ABSTRACT

Though Islamic banking in Indonesia has shown a promising performance over the last two decades, it still occupies a small niche in the market share of the national banking industry. How we can understand the phenomena of the extraordinarily low level of Islamic banking penetration and the slow pace of growth of Indonesia's Islamic banking, nevertheless Indonesia is considered to have the biggest Muslim population in the world? This research aims to clarify the causes or fundamental constraints behind the above puzzles, drawing on the traditions of Institutional Economics which are concerned with the rules or mechanisms of creating the 'incentive' and 'threat' for the economic players because the rules (institutions) would matter as the determinant for economic development and economic efficiency. Apparently, the existing arguments in the literature do not sufficiently shed analytical light on the 'incentive' in the credit risk management and banking operation of the Indonesia's Islamic banks. This research uses, in particular, the theoretical framework of 'financial sector rent' (bank rent) to analyze how well or poorly the creation of 'rent (surplus) opportunity' to be captured by banks was effective as the incentive of making them to become prudent fund providers. In addition, this research analyzes how the Indonesian financial restraint policy might have failed to give Islamic banks the profits enough to create and maintain the franchise value, resulting in the above puzzles. This research specifically uses the fairly new analytical lens of 'Islamic bank rent' and hypothesizes that Islamic banks need to earn extra profit as compared to conventional banks to maintain their franchise value as prudent *Shariah*-compliant lenders. This research suggests that the deterioration of financial indicators such as Return on Assets (ROA) and Non Performing Financing (NPF) in Indonesian Islamic banks reveals that there has been less incentives for the Islamic banks in expanding their business and accelerating their growth in the banking industry during the observed periods. This research also analyzes how the intemsifying competition with Indonesian conventional banks may have hampered the profit opportunity to be caputured by Islamic banks. In addition, this research points out that the Indonesian government and financial authorities have been too lax in well-designing the regulatory framework and providing tax and fiscal incentives to incubate the Islamic banking industry. We compare the governmental initiatives for incubating the Islamic banking industry between Indonesia and Malaysia. The latter has conducted a series of comprehensive regulatory frameworks and implemented intervention policy for incubating the Islamic banking development. This governmental initiative, through allowing the Islamic banking windows to effectively utilize the conventional bank infrastructure and network, brought the Malaysia's Islamic banks to capture adequate profit opportunities. In the Indonesian context of banking supervision, this research points out the governmental (regulatory) failure in preparing the level playing field between conventional and Islamic banks, which has left Indonesian Islamic banks to be less efficient and less competitive in comparison to conventional banks. A policy option for improving the efficiency in Islamic banking by creating sufficient bank rent opportunities as an incentive to encourage Indonesian Islamic banks to seek the economies of scale is argued.

Keywords: Islamic bank, bank rent, Islamic bank rent, financial sector rent, rent effect, financial deepening, structural dilemma, *murabaha syndrome*