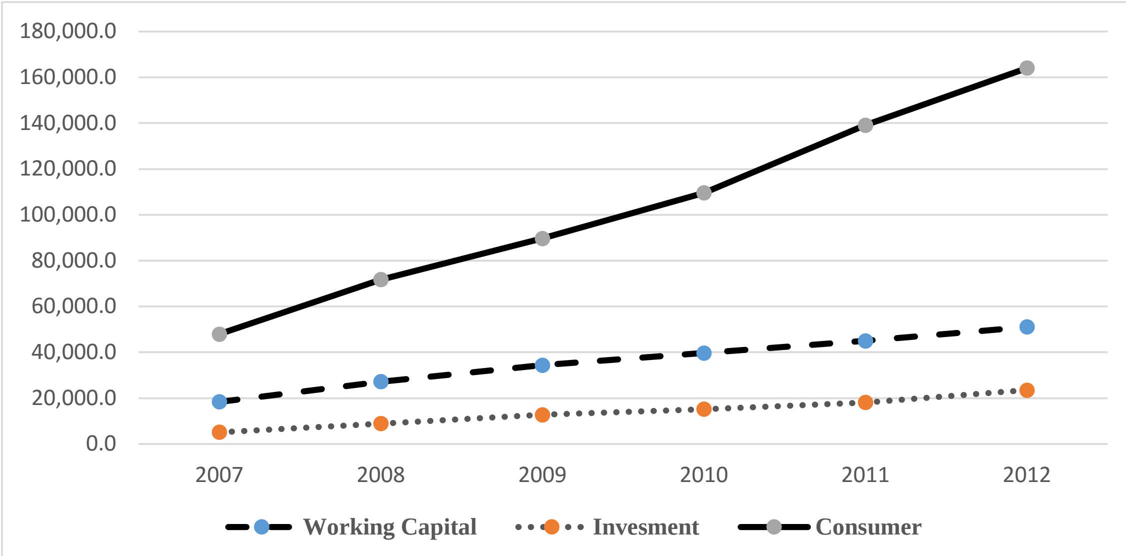
Figure 4.9. Financing by Sector in Islamic Banks in Indonesia: 2007-2012 (in Billion IDR)



Source: BI (Bank Indonesia), 2014l (Edited)

[61] However, it is needless to say that Islamic banks should continue to supply financial services to small and medium enterprises all the more because they perform better than conventional banks in financing small and medium enterprises. According to Mahfudz, NPF (non-performing finance) of Islamic commercial banks (Bank Muamalat Indonesia and Bank Syariah Mandiri) for small and medium enterprises maintained below 1% in the years of 2000-2002. On the other hand, a ratio of NPL (non-performing loan) of the five largest conventional commercial banks in Indonesia for small and medium enterprises was 4.23% in 2000 and 3.24% in 2002. A ratio of SMEs that were unable to repayment was 2.9% in 2000 and 1.49% in 2002 in Islamic banks, while the same ratio was 5.75% and 7.08% in conventional banks. These means that Islamic banks actually contribute better to finance small and medium enterprises than conventional counterparts (Mahfudz, 2011).

Figure 4.10. Financing by Sector in Islamic Banks in Malaysia: 2007-2012 (in Million RM)



Source: BNM (Bank Negara Malaysia), 2014 (Edited)

The Figure 4.9 shows that financing of Islamic banks in Indonesia for working capital was more than financing for investment and for consumption from 2007 to 2010, but that in the subsequent two years, in 2011 and 2012, financing for consumption increased and exceeded the other two types of financing[62]. However, considering that Malaysia, as a predecessor model for Islamic banks in Indonesia, already traced the same pattern (The Figure 4.10), it does not seem to have any significant problem.

[62] Consumer financing has four categories: home financing (mortgage financing) such as KPR (*Kredit Pemilikan Rumah*: credit for purchasing houses); automotive financing (vehicle financing); *Hajj* and *Umrah* (spiritual trip to Mecca in Saudi Arabia conducted by Muslims which can be implemented at any time) financing, and; cooperative member pension financing (employee, teacher, or civil servant financing). Working capital financing is for corporations which need working capital to smooth operations and development of their business. Investment financing is for corporations to support business expansion.

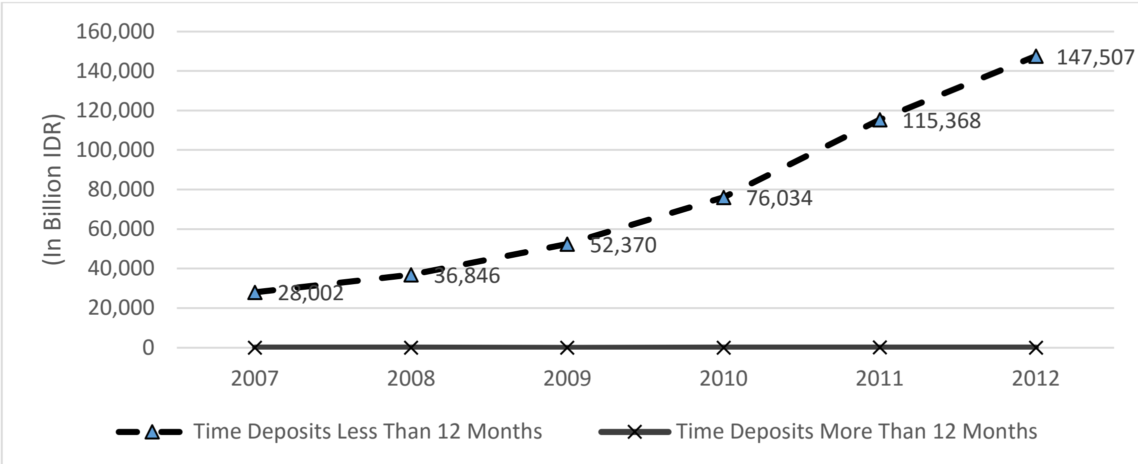
4.2.3. Suboptimal Funding Structure

The funding structure from a third party (investors or depositors) in Islamic banks in Indonesia is still dominated by the short-term deposits. This makes it difficult for Indonesia's Islamic banks to finance large-scale projects (see the prior subsection). As a result, their profit is also limited.

The Figure 4.11 explains that main sources of funds of Islamic banks in Indonesia from a third party which take a form of time deposits are those of short-term less than one year. In contrast, a ratio of long-term time deposits more than one year is conspicuously small. This is a problem that should be taken seriously by practitioners and stakeholders of Islamic banks in Indonesia[63]. The Figure 4.12 also demonstrates that most deposits are composed by time deposits less than one month, except saving deposits ('saving accounts' used in the second chapter as a general term), and demand deposits ('current accounts' in the second chapter).

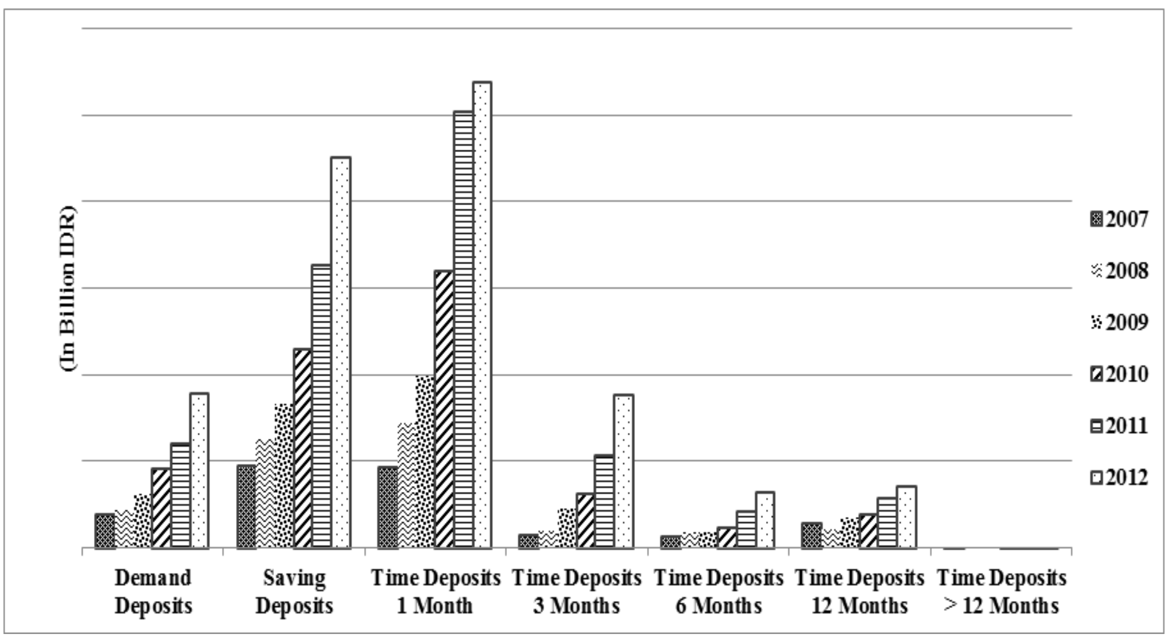
[63] Concentration into short-term deposits is not only true to Indonesian Islamic banks because the depositors of BIMB, a representative major Islamic bank in Malaysia, have not so different preference of maturity. Composition of time deposits of BIMB in 2013 is classified as follows: An overwhelming majority of third party funds, 90 percent, is occupied by the type of 6 month maturity, followed by the type of 6 to 12 month maturity, 9 percent, and by the other longer maturity types, 1 percent in total. Accordingly, if long-term time deposits in not only in Indonesian Islamic banks but also in Malaysian counterparts, such as in BIMB, increase, it will make them easier to manage these funds, particularly for long-term financing.

Figure 4.11. Comparison of Long-term and Short-term Time Deposits in Islamic Banks: 2007-2012



Source: BI (Bank Indonesia), 2014l (Edited)

Figure 4.12. Structure of Deposits in Islamic Banks: 2007-2012



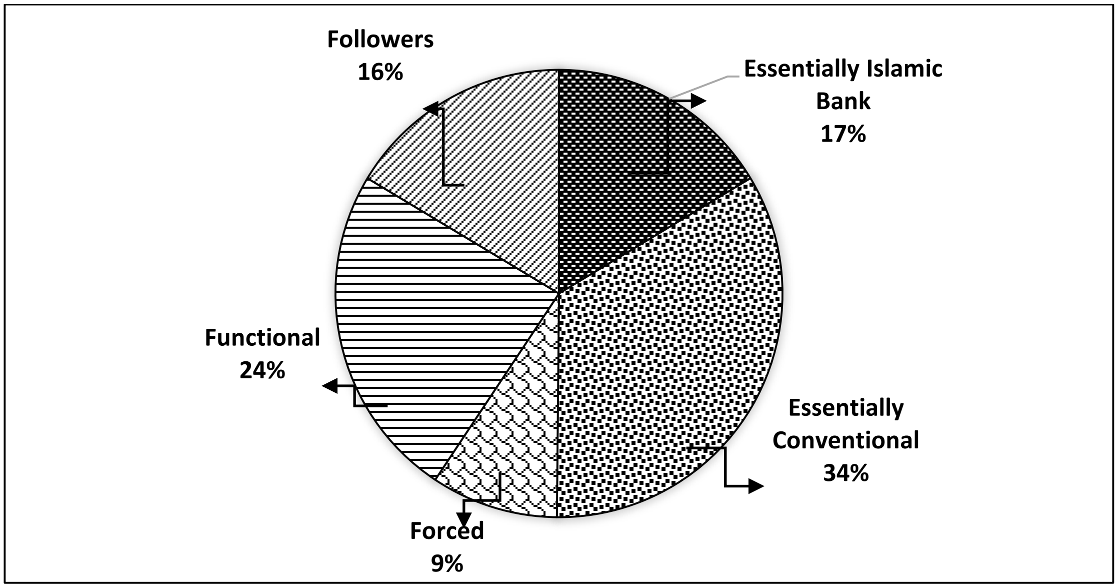
Source: BI (Bank Indonesia), 2014l (Edited)

Ismal (2013) observes that Indonesian Islamic banks are confronted with short-term liquidity management under conditions of short-term deposits and with difficulty of mismatch of funding and larger industrial investment. Admittedly, there is no denying that, once seriously unfavorable conditions such as economic turmoil or non-economic social and political incidents occur, long-term investment will expose the banking sector to higher credit risk. However, Islamic banks in Indonesia should be more aggressive in order to increase a ratio of time deposits not only of twelve month-term, but also of longer-term.

A series of the data above reveals that the structure of deposits from third-party-majority loses balance which impedes, as I already argued, Islamic banks in Indonesia to advance large corporate or long-term financing. Consequently, Islamic banks in Indonesia are not able to get a great income through financing to great enterprises. This must be one of the reasons why Islamic bank assets in Indonesia are still small when compared with conventional bank assets in Indonesia. It is below 5 per cent of that of conventional banks.

However, we should consider here importance of savings motivation of the people. It is doubtless that Indonesian people save money in bank accounts with certain motivation. In this respect, some researchers demonstrate that in general the motivation of people who deposit their money in Islamic banks or conventional bans is to simply get ready returns of money, irrespective of their religious identification or religiosity (Haron and Ahmad, 2000).

Figure 4.13. Depositor Motivations of Short-term Saving Products in Indonesia in 2008



Source: BMI (Bank Muamalat Indonesia), 2014a (Edited)

A research of Markplus (one of the most reputable marketing researchers in Indonesia) demonstrates that most people still prefer conventional banks to Islamic banks: Respondents who deposit all their money with conventional banks comprise the largest segment. Besides, the percentage of respondents who do not rely on Islamic banks is 83 per cent, whose components are as follows: "essentially conventional bank" is 34 percent, "forced" is 9 per cent, "functional" is 24 per cent, and "followers" is 16 per cent. The percentage of respondents that rely on Islamic bank is just only 17 per cent (See the Figure 4.13). These results convince us that it is necessary for Islamic banks, banking regulators, and all the stakeholders in Indonesian Islamic banks to make efforts to enhance the motivation of depositing at Islamic banks (Ismal, 2013).

Islamic banks should not only convert short-term deposits into long-term deposits, but also, first of all, promote socialization of Islamic bank and make the public confidence for them more solid. Two approaches can be used to solidify the public confidence. Firstly, the worldly approach which emphasizes secular material benefits to be gained: for example, high yields, safely guaranteed money, or satisfactory banking services. Even if customers are not Muslims, they can make a profit from depositing at Islamic banks. Additionally money deposited in Islamic banks in Indonesia obtains guarantees of the Deposit Insurance Agency whose services are naturally available in conventional banks. Secondly and more significantly, the hereafter approach which emphasizes spiritual benefits for every Muslim who uses Islamic banks. They will be free from usury (*riba*) that is clearly forbidden in Islam. Therefore, if Muslims are to save their money at Islamic banks, it may be interpreted as a means of implementing Islamic religious rules through economic behaviors. It does not occur if they do not have Islamic consciousness. Islam is a religion that can give mercy to all mankind, and it is what the majority of Indonesian people believe. How to socialize Islamic banks in Indonesia will be argued in the fifth chapter.

4.3. Key Factors for Intensification of Islamic Banks in Indonesia

4.3.1. Human Resources

How will the Indonesian people save their money in Islamic banks more than at present? The answer is suggested by an argument at the end of 4.2.3 where it is argued that saving money will be accompanied with exact understandings of Islamic banking. Then how can the Indonesian public understand it better? One of the main solutions is to supply them with Islamic banking education. It will be better if it is introduced at an early educational stage, in kindergarten, and is extended to elementary school, junior high school, senior high school, and university which will create Indonesian citizens who understand Islamic banking well and save their money in Islamic banks as a practice of their mission as Muslims. The government of Indonesia, Islamic banks, stakeholders, and the other parties should conduct more effective socialization program of Islamic banks to the public. At present there are still many Indonesian people who do not understand correctly Islamic bank contracts. Proper socialization program will encourage more persons in Indonesia to be customers of Islamic banks. However, since Islamic bank socialization program will be argued in detail in the fifth chapter, here we limit the issue to the way of growing competitiveness of Islamic banks in Indonesia through the higher educational system as follows.

It is crucial for the Indonesian Islamic banks in Indonesia to resolve the problem of lack of human resources by bringing up professionals and experts of Islamic banking in the higher educational institutions (BMI, 2014a).

It was only several years ago that the government introduced the curriculum or program of Islamic economics, finance and banking into college or undergraduate school of university: The first Islamic economic department in Indonesia was introduced into Airlangga University in 2007/2008, whose curriculum of Islamic economics consists of 144 credits that are arranged into the five elements of the following competencies: 1. Personality Development courses (9 credits, such as: Islam, *Pancasila* [the state-building idea] and Citizenship, and Philosophy of Science); 2. Skills and Expertise courses (47 credits, such as: Introduction to Business, Introduction to the Theory of Macro and Micro Economics, Introduction to Accounting, Mathematical Economics, and Monetary Economics); 3. Work Skills courses (15 credits, such as: Introduction to Management, Financial Management, Marketing Management, and Management of Islamic Banking); 4. Work Behavior courses (43 credits, such as: Computer Applications, Economic *Zakat*, Islamic Accounting, Financial Management and Investment *Sharia*, and Islamic Business Management); and 5. Integrity subjects (30 credits, such as: English, *Muammalat Fiqh* [understanding of rules and precepts of economic transactions and activities and financial rights and obligations], *Usul Fiqh* [learning of the rules, theories and Islamic law sources, namely the *Quran*, the *Sunnah* of the Prophet Muhammad, *Ijma*: consensus of the scholars, and *Qiyas*: analogy of the laws], Corruption Prevention, Basic Natural Sciences, and Thesis).

Although some universities have been trying to extend the curriculum or program of Islamic economics, finance, and banking to master and doctoral courses, the number of them in the graduate schools is still limited. For example, the master curriculum of Airlangga University called MSEI (*Megister Sain Ekonomi Islam*) which consists of 42 credits is as follows.

Table 4.6. The Master Curriculum of Airlangga University on Islamic Economics

No.	**Subjects in Semester 1 (12 Credits in Total)**	**Credits**
1	Methods and Logic of Economic Science of Islam Qualitative and Quantitative *Ushul Fiqh* and *Qawaid Fiqh*	3
2	Macroeconomic of Islam	2
3	Microeconomics of Islam	2
4	Islamic Philosophy	2
5	Islamic Financial Management	3
No.	**Subjects in Semester 2 (13 Credits in Total)**	**Credits**
1	Investment and Capital Markets	3
2	Islamic Bank Management	3
3	Islamic Financial Institutions	2
4	Islamic Monetary Economics	3
5	*Fiqh Muamalat*	2
No.	**Subject in Semester 3 (11 Credits in Total)**	**Credits**
1	Econometrics	3
2	International Economics	3
3	Research Methods	2
4	Elective Courses	3
No.	**Subject in Semester 4 (6 Credits in Total)**	**Credits**
1	Thesis	6

Source: Unair (Universitas Airlangga), 2015a (Edited)

Concerning doctoral course where the top level of education in Indonesia is performed, if we take an example of UIN Syarif Hidayatullah Jakarta, Islamic or *Sharia* economics, finance and banking are only comprised by the research of doctoral dissertation theme. On the other hand, each doctoral course of UIN Alaudin Makasar, IAIN Sumatra Utara Medan, IAIN Sunan Ampel Surabaya, and Airlangga University in Surabaya offers the curriculum of Islamic economics, finance, and banking. The following two tables are the curriculum of Islamic economics in the doctoral courses in Airlangga University (the Table 4.7) and in IAIN Sumatra Utara Medan (the Table 4.8). However, at any rate, there are few universities in Indonesia which offer the curriculum or program of Islamic economics, finance, and banking in doctoral courses.

Table 4.7. The Curriculum of Islamic Economics in Doctoral Course in Airlangga University

No.	Subject	Credit
	Semester 1.	
1.	Philosophy of Islamic Economics	2
2.	Islamic Economic Theory	2
3.	General Management from Islamic Point of view	2
4.	Intuitive/ Qualitative Analysis Method and Quantitative	3
	Semester 2.	
5	Civil Society Development in Islamic Point of View	3
6	State Finance Policy in Islamic Point of View	2
7	Monetary System and Islamic Bank	2
8	Islamic Accounting Theory	2
	Semester 3	
9	Supporting Subject to Dissertation	6
	Semester 4	
10	Proposal Examination	
	Semester 5	
11	Examination of Dissertation Manuscript	
12	Final Examination I (Close)	
	Semester 6	
13	Final Examination II (Open)	

Source: Unair (Universitas Airlangga), 2015b (Edited)

Table 4.8. The Curriculum of Islamic Economics in Doctoral Course in UIN (Universitas Islam Negeri) Sumatra Utara Medan

No.	Subject	Credit
Year 1.		
1.	Methodology of Islamic Study	3
2.	Philosophy of *Sharia* Economics	3
3.	Principles of *Al Fiqh* and *Qowaid Fiqhiyah*	3
4	Capita Selecta Islamic Economics	3
5	Ethic Business	3
Year 2		
6	Managerial Economic	3
7	*Sharia* Finance	3
8	*Sharia* Bank	3
9	Manuscript Studies of Islamic Economics (English)	3
10	Manuscript Studies of Islamic Economics (Arabic)	3
Year 3		
11	Qualification	3
12	Dissertation Proposal	3
Year 4		
13	Dissertation	10

Source: Uinsu (Universitas Islam Negeri Sumatera Utara), 2015

As argued in 4.2.1, it is necessary to intensify education of Islamic economics, finance, and banking at the higher education levels to bring up human resources for professional employees (roughly corresponding to undergraduate schools) and experts (roughly corresponding to master and doctoral courses) and to reduce costs and increase efficiency of the management.

The roles that are expected to be played by skilled professionals are to support operations of Islamic banks smoothly, to explain satisfactorily contracts and products of Islamic banks which are still unfamiliar to the general public, and by doing so, to increase correct image of Islamic banks and the public credibility towards Islamic banks. Experts are expected to participate in what is called think tanks of Islamic banks. They can discover some new findings through research and development, making reports and articles, and other activities. As is repeatedly pointed out, the number of experts of Islamic banks is still very limited.

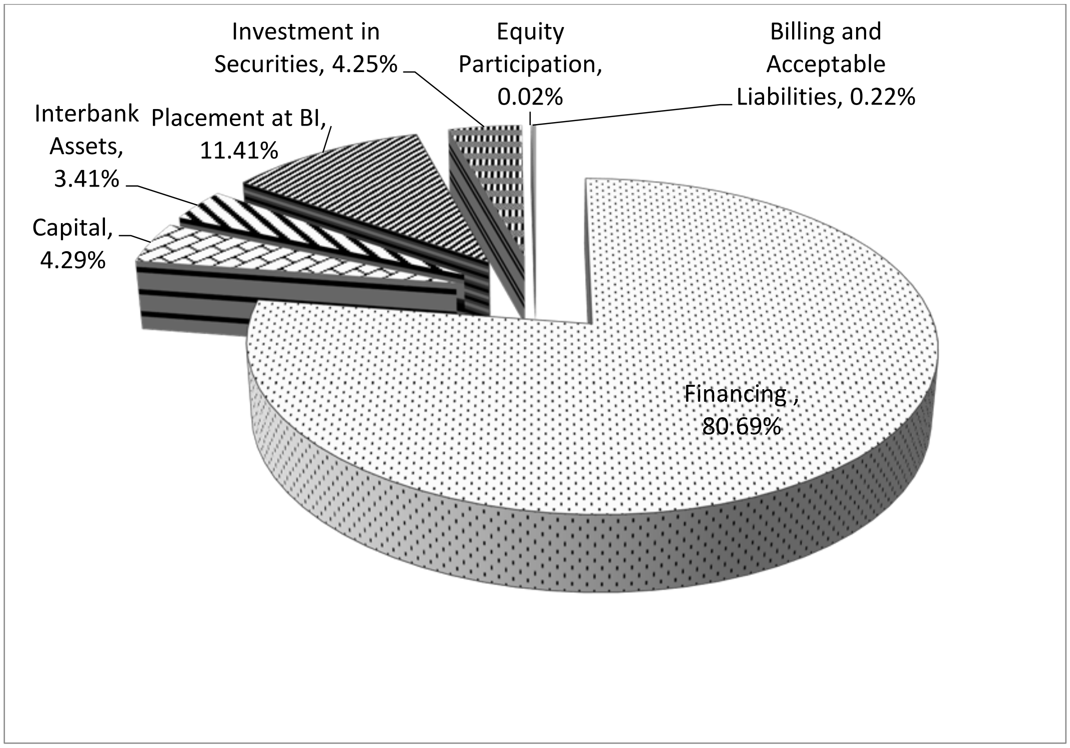
Islamic banking institutions, as well as conventional ones, are required to acquire the latest technology and facilities so that they can catch up with social change, economic change, and other forces that affect the core business of them. These requirements promote the principles of organizational learning (OL). OL application mistakes are likely to give fatal impacts especially to the institutions that are not competitive and less productive, making them survive no longer in the business cycle (Mansor et al., 2010). Doubtlessly, the latest technology and facilities cannot be supplied without professionals and experts.

4.3.2. Diversification of Islamic Bank Finance and Funding

We pointed out in 4.2.2 and 4.2.3 that there is suboptimal market segmentation both in finance and in funding structure of current Islamic banks in Indonesia. However, there is more seriously unbalanced structure at the fundamental level: placement of funds is concentrated into direct financing too much and sources of Islamic banks depend on deposits too much.

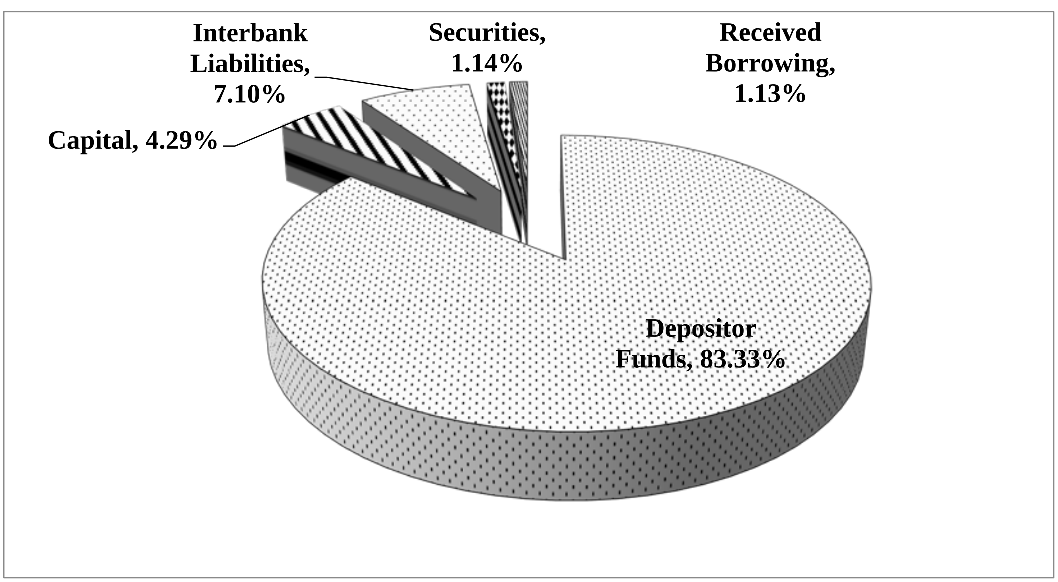
The Figure 4.14 reveals that direct financing constitutes the majority of the placement of funds of Islamic banks in Indonesia, as high as 80.69 per cent, being a huge dominant ratio when compared with the whole Indonesian banks (62.46 per cent in the second semester in 2012) indicated in the Figure 4.16. Furthermore, as already stated, financing of Islamic banks in Indonesia is concentrated on micro and small scale companies.

Figure 4.14. Placement of Funds of Islamic Banks in Indonesia in 2012



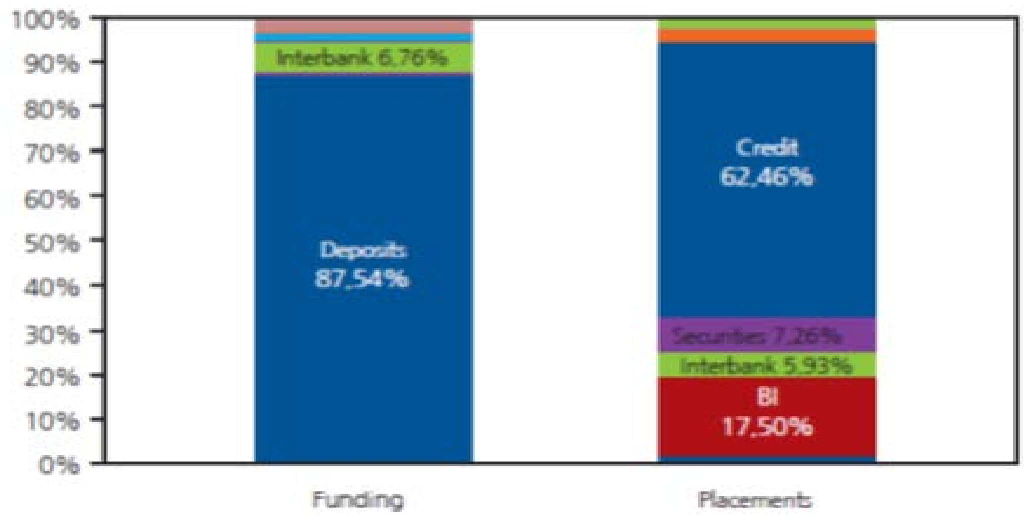
Source: BI (Bank Indonesia), 2014l (Edited)

Figure 4.15. Fund Composition of Islamic Banks in Indonesia in 2012



Source: BI (Bank Indonesia), 2014l (Edited)

Figure 4.16. Share of Funding and Bank Financing in Indonesia in 2012

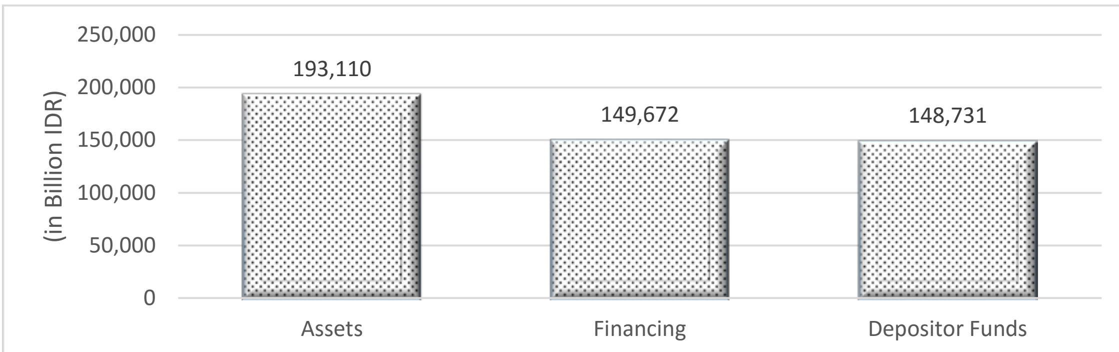


Source: BI (Bank Indonesia), 2013b
Note: Another sources of funds than deposits are: interbank funds (6.76%), loans (1.21%), securities (0.93%), other liabilities (0.76%) as well as liabilities to Bank Indonesia and security deposits at 0.11% and 0.14% respectively.

Likewise, the Figure 4.15 illustrates a composition of funds in Islamic banks in Indonesia where an overwhelming majority is comprised by deposits (83.33 per cent). Capital, interbank liabilities, securities, and received borrowing compose 4.29 percent, 7.10 per cent, 1.14 per cent, and 1.13 per cent respectively. Furthermore, as already stated, deposits in Islamic banks are concentrated upon short-term ones. However, as shown in the Figure 4.16, more reliance on deposits can be observed in the whole Indonesian banks (87.54 percent), which implies that diversification of funding is a task also for conventional banks in Indonesia.

The Figure 4.17 shows that the amount of financing (149,672 billion IDR) is in excess of the amount of all deposit funds (148,731 billion IDR), proving that financing in Islamic banks in Indonesia is very active. However, highly active financing also implies high credit risk. It is risky if companies that the bank finances are into the bankruptcy. Furthermore, funds are mainly deposits, especially short-term deposits. Banks need to add more funds not only from deposits and their own capital but also from other resources to lessen liquidity risk. It confirms importance for Islamic banks in Indonesia of developing various types of products for collecting stable funds (Johansyah, 2013).

Figure 4.17. Total Assets, Financing, and Depositor Funds in 2013 (in Billion IDR)



Source: BI (Bank Indonesia), 2014l (Edited)

Being synthesized by what we observed in 4.2.2 and 4.2.3, the argument in this subsection means that the main income source of Islamic banks in Indonesia is direct financing, especially lending to micro and small enterprises, and main liability is deposits, especially from short-term deposit funds. The problem is intertwined with another problem of lack of *sukuk* market growth available to Islamic banks, as explained in the next subsection. In all, financial and funding dealings and products of Islamic banks in Indonesia are both still relatively less various. Such unbalanced finance and funding structure restrains Islamic banks in Indonesia at unstable and unproductive level.

Placement of funds can be improved in other areas than financing, such as investment in securities, equity participation, and others, by which portfolio in the banking business can be diversified. The principle is minimizing risk strategy whereby banks make balance among placed funds and do not hold too any dominant finance or investment. Islamic banks need to diversify the types of markets and products for finance and investment, such as investment in securities or equity participation which are still underdeveloped in Indonesia, in order to keep optimal portfolio, but at the same time, without any infringement of *Sharia* law.

4.3.3. Utilization of *Sukuk*

Sukuk is originally a plural form of an Arabic word "*sakk*" which means a document of certificate. AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) defines *sukuk* which is issued currently in Islamic finance as a negotiable certificate that underlies asset ownership. An owner of *sukuk* can execute certain right and procure benefit as owner of the assets based on Islamic financial contracts: PLS, such as *Musharakah* and *Mudharabah*, lease, such as *Ijara*, and sale and purchase, such as *Murabaha* (AAOIFI, 2013).

Sukuk investors have ownership in specific productive assets, usufructs and services in a given investment project and activity. Though asset-based *sukuk* appears similar to asset-backed conventional bond at a first glimpse, it is fundamentally different from bond in conventional finance in that, while the latter (bond) functions as transfer of credit and is debt of issuer, the former (*sukuk*) means ownership in tangible assets or services of issuers. *Sukuk* holders have defined responsibility for underlying assets according to the extent of participation in the issuance, while bondholders have no responsibility for circumstances of the issuer (Warde, 2012). *Sukuk* is based on concept of Islamic profit and loss sharing, lease, and sale and purchase contracts which are underlying transaction form (*aqad*) or agreement that is based on Islamic principle.

Sukuk based on *Mudharabah* is illustrated in the Figure 4.18 below. *Mudharabah* contract was already explained in the second chapter. *Mudharabah sukuk* is a certificate representing proportionate ownership of assets for a specific project undertaken by an entrepreneur. Transaction is divided into eight steps.

Both governments and companies, including financial companies, are admitted to raise funds through *sukuk*. Short-term *sukuk* has a tenor of around one year or less than one year while some long-term *sukuk* has a tenor more than 20 years[64]. Issuers are not only Muslims but also non-Muslims as long as under the Islamic law.

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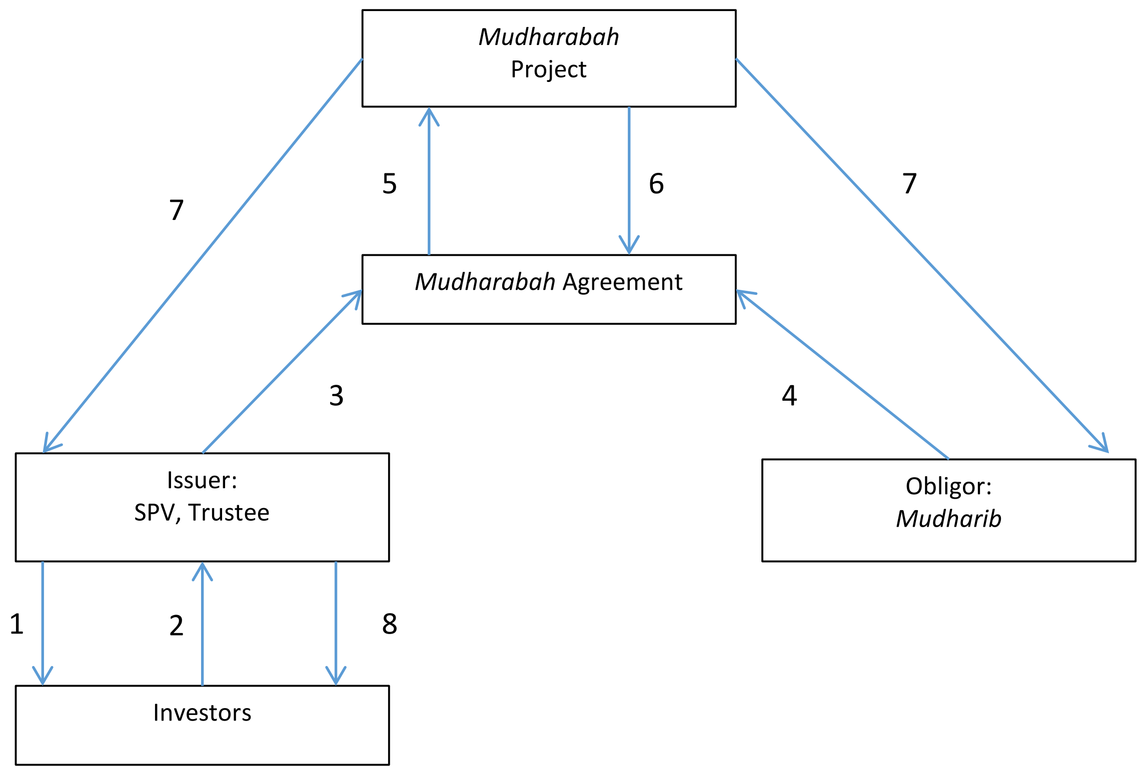
[64] *Sukuk* are also used in Islamic retailing transaction. *Sukuk* based on *Bai' Bithaman Ajil* (BBA) is one of the most important instruments of housing purchases in Islamic financial system. For example, this type of *sukuk* is used quite often for Muslim minorities in the United States of America, the growing middle class in Malaysia, and the poor in some Muslim countries. Demand in this type of *sukuk* always exceeds the funds available (Thomas et al, 2006).

Figure 4.18. Structure of *Sukuk* Based on *Mudharabah*



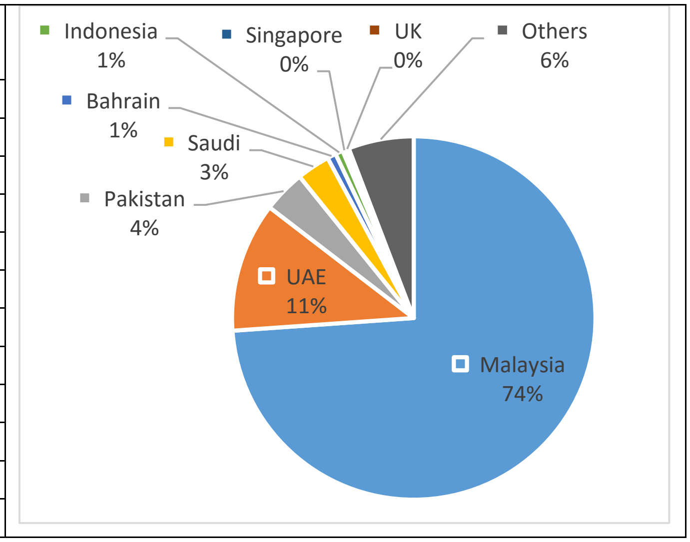
Source: IFIS (Islamic Finance Information Services), 2015a (Edited)

1. A special purpose vehicle (SPV) is set up.
2. Investors purchase *sukuk*.
3. SPV contracts a *Mudharabah* agreement as trustee of investors.
4. Obligor (*Mudharib*) provides expertise of an investment project.
5. Both funds and expertise are transferred to a *Mudharabah* project.
6. *Mudharabah* profits or losses occur after project operation.
7. Profits or losses are transferred among SPV and *Mudharib* according to their specified sharing ratio.
8. SPV pays periodic returns to investors.

Shell Middle Distillate Synthesis (A Shell owned plant in Bintulu, Sarawak in Malaysia) was the first issuer of *sukuk* in the world as a private company, which was issued in Malaysia in 1990 on Malaysian Ringgit (Saeed and Salah, 2012). Since then *sukuk* has become remarkably popular in Malaysia where it is also called Islamic debt securities. As a result of development of *sukuk* in Malaysia, 22 new *sukuk* were issued in the first half of 2007 whose amount was as much as 17.7 billion RM, representing 31 percent of Malaysia's domestic corporate bond market. Surprisingly, 76 percent of new private debt securities were approved as *sukuk* at the end year 2007 in Malaysia (Venardos, 2010). The ratio amounted to 80.2 percent by the third quarter of 2014 (Ismail, 2015).

Figure 4.19. Outstanding Volume of Corporate *Sukuk* by Country and Value in 2010

Country	USD Million	%
Malaysia	71,612	73.9%
UAE	11,180	11.5%
Pakistan	3,659	3.8%
Saudi	2,862	3.0%
Bahrain	754	0.8%
Indonesia	655	0.7%
Singapore	300	0.3%
UK	261	0.3%
Others	5,640	5.8%
Turkey	-	0.0%
Iran	-	0.0%
Total	**96,924**	**100.0%**



Source: Ghani, 2010 (Edited)

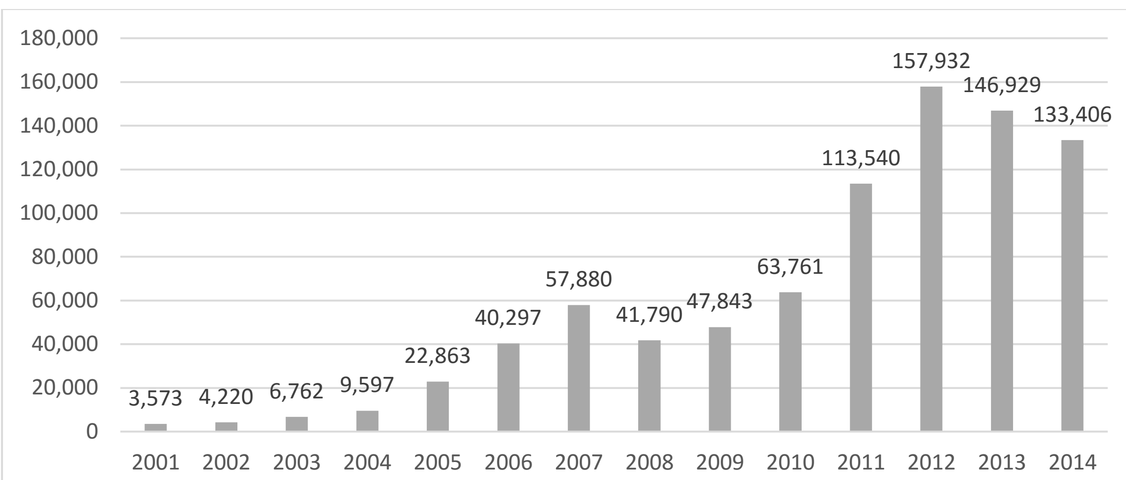
As a result, as the Figure 4.19 demonstrates, Malaysia has been the country that issues *sukuk* the most in the world. The outstanding volume of corporate *sukuk* in Malaysia is 71,612 million USD and the share in the world is 73.9 percent in the midst of 2010, which we can compared with, as will be discussed later, 655 million USD and 0.7% respectively in Indonesia.

Two figures (the Figure 4.20 and 4.21) below reveal that, as a whole, *sukuk* market in the world has increased since 2001 in terms of transaction volume, transaction number, and issuer number, and that, however, *sukuk* market seems to have been stagnated after 2012.

Due to such a non-linear trend, it is difficult to predict future development of the *sukuk* market in the world, but it is predicted to be promising and continue to grow in the near future (Abdel-Khaleq and Richardson, 2007), although an optimistic prospect that it will reach to a scale of a minimum of 400 billion USD by 2015 (Ernst and Young, 2012) is found entirely unrealistic, which is evident from the Figure 4.20.

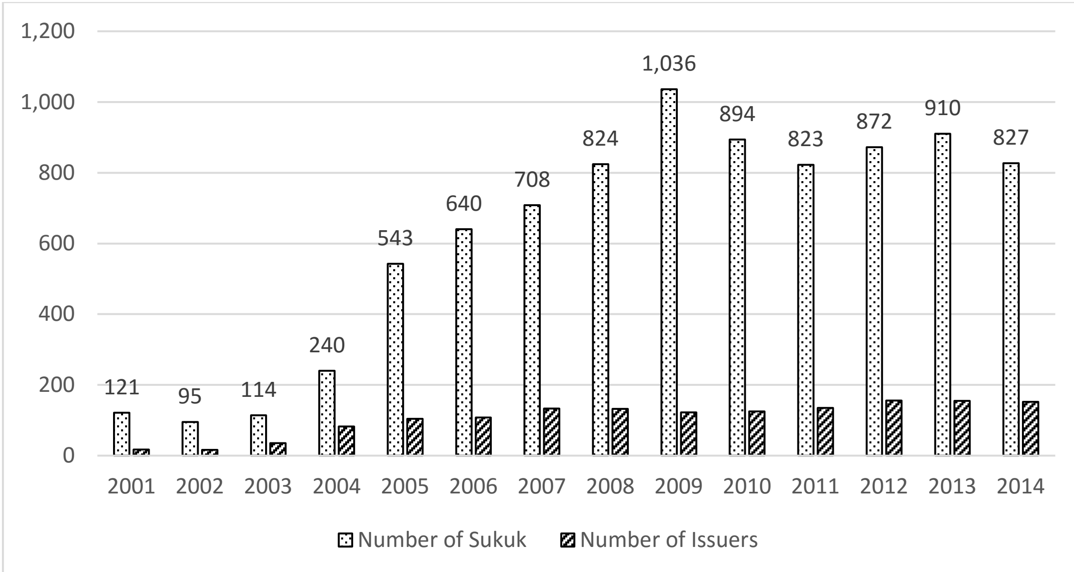
At any rate, not only the international community of Islamic finance but also the conventional counterpart has already been attracted to potentiality of *sukuk*. It is now considered to have a good level of returns on investment, when compared with saving in banks.

Figure 4.20. The Volume of *Sukuk* Issued in the World: 2001-2014 (in Million USD)



Sources: IIFM (International Islamic Financial Market), 2014 (Edited) and IFIS (Islamic Finance Information Services), 2015b (Edited)

Figure 4.21. The Number of *Sukuk* and *Sukuk* Issuers in the World: 2001-2014

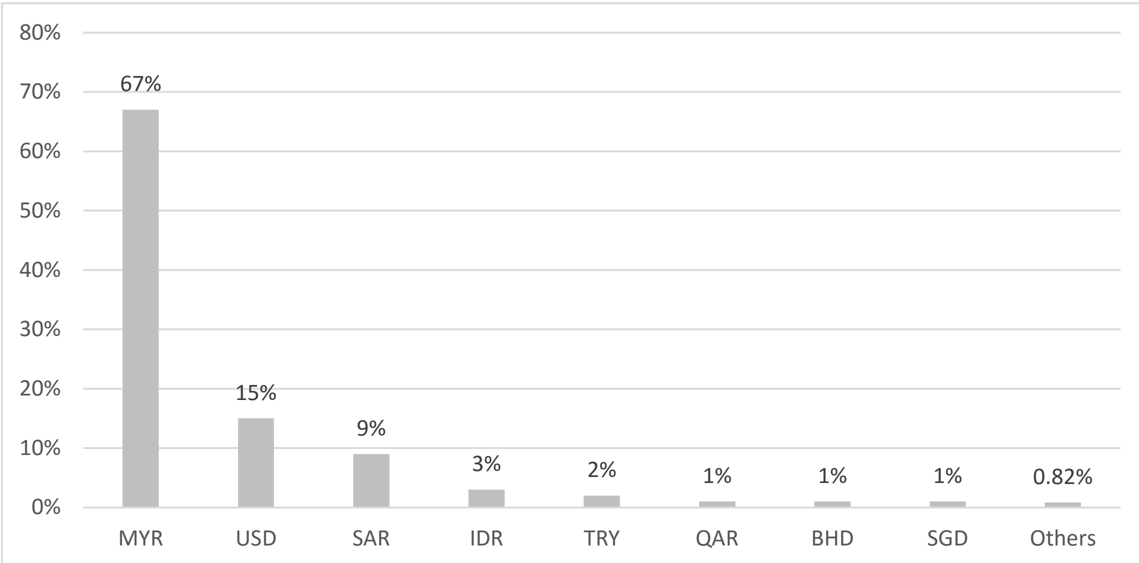


Sources: IIFM (International Islamic Financial Market), 2014 (Edited) and IFIS (Islamic Finance Information Services), 2015b (Edited)

The Figure 4.22 reveals that 67 percent of global *sukuk* (a kind of *sukuk* whose investors are residents in the countries other than from the issuing places) in 2013 was issued in Malaysia and used Malaysian Ringgit. It was a result of effort in the country to grow a global Islamic financial market (DeLorenzo, 2011)[65] based on the domestic *sukuk* market. Global *sukuk* issuance in the world amounted to 82.4 billion USD or 271 billion RM in 2013 (IIFM, 2014).

[65] Malaysia offers an innovative financial infrastructure, Labuan International Business and Financial Centre (Labuan IBFC) where Labuan Financial Services Authority, on the Labuan Islamic Financial Services and Securities Act 2010, regulates Islamic-compliant financial services, such as banking, *takaful* (Islamic insurance), *retakaful*, *sukuk*, mutual fund, Islamic securities licensee, and Islamic trust. Islamic-compliant financial transactions are supported by tax incentive (IIFM, 2014).

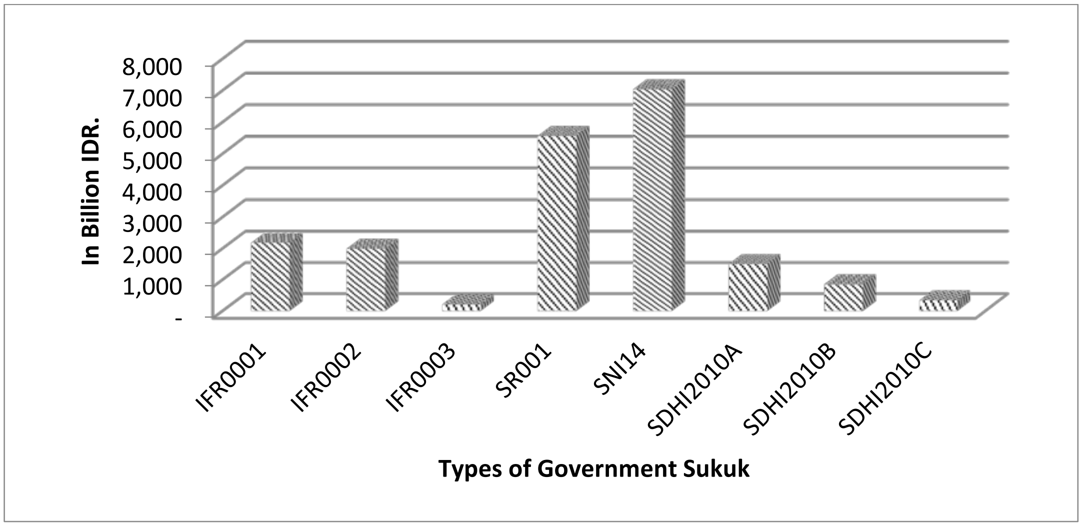
Figure 4.22. Global *Sukuk* Issuances by Currency in 2013.



Source: IIFM (International Islamic Financial Market), 2014 (Edited)
Notes: Total issuance was 82.4 Billion USD (271 Billion MR).

Contrastingly, as indicated in the Figure 4.20, *sukuk* has never been fully developed in Indonesia and has only just begun to grow. It is true that Indonesian government has promoted *sukuk* to cover the budget deficits and supply liquidity in the Islamic money market, and that, as a result, Indonesian sovereign *sukuk* (SBSN) has amounted to a relatively large scale, near to 16.7 billion USD in September in 2013 (the outstanding volume which includes non-tradable *Hajj* fund, 3.15 billion USD). Furthermore, as the Figure 4.23 shows, the government issues various types of *sukuk*, one of which is newly admitted SNI (Sukuk Negara Indonesia: global *sukuk*). In parallel with the government, Indonesian corporate *sukuk* has been growing whose volume of outstanding is 0.75 billion USD at the same period, though not so conspicuous because the volume was already 0.66 billion USD in 2010 (Setiadi, 2013). Considering that Indonesia is now revising regulations on *sukuk*, it is expected that it will be available not only for the initial investments, but also in the secondary market which should naturally be based on *Sharia* (Venardos, 2012).

Figure 4.23. *Sukuk* Issued by the Indonesian Government



Source: DIF (Directorate of Islamic Financing), 2013 (Edited)

Note:
IFR001: Islamic Fixed Rate, published on August 26, 2008, 7 year tenor.
IFR002: Islamic Fixed Rate, published on August 26, 2008, 10 year tenor.
IFR003: Islamic Fixed Rate, published on October 27, 2008, 6 year tenor.
SR001: Retail Sukuk, published on February 25, 2009, 3 year tenor.
SNI14: Sukuk Negara Indonesia (Global Sukuk), published on April 23, 2009, 5 year tenor.
SDHI2010A: Hajj Fund Sukuk, published on May 7, 2009, 1 year tenor.
SDHI2010B: Hajj Fund Sukuk, published on June 24, 2009, tenor 11 months.
SDHI2010C: Hajj Fund Sukuk, published on June 24, 2009, tenor 13 months.

Raising funds in the *sukuk* market by Islamic banks in Indonesia has also never been fully developed in spite of the fact that both long-term and short-term *sukuk* are so useful instruments for banks, not only for diversification of funding which also concentrates heavily on short-term deposits, but also for diversification of investment which now concentrates heavily on direct financing, and that such diversification in financing and funding is one of key factors for intensifying Islamic banking sector in Indonesia. However, here do we limit the argument to a funding side.

Sukuk issued by Islamic banks in Indonesia in the year 2010 only amounted to 31.4 million USD, compared with about 660 million USD of corporate *sukuk* (including the banking sector) and about 6 billion USD of government *sukuk*, whose share is more than 90 percent (Setiadi, 2013). The share of Islamic banks in the *sukuk* issuers is about 0.5 percent in Indonesia in 2010, which can be compared with about 2 percent in Malaysia in contrast with the government sector 63 percent, and corporate sector 35 percent in the year 2013 (IIFM, 2014). Though the Islamic bank share is not high in both countries, since the absolute issuance volume is much larger in Malaysia, the fact does not deny that Islamic banks in Indonesia should consider the possibility of expanding *sukuk* market to raise more funds (OJK, 2013).

4.4. Comparison with Malaysian Islamic Banks in Some Aspects

4.4.1. Financial Contracts

Islamic banks in Indonesia use direct financing contracts, such as: *Mudharabah*, *Musharakah*, *Murabahah*, *Qard* (requirement of no returns) and Others, and share of these contracts are 9%, 19%, 58%, 4% and 9% respectively in June 2012 (Kusuma and Asif, 2012). While these contracts were explained in the second chapter, as an individual bank case in Indonesia, for example, each share of financial contracts of Bank Muamalat Indonesia (BMI) is as follows:

Table 4.9. Financing by Contract of Bank Muamalat Indonesia in 2013

Type of Financing Transaction	Name of Financing Contract	Percentage
PLS	*Mudharabah* (MDH)	5.41%
PLS	*Musharakah* (MSH)	45.44%
Leasing	*Ijarah*	0.46%
Selling and Purchasing	*Murabaha* (MRH)	47.61%
Borrowing and lending	*Istishna*	0.05%
Borrowing and lending	*Qard*	1.02%

Source: BMI (Bank Muamalat Indonesia), 2014c (Edited)

The Table 4.9 reveals that the most popular financing transaction in BMI was *Murabaha* whose share was 48 percent, and that *Musharakah* (PLS transaction) was next to it, with a 45 percent share, a transaction where Islamic bank shares the financial risk with customer, not transfer it to him or her and it shares profit or loss with him or her after a contract term. In contrast to *Musharakah*, another kind of PLS, *Mudharabah*, had a share of only 5.4 percent. At any rate, constitution of financial contracts in Indonesia Islamic banks has a different pattern from that in a Malaysian case.

Table 4.10. BIMB Financing by Contract in 2013

Type of Financing Transaction	Name of Financing Contract	Percentage
Leasing	*Ijarah*	0.80%
Leasing	*Ijarah Muntahiya Bit Tamlik* (IMB)	0.20%
Selling and Purchasing	*Murabaha* (MRH)/BBA/ *Tawarruq*	92.80%
Selling and Purchasing	*Istishna*	0.50%
Borrowing and Lending	*Bai Inah*	5.30%
Borrowing and Lending	*Ar Rahnu*	0.40%

Source: BIMB (Bank Islam Malaysia Berhad), 2014b (Edited)

The Table 4.10 shows that over ninety percent of financing in BIMB, the largest Islamic bank in Malaysia in 2013 was used in the form of *Murabaha* (MRH), BBA, or *Tawarruq*, with internal share of 3.5 percent, 37.8 percent, and 51.5 percent respectively. *Murabaha* and BBA are contracts where firstly Islamic bank buys from a third party a product that customer wants and secondly Islamic bank sells it to customer with profit to be charged to him or her. *Tawarruq* will be referred to soon later. It can be pointed out that there is a remarkable difference between Indonesian Islamic banks such as BMI and BIMB in Malaysia since PLS financing is major in the former while non-PLS financing (selling and purchasing) is dominant in the latter (Hamid and Azmi, 2011).

Besides, it must be noted that *Tawarruq*, the most popular contract in Malaysian Islamic finance is controversial and dubious product. As explained in the second chapter, commodity purchaser (bank customer) in *Tawarruq* contract has no intention of ownership and, in consequence, such absence of any real economic activities creates interest inevitably. For that matter, *Tawarruq* is judged to be tricky in Indonesia and is forbidden in obedience to the opinion of Indonesia National Syariah Board (*Dewan Syariah Nasional*: DSN). The Islamic Fiqh Council at the 19th Conference of the Organization of Islamic Cooperation (OIC) which was held in Sharjah in 2009, also declared that *Tawarruq* was impermissible. The Islamic Fiqh Council is one of the most authoritative International *Sharia* organizations that issue *fatwa* (*Sharia* jurisprudence). However, as if against this international mainstream, and in spite that Malaysia is a member of OIC, *Tawarruq* is allowed in Malaysia (Hosen and Nahrawi, 2012)[66].

[66] *Murabaha* and BBA are justifiable since they get profit by buy and sell procedure of certain product that customer truly wants, and since bank holds risk of ownership in the procedure (Rosly, 2005: 94).

Bai Inah, a type of borrowing and lending is another problematic contract where firstly customer buys an item (in all most cases, it is a fictitious item) from bank and secondly bank buys back it from customer immediately with fewer prices than in the first trade, from which customer is obliged to repay the price difference to bank (See also the second chapter). It is prohibited in Indonesia for the reason that it is considered to be substantial interest charge through mere exchange of money. In contrast, it is allowed in Malaysia[67].

Tawarruq and *Bai Inah*, two contracts forbidden in Indonesia, are similar to each other in that customer borrows money through price gap which is generated by high price purchase and low price selling of a same commodity. In both contracts, bank knows that client has no interest in transacted commodity but to resell it immediately. However, they are different from each other in that while buying and selling in *Bai Inah* is fixed between bank and customer, it involves third party beyond bank and customer in *Tawarruq*.

Table 4.11. *Sukuk* Issuance by Structure in 2013

Malaysia		Indonesia	
Bai' Bithaman	2.69%	*Ijarah*	72%
Combination	3%	*Mudharabah*	28%
Ijarah	4%		
Bai Inah	5.42%		
Musharakah	7%		
Wakalah	2%		
Murabahah	75%		

Sources: IIFM (International Islamic Financial Market), 2015 (Edited) and BMI (Bank Muamalat Indonesia), 2014b (Edited)

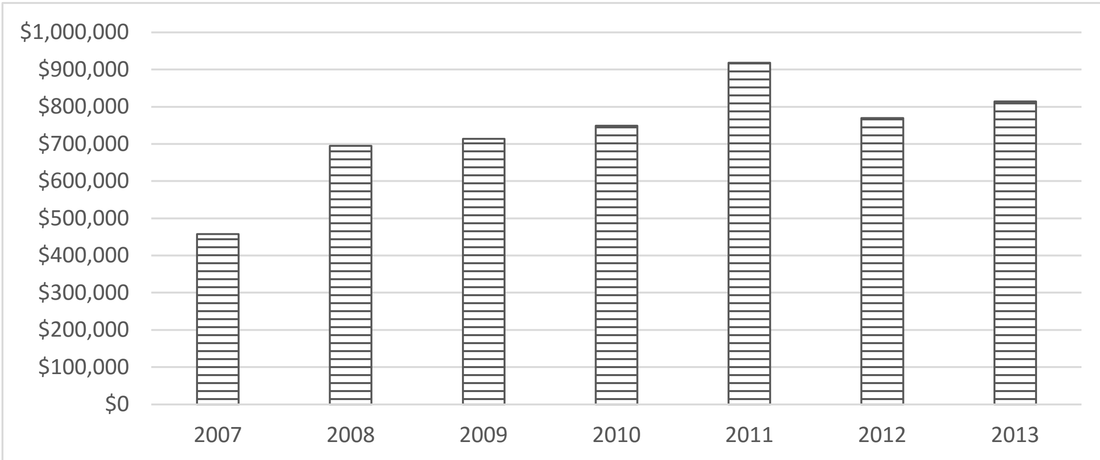
[67] *Bai Inah* is considered to be "a void contract" by the *Maliki*, *Hanafi* and the *Hanbali* School, while it is acceptable but discouraged by the *Shafie* to which Malaysian belong predominantly, and by *Zahiri* School (Rosly, 2005).

As I emphasized in 4.3.3, Malaysia is a leader of *sukuk* development in the world, and one important reason is found in the government policy of developing domestic and international Islamic financial market including global *sukuk* together with tax incentive for *sukuk*. Further, as indicated in the Table 4.11, *sukuk* structure in Malaysia is more various than in Indonesia, which suggests that Indonesian government needs to be more active in supporting Islamic financial market. However, here we also find a remarkable difference in the base contracts on which *sukuk* are structured between the two countries: while Malaysian *sukuk* contains *Bai Inah*, a dubious contract in terms of *Sharia* in most Islamic countries, Indonesian *sukuk* does not contain it.

4.4.2. Islamic Interbank Money Market

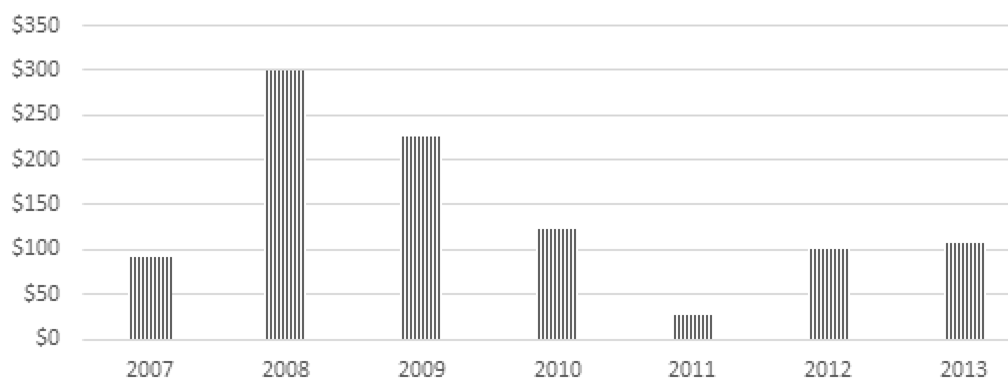
The Figure 4.24 and the Figure 4.25 below clearly show that volume of Islamic interbank transaction (IIMM) in Malaysia is much bigger than that of Indonesia and that while Malaysia has an upward trend from 2007 to 2013 as a whole, Indonesia has an fluctuated one during the same years, annual average volume in IIMM in Malaysia and in Indonesia being 730,935.61 USD and 138.31 USD respectively. There is so overwhelmingly wide a gap in IIMM trade volumes between the two countries that Indonesian IIMM can be said to be almost equal to zero.

Figure 4.24. Islamic Interbank Transaction in Malaysia: 2007-2013 (in Million USD)



Source: IIMM (Islamic Interbank Money Market), 2015 (Edited)

Figure 4.25. Islamic Interbank Transaction in Indonesia: 2007-2013 (in Million USD)



Source: OJK (Otoritas Jasa Keuangan or Indonesia Financial Services Authority), 2015 (Edited)

It is not only because Indonesian Islamic banks have originally less capital and assets than Malaysian Islamic banks (See the first section), but also because they offer fewer financial instruments in IIMM than Malaysian banks. In Malaysian IIMM, various types of instruments are permitted, such as *Mudharabah* Interbank Investment (MII)[68], *Wadiah* Acceptance (WA)[69], Government Investment Issue (GII)[70], Bank Negara Monetary Notes-i (BNMN-i)[71], Sell and Buy Back Agreement (SBBA)[72], Cagamas *Mudharabah* Bonds (SMC)[73], Islamic Accepted Bills (IAB)[74], Islamic Negotiable Instrument (INI)[75], *Ar Rahnu* Agreement-i (RA-i)[76], and *Sukuk* Bank Negara Malaysia *Ijarah* (SBNMI)[77] (BNM, 2015a). *Sukuk* are to be used as a short-term financial product in IIMM if it is based on a legitimate

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[68] MII is an insturment to maintain liquidity where deficit Islamic bank (DIB) borrows money from surplus Islamic bank (SIB) based on *Mudharabah* (PLS) deposit contract with time duration from 1 day to 365 days (one year).

[69] WA is an instrument where DIB accepts fund from the Central Bank (Bank Negara Malaysia) or SIB as custodian, or SIB places their surplus in the Central Bank with *Wadiah* contract.

[70] GII is one of liquid government paper to park idle funds from SIB. GII is tradable in the secondary market as *Bai-al Dayn* (a kind of debt trading).

[71] BNMN-i is, like GII, Islamic securities issued by the Central Bank to maintain liquidity which is tradable in the secondary market as *Bai-al Dayn*.

[72] SBBA is a transaction in IIMM, where DIB and SIB have agreement to sell and buy back against the asset based on approved price.

[73] Cagamas (Cagamas Berhad) is the National Mortgage Corporation established in 1986 for purchasing housing loans including Islamic ones which are contracted under the form of BBA or *Ijara* and for securitizing them as *sukuk*. Besides, the state-sponsored Cagamas *Mudharabah* Bond (SMC) based on PLS is issued by Cagamas for funding itself. Then these securities are traded in a seondary market, IIMM, between DIB and SIB (Thomas et al, 2006).

[74] IAB is Islamic tradable bills in IIMM, which are originally issued by domestic and foreign traders based on *Murabaha* and *Bai al-Dayn*.

[75] INI comprises two instruments, Islamic Negotiable Instruments of Deposit (INID) and Negotiable Islamic Debt Certificate (NIDC). INID is negotiable *Mudharabah* deposit money in Islamic bank and repayable on certain future date with extra dividend. NIDC is negotiable certificate which will be paid back in the future date with value plus profit.

[76] RA-i is borrowing money from SIB with securities as collateral under *Qard al-Hasan* contract.

[77] SBNMI is *sukuk* that is issued by the Central Bank based on *Ijarah* contract.

contract in *Sharia* law (see 4.3.3). Besides, Malaysia has already introduced Labuan offshore money market where licensed foreign banks trade foreign currencies. FAST (Fully Automated System Tendering) system is available in Malaysia which is connected to the foreign clearing systems and makes negotiation such as Negotiable Instruments of Deposit (NID) and Islamic Negotiable Instruments (INI) with some other countries (BNM, 2015b).

On the other hand, Indonesia has only five instruments in IIMM: Bank Indonesia Certificates Syariah (SBIS)[78], Repurchase Agreement (Repo)[79] of SBIS, Government *Syariah* Securities (SBSN)[80], Repurchase Agreement (Repo)[81] of SBSN, and Certificate of Islamic Interbank Money Market (PUAS)[82] (Zaky, 2015), all of which are traded in the BI-SSSS[83]. Unlike Malaysian IIMM, Indonesian IIMM has no connection to any other foreign clearing system which makes it difficult to bring foreign liquid capital into the interbank market (BI, 2015h).

As I mentioned above, a few factors are pointed out for a huge scale gap in IIMM in both countries: smaller bank assets and fewer financial instruments in Indonesian Islamic

[78] SBIS is securities based on Islamic principle, *Mudharabah*, in short time period with rupiah currency issued by the Bank Indonesia

[79] Repo SBIS is conditional sale transaction of securities by Islamic banks to Indonesia Central Bank with agreement in the obligation repurchase in the determined price and time period.

[80] SBSN is government securities or sovereign *sukuk* issued based on Islamic law principle, *Musharakah*, as evidence of partial ownership of the specified assets in rupiah or other currencies.

[81] Repo SBSN is a purchase transaction of SBSN by banks from Indonesia Central Bank with promise of redemption by bank in accordance price and period of time agreed.

[82] PUAS is a short-term financial transaction in inter-bank based on Islamic principle, *Murabaha*, in rupiah currency or the other currency.

[83] BI-SSSS (Scrip-less Securities Settlement System) is an online system transaction which unites Indonesia central bank securities and government securities into a single market.

banks. However, it should be noted that GII, BNMN-i, IAB and INI in Malaysia are based on *Bai al-Dayn* contract, a kind of debt trading and are permissible in Malaysia, but not in Indonesia and in the Middle Eastern countries. As referred to in the second chapter, the Islamic Fiqh Council of the Organization of Islamic Cooperation (OIC) in 1998 agrees that this contract is not permitted since return on debt is usury or *riba* and since *Bai al-Dayn* is simple exchange of securities, bills, or certificates and money through which profit is generated through discounting and so on. The concept of loan in Islam must be philanthropic and generous with no return and be mediated by real goods. According to Iqbal, "sale of debt is not permissible except at face value", for a majority of Islamic scholars. However, although Malaysia has a membership of the OIC, it admits *Bai al-Dayn*. Some scholars in Malaysia have allowed selling of debt at a discounting price. Whereas "they refer to a ruling of the *Shafei* School wherein it is held that the sale of debt is allowed", "they do not pay attention to the fact that the *Shafei* jurists have allowed it only in the case where the debt is sold at its par value" (Iqbal, 2014).

As Obaidullah argues, even if *sukuk* based on *Mudharabah*, *Musharakah*, *Ijarah*, *Murabaha* or *Bai-Bithaman Ajil* (BBA) are themselves legitimate, they are obliged to be ruled out cautiously when they are negotiated in the secondary market, because, even in these dealings, *sukuk* should be transferred only at par. Unless they are transferred at par, they are interpreted to be *Bai al-Dayn* since they delink financing from underlying assets. In spite of this, Obaidullah continues, these kinds of *sukuk* have been widely used in Malaysia "because of more liberal interpretation of *Fiqh* by Malaysian jurists permitting sale of debt (*Bai al-Dayn*) at a negotiated price", which has effectively blurred the distinction between *sukuk* and conventional debt instruments (Obaidullah, 2007).

Indeed, since IIMM in Malaysia has a larger trade volume and has more various financial products than IIMM in Indonesia, Indonesia may introduce some instruments transacted in Malaysia to stimulate further growth of Indonesian IIMM to maintain liquidity, improve liquidity management, and stabilize the Islamic financial system better than at present (Antonio, 1999). However, The Indonesian should be restrained from simple copying Malaysian IIMM and should obey the Islamic law that is thought to be authentic in the country and in the most of Islamic countries. For example, National Sharia Board of Indonesia (DSN), an authoritative MUI institution of *Sharia* compliance independent from Bank Indonesia and the government, issued a *Fatwa* on September 14, 2002 (No.32/DSN-MUI/IX/2002), whereby DSN manifested that SBSN (see the Footnote 80), a kind of government securities or sovereign *sukuk* both in Indonesian Rupiah and in foreign currency is an authentic security based on *Sharia* (DIF, 2013).

4.4.3. Compliance of *Sharia* System and Government Role

If the *Sharia* compliance system in Indonesian Islamic financial institutions that is described in the third chapter (3.2.1) is compared with the Malaysian one, it will show a remarkable contrast between the two systems. *Sharia* Advisory Council (SAC) and *Sharia* Committee (SC) in Malaysia are the counterparts of National Syariah Board (*Dewan Syariah Nasional*: DSN) and *Sharia* Supervisory Board (*Dewan Pengawas Syariah*: DPS) in Indonesia respectively. The tasks and responsibilities of SC are to advise the Islamic financial institutions on the matters of Islamic law and Islamic financing activity; to review, assess and ensure the mechanism of funding, financing and bank services with the operational guideline based on the Islamic principle; to supervise the new products of Islamic banks; to request SAC to issue new *fatwa*; and to request individual financial institutions to submit data and information on their activities[84]. However, while SAC in Malaysia is completely controlled under the central bank (Bank Negara Malaysia), DSN in Indonesia is positioned under MUI which is an authoritative but private organization independent from the government. MUI, far from being controlled by the government, exerts much influence over the government policies.

Compliance of *Sharia* system in Malaysia can be characterized to be rather the top-down approach in contrast with the bottom-up approach in the Indonesian *Sharia* compliance system (Alamsyah, 2012). The bottom up motivation in Indonesia means the willingness to bring up Islamic banks from the Islamic public and their religious leaders, the Islamic scholars (*Ulama*), and their organizations, such as UMI, especially appealing not only to material benefits but also to religious mind of the Muslims in Indonesia[85]. In fact, *Tawarruq*, *Bai Inah*, and *Bai al-Dayn* are all allowed in Malaysia, while they are considered to be dubious and forbidden in most Muslim countries[86].

[84] Each SC in Malaysia is required to be composed of at least three members and DPS in Indonesia must consist of a minimum of two persons and at the maximum of not more than half the number of members of its board of directors.

[85] With regard to GCC countries whose attitude of each government toward Islamic finance is neutral, Dar and Azmi point out that in contrast with Malaysia, an example of patronage of Islamic banking and finance "as a policy tool to promote and protect economic interests of the ethnic Malay Muslim population", *Sharia* governance in the GCC region has not been taken "seriously on a governmental level" and *Sharia* compliance are by and large left to the individual Islamic banking and financial institutions, which makes the authors advocate necessity of developing "a GCC level *Sharia* governance framework" (Dar and Azmi, 2015). At any rate, *Sharia* compliance system in GCC region is different not only from the Malaysian but also from the Indonesian system.

[86] Hasan remarks *Sharia* non-compliance risk, a risk which arises from Islamic financial institutions' "failure to comply with the *Shari'ah* rules and principles determined by the *Shari'ah* board" or a risk due to "non-standard practices of Islamic financial products" (Hasan, 2012). In the context of our argument, *Sharia* non-compliance risk in Indonesia will probably increase if, for example, *Bai al-Dayn* or *Tawarruq* are allowed.

In this regard, Ariff and the others point out that there is a concern in Malaysia that pursuit of standardization in *Sharia* interpretations from the top-down, that is, from Bank Negara Malaysia, may "encourage regulatory laxity to prevail". Malaysia, for example, in its approval of *Tawarruq* and its relaxed interpretation of *Sharia*-compliant equities, might be seen as trying hard to "expand the market share of Islamic financing at the expense of Islamic 'purity'". Instead, Ariff and the others, being critical to such laxity, advocate that Islamic banks should compete in terms of their willingness to adhere to the 'spirit' rather than merely to the 'letter' of Islamic law, and be judged on their pursuit of "the wider social and communal goals in financing" (Ariff et al, 2014).

There is a huge deposit of government and state-owned enterprises in Islamic banks in Malaysia (Alamsyah, 2012). For example, the Malaysian government deposits sufficient money in BIMB to amount 23 percent of the total deposits of BIMB. The cooperative attitude towards Islamic banks such as this is associated with the "government vision" that Malaysia aims to be one of the largest international hubs for Islamic banking and finance by 2020 (Nawi et al, 2013). Being supported financially by such a strong policy, Malaysian Islamic banks pursue more attractive financial products which are competitive with conventional banks.

Indonesian government may follow the same funding policy and deposit their large scale of money in Islamic banks. Ismal (2015b) explains some reasons why Indonesia government does not deposit a lot of money in Islamic banks: 1) There is a government regulation that the rate of yield (interest or profit-sharing) of the government fund must be more than the average of interest rate in the market. The rate of yield of Islamic banks is sometimes under the average of interest rate in the market. The current rate of yield of

Islamic banks of the day when Ismal argued was 4-6 percent, while the central bank rate was 7.75 percent; 2) For a practical reason, Islamic bank office networks are not wide-scales and less convenient for the government; 3) There are inconsistency in the government for the use of the deposited funds: Whereas the Ministry of Religion started to increase deposits for *Hajj* fund in Islamic bank, the other ministries does not have linkages with Islamic bank activities; and 4) Indonesia government, unlike Malaysia government, is not obliged to deposit their fund in Islamic bank by law. If Indonesian government deposits more money, deals through the accounts in Islamic banks more than at present, and converts its passive attitude towards Islamic banks to positive one like Malaysian government, asset scale of Islamic banks will be larger, and efficiency in Islamic banking will be improved.

Even if it is so, however, it is not always the best way for the Islamic banks in Indonesia to follow the Malaysian top-down strategy simply and to catch up with the market scale attained by the Malaysian Islamic banks. For example, in Malaysia, a lot of debt securities are issued based on *Bai Inah* whereby money can be raised without any exchanges of products or properties, and further on, they are tradable as *Bai al-Dayn* whereby discounts are permissible. Here we find one of the reasons why Malaysian Islamic bonds market has made "a success story" (Rosly, 2005: 449). Meanwhile Indonesia may have an option to develop Islamic Interbank Money Market with more limited function, where non discountable securities are only admitted, if it is to maintain its *Sharia* compliance completely[87].

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[87] Miki Hamada suggests that a coordination and standardization of Islamic bank products is necessary for the further development of Islamic bank in the globalization era and expects a leading role of Malaysia in the standardization and globalization process. However, she also refers to *Tawarruq* as a product which is impermissible for some Islamic scholars even in Malaysia. It

Total assets of Islamic banks in Indonesia are admittedly small as referred in 4.1. Further, as Dusuki and the others observe, there is no denying that Islamic bankers can no longer entirely depend on "marketing strategy of attracting pious and religious customers who might only concern about Islamicity of financial product", especially in the country that adopts the mixed banking system such as Malaysia or Indonesia. "The need for Islamic bank to enhance its service quality" is now considered "a critical success factor" that affects its competitiveness (Dusuki and Abdulah, 2007). However, they are to be understood from the economic and, at the same time, the religious perception of depositors, banks, businessmen, the Islamic public, and *Ulama*, all of whom are concerned not only with economic scale of the Islamic banks but also with the religious aspects of Islamic banks, such as PLS, and services which are consistent with *Sharia* (Ismal, 2013).

4.5. Conclusion

There are a few key factors to intensify Islamic banks in Indonesia: (1) improvement of human resource quality in the banking sector and increase of supply of them; (2) not only optimizing direct financing and deposit structure, but also diversifying financing and funding beyond much dependence on direct financing and deposits; and (3) related to this matter, increase of utilization of *sukuk* by Islamic banks.

Qualified human resources can produce excellent understanding of the Islamic banks for the Indonesian public. Therefore, the number of professionals and experts of Islamic banks through the higher educational institutions should be increased as early as possible.

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implies a difficulty of making coordination beyond the difference between the countries which introduce Islamic banks and have their own standards (Hamada, 2011).

Additionally, introduction of education of Islamic banking can be started from kindergarten school, to elementary school, junior high school, high school, and university. As will be argued in the next chapter, socialization of Islamic banks needs to be systematically proceeded.

Target of financial market segmentation of Islamic bank in Indonesia should be changed and be focused more on medium and large companies. Composition of short-term deposits should be also converted into long-term ones. In addition to these optimization, placement of funds in Islamic banks itself will be able to be diversified in other areas such as investment in securities, equity participation, and others. As with diversification of funding, use of *sukuk* in Indonesia should be activated not only by the government which already uses *sukuk* actively to cover the state budget deficits, but also by the potential promising actors, Islamic banks, as well as corporations. It will provide a good condition to diversify funding and investment of Islamic banks in Indonesia.

As discussed in the first, second, and third chapter, Islamic banks have demonstrated their supportive, if not omnipotent, function of stabilizing each national financial system including Indonesia. Indonesia is a part of the extremely complex global financial system where the most of the countries adopt the conventional banking system. Complexity makes the global and national financial system vulnerable to various financial risks and turmoil. In such circumstances, intensifying Islamic banks has an indirect effect to support stability of the financial system in Indonesia, delinking it from malevolent effects of the global financial system, if not perfectly.

However, in an initial dimension, we should consider how to enhance motivation of saving in Islamic banks in Indonesia. Firstly, customers have intention of gaining material benefits, such as high yields and safely guaranteed money. Secondly, for the Muslims, using Islamic banks means that they implement Islamic religious deeds through economic activity. Here again we find necessity of socialization of Islamic banks which seems to be an initial path for enhancing motivation of customers, increasing long-term deposits, stimulating Islamic bank investment, and stabilizing the financial system.

It is conceded that each Islamic bank is given freedom to offer its products as long as they are under the Islamic law. Although every contract and product of funding and financing must be examined and authorized by the national Islamic council (NIC), NIC has subtly different policy towards Islamic bank contracts and products from each other. For example, Sharia Advisory Council (SAC) of Malaysia permits *Tawarruq*, *Bai Inah*, and *Bai al-Dayn*, while these contracts are not permitted in Indonesia (Hosen and Nahrawi, 2012; Prabowo, 2009). The reason why their views are different is found in their interpretations based on *fatwa* in each country. In Indonesia, and also in the most of the countries where the Islamic banking are already introduced, these contracts are prohibited because they are interpreted as simple evading way of consumer financing loan (*Bai al-Dayn* is straightforwardly discounting). What matters is that financial products depend on conviction that they are authorized in term of the Islamic law. It should be taken into consideration that Indonesia does not always need to follow the Malaysian ways of Islamic banking policy, because Islamic banks, first of all, should comply with their national conception of *Sharia*.

Chapter 5. A Design of Organized and Continuous [OC] Islamic Bank Socialization Program to Confirm the Social Significance of Islamic Banks in Indonesia

5.1. Introduction

As discussed in the first chapter, Islamic banks are assumed on the solid base of moral and ethical values, although conventional banks cannot entirely neglect morality and ethics and, and as discussed in the second chapter, performances of Islamic banks were more stable than conventional banks during the severe global financial crisis, which were due to their fundamental discreet and conservative principles. However, Islamic banks cannot escape from crises originated from conventional finance. Given the wide gap of scale and close interconnection between Islamic and conventional banks, the former will continue to complement to, not alternate with, the latter.

This chapter, standing on the qualities of Islamic banks clarified above, aims to design a model of socialization of Islamic banks in Indonesia. Socialization of Islamic banks does not merely mean marketing of them in that marketing has a goal of expanding their market and, on the other hand, socialization has a goal of propagating not only economically, but also ethically significant Islamic banks into the society. However, ongoing socialization of Islamic banks performed by several institutions is less integrated, less efficient, and less persistent than expected.

Then I will attempt to design a better organized and more continuous socialization program (OC [Organized and Continuous] Program) of Islamic banks that will be conducted by one, but a popular, major, and highly appreciated Islamic religious leaders' social association, MUI, for a purpose of obtaining more customers of Islamic banks who are more aware of moral and ethical significance of Islamic banks. I will address myself here to OC educational programs which should have not a few channels of educational institutions, educational levels of the public, or location (urban or rural areas). If socialization of Islamic banks proceeds successfully, Islamic banks will solidify their standing position and the distinguished social and ethical quality on which they act.

5.2. Preliminary Research

5.2.1. Definition of Socialization

When we talk about the prospect of Indonesian Islamic banking system in the future, we should consider deeply not only the way of growing them economically, but also the way of socializing them morally and ethically. Generally speaking, socialization is an attempt to popularize something in order to make it be well known, understood, and internalized by the society (Bahasa, 1988). Based on this definition, socialization of Islamic banks can be termed as a step of disseminating Islamic banks to the public, providing the public with acknowledgement and social and moral significance of it, and inducing them to use Islamic banks more often.

It is true that socialization of Islamic banks is currently implemented by some Islamic institutions in Indonesia. However, it is not appreciated to be so effective, and it is the reason why we are going to discuss socialization of Islamic banks here. Without much consideration we can easily find the reason of ineffectiveness of ongoing socialization of Islamic banks: (1) Socialization are not extended into rural areas beyond urban areas, and; (2) Insight and knowledge of Islamic banking is generally limited within the academics and the practitioners, whereas the public are not familiar with nor understand clearly Islamic financial institutions (Sutanto and Umam, 2013).

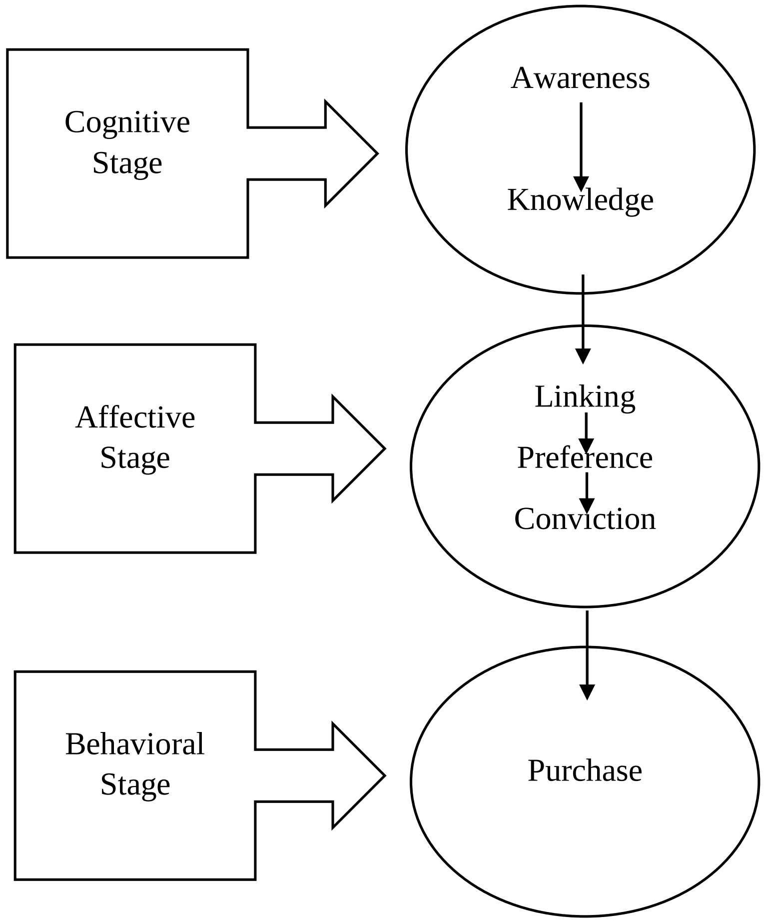
5.2.2. From Marketing to Socialization

Is socialization different from marketing? Kotler observes that marketing is a social process where suppliers aim at satisfying consumers and consumers (individuals or groups) when the latter obtain certain products and services that they need and want (Kotler, 2000). Marketing has five tools: 1) advertising, 2) sales promotion, 3) public relations and publicity, 4) personal selling, and 5) direct marketing (use of mail, telephone, fax, email, or internet).

Consumers of banks are customers. Being based on agreement with banks, customers seek satisfaction with banking products and services in return for their investments or deposits. Customers always evaluate alternative products and services, gathering information on financial products and services they want, from their families, friends, reference groups or promotional programs before they decide to select their favorite banks.

Marketing is a kind of communication. According to Lavidge and Steiner, communication process between suppliers of goods and services and clients or potential clients can be shown in the Figure 5.1. There are three stages in the communication hierarchy: cognitive, affective and behavioral. At the cognitive stage, potential customers become aware of suppliers and their products and increase knowledge of them and companies give them knowledge and favorable attitudes. At the affective stage, customers are linked to suppliers and their products, prefer to them, give confidence to them, and lastly are convinced of their merits. At the final behavioral stage, customers start action of using goods and services of suppliers. It is at this final stage that customers actually switch their behavior of purchasing goods and services (Lavidge and Steiner, 1961). Customers tend to be involved deeper and deeper with goods and services, spending much time and effort to find opportunities to purchase them.

Figure 5.1. Hierarchy of Effective Marketing



Source: Lavidge and Steiner, 1961

The models shown respectively by Kotler and by Lavidge and Steiner are true to Islamic banks as well as to conventional banks. The cognitive stage is a process of awareness towards the presence of Islamic banks and of incrementing knowledge of them. At the affective stage, customers are inclined to do something through linking, preferences, and conviction to Islamic banks. Lastly at the behavioral stage, clients start action to deal with Islamic banks and purchase their financial products and services (Kotler, 2000).

However, socialization of Islamic banks is different from pure and simple marketing of them in that the latter has no other purpose than increment of economic satisfaction and utility of both consumers and providers of products and services in the banking markets, meanwhile socialization of Islamic banks is a process where Islamic banks which comply *Sharia* have a solid purpose of increasing their social and ethical presence, of making the public understand well the social significance of Islamic banking, and of making the customers use products and services of Islamic banks on these understandings[88].

According to Wilson (2009) and Tawari (2015), one of the factors which are driving growth of Islamic banking is that Muslim requires consciously financial products and services under *Sharia* law. As bank finance without interest have not been developed and supplied for a long time, many Muslims were forced to exclude themselves from formal financial products and services. This is a reason why only 25 percent of the adults in the member countries of OIC (Organization of Islamic Countries) have an account in the formal financial institutions in the year 2011, which is below the global average of 50 percent (World Bank, 2014). Indeed, there are other purely economic reasons, for example, a lack of money to be deposited or invested, because about 700 million of the poor in the world

[88] Naser and the others investigate awareness and satisfaction of customers with Islamic financial products and services offered by Kuwait Finance House, the second largest Islamic bank in GCC countries, in 2011 (650 questionnaires and 429 returned). It reveals that most respondents are not aware of many of the Islamic financial products: More than 50% of the respondents are not aware of the products *Bai Beslom* and *Musana*; more than 40% are also not aware of products such as *Bai Bethaman Ajel*, *Mudharabah*, *Musharakah* and *Ijara Waktina*. On the other hand, a considerable proportion of the respondents are aware of *Murabaha* and they actually use it “mainly in trading cars”. Meanwhile, customers have solid consciousness of obeying Islamic rule, proved by a fact that ‘confidence in the bank Sharia Supervisory Committee’ is ranked in the fourth as reason behind dealings with an Islamic bank, next to ‘confidentiality’, ‘bank reputation’, and ‘bank credibility’, although they diversify their investment both into Islamic and into conventional banks. The authors observe that more efforts are required from the bank’s management “to familiarize its customers with all its existing products and services as well as introducing new products. The Islamic banks should move from just relying on *Murabaha* arrangements to other products” (Naser et al. 2013: 185, 190-191, 195).

live predominantly in Muslim-populated countries. Still, religious reason is not negligible: For instance, as many as 34 percent of the unbanked Afghan population does not have any accounts in formal financial institutions because of religious reason (World Bank, 2014). Therefore, *Sharia*-compliant financial products and instruments can play a significant role in enhancing financial inclusion among Muslim populations.

5.3. Ongoing Socialization of Islamic Banks in Indonesia

5.3.1. Bank Indonesia

It is needless to say that Bank Indonesia, as the central bank of the Republic of Indonesia, has one primary mission of stabilizing the value of Indonesia rupiah (BI, 2014a). With regard to Bank Indonesia as a regulatory authority of Islamic banks, I already explained it in the third chapter (3.2.1). However, Bank Indonesia has another important mission to socialize Islamic banks, to deliver messages and information on Islamic banks to the public, and to promote Islamic financial products, in collaboration with another parties including Islamic banks themselves, PKES (*Pusat Komunikasi Ekonomi Syariah*: Sharia Economy Communication Center), MUI (*Majelis Ulama Indonesia*: Indonesian Ulama Council), Muhammadiyah, concerned universities, and the other various public figures, parties and institutions [89]. PKES, MUI, and Muhammadiyah will be explained in 5.3.4 and 5.3.5.

[89] On the other hand, Bank Indonesia organizes various seminars under the joint sponsorship with some industrial and business associations of Indonesia, such as *Kadin*, for purposes of raising funds of Islamic banks and promoting asset management of industrial and business customers under Islamic banks.

One of the main projects of Islamic bank socialization launched by Bank Indonesia was “The Grand Strategy of Islamic Banking Market Development”, a new ambitious middle term vision of Islamic bank socialization, which was started in 2008 with the following four programs to make the Indonesian people comprehend Islamic banking more profoundly. Their social significance could be represented by a few slogans, such as “Beyond banking” or “Islamic bank, more than just a bank” (OJK, 2013)[90].

Firstly, the strategy built a program of branding a new image of Islamic banks, a new image that Islamic banks made every effort to bring mutual benefits to both customers and themselves. It was to differentiate Islamic banks from conventional banks not only in competitive advantages of various financial products and services but also in transparent and ethical aspects of their management, and, in parallel to such differentiation, it promoted Islamic banks to update the user-friendly information technology to meet customers’ requirement and satisfaction.

Secondly, the strategy had a new mapping program for more effective and more intensive socialization of Islamic banks, whereby the actors of socialization of Islamic banks would know easily the present location of Islamic banks, the present distribution of the population and the customers, and their accessibility to Islamic banks, and, on the other side, whereby the population and the customers would comprehend the services supplied by Islamic banks as universal ones. The program would enable the actors to decide priority of

[90] Beside the Grand Strategy, Bank Indonesia manifested the following plan: 1) to reach an asset target of 50 trillion IDR in Islamic banks in 2008; 2) to position Indonesian Islamic banks as the most attractive financial sectors in ASEAN in 2009, and; 3) to attain a status of leading Islamic Banking in ASEAN in 2010. However, total assets of Islamic banks in Indonesia were 48 trillion IDR in 2009. Besides, while Malaysia nowadays is estimated to be a leading Islamic banking sector in ASEAN, Indonesia is far from being so.

socialization and concentrate effectively their limited resources and energy for the people who need Islamic bank products and services the most in Indonesia. However, although Bank Indonesia made some preliminary research for the new mapping project in collaboration with some universities and Mark Plus conducted by Hermawan Kerta Jaya, a famous marketing institution in Indonesia, and obtained many good results, the universities in Indonesia that could join in the research were very limited, because the research budget for the mapping had been insufficient (Pddikti, 2015).

Thirdly, the Grand Strategy had a program of developing more various financial products and services which, due to their merit of mutual benefits, were attractive for potential customers both commercially and religiously. Such a research and development program would be realized by competent human resources. The issue that Islamic banking professionals and experts are not supplied sufficiently which was explained in the fourth chapter is not reiterated here.

Fourthly, the strategy had a program of supplying customers with products and services of enhanced quality under *Sharia* compliance. Islamic banks are required to inform customers correctly of their products and services which are consistent with *Sharia* principle by extending nationwide office network of Islamic banks, by naming Islamic financial products “deposit–iB” or “financing–iB” where the “iB” logo means Islamic bank so that the public could perceive, accept, and be persuaded to use them, and nowadays the logo is familiar with Indonesian people, and by advertisement through printed and electronic media, websites, in variety talk shows on TV and radio, in billboards, and in other media to make the public comprehend the advantages of Islamic bank products and services that can be beneficial to them (OJK, 2014d)[91].

5.3.2. OJK (*Otoritas Jasa Keuangan*) or FSA (Financial Service Authority)

As I explained in the third chapter (3.2.2), OJK is a financial agency which was newly established in 2012 to take over micro level financial regulation and supervision from Bank Indonesia. While such a division of labor has been advanced, OJK, together with Bank Indonesia, and with basic acknowledgement of a role that Islamic banks will play for the financial stability in Indonesia, has strategies of marketing and socializing Islamic banks. However, since the organization is new, the activities of this agency are still limited.

For example, OJK supports the "GRES! Program" led by PKES and other Islamic business communities (With regard to the GRES!, see 5.3.4). OJK also promotes the research of *Sharia* economy, finance and banking by calling annually for papers to the researchers and by opening a research forum of *Sharia* economy, finance and banking where the 12 winners get prize from OJK every year. The event will attract much attention if the excellent research papers are published in an accredited journal. The other socialization activities are: exhibition of the 'iB Vaganza' in various cities in Indonesia ('iB Vaganza' is a name of the exhibition to promote "iB" logo where *Vaganza* means 'spectacular'); the program of training of trainers of Islamic banking in various cities, too, and; advertisement,

[91] One of the main reasons why socialization of Islamic banks to the public is needed further is that a lot of people in Indonesia do not understand Islamic banks well. In this regard, an idea worths considering that the Indonesian words should be used for Islamic banking products and services as substitute for those written in the Arabic so that the people can understand more easily the methods of Islamic banking. It will have an effect of social propagating use of Islamic banks (Purwata, 2013).

dissemination, and communicating of Islamic banks to the public through various published prints and electronic media.

OJK has three important plans in the future which are related to Islamic banks in Indonesia: 1) strengthening structure and resilience of Islamic banks to support development and transformation of the national economy; 2) coordination and collaboration between conventional banks and Islamic banks in micro and macro prudential policy for stability of the financial system in Indonesia, and; 3) education and promotion of Islamic banking and finance with more integrated and massive way. The last third plan is relevant much to the theme of the chapter, that is, socialization of Islamic banks. While OJK is a financial regulation agency, it promotes socialization of Islamic banks and, in tandem with Bank Indonesia, takes it for granted that education of Islamic banking and finance should be pursued.

Overviewing the various activities of Bank Indonesia and OJK makes us acknowledge that these public financial organizations are obviously one of the main actors of Islamic bank socialization (BI, 2015i). However, they are lacking in a better organized system for effective implementation of socialization activities, since they have concentrated their socialization programs mainly into the five big cities in Indonesia, and therefore, do not cover the nationwide regions and, more importantly, nor certain targeted people, class, and area whose needs of Islamic banks are potentially large. Their needs cannot be grasped unless socialization activities are expanded into the grass root level.

5.3.3. MES (*Masyarakat Ekonomi Syariah*: Islamic Economic Society)

Now we refer to some Islamic economy associations and social institutions whose mission is to propagate Islamic economy and finance in Indonesia. Although I will overview their socialization activity of Islamic banks, I will refrain from judgment of their subjective mission since a viewpoint of the author is to think about the role of Islamic economy associations and social institutions in Islamic bank socialization, based on the acknowledgement that that Islamic banks cannot substitute, but complement to, conventional banks.

While OJK is an agency of Bank Indonesia, MES is a purely private economic association that encourages the public to adopt the economic system of Islam in Indonesia. MES, since the establishment in 2001 in Jakarta, has expanded the branches in almost all regions in Indonesia and in several foreign countries such as the United Kingdom, Saudi Arabia, Malaysia, and Germany. The association derives financial resources from members' fee, donations, and some charity in Islamic way, except from a foundation of ten million IDR succeeded by the founding fathers (MES, 2014).

MES advocates Islamic economy and business ethics in Indonesia and attempts to accumulate human resources that are endued with morals, knowledge and ability to run the economic activities of Islam, with a vision in the future that it will be able to be accepted as an influential economic reference of Islamic behavior and be followed by the public to such a degree that the primary choice of the public can be Islamic business, investment and finance.

MES recommends firmly that the Muslims use Islamic banks when they need banking services, as if they eat *halal* food when they need to eat. However, the actions of the association for Islamic bank socialization are too sporadic. For example, it held only one workshop in 2013 titled "National Training and Workshop: Legal Aspects and *Akad* Contract of Islamic Banking" in Bandung, and one workshop also in 2012 whose title was

"Workshop of Islamic Banking (Basic Level)" in Semarang, while it had a lot of program concerning Islamic stock exchange and Islamic insurance.

5.3.4. PKES (*Pusat Komunikasi Ekonomi Syariah*: Sharia Economy Communication Center)

PKES is another major private economic association whose mission is similar to MES's one, although it is tied with the public financial organizations more intimately than MES: The final vision of PKES is to create the community whose members understand, believe and apply themselves to the Islamic economy as a whole ("*kaffah*" in Arabic). The association was established in 2003 in Jakarta and thereafter, like MES, expanded branches or representatives in several places in Indonesia and abroad. Likewise, PKES has a lot of financial resources, such as donations of the founding fathers and others, members' fee, government subsidy, and profits from their own business (PKES, 2014)[92].

The missions of PKES are: 1) increment of people's understanding of the essentials of Islamic economy; 2) creation of the public confidence in economic advantages of complying with the rules of *Sharia*, and; 3) growth and development of Islamic economy in

[92] Before formation of MES and PKES, socialization and communication of Islamic economy conducted by each Islamic company such as Islamic banks and Islamic insurance companies was found only locally and did not have a wide impact on society. Therefore, Bank Indonesia had an idea for establishment of an institution or a professional body to undertake joint communications activities and socialization of Islamic economics as one of the elements in the Blueprint for Development of Islamic Banking publicized by the Bank in 2002. In an effort to build up the new agency, Bank Indonesia conducted further meetings from which in the end PKES was established. On May 14, 2003, being witnessed by the Governor of Bank Indonesia, was signed the Charter of Establishment of PKES, as a body whose role is communication and socialization of Islamic economy. PKES consists of Islamic enterprises and Islamic financial institutions, government institutions, and other institutions which intended to encourage industrial growth and development of Islamic economy. The Charter was signed by the 25 actors of *Sharia* economy. The institution encompasses socialization of Islamic banking, Islamic insurance, Islamic mutual funds, Islamic capital markets, pension funds, the management of *zakat* and other Islamic commerce.

Indonesia. In particular, PKES is required with collaboration with Bank Indonesia in API which was referred to in the third chapter to educate Indonesian people widely on Islamic banking and their products and services. It aims to facilitate the public to obtain information on Islamic financial products and services properly.

PKES has recently launched a new notable movement called GRES! (*Gerakan Ekonomi Syariah*: National Movement of Islamic Economy) to construct the overall Islamic economy, involving many Islamic companies, business persons, financial institutions, regulators, associations, universities, and many other stakeholders. Each unit can hold its own program, but, at the same time, they converge into GRES! The movement was started directly by an address of Indonesian President, Susilo Bambang Yudoyono, on November 17, 2013 in National Museum, Jakarta, as an innovative campaign of building Islamic economy (Aryani, 2013). It is obvious from this process that, although PKES is a private economic association, it has close relationship with the government as well as with the central bank.

However, outcome of the program cannot not be clearly estimated because GRES! is merely "moral touch" without any calculated goal. The staffs of PKES are so scarce and absolutely limited that it is difficult to implement Islamic bank socialization in full scale. There is recorded one primary forum concerning Islamic bank socialization in 2013, "On Waiting for State-owned Islamic Banks", a joint program with Ministry of State Enterprises and Indonesia Central Bank[93].

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[93] Rudnyckyj points out that such religious resurgence in economic actors, companies, associations, and managers and employees of them is not "refuge" from economic globalization. Instead, reformers advocate religious virtues based on the Islamic understanding and practice ("such as hard work, honesty, transparency and self-discipline" which Max Weber may call "worldly

5.3.5. Islamic Social Organizations

Islamic social organizations are different from associations of Islamic economy in that while the latter consist of various but narrow economic groups and individuals, the former consist of Islamic religious leaders or of actors in the fields of Islamic social welfare, education, and so on at the grass root level and in a nationwide scale. MUI (*Majelis Ulama Indonesia*: The Indonesian Ulama Council), an Islamic social organization which was established in 1975, is an association of Islamic scholars, leaders, and intellectuals. The organization aims at the realization of a country that is safe, peaceful, equitable and prosperous both spiritually and physically so that God may bless. To achieve the goal, MUI assists and guides the people, issues *fatwas*, formulates policy on Islamic mission, and offers a liaison between the Islamic scholars and the government leaders (MUI, 2014a).

MUI was already referred to in the third and the fourth chapter in explaining the *Sharia* compliance system in Indonesia and in comparing it with the counterpart in Malaysia respectively, where I pointed out autonomous and leading position of MUI in urging Islamic banks to comply *Sharia*. Also, in the third chapter, MUI was described as an important player which exerted influence over the government in Islamic banking and finance, for example, in establishing the first Islamic bank in Indonesia.

Taking into consideration the fact that Bank Indonesia and OJK act only in the major cities and that MES and PKES act in less persistently in proceeding Islamic bank

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asceticism") to create greater productivity, competitiveness, and reduction of corruption and to "optimize the efficiency and productivity of workers in an increasingly globalizing economy" (Rudnyckyj, 2010). For example, Bank Muamalat Indonesia, a largest Islamic bank in Indonesia, has ever practiced the Islamic training program for the employees to improve corporate human resources (Rudnyckyj, 2010: 96).

socialization programs, MUI may be considered as a more empowered candidate of the conductor of dissemination, understanding, increment of confidence, and encouragement of Islamic banks to potential customers since it has ever demonstrated itself as an axis of Islamic popular movement in the field of banking: For example, MUI issued a *fatwa* in 2004 which manifested that bank interest, whichever form it may take, should be distinctively forbidden as *haram* or things and behaviors which are forbidden in Islamic law, and that Muslims are recommended to take Islamic financial services by Islamic bank (MUI, 2014b).

Besides, there are several Islamic social organizations, and the presence of Muhammadiyah is worth mentioning in particular. It is one of the largest modernist Islamic social organizations, and it aims primarily, but not radically, to practice the religion of Islam in everyday life according to the holy book of Islam, *Al-Quran* [the scripts from the God], and *Hadiths* [sayings, actions and approvals of the Prophet Muhammad]. Muhammadiyah was established by K. H. Ahmad Dahlan in Yogyakarta in 1912. Since then, education and health have been two of the most prominent social fields of Muhammadiyah, and now in Indonesia there are as many as 172 higher educational institutions and 457 hospitals or clinics managed by Muhammadiyah (Muhammadiyah, 2014).[94] Muhammadiyah has also revealed beneficial attitude to solidification of Islamic economic system. Muhammadiyah made a *fatwa*, the Number 8 in the year 2006, where it censured bank interest as *haram*

[94] Since Muhammadiyah has a depth of presence in Indonesian society without rival in other Muslim-majority countries, Indonesian Islam is said to be “an associationalised Islam”. Hefner observes that “the single most striking organizational feature of Muslim society in Indonesia is the presence and durability of Muslim social welfare associations” such as Muhammadiyah. These associations regard the “middle ground of health care, social welfare and schooling” as “valued ends”. In this manner, associational life in Indonesia has helped to create a practical religious culture of the Islamic “middle” way (Hefner, 2013).

(Muhammadiyah, 2006), and at the 45th Congress of Muhammadiyah in Malang, it manifested that it would transfer all the assets to Islamic banks to use them to expand Islamic financial services through Islamic banks (Anhar, 2013).

Given that attitude and performance of Muhammadiyah toward Islamic banks have been clearly positive, that its social status in Indonesia has been very high, and that its social activity has been highly appreciated by the public, it will be expected to support MUI from below so that MUI will be able to take a leadership of continuous and well organized Islamic bank socialization in the nationwide scale and at the same time, at a popular level.

5.4. Finding and Implication

In an interview conducted by me, Rifki Ismal, senior researcher of Bank Indonesia, told that socialization, propagation and public understandings of Islamic banks in Indonesia has not yet reached at an optimal level (Ismal, 2014) [95]. In fact, as I discussed in the prior section, ongoing efforts to socialize Islamic banks in Indonesia seem to have many limitations. Ismal points out an important factor which demonstrates insufficient

[95] As a result, as I have discussed in the fourth chapter, Islamic banks have shown only slow acceleration for 22 years since the establishment of the first Islamic bank in Indonesia, and market share of assets of Islamic banks is still as small as less than 5 percent. Indonesia is a country which has the largest Muslim population. Halim Alam, Deputy Governor of Bank Indonesia, says that Indonesia could have already been a pioneer and reference for the development of Islamic finance in the world. He stated in February 2012 that the Islamic banking industry has a network of 11 Islamic banks, 24 Islamic business units, and 155 Islamic Rural Banks. 11 Islamic banks are BNI Syariah, Bank Muamalat Indonesia, Bank Syariah Mandiri, and Bank Syariah Mega Indonesia, Bank BCA Syariah, Bank BRI Syariah, Bank Jabar Banten Syariah, Bank Panin Syariah, Bank Syariah Bukopin, Bank Victoria Syariah, and Bank Maybank Syariah Indonesia. Admittedly, growth rate of Islamic banks in Indonesia now exceeds the whole national banking growth rate (Alamsyah, 2012). However, the amount of the asset is much less than that of the conventional banks.

socialization of Islamic banks: Coordination among the actors is not smooth and their actions are too general and too fragmented. They merely undertake their fragmental projects which are not interconnected smoothly with each other. If collaboration of the actors, such as the public financial organizations including Bank Indonesia and OJK, non-governmental economic organizations like MES and PKES, and Islamic social organizations like MUI and Muhammadiyah, functions well, socialization of Islamic banks to the public in Indonesia will be expected to be improved much better and be more persistent. Additionally, a crucial defect of the ongoing socialization is that there are little available data which indicates how many populations in each region and district need what kind of knowledge and information of Islamic banks. Such a difficulty is caused by the lack of mapping of Islamic banks and the populations.

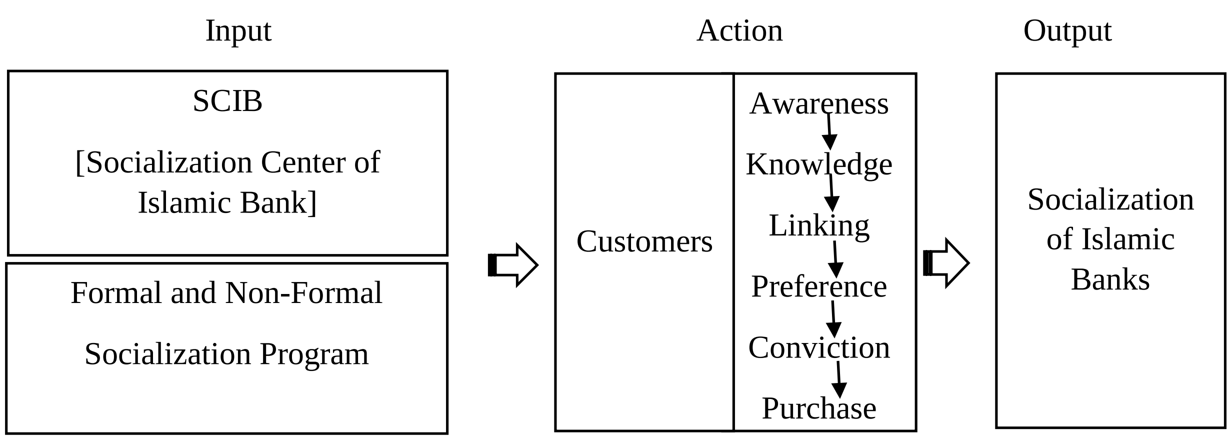
As MUI is the most influential Islamic social institutions in Indonesia, it will be able to orchestrate the players to socialize Islamic banks strategically on the national and popular level. The orchestration will include ongoing socialization programs, such as branding a new image of Islamic banks for differentiation of Islamic banks against conventional banks, a new mapping program for more effective and more intensive socialization of Islamic banks, opening research forum, workshops or seminars of *Sharia* economy, finance and banking, promotion of "iB" logo, mobilizing various media for Islamic banks, and so on. These will be undertook continuously by the existing organization, however, in more persistent and better organizing way under the conduct of MUI.

In particular, Ismal, assuming the potentiality of MUI, suggests how to solve current difficulties of socialization of Islamic banks in the following ways: a) involving *Ulama* (Islamic scholars) of MUI more profoundly to socialize Islamic banks; b) arranging intensive curriculum of Islamic banking and financing in some kinds of schools in Indonesia to overcome lack of human resources of Islamic banks, and; c) increasing publications and distributions of textbooks concerning Islamic banks and finance by using expansive network of MUI and the other mass Islamic social organizations, such as Muhammadiyah (Ismal, 2013). Above all, MUI has a social power to prompt the central and local governments to play an active role in supporting Islamic banking and finance by making use of its close relationships with Indonesian political authorities.

5.5. An Attempted Sketch of OC Socialization Program

In this section, making reference to Ismal's suggestion, I will attempt to sketch a model of socialization program of Islamic banks in Indonesia, called "the Organized, and Continuous [OC]" socialization program conducted mainly by MUI. Such an influential Islamic association as MUI will control and orchestrate socialization of Islamic banks in a well-organized and continuous way. The Figure 5.2 shows a model for input, action, and output process of OC socialization program.

Figure 5.2. Input, Action, and Output Process of OC Socialization Program



Source: Santoso (Suryo Budi Santoso), 2015

OC program covers the Input-Action-Output process. Firstly, input is implemented by SCIB (Socialization Center of Islamic Banks). Although SCIB cannot be delineated clearly in my design, it is supposed to be a non-governmental organizer mainly consisted of the representatives of a wide range of socializing groups overviewed in the third section, but conducted by MUI. SCIB focuses its work on controlling and orchestrating of socialization of Islamic banks in Indonesia which consists of 33 provinces. Tasks of SCIB are planning, execution, control, and evaluation of some programs of Islamic bank socialization. It also undertakes a work of mapping which segments the population by region or by educational background to promote socialization effectively.

Secondly, through action process, potential customers experience each stages of socialization: Initially customers become aware of the presence of Islamic banks, and then increment knowledge of them. They are soon linked to, prefer to, and believe in Islamic banks. Customers, at this stage, begin to have positive and sympathetic images and attitudes to Islamic banks. Lastly at the stage of behavior, customers actually use Islamic banks.

Thirdly, in output process, OC program will progress socialization of Islamic banks, and will lead to the development of Islamic banks steadily.

While, as surveyed in the third section, there are a lot of ongoing programs of socializing Islamic banks which will be also continued more effectively in the OC program, here I will focus one of the most important socialization programs: socializing Islamic banks through some education programs.

5.5.1. A National Education Program for Socializing Islamic Banks

Under the conduct of SCIB and receiving support from MUI, socialization of Islamic banks through the national religious education curriculum which has been already introduced in Indonesia will be implemented[96]. It will begin from kindergarten to elementary school, junior high school, senior high school, and university, in accordance with their respective levels of education and understandings, materials and contents being also adjusted to each level[97]. It will induce not only pupils and students, but also teachers, lecturers, and dispatched tutors from the outside to be conscious of Islamic banking, obtain knowledge of it, be linked to it, prefer to it, and be confident of it until they will eventually make dealings with Islamic banks.

Figure 5. 3. School System in Indonesia

<table>
<tr><td rowspan="2">Ages</td><td rowspan="6">Higher Education</td><td>Islamic Doctorate Program (S3)</td><td>Doctorate Program (S3)</td><td>Specialist 2 Program (SP II)</td><td></td><td></td><td></td></tr>
<tr><td>Islamic Master Program (S2)</td><td>Master Program (S2)</td><td>Specialist 1 Program (SP I)</td><td></td><td></td><td></td></tr>
<tr><td>22</td><td rowspan="4">Islamic Graduate Program (S1)</td><td rowspan="4">Graduate Program (S1)</td><td rowspan="4">Diploma 4 Program (D4)</td><td></td><td></td><td></td></tr>
<tr><td>21</td><td rowspan="3">Diploma 3 Program (D3)</td><td></td><td></td></tr>
<tr><td>20</td><td rowspan="2">Diploma 2 Program (D2)</td><td></td></tr>
<tr><td>19</td><td>Diploma 1 Program (D1)</td></tr>
<tr><td>18</td><td rowspan="3">Secondary Education</td><td colspan="2" rowspan="3">Islamic Upper Secondary School</td><td colspan="2" rowspan="3">General Upper Secondary School</td><td colspan="2" rowspan="3">Vocational Upper Secondary School</td></tr>
<tr><td>17</td></tr>
<tr><td>16</td></tr>
</table>

[96] Hefner observes that "Islamic education in Indonesia ranks among the most vital and innovative in the Muslim world". The openness of education has been facilitated by the fact that Indonesia's Islamic educators have embraced "the main currents of social reform" and "curricula innovation" promoted by Indonesia's leaders (Hefner, 2013). Even in the Islamic schools in Indonesia, such as *Pesantren* and *Madrasah* which put more efforts on the Islam in their curricula than public schools, most of them are innovative and "go beyond religious studies to offer marketable skills and general education" (non-religious subjects) (Tan, 2011).

[97] Naturally, non-Muslim children, pupils, and students do not need to attend the national Islamic religious education curriculum and they have the right to take alternative subjects in place of the Islamic education classes.

<table>
<tr><td>15</td><td rowspan="9">Basic Education</td><td rowspan="3">Islamic Lower Secondary School</td><td rowspan="3">Lower Secondary School</td></tr>
<tr><td>14</td></tr>
<tr><td>13</td></tr>
<tr><td>12</td><td rowspan="6">Islamic Primary School</td><td rowspan="6">Primary School</td></tr>
<tr><td>11</td></tr>
<tr><td>10</td></tr>
<tr><td>9</td></tr>
<tr><td>8</td></tr>
<tr><td>7</td></tr>
<tr><td>6</td><td rowspan="2">Pre-School</td><td rowspan="2">Islamic Kindergarten</td><td rowspan="2">Kindergarten</td></tr>
<tr><td>5</td></tr>
</table>

KBRI London, 2015 (Edited)

The Figure 5.3 shown above is a national education system in Indonesia. A national education program for socializing Islamic banks that I attempt to sketch encompasses all the stages in the system.

Pre-school education is for fostering physical and spiritual capabilities of 5 and 6 age children in preparation for the next education level or basic education. However, pre-school level education is not a prerequisite for entering the next level. There are two types of pre-school, one is kindergarten, and the other Islamic kindergarten. Kindergarten is either public or private.

Basic education consists of primary school (elementary school) for children of 7 to 12 ages, and lower secondary school (junior high school) for 13 to 15. Primary school receives pupils who have just graduated from kindergarten or children who not. Lower secondary school receives pupils from primary school. There are two types of these schools: primary school and Islamic primary school, and lower secondary school and Islamic lower secondary school. Basic education is either public or private, and is compulsory.

Secondary education is a further education in 3 years following basic education (16 to 18 ages) which consists of three types: general upper secondary school, vocational upper secondary school, and Islamic upper secondary school.

Kindergarten, and primary, lower secondary, general and vocational upper secondary school, whether public or private, are under jurisdiction of Ministry of National Education, and are called *Sekolah* in the Indonesian language. Meanwhile, Islamic kindergarten, and Islamic primary, lower secondary, and upper secondary school are under jurisdiction of Ministry of Religion, and are called *Madrasah* in the Indonesian language. They are either public or private, too. While Islamic religious education lessons in *Sekolah* are allotted two hours a week, those in *Madrasah* allotted five.

I interviewed two Islamic religious subject teachers in a primary school, Sulhan Arifin and Ayi Istianah (Muhammadiyah University of Purwokerto (MUP) Elementary School) (Arifin and Istianah, 2015) and an Islamic education lecturer of the Faculty of Islamic Religion of MUP, Slamet Budi Santoso, in August 2015 (Santoso (Slamet Budi Santoso), 2015). They were all of the same opinion that socialization of Islamic banks will be able to be inserted in the eldest grade in each primary school, since Islamic religious educational materials for the earlier grades are still the basics of Islam.

Islamic education contents are generally divided into five parts: the Holy *Quran* (guidance for mankind from God), *Aqeedah* (strong belief in *Allah* SWT as the one God in the world), *Akhlaq* (behavior driven by a conscious desire to do a good deed), *Fiqh* (science and law on various aspects of personal, social, and human life with God), and *Tarikh* (history of Islam). Islamic banking may be inserted in the section of *Akhlaq* and *Tarikh* because Islamic bank activity is a kind of a good deed by which the rich people can help the other people who have a business project but do not have money. In *Tarikh*, Prophet Muhammad can be taught as the first people that did business in PLS (profit loss sharing system). At the junior high school and high school levels, these two sections may be used for socializing Islamic banks.

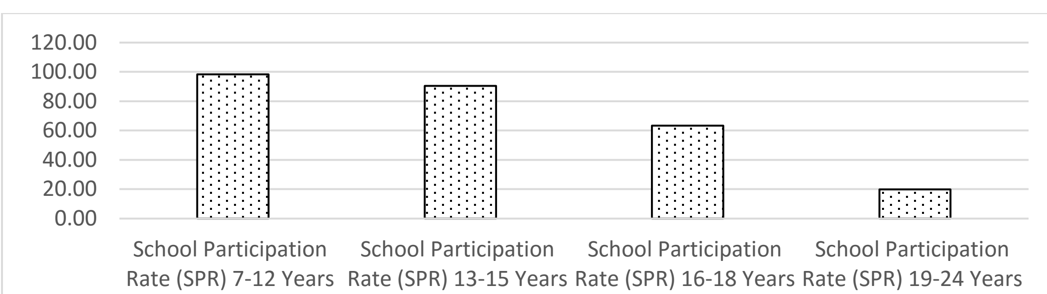
Before implementing the Islamic bank socialization program, the lesson plan of what should be taught (contents) and what should be used (materials and textbooks) for Islamic banks socialization must be examined by the teachers of Islamic religious education to attain certain consensus from the local level to the district level, provincial, and national levels. Such consensus will be needed because all the teachers should follow the minimum lesson plan, contents, materials, and textbooks.

Higher Education is positioned at the level next to secondary education, more than 19 ages, which consists of diploma 1 to 4, graduate program, and Islamic graduate program. Diploma 4 connects specialist 1 and 2 programs for graduates. Graduate program and Islamic graduate program are followed by their post graduate programs which encompass master and doctoral degrees and Islamic counterparts respectively. These programs (public or private) are under jurisdiction of Ministry of Research-Technology or Ministry of Religion, and all of them supply Islamic subjects. For instance, each Muhammadiyah University under Ministry of Research-Technology and Higher Education has the five courses on Islamic religious education, and each diploma program in the public college under the same authority has one course of Islamic religious education. Since an issue of how to bring up professionals and experts in the Islamic banking sector was already examined in the previous chapter, here we limit discussion to general Islamic bank socialization in higher education.

In a discussion with me in August 2015, Ida Nurlaeli and Slamet Budi Santoso, Islamic education lecturers of the MUP Faculty of Islamic Religion told that, if not 82 universities which supply the curriculum or program of Islamic economics, finance, and banking (see the fourth chapter), it will be feasible that a few subjects of socialization of Islamic banks in the courses of Islamic religious education are added both in graduate programs and in diploma 1 to 4 programs (Nurlaeli and Santoso (Slamet Budi Santoso), 2015).

With regard to the educational program outlined above, the Figure 5.4 which may be called a prototype of mapping, shows that school participation rate (SPR) is 98% for the aged 7-12 years, 90% for 13-15, and 63% for 16-18, while SPR is only about 20% for 19-24 years. It can be said from these data that it will be effective to concentrate more intensive socialization program of Islamic banks at the lower levels from primary school to high school. Since most of Islamic bank curriculum of Islamic banking and finance are currently prepared for students at the university level for bringing up professionals and experts in Islamic banking industry, if not sufficiently as discussed in the fourth chapter, an idea of educational curriculum at the lower levels of primary education schools, junior high school, and high school seems to be innovative and attractive.

Figure 5.4. Formal Education Participation in Indonesia in 2013



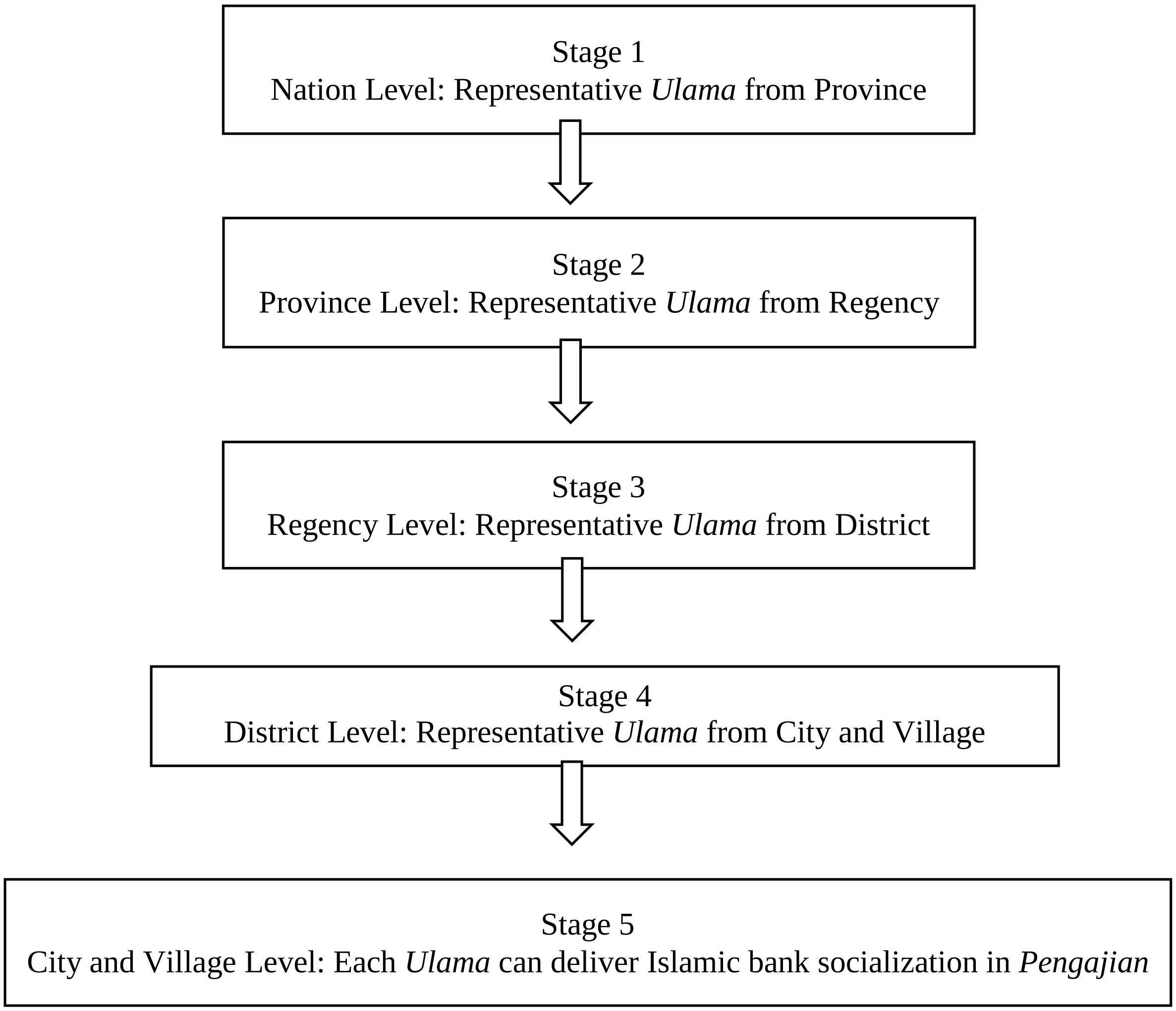
Source: BPS (Biro Pusat Statistik or Statistics Indonesia), 2014b

5.5.2. Training of *Ulama* for Socializing Islamic Banks in *Pengajian*

The other important educational socialization program in OC will be *Ulama* (Islamic scholars) training by MUI concerning Islamic banking. The reason is as follows: In general, the people of Indonesia, especially the members of Muslim communities are likely to have some key persons play a role model. In *Pengajian* (as explained soon later, non-formal Islamic meetings in the communities), persons who undertake role model are *Ulama*. Therefore, if *Ulama* in Indonesia are firstly socialized through training program, it will give desirable impact on their followers and audience in *Pengajian*. As *Ulama* have originally more knowledge of Islamic banks and finance than ordinary people, they will be soon capable of teaching significance of Islamic banks to their audience and followers in *Pengajian*.

Mintaraga Eman Surya, Young *Ulama*, Chief of Fatwa Department in MUI Banyumas Regency, Chief of Islamic Study Institute in Muhammadiyah University of Purwokerto, and Lecturer of Faculty of Islamic Study in Muhammadiyah University of Purwokerto, told in my interview in August 2015 that *Ulama* training will be completed in the several stages from nation to province, regency, district and city and village levels under the conduct of SCIB, where *Ulama* who will be trained in a higher level, in turn, will teach and train other *Ulama* at a lower level until they, at the bottom level, will be qualified to socialize Islamic banks in *Pengajian* (Surya, 2015). An *Ulama* training system is illustrated in the Figure 5.5. Training will be designed to increase of knowledge of *Ulama* about social significance and actual role of Islamic banks.

Figure 5.5. Training of *Ulama* in OC Program



Source: Surya, 2015 (Edited)

Ulama will be expected to play role model to guide a lot of followers in *Pengajian* in awareness of, acknowledgement of, linking to, preference to, conviction with, and purchase in Islamic banks in daily life. *Ulama* will be able to give the best recommendations of Islamic banks, deposit opportunities, and financing feasibility to their audience and followers. These processes will increase popular transaction with Islamic banks.

5.5.3. Socializing Islamic Banks in *Pengajian*

Another educational OC socialization program is implemented in *Pengajian* which is non-formal Islamic meetings in the communities in Indonesia conducted by *Ulama* that aims to transfer the knowledge of the religion of Islam from *Ulama* to the public. *Ulama* can provide Islamic religious knowledge to his followers directly. However, when knowledge of Islamic banks is transferred to the public through Islamic religious books, video and others types of media, the method will be indirect, meanwhile transfer of knowledge of Islamic banks mediated by *Pengajian* will be able to induce their audience and followers to be familiar with dealings with Islamic banks, such as investment, deposit and borrowing. When Islamic scholars address audience and followers, they will be able to teach importance of discipline and rules of transactions, such as repayments[98].

When we consider a feasibility of Islamic bank socialization program in *Pengajian*, the Table 5.1 below will be relevant since it estimates the number of *Pengajian*. If we

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[98] In socializing Islamic commercial banks and the people's credit banks (BPR Syariah), we can consult one successful model of non-bank institutions, BMT (*Baitul Maal Wattamwil*). While I already referred, in the third chapter, to the growth of BMT in recent years which are much smaller than Islamic banks in scale, one reason of the reason of the growth is found in *Pengajian* where BMT engage Islamic teachers (*Ustadz* who are sometimes called 'young *Ulama*') to teach Islamic thought in villages, paying for them fee of gasoline and motorcycle under *Qardhul Hasan*. *Qardhul Hasan* is financing program for help someone or organization with no profit. *Ustadz* are teachers whose Islam knowledge is apparently less than *Ulama*. *Ulama* are *Ustadz*, but *Ustadz* are not always *Ulama*. *Ustadz* teach Islamic religion to the rural population and at the same time introduce Islamic micro finance for BMT. A synergy between BMT and *Pengajian* has recently increased the number of membership of BMT. Socialization program of Islamic commercial banks and BPR Syariah in *Pengajian* may consider successful relationships between BMT and *Pengajian*. However, *Ustadz*, although most of them are also the religious education teachers at schools with full licenses and have much acknowledgement of Islam through educational trainings in *Pezantren* (Islamic boarding schools) and graduate schools, *Ulama* are qualified higher than *Ustadz* for disciplined Islamic leaders, and will suit for Islamic bank socialization.

assume that each *Pengajian* (67,243 in total) which usually is opened every week will insert an opportunity of a short socialization program of Islamic banks once a month and that each Ulama (28,743 in total[99]) will teach Islamic banking and finance two or three times a month, the program will be feasibly implemented. If they are in short of doing their allotments, they may ask a support and mobilization of *Ustadz* (Concerning *Ustadz,* see the Footnote 97).

Table 5.1. An Estimation of the Number of *Pengajian* for Islamic Banks Socialization

No.	Islamic Mass Organization	Total/Month
1	Nahdlatul Ulama (NU)	
	Total Village and City Level *Pengajian*	47,125
2	Muhammadiyah	
	Total Village and City Level *Pengajian*	8,107
	Autonomous Organization	12,011
	a. Women	6,924
	b. Young People	2,000
	c. Students	172
	d. Pupils	2,915
	Total *Pengajian* in Muhammadiyah	20,118
Total *Pengajian* for Socializing Islamic Banks		67,243

Sources: Muhammadiyah, 2015 (Edited) and NU (Nahdlatul Ulama), 2015 (Edited)

Assumptions:

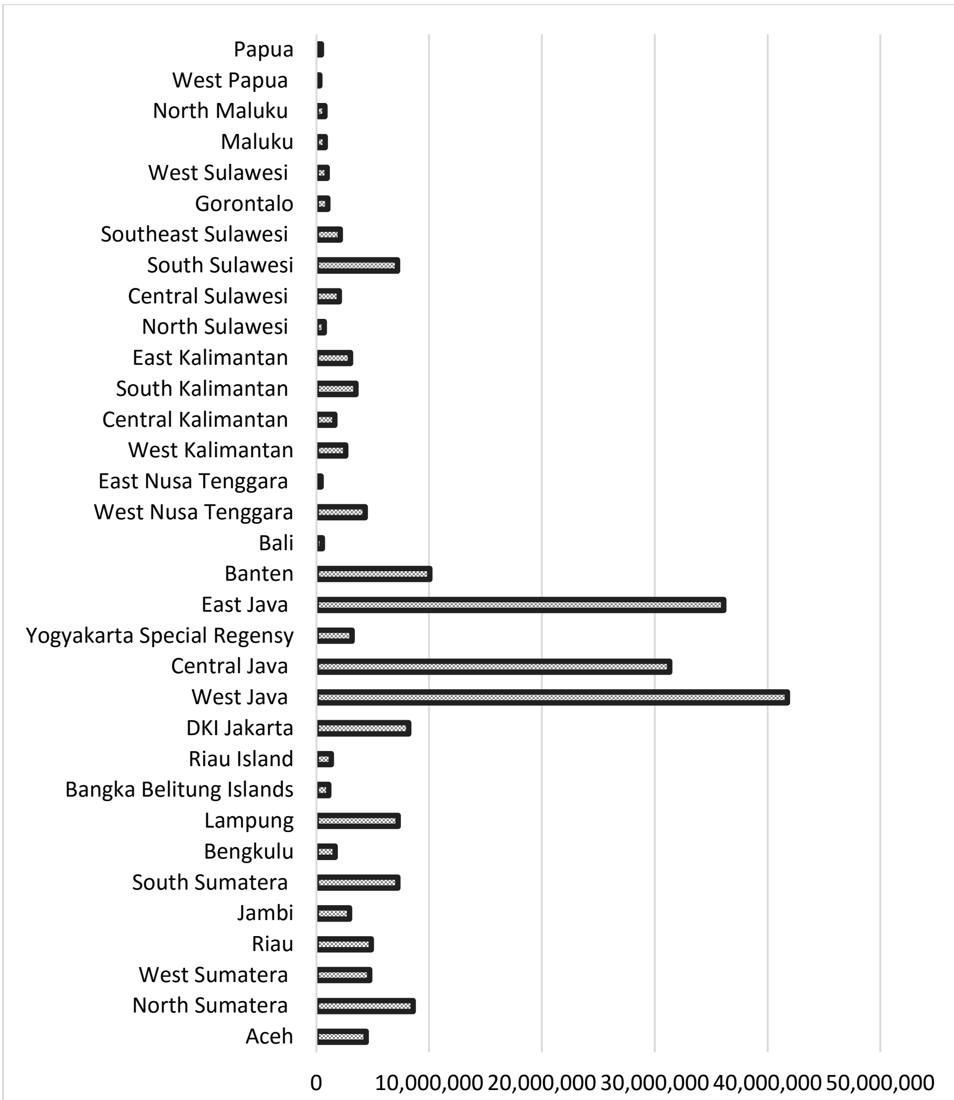
1) Every affiliation at village and city levels of two Islamic mass organizations, Nahdlatul Ulama and Muhammadiyah, and every autonomous organization of Muhammadiyah opens *Pengajian* regularly every week; 2) Each *Pengajian* opens a special short teaching program on Islamic banks socialization once a month.

[99] The total number of Ulama (28,748 persons) was calculated by an addition of the number of *Ulama* in National level (108), Province level (2,890), and Regency level (25,750). Source: MUI Websites: http://mui.or.id/ (National level); http://www.muidkijakarta.or.id/ (Province level), and; http://www.mui-bogor.org/ (Regency level).

Here I need to explain another Islamic mass organization than Muhammadiyah, that is, Nahdlatul Ulama (NU). NU is an Islamic organization which was established on January 31, 1926, by some *Ulama* in Surabaya. Since then, NU has acted in the various religious, educational, social, cultural and economic fields in Indonesia like Muhammadiyah. However, although NU has a larger membership (about 40 million) than Muhammadiyah (about 20-30 million) (NU, 2015), it is possibly due to the NU traditional approach where Islam is mixed with traditions that still exist in the Indonesian society and, owing to it, are popular among mass people, traditions such as various ceremonies outside the thoughts of Islam (Asyari, 2009). Meanwhile, Muhammadiyah is a modern Islamic organization which has a vision of pure Islamic deeds and behaviors derived from the *Qur'an* and the *Sunnah* of the Prophet Mohammad SAW. It considers that traditions mixed with Islam should not be observed. While Muhammadiyah is known as a reformer of pure Islam and are supported in the city and by the educated people, NU mainly continues to act in villages and is also supported by the urban workers. When Islamic bank socialization program in *Pengajian* is planned, NU should firstly change its attitude towards bank interest since, while some NU *Ulama* consider bank interest as *haram* or forbidden, others as *halal* or permitted. Therefore, NU has never issued any *fatwa* that bank interest is *haram*.

In making an OC educational program in *Pengajian*, it will be also relevant to see the Figure 5.6, a prototype of mapping as well as the Figure 5.4 which will suggest the regional priority of socialization of Islamic banks to the Muslim communities: We find from distribution of Muslim population in Indonesia indicated in the figure that the largest number of Muslims live in East Java, West Java and Central Java and that it will be recommended that an OC educational socialization program of Islamic banks be concentrated in these three provinces as the main target, which will be followed by the other provinces populated with many Muslim populations after three provinces, such as Banten and DKI Jakarta.

Figure 5.6. The Number of Muslims in Indonesia by Province in 2010



Source: BPS (Biro Pusat Statistik or Statistics Indonesia), 2014d

Adding to the figure, according to the census of Indonesia in 2010, the total population is more than two hundred million. They are divided into 119,321,070 (50.21

percent) in rural areas, and 118,320,256 (49.79 percent) in urban areas (BPS, 2014c). Given this division, SCIB should make two approach strategies of *Pengajian* educational program. The first approach will be socialization of the population who live in rural areas where *Pengajian* will need to emphasize the basic understanding of Islamic banks so that people can be aware of, and get accustomed with, various basic services of Islamic banks, such as savings and financing for agriculture, farming, and plantations, and other small-scale usages. The second approach will be socialization of the population who live in urban areas, some of whom are engaged in the middle and large scale of industries and services. In urban communities, *Pengajian* will need to emphasize understanding of Islamic banks in the mid-level so that people can transact with Islamic banks for savings and financing for the industries and investment which are occasionally of middle and large scale.

Lastly, different from three OC educational socialization of Islamic banks (a national religious education program, a program of *Ulama* training, and an educational program in *Pengajian* at the grass root level) that I roughly attempted to propose here, there is another socialization program: focus group discussions. SCBI will need to conduct focus group discussions with business managers, directors and investors of various industries, including those in the large Muslim conglomerates in Indonesia. According to *Forbes* in 2012, total assets of the four largest Muslim conglomerates, Chairul Tanjung , Achmad Hamami, Garibaldi Tohir, and Aksa Mahmud recorded 73 trillion IDR (Oktarianisa, 2012). If all of these assets are invested or deposited into Islamic banks, total funding of Islamic banks will increase by 33 percent, and amount to 291 trillion IDR. Hence socialization of Islamic banks will also need to be approached to the big business and large investors. Rifki Ismal said in an interview conducted by me in 2014 that Islamic banks can increase their performance significantly by attracting investors and large conglomerates, including those of non-Muslims (Ismal, 2014). OC socialization program of Islamic banks will need to hold a wide range: It should cover not only the public and the small and medium business but also the large businesses for propagating social and ethical significance of Islamic banks as well as for improving profitability of Islamic banks (Santoso, 2014).

5.6. Conclusion

Islamic banks in Indonesia have two purposes. Firstly, they aim to be more competitive against conventional banks, even if they will not probably be alternative to them. They are now emerging side by side with conventional banks and being complement to the financial system both in a national level and in a global level. Islamic banks have potentiality of being more attractive and competitive, because they are intrinsically resistible to fluctuations of international financial market. Secondly, Islamic banks make an effort to be socialized, uniting themselves to customers with religious and social consciousness. In this chapter, a way for attaining the second purpose was sketched roughly.

Socialization and dissemination of Islamic banks has been carried out by various parties, such as government authorities such as Bank Indonesia and OJK, non-governmental organizations such as MES and PKES, and Islamic social organizations such as MUI and Muhammadiyah. However, there have been many shortcomings and limitations in their actions with a result that socialization is still now less optimal, being unintegrated, inefficient, and discontinued.

I designed a plan to be called “the Organized, and Continuous (OC)” socialization program of Islamic banks to be conducted by Socialization Center of Islamic Bank (SCIB), an independent organizing agency for planning, implementing, monitoring, and controlling

OC programs, mainly consisting of the representatives of Islamic bank socialization parties under the leadership of MUI. Through Input-Action-Output process of OC programs, potential customers experience awareness, knowledge, linking, preference, conviction of Islamic banks, until customers decide to use Islamic banks and purchase their products and services. SCIB will exert sufficient influence not only over the government, Islamic scholars, and Islamic organizations, but also over the public at the grass root level in socialization of Islamic banks, with a result that they will have advantage in executing their leadership to both levels, that is, the top authorities and the people at the glass root level and in the nationwide scale.

While SCIB will continue ongoing socializing programs more effectively, I sketched in the fifth section some educational socialization program: In a national educational program, will be arranged the curriculum of Islamic banks in each level of schools; In an *Ulama* training program, *Ulama* will be able to acquire capabilities to guide and lead their followers in *Pengajian* to be actual customers of Islamic banks, and; In *Pengajian* education program, *Ulama* will not be trainee, but leaders of audience and followers. I added to these a focus group discussion program where SBIC will encourage businessmen and investors to place their funds in Islamic banks with consciousness of Islamic ethics.

As far as Islamic banks in Indonesia have willingness not only to be economically competitive, but also to be financial institution based on *Sharia* rule, it is worthwhile to design socialization programs to be performed not forcibly but voluntarily in the Indonesia society.

Chapter 6. Conclusion and Research Contributions

Progress in information and technology by leaps and bound has been integrating most of the banks around the world and making the global financial system more and more complex and volatile. These circumstances are likely to make the financial system fluctuate very quickly, as indicated by harsh movements of interest rates, foreign exchange rates, and inflation rates. I explained, in the second chapter, that Islamic banks can coexist with conventional banks in the world and that, while the conventional banking system which regulates only interest-taking banking (conventional banking) is still dominant in most countries, the mixed banking system which offers the separated regulatory laws for conventional banking and for Islamic banking respectively is expanding gradually. The mixed banking system allows conventional banks to open the Islamic bank units or Islamic bank windows.

As also discussed in the second chapter and in the first chapter, too, Islamic banks have attracted much attention due to the fact that they have steadily developed in recent years and that they have been relatively stable in the global financial turmoil and crises, although they also hold the risks which are particular to them. Stability in the long term of Islamic banks against the financial fluctuations is one of the reasons of the development of Islamic banks. Although they naturally cannot evade by any financial crises, Islamic banks have never been originators of the crises. However, as also argued in these two chapters, it should be noted that Islamic banks are in competition with conventional banks whose scale gives asymmetrically much influence to Islamic banks, and that, therefore, various financial risks connect these two banks, which gives us a perspective that Islamic banks will not be alternative to, but complement conventional banks.

Indonesia and Malaysia belong to the countries that have introduced the mixed banking system. I explained, in the third chapter, the mixed banking system in Indonesia and argued that, in spite of the fact that the national financial system has been reformed and sophisticated under the direction of Bank Indonesia after severe damage of the Asian currency crisis in the years 1997-1998, some fluctuating factors have been still found in the Indonesian macro-economy in recent years, and that, in such a circumstance, Islamic banks in Indonesia showed better performances, or at least, no worse performances than conventional banks before, during and immediately after the global financial crisis in the years 2008-2009.

Viewed from a magnitude of the potential customers of Islamic banks in Indonesia which is a country that has the largest Muslim population in the world, the country has much possibility of developing Islamic banks. However, as argued in the fourth chapter, Islamic banks in Indonesia, owing to the fact that they are newly introduced financial institution (only twenty four years have been passed since the establishment of the first Islamic bank in Indonesia), still hold some shortcomings to be overcome, such as a scarcity of human resources, suboptimal funding and financing structures, limited financial products and contracts, and insufficient utilization of *sukuk*. These problems may contribute to a result that the total assets of Islamic banks are still very low: five percent of the assets of conventional banks.

Therefore, we argued and suggested some key factors for the intensification of Islamic banks. The fact that Islamic banking professionals and experts are insufficient puts a severe limitation on expansion of Islamic banks and Islamic financial products development. Since the main supply of them is to be found nowhere but in the master and doctoral courses of the universities in Indonesia that offer Islamic economy, finance and banking curriculum or programs, it is necessary to reinforce the graduate schools where professionals and experts are trained. The fact that financing and funding in Islamic banks are much concentrated into small and medium scale of business sectors and short-term deposits respectively impedes profitability growth of Islamic banks. In order to dissolve such suboptimal structures, enlarging of financing to large businesses and funding of medium and long-term deposits are indispensable. However, adding to these measures, Islamic banks should develop *sukuk* market, interbank money market, and various products in funding or investment for a purpose of breaking heavy dependence on finance and deposit themselves.

In overcoming these problems in Indonesian Islamic banks, while those who are concerned with Islamic banks in Indonesia should make effort to resolve them by especially referring to a success story of Malaysia, neighborhood of Indonesia, they should also search for a proper course for Islamic banks in Indonesia. We pointed out in the fourth chapter that the top down approach of government and central bank (Bank Negara Malaysia) is dominant in growing Islamic banks in Malaysia, that some financial products and contracts which are not allowed in terms of *Sharia* law in the other countries where Islamic banking are introduced are permitted in Malaysia, and that these rather lax financial policy in Malaysia seems to be related to an ambition of making Kuala Lumpur the biggest Islamic financial market in the world. In contrast with Malaysia, Indonesia has adopted, whether consciously or unconsciously, the bottom up approach in bringing up Islamic banking, which is to be ascertained in a negative government supportive attitude to deposit the money into Islamic banks and in the national *Sharia* compliance system under the initiative of MUI, a private Islamic social organization comprised by Islamic religious and intellectual leaders which is independent from government and central bank. Although MUI has an intimate connection with the government, it is MUI, not the government that exerts influence over the other. Some financial contracts in Malaysia, namely *Bai Inah*, *Tawarruq* or *Bai al-Dayn*, are not permitted in Indonesia and in many other Muslim countries too, because they are highly dubious in terms of Islamic law (See the second and fourth chapters).

Being based on a suggestion in the fourth chapter that the Indonesians should search for the proper way of Islamic banks, I attempted to design a plan of socialization program of Islamic banks in the fifth chapter which is called "Organized and Continuous (OC) socialization program". Socialization which should be distinguished from marketing is a kind of social movement, having an object to disseminate Islamic banks and to communicate their social and moral significance to the public in coordination among the concerned groups. OC program, though it is a rough sketch, is proposed to be conducted by Socialization Center of Islamic Bank (SCIB), an independent organizing agency for planning, implementing, monitoring, and controlling OC programs. SCIB consists of the representatives of the concerned groups and under the leadership of MUI which exerts influence not only to the government, Islamic scholars, and Islamic organizations, but also to the public at the grass root level.

In particular, I focused on some educational OC socialization programs, one of which will arrange the national curriculum of Islamic banks inserted in the religious education subjects in each level of schools from kindergarten to universities. It will be feasible and expected to have an impact on improving understanding of Islamic banks in a nationwide scale which will be able to ultimately make the public accept Islamic bank in Indonesia. The second idea is that *Ulama* (Islamic scholars) are trained at a preparatory stage so that they can socialize the public in *Pengajian* (non-formal Indonesian Islamic meetings in communities) at a next stage. Through training, *Ulama* will be soon able to acquire the ability to guide and lead their followers and audience in *Pengajian* for a purpose of making them understand the social significance of Islamic banks and become actual customers of Islamic banks. The third idea is socialization in *Pengajian* where trained *Ulama* will play role models of audience and followers in Islamic bank understandings. I proposed another OC socialization program other than educational ones: focused group discussion where SBIC will encourage businessmen and investors to place their funds in Islamic banks with consciousness of Islamic ethics.

It is needless to say that these suggestions are tentative and, therefore, are yet to be scrutinized in detail. For example, more research will be required to investigate how many funds will be needed for the OC program, what coordination system among the various parties and stakeholders in socializing Islamic banks should be formed under SCIB, and how feasible the proposed Islamic bank educational curriculum in each level of education is. At any rate, however, it will be worthwhile to consider and put into practice a continuous and well-organized socialization program of Islamic banks because Islamic banks in Indonesia should be intensified with solid consciousness of keeping the social and moral significance.

What I argued so far in the doctoral dissertation for suggesting the way to be pursued by Islamic banks in the world generally and in Indonesia in particular can be summarized in a following statement of Rodney Wilson that Islamic banks must focus on the essential needs of their customers and "not simply mimic conventional banks" with respect to product and service offerings, and that customer education (socialization) should focus on explaining the nature of *Sharia*-compliant products so that Islamic bank clients will be "receptive" to it.

These two foci are more important than encouraging the devout Muslims to simply use "as wide a spectrum of products as some conventional banks offer" (Wilson, 2005).

To this viewpoint we can relate a concept of *maqasid al-Sharia*, or true objective of *Sharia*. Realization of *maqasid al-Sharia* in the Islamic financial industry is not simply for satisfaction of "the minimum legal requirement" but, more importantly, for a broader perspective based on the beliefs and faith (*aqidah*) and Islamic ethics (*akhlaq*) which guide economic matters. *Maqasid al-Sharia* is "the basic moral-philosophical foundation that gives guidance and justifications for Islamic banking's *raison d' être"* (Laldin, 2014). I cite here Laldin' statement as follows: "the *maqasid* orientation in developing Islamic banking would set a new perspective and comprehensive changes in framework and approach that would provide unconventional solutions in satisfying financial needs. The ultimate aim is to cater to the larger number of people in society in the mobilization of resources for wellbeing" (Laldin, 2014).

However, Islamic banks serve not only Muslims but also non-Muslims, because, as Parker (2011) asserts, the essential principles of Islamic finance are not entirely specific to Islamic faith. They are a part of not only the divine religious but also of the secular ethical paradigms. Therefore, the main ethical message of Islamic finance is universal. It is in accordance with the Verse 107, the Chapter 21 in the *Quran*, which essentially states that Islam is a mercy to the entire world. At a time when the world leaders are calling for the financial reforms being confronted with difficulties, it is appropriate to have financial systems rebuilt on the widely accepted ethical and moral bases to serve the common good of humanity. El-Zoghbi (2013) also supports the idea that rapid growth of Islamic finance in the world makes Islamic finance inclusive and, as a matter of fact, it has recently galvanized a great interest among regulators, financial service providers, and other financial stakeholders including conventional finance and banking. However, as stated so far at several times, we cannot expect that Islamic banking will be completely alternative to conventional banking.

Asutay (2008) proposes that the dramatic growth of Islamic banks and finance in the world needs consistency within the Islamic moral economy. "Islamic moral economy" is a modern term which began to be used in the early 1970s mainly for critique of the previous economic development strategies that ignored importance of societal and human well-being. It formulates human-centric development strategy onto the following foundation: 1) *tawhid* (unity), vertical dimension of the Islamic ethical system in terms of equality in front of God; 2) *al-'adl wal'-ihsan* (justice and equilibrium), horizontal dimension of equity in terms of equality between individuals; 3) *ihktiar* (free will), individual opportunities in the economic system to choose between various options; 4) *fard* (responsibility) which means that individuals and society exist for the public good; 5) *rububiyyah*, divine arrangements for nourishment of individuals, sustenance of them, and directing things towards their protection; 6) *tazkiyah*, growth to be accompanied with incorporation of the good of the others and to be conducted with ethical and moral considerations, and; 7) *khilafah*, role of individuals as God's vicegerent to earth.

In concluding the doctoral dissertation study, I would like to show concisely my research contributions.

Research contributions of my doctoral dissertation are as follows:

1. To prove some relatively stabilizing properties of Islamic banks both on theoretical level and on empirical level. Such stability may be a base of development of Islamic banks.
2. To propose some practical measures of intensifying Islamic banks in Indonesia based on the empirical data, with a comparative study of Islamic banks in Indonesia and in Malaysia.
3. To provide an insight on Islam bank socialization program in Indonesia based on a review of the ongoing socialization program.
4. From 1 to 3, to construct an approach which synthesizes a way of intensifying Islamic banks in Indonesia in an economic and commercial point of view on the one hand and a way of searching for socializing them in a moral and ethical point of view on the other hand.

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