Analysis of Slow Paced Market Penetration of Indonesia's Islamic Banking:

An Islamic Bank Rent Perspective

By:

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For:

My beloved Father and Mother,
My beloved Wife and Children
My respected Professor
without their love, patience, and kindness
this memorable academic work will not see light of the sun

STATEMENT OF AUTHENTICITY

I hereby declare that the content of this dissertation is original and true, and has not been submitted at any other university or educational institution for the award of degree or diploma. All information derived from other published/unpublished sources has been cited and acknowledges appropriately.

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LIST OF ACRONYMS

AAOIFI	: Accounting and Auditing Organization for Islamic Financial Institutions
BCC	: Banker-Charmes-Cooper model
BI	: Bank Indonesia (Indonesian central bank)
BIMB	: Bank Islam Malaysia Berhad
BNM	: Bank Negara Malaysia
CAMELS	: Capital adequacy, Asset Quality, Management capability, Earnings, Liquidity, Sensitivity to market risks (sometimes, another S is added the end, which stands for Systems and operations controls)
CAR	: Capital Adequacy Ratio
CCR	: Charnes-Cooper-Rhodes model
CR	: Concentration Ratio
DEA	: Data Envelopment Analysis
DMU	: Decision Making Unit
FSA	: Financial Services Authority
GCC	: Gulf Cooperation Council
GDP	: Gross Domestic Product
HHI	: Herfindahl-Hichsman Index
IAH	: Investment Account Holder
IBRA	: Indonesia Banking Restructuring Agency
IDB	: Islamic Development Bank
IDR	: Indonesian Rupiah
IFSB	: Islamic Financial Services Board
IMF	: International Monetary Funds
IRTI	: Islamic Research and Training Institute
LDR	: Loan to Deposit Ratio
LPS	: *Lembaga Penjamin Simpanan* (Indonesia Deposit Insurance Company)
MENA	: Middle East and North Africa

NPL : Non-Performing Loans
Pbuh : Peace be upon Him (used with the name of the holy Prophet of Islam)
PLS : Profit and Loss Sharing
PSIA : Profit-sharing investment account
RIA : Restricted investment account
ROA : Return on Assets
ROE : Return on Equity
SMEs : Small and Medium Enterprises
SSB : *Shari'ah* Supervisory Board
USD : U.S. dollar

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*

CHAPTER 1
INTRODUCTION

1.1 Introduction

Since the first launch of the Islamisation of economic movement and the experimental establishment of Islamic financial institutions in the 1970s, nowadays Islamic finance has developed into a global phenomenon. In the past four decades, Islamic finance and banking have experienced rapid expansion with a vigorous performance of financial indicators (Sardar, 1988; Iqbal & Mirakhor, 2007; Ismal, 2011; Ismal, 2013).

According to the Islamic Financial Services Industry (IFSI) Stability Report 2014 (IFSB, 2015), global Islamic finance has shown an impressive growth trajectory during this period. The global Islamic finance has indicated that the total assets reached USD 1.8 trillion with recorded assets' double-digit compound annual growth rate (CAGR) of 17% between 2009 and 2013. Approximately, global Islamic finance is widespread operated in around 70 countries and covers more than 300 Islamic financial institutions around the world (Amirzadeh & Reza Shoorvarzy, 2013, p. 66; Johnes, Izzeldin, & Pappas, 2014).

It is evident that the Islamic banking sector is the dominant segment of the global Islamic finance industry. In terms of assets, the global Islamic banking (covering full-fledged Islamic banks, subsidiaries, and windows amounting) is worth about USD1.48 trillion as of mid of 2014. The sector grew at a CAGR (cumulative annual growth rate) of 16.89% between 2008 and 2013 and grew by

16% in 2013 y-o-y. It is noticeable that the overall global banking growth assets of the top 1000 global banks grew by only 4.9% in 2012 and 0.6% in 2013 (IFSB, 2015; IFSB & ADB, 2015).

In Indonesia, a country with the largest reported Muslim population, Islamic banking has shown a promising performance over the last two decades. By the end of 2014, it had booked its total assets at Rp 242 trillion, where total deposits were Rp 183 trillion and total financing was 184 trillion. Specifically, Alamsyah (2012) asserts that Islamic banking in Indonesia had an average rate of growth of 40.2% per year during the 2007-2011 period, which was much higher than the conventional banking growth of 16.7% per year. Besides this, a number of optimists to the potential development of the Indonesian Islamic bank also based on arguments that Indonesia has a relatively high economic growth and stable political circumstances, an investment grade level of sovereign credit rating, and an abundance of natural resources. It is worth noting that Islamic banking in Indonesia has produced a promising market with rapid expansion and superior growth since the establishment of the first Islamic bank in 1993, but in fact, Islamic banking only occupies a small niche in the market share of the national banking industry. Nevertheless, we noted that during the period between 2005-2014, the growth of both asset and financing within Islamic banking had slowed down. Even so, this rate of growth still placed in a higher position than the conventional bank (Ismal, 2011).

Thus, further scrutiny is required to analyze the current achievement and outline the main problems faced by the Indonesian Islamic banking amid the dynamics of the Islamic banking market at the global and domestic scales. It is

worth noting that the phenomena of the extraordinarily low levels of Islamic financial deepening and slow pace of growth in Indonesian Islamic banking have occurred. Obviously, in terms of market share, Indonesian Islamic banking has been stagnant for only about 1-4.9% of the total market share in the Indonesian banking industry during the period 2003-2014 (Ismal, 2014; FSA, 2015). Moreover, in comparison to other Muslim countries, Indonesia has an extraordinarily low level of Islamic financial deepening. Indonesia is considered to have the largest total Muslim population while it maintains only about 5% of the overall Islamic banking market share within the total Indonesian banking industry. Evidently, Islamic banking market penetration is relatively small, hence it will have an insignificant impact on the economic scale and competitiveness level of the national economy.

This deteriorating condition has also been highlighted in the strategic document issued by the Financial Services Authority (FSA) entitled *"Roadmap of Indonesian Islamic Banking 2015-2019"* (FSA, 2015). According to the FSA (2015), amidst the remarkable performance of the Indonesian Islamic banking over the last two decades, a slow growth phenomena occurred between the years of 2012-2014 where the development of business volume only recorded 12%. Hence, FSA (2015) has launched a vision for the development of Indonesian Islamic banks as formulated by "Actualizing Islamic banking that gives significant contributions to sustainable economic growth, equitable development, financial system stability, and has high competitiveness". Furthermore, this development vision has been translated into policy directions, work programs, and time schedule implementations. Accordingly, there are seven policy directions to be

comprehensively realized in the time frame between 2015 – 2019 (FSA, 2015, pp. xv - xvi).

Taking into consideration these conditions, it is imperative to discuss the literature on the important factors that may be hindering Islamic banking development.

1.2 Economic Realities: Profound Puzzles on Indonesia Islamic Banking Development

Evidently, Islamic banking market penetration in Indonesia is relatively small, thus it results in the limited contribution as one of the economic engines of the national economy. Accordingly, it is important for the whole stakeholder of the Islamic banking industry to have concerns on the occurrence of the slow pace growth of the Indonesian Islamic banking for period 2005-2014. While acknowledging that the banking sector can play a major role as an engine of growth in the economy, further analysis on the performance and direction of the Indonesian Islamic banking development is imperative.

As we admit that the banking sector is a highly regulated industry, we cannot ignore the role of the regulatory system and the creation of the market field by the financial authorities in order to develop banks into a mature industry. In this sense, the financial industry still needs support from the authorities towards a higher stage of development.

It is worth noting that some important initiatives have been conducted by the Indonesian government to support the development of Islamic banking. Ratification of a number of legal products and regulations have provided lawful certainty and have enhanced the Islamic financial market industry. Specifically, the enactment of

the Islamic Banking Act No. 21 of 2008 has increased legal assurance and trust for stakeholders on the products and services of Islamic banking and finance in Indonesia. Besides the particular laws concerning banking and central banks, there are several regulations supporting the development of the Indonesian Islamic bank. Among these are Act No. 38 of 1999 on Zakat, Act No. 41 of 2004 on Waqaf (Islamic Endowment), Act No. 24 of 2004 on Lembaga Penjamin Simpanan (Deposit Insurance Corporation), Act No. 3 of 2006 on Peradilan Agama (Religious Court), and Act No. 40 of 2007 on Perseroan Terbatas (Limited Company), and Act No. 19 of 2008 about Surat Berharga Syariah Negara (SBSN, Sukuk Act).

Both the potential to boost the development of the Indonesia's Islamic bank and the occurrence of the slow growth of the Indonesian Islamic bank above have led us to propose some inquires on the following puzzles:

1. **Puzzle 1**: Despite the fact that Indonesia has the largest Muslim population in the world, why is the Islamic financial deepening (the market share of Islamic banks) extraordinarily low? What is the root causes of this phenomena? What has caused the recent trend of "slow-pace" in Islamic financial deepening? How has the Islamic bank's performance on operational efficiency been improved (or deteriorated) in Islamic banks?
2. **Puzzle 2**: Furthermore, in comparing Indonesia to Malaysia; a close neighbouring Muslim country to Indonesia that has somewhat successfully proceeded the Islamisation of its own banking industry, what have been the secrets to the successful development of the Malaysian Islamic banking? How successful is the applicability of Malaysia's Islamic financial architecture to Indonesia? How do the stakeholders of the Islamic banks in Indonesia interact

and resolve “the structural dilemma” faced by the Indonesia Islamic banking industry (especially Financial Services Authority (FSA), the Bank Indonesia (BI/the central bank), the Indonesian government, and the bankers)? How does managing the market and institutional/state failures align with the process of “the Islamisation of banking industry” under the dual banking system?

There are two reasons why observing the genesis and development of Indonesia’s Islamic banking and finance is considered an important point to the contemporary Islamic banking and finance literature. Firstly, Indonesia is the most populous Muslim country in the world. In 2013, it was estimated that the total population was 248.8 million people and the Muslim proportion was about 87.18% (BPS, 2014; Bappenas, 2014). Therefore, when one considers the potential of the plentiful natural resources, the large Muslim population, and the overall size and area of the country, Indonesia should become a magnet for the development of Islamic banking and financial markets. Furthermore, the extraordinarily low Islamic financial deepening (the market share of Islamic banks) and the recent trend of slow-pace growth in the Indonesian Islamic banking have become challenging phenomena to be analysed. This is because they will determine the future direction of policy and strategy in developing the Islamic bank of Indonesia in the future by the financial and banking authorities in order to provide an optimal contribution to the national economy.

1.3 Existing Argument and Research Gap

Several approaches have attempted to explain the extraordinarily low financial deepening and the recent trend of slow-pace growth in the Indonesian

Islamic banking system (Abduh & Omar 2012; Ismal, 2013, Ismal, 2014; FSA, 2015). However, taking into consideration the reality in which the conventional banks have been constantly expanding their business under the same economic environment, it is apparent that the previous approaches did not sufficiently explain the reason behind the extraordinarily low level of Islamic financial deepening. Whereas some scholars point out that the Indonesian Islamic banks are still in the “infancy" stage, a lack of regulation and a tendency for government support to be solely concentrated on *Shariah*-loyalist customers resulted in a failure of installing sufficient confidence and trust in Islamic banking to compete with conventional banks (Kasri & Kasim 2009; Lindsey, 2012; Karim & Affif, 2005; Sari, Bahari & Hamad, 2016). This results in a higher "displacement risk" (Kasri & Kasim 2009). However, these approaches do not sufficiently explain how Indonesian Islamic banks are still considered to be “an infant” by some. Also, these approaches do not sufficiently explain what caused the recent trend of slow-paced Islamic financial deepening.

On the other hand, Lai (2014) attempts to justify the Malaysian governmental initiative of incubating "infant" Islamic banks under a protective financial architecture. This was done in order to strengthen Malaysia's position as a key player in the international financial hub by contributing to the globalization of Islamic financial industry. However, this argument does not sufficiently address how to measure the economic benefit of the protective financial architecture and does not clearly mention until when the protection should last.

In order to fill in the lacuna in the existing literature, this research aims to shed analytical light on the "incentive" and "threat" in banking operation by the

Indonesian Islamic banks. As such, in order to provide a theoretical framework underpinning the issues and analysis tools for the research questions, we intend to borrow the traditions of Institutional Economics (IE) which are concerned about the rules or mechanisms of creating the incentive and threat to the economic players. Under this presumption, economic institutions would matter as the determinant for economic development and economic efficiency. In particular, we use the theoretical framework of "financial sector rent" (bank rent) to justify the creation of "rent (surplus) opportunity" to be captured by banks as the incentive of making them become prudent fund providers (Hellman, et al., 1997; Khan, 2000; Suzuki, 2011; Suzuki & Uddin 2014). (We will further discuss the bank rent theory in Chapter 4).

Although some studies have discussed issues related to the slow pace of growth in Indonesia Islamic bank system, this research intends to fill some of the research gap in the literature as such:

1. Research in portraying insufficient opportunities of ”the Islamic bank rent” as the reason for the slow pace of growth occurrence in the Indonesian Islamic banks
2. Research in presenting efficiency and competition levels of the Indonesia Islamic banks as the explanation of the consequences of the incentive mechanism provided by the regulator (FSA, BI, and Indonesian government) for Islamic banks.

In addition, the dynamics of the Indonesian Islamic banking market also indicates that the Islamic banking industry is still in need of regulations and an incentive mechanism, which are expected to provide incentives in triggering a

boosting growth and optimizing financial intermediary functions.

1.4 Research Objective, Main Question and Hypotheses

1.4.1 Research Objective

This thesis aims to clarify the reasons or fundamental constraints behind the extraordinarily low level of Islamic financial deepening in Indonesia. Also, it strives to make sense of the recent trend of slow-pace in the credit expansion by Indonesian Islamic banks. In addition, this research intends to observe the regulatory framework on which the establishment of Islamic banks in Indonesia are built and analyse the contemporary progressive performance of Indonesia Islamic banking development.

As an initial study which underlines the phenomena of the slow pace growth of Indonesian Islamic bank; in spite of elaborating on existing reasons (such as infant industry categorizing, limited capital resources and infrastructure, lack of regulation and legal support, late comer, inadequate human resource competency, etc.) has been explaining some plausible causes, this research intends to contribute in analysing the nature of interaction between regulators, market players, and customers of the Islamic banks under bank rent situation so called ‘Islamic bank rent theory’ (Suzuki & Uddin, 2014).

We draw on the traditions of Institutional Economics (IE) which are concerned about the rules or mechanisms of creating incentive and threats to the economic players because the rules (institutions) would matter as the determinant for economic development and economic efficiency. In particular, we use the theoretical framework of "financial sector rent" (bank rent) to justify the creation of "rent (surplus) opportunity" to be captured by banks as the incentive of making

them become prudent fund providers (Hellman, Murdock & Stiglitz 1997; Khan 2000; Suzuki 2011; Suzuki & Uddin 2014).

1.4.2 Main Question

To achieve these research objectives, the main questions in this research have been proposed in two puzzles as explained in Section 1.2.

1.4.3 Hypotheses

Moreover, in conducting this research, some hypotheses are proposed as follow:

- Hypothesis 1: The banking industry in Indonesia does not provide the Islamic bank with an adequate incentive (including rent opportunity) for financial deepening. In other words, the financial regulator (the central bank and Financial Service Authority/FSA) failed to create an adequate incentive to Islamic banks in Indonesia (state failure of omission).
- Hypothesis 2: Due to "severe" competition with conventional banks (also among Islamic banks) in the banking industry, Islamic banks cannot earn sufficient profits for financial deepening while maintaining the franchise value and reputation. Meanwhile, facing challenges unique risks such as displacement risk (due to *Shariah* non-compliance) and credit risk and uncertainty upon the Profit-Loss Sharing, the tight competition (particularly the market for consumer financing) does not allow Islamic banks to earn the "Islamic bank rent" to compensate for the Islamic unique risks.
- Hypothesis 3: The occurrence of governmental (regulatory) failure in

Indonesia to prepare the same level playing field between conventional and Islamic banks.

1.5 Methodology, Data Collection, and Data Analysis

1.5.1 Methodology

For the research method, this study is categorized as an exploratory study which uses Islamic bank in Indonesia as a case study. This research intends to contribute a relatively different approach to using Institutional Economics (IE) perspective in analyzing the issues of Islamic bank rent in Indonesia.

In order to resolve particular issues raised in the several puzzles above, this research will conduct:

1. Puzzle 1:

1. We should review the genesis and development of Indonesian regulatory policy for incubating Islamic banks in order to clarify the features (or constraints) in the Indonesian policy for the Islamisation of its banking industry. We are going to compare it with Malaysia's regulatory policies for incubating Islamic banks.
2. We should look into the profitability and stability of Indonesia's Islamic banks compared to conventional banks. We hypothesize that Indonesia's Islamic banks are not given an adequate incentive (rent opportunity) for expanding their credit. We are going to collect and analyze the financial statements of major Islamic/conventional banks in Indonesia. We support the concept of "Islamic bank rent" proposed by Suzuki and Uddin (2014), in which Islamic banks must earn an extra profit (they call this as "Islamic bank rent") to maintain its franchise value as prudent "*Shariah*

compliant" lenders by absorbing peculiar risks embedded in the mode of profit-loss sharing (PLS). We hypothesize that the extraordinarily low level of Islamic financial deepening is the result of the failure to create appropriate extra profits to be captured by Islamic banks in Indonesia.

3. We hypothesize that "severe" competition with conventional banks may have hampered with the opportunity to expand their operation by Islamic banks. We hypothesize that the competition has recently intensified, particularly since 2012. To test the hypothesis, we are going to: (i) review the credit portfolio of Islamic banks and conventional banks, respectively to see how their customers and domains are overlapping (how they are competing); (ii) assess how the concentration and competition level has been changed in the banking sector in Indonesia. We apply two concentration measurement methods; *k*-bank concentration ratio and Herfindahl-Hirschman Index (HHI); (iii) conduct the interviews with Islamic bank managers as a qualitative method to clarify what happened since 2008 in the credit policy and portfolio particularly in major Islamic banks.
4. It is reported that Indonesian Islamic banks maintain a portfolio of "*musharaka*" (participatory financing), while Islamic banks in other countries have fallen into the so-called "*murabaha*" (asset-based financing, hire purchase) syndrome. This thesis aims to analyze the reality of their credit portfolio in Islamic banks to seek for a reason or constraint for the recent trend of slow-down in their banking operation. The above mentioned qualitative methods are used for the analysis.

Hence, this research also aims to analyse how the operational efficiency in Islamic banks has been improving or deteriorating. We are going to employ Data Envelopment Analysis (DEA) for estimating the changes in the level of efficiency.

2. **Puzzle 2:**

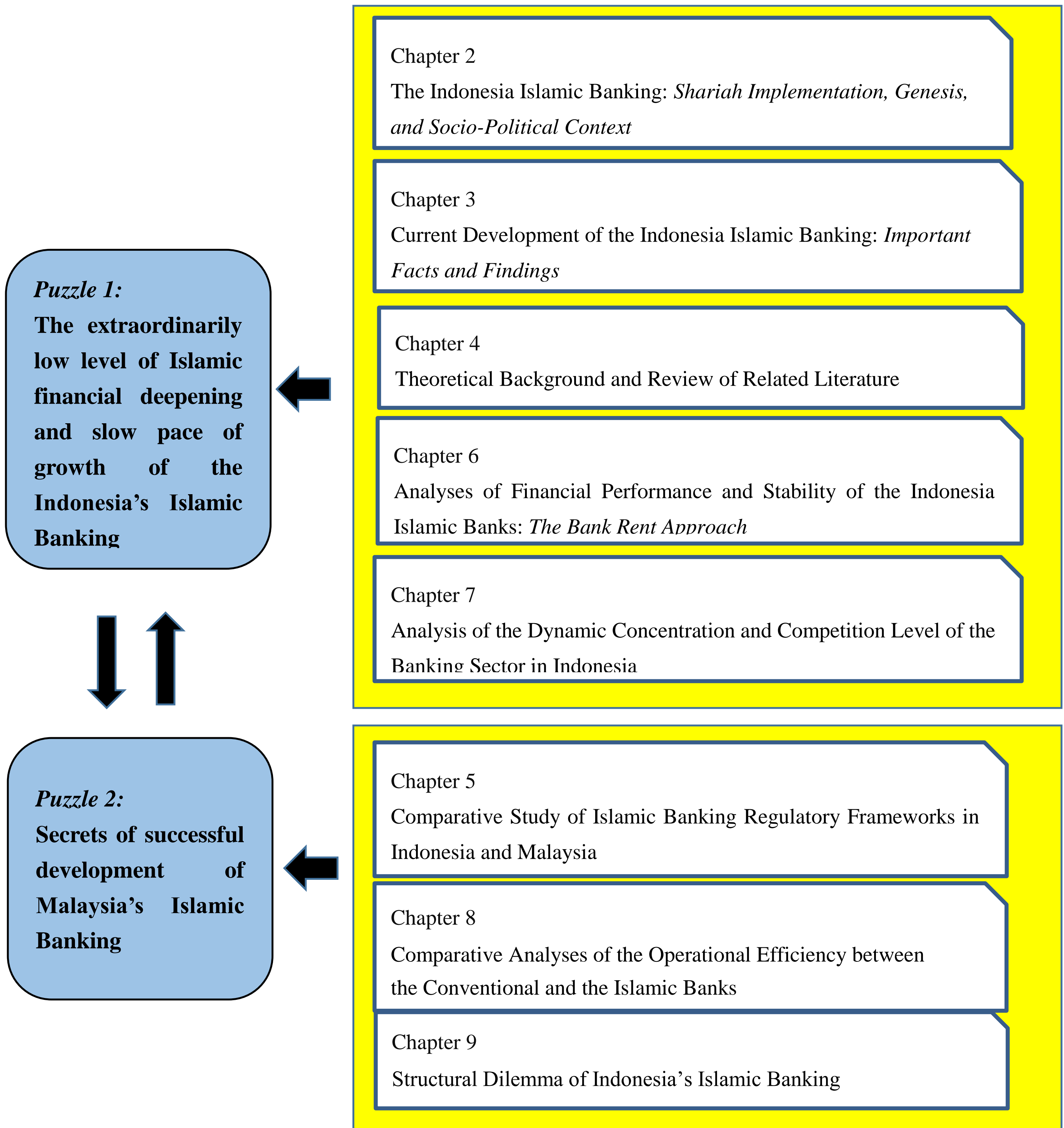
   a. This research will shed light on the historical, socio-economic, and socio-political background of the genesis of Islamic bank in Indonesia in order to have a better understanding of the Indonesia's Islamic banking landscape as a dual banking regime implemented as a whole financial and banking system in the national economy. In addition, this research attempts to point out the cause of the successful transformation (Islamisation) of the banking industry in Malaysia and to clarify the reason or constraint behind the stagnant transformation in Indonesia. We hypothesize that while the positive "rent effect" in terms of the expansion of branch network (seeking for the economies of scale) is observed in Malaysia, the rent opportunity to be captured by Indonesian Islamic banks is not enough to expect the "rent effect".

   b. We expose the structural dilemma faced by Indonesia's Islamic banking. Moreover, we hypothesize that the governmental (regulatory) failure in preparing the same level playing field between conventional and Islamic banks has caused the Islamic bank to be less competitive and profitable in comparison to the conventional bank. In contrast, in the case of Malaysia, Malaysian government is successful to prepare the 'same level playing field' between conventional banks and Islamic banks and

preparing an effective government intervention to incubate the Islamic banking industry.

In summary, this research will utilize the flow of analysis in tackling the puzzles as described in Figure 1.1 below:

Figure 1. 1 The Flow of Analysis in Tackling the Puzzles



Based on Figure 1.1, the analyses made in this research will apply the methodology and basic approaches as follows:

First, to tackle the issues raises in Puzzle 1 (the phenomena of extraordinarily low level of Islamic financial deepening and slow pace of growth of the Indonesian Islamic banking), Chapter 2 provides a depth discussion of the birth and initial development of the Indonesia's Islamic banking in the context of social, political and economic dimension of Indonesia.

Chapter 3 will present the current development of the Indonesian Islamic banking in the particular period of 2008-2014. This chapter will present the facts and findings on the current performance of the Indonesia's Islamic banks. From the evidence shown in Chapter 3, we found that the Indonesia's Islamic banks have a lower profitability performance and trend towards deterioration in comparison to conventional banks. This at least has been reflected as having relatively lower Return on Asset (ROA) and Net Margin of Income (NMI). In fact, it is seemingly self-evidence that the Indonesia's Islamic banks have insufficient profit to develop their business. Thus, it makes sense as adequate profit is highly important in the banking business. This situation has proved that there is less incentive for the Islamic banks in their business and accelerated growth in the banking industry.

In Chapter 3, we have exposed that the Indonesia's Islamic banks have experienced a lower profitability performance and have not earned a sufficient profit accumulation to expand their business. In this sense, it is worthwhile to underline the idea from the rent bank theory perspective that banking business should generate adequate "rent" to maintain their franchise value and reputation in order to ensure their sustainability profit in the future (Hellman, et al., 1997; Khan,

2000). In order to provide a theoretical framework underpinning the issues and analysis tools for the research questions, we borrow the traditions of Institutional Economics (IE) which are concerned about the rules or mechanisms of creating the incentive and threat to the economic players. Next, Chapter 4 aims to present a theoretical background and review of the related literature as a theoretical framework which will be used to analyse the puzzles raised in this research.

Thus, this research will adopt the financial restraint model in order to examine the hypothesis that the bank rent theory exists as the root in the occurrence of the phenomena of the extraordinarily low Islamic financial deepening and the recent trend of slow-pace growth of the Indonesian Islamic banking.

In order to extend the discussion in analysing the hypothesis that the extraordinarily low level of Islamic financial deepening is the result of the failure to create rent opportunities for the Indonesia's Islamic banks, Chapter 6 will specifically present further analysis of the robust performance of the Islamic banks in Indonesia. In this regard, a comparative study will be carried out to demonstrate the overall performance of the Islamic banking in Malaysia and Bangladesh. Furthermore, in order to examine the Islamic bank rent theory hypothesis, Chapter 6 will present an analysis of financing activities and financial performance indicators as reflected in the Islamic banking operations in Indonesia, Malaysia, and Bangladesh. In this chapter, we underline that the *murabaha* syndrome is applied by the Islamic banks in these three countries. Besides, this chapter will present the unique practices in modes of financing of the Indonesia's Islamic bank, in which the financing proportion under *mudaraba*/*musharaka* contracts are relatively higher in comparison to the proportion practiced by the Islamic banks in Malaysia and

Bangladesh. Nevertheless, we admit that this uniqueness in the Indonesian Islamic bank mode of financing is quasi-*murabaha* financing because it does not conduct purely *mudaraba*/*musharaka* financing. Indeed, the Indonesian Islamic banks have applied the two steps *mudaraba*/*musharaka* mode of financing contracts that are *murabaha* financing mode in nature.

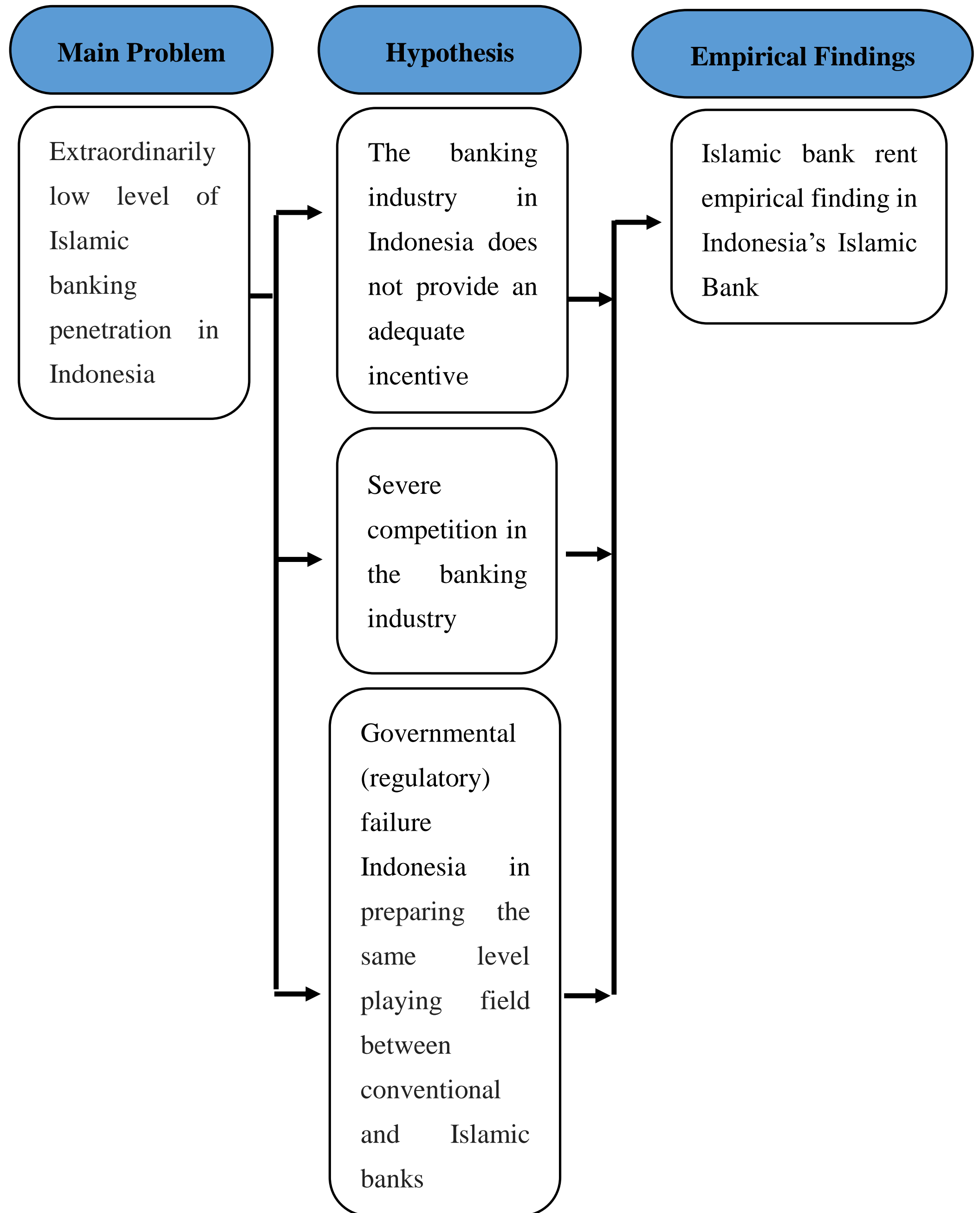
Through the discussions in Chapters 2, 3, 4, and 6, it is expected that these discussions will test the Hypothesis 1 which assumes that the Indonesia's banking industry does not provide the Islamic banks sufficient incentive (including rent opportunity) for financial deepening. Following this, to test the Hypothesis 2 we assume that the Indonesia's Islamic banks have faced a severe competition with conventional banks (also among Islamic banks) in the banking industry, so the Islamic banks cannot earn sufficient profits for financial deepening while maintaining the franchise value and reputation. Chapter 7 will perform analysis of the dynamic concentration and competition level of the Islamic banking sector in Indonesia.

Secondly, to tackle the issues raises in the Puzzle 2 (the secrets of successful development of Malaysia's Islamic banking). Chapter 5 will extend the discussion on regulatory frameworks of the Islamic banking in Indonesia with appropriate comparison with Malaysia's Islamic banking. The aims of these chapters are to bring a better understanding of the Indonesia's Islamic banking on the issues of contemporary performance and regulatory frameworks. In addition, Chapter 8 will conduct a comparative analysis of operational efficiency between the conventional banks and the Islamic banks in Indonesia. Besides this, Chapter 8 also includes a review of some literature which discusses the empirical results of the efficiency

level in the Malaysia’s Islamic banking industry. Accordingly, Chapter 5 and 8 will clarify the hypotheses that assume that the positive "rent effect" with regards to the expansion of branch networks (seeking for the economies of scale) is observed in Malaysia. The rent opportunity to be captured by Indonesia’s Islamic banks is not adequate to expect the "rent effect". Following, in Chapter 9 we discuss the occurrence of structural dilemma in Indonesia’s Islamic banking industry. We borrow the approach used by Khan (2000) to observe the process of institutional (governmental) failure in applying economic policies to the development of Indonesia’s Islamic banks. In this sense, we underline a governmental failure of creating 'the same level of playing field' between conventional and Islamic banks has caused extraordinarily low level of penetration and recent slow down of the Islamic banking in Indonesia.

Figure 1.2 intends to briefly describe the main empirical findings in this research.

Figure 1. 2 The Main Empirical Findings in The Dissertation



1.4.4 Data Collection

Data used in this research will be gathered as follows:

1. Primary data was taken from:

In-depth interviews conducted with the banking regulators in Indonesia (Bank Indonesia (BI), the Central Bank, and Financial Service Authority (FSA)), bankers of the Islamic banks (Senior Manager or Director) in Indonesia and Malaysia, academics (lecturers/researchers at the University or Research Centre) in Indonesia and Malaysia, and senior officer of the Ministry of State Owned Entrerprises of the Republic of Indonesia. Taking into account the character of the information to be extracted from interviewees, this research will perform unstructured interviews to draw out the interviewees' narration and perspective on the issues in the which needed to be clarified to have a better understanding of the complex circumstance and people behavior (Punch, 1998). In this sense, this unstructured interview method is expected to prevent the condition in which interviewees hesitate to expose their opinion with extroverted insight. On the other hand, this interview method will help the interviewer to have a non-standardized question and in depth-exploration into the topic (Patton, 2002).

2. Secondary data:

The secondary data we are going to use includes (1) Literary studies and (2) Series data and information from the regulator and banks related to the topic in the periods of the years between 2003-2014.

This data collection will involve 12 full-fledged Islamic commercial banks and 22 Islamic bank windows in Indonesia as of December 2014. The randomly selected Islamic banks and the conventional banks in Malaysia and Bangladesh will

be used as counterparts of comparison with the Indonesian Islamic banks.

1.4.5 Data Analysis

This research will use a combination of qualitative and quantitative methodologies in elaborating the topic (Burrel & Morgan, 1979; Yin, 2003; Suzuki, 2011). The quantitative approach is mainly used for descriptive analysis from the literature and empirical investigation of the issues. This research adopts the Structure Conduct Performance (SCP) paradigm in examining the market concentration and competition level of the Indonesia Islamic banking business environment. In attaining this objective, this paper will apply two concentration measurement methods: the k-Bank concentration ratio and the Herfindahl-Hirschman index (HHI) (see sections 7.3.1. and 7.3.2. in Chapter 7 for the details of measurement methods). Also, the Data Envelopment Analysis (DEA) is employed in this research for measuring the Islamic bank's level of efficiency (see section 7.3. in Chapter 7 for the details of DEA method). Meanwhile, the qualitative approach will be used to develop "narrative" and "argument" on the perceptions provided by the regulator, banker and academician during the in-depth interviews (Eisengardt & Bourgeois, 1988).

1.6 A Need for the Islamic Bank Rent Theory Perspective

The extraordinarily low rate of Islamic financial deepening and the recent trend of slow-pace growth of the Indonesian Islamic banking is becoming an essential topic of discussion in academic research on finance and banking since they will contribute empirical findings from the Indonesia`s experience in developing Islamic banking. These phenomena are crucial objects to be analyzed because they

expose research findings that show a relatively different trend in the midst of such arguments that consider the global Islamic finance and banking to have experienced rapid expansion with vigorous performance.

It is worth noting that important facts and findings that we have discussed throughout Chapter 3 have revealed a lower profitability performance and a worsening trend of the financial performance indicator of the Indonesia's Islamic banks in comparison with the conventional banks during the period between 2005 and 2014. Moreover, we acknowledge that the deteriorated financial performance indicators of the Indonesia's Islamic banks are becoming self-evident that the Indonesia's Islamic banks have experienced insufficient profit earning to develop their business.

From the academic perspective, this analysis aims to do three things. It aims to act as a theoretical framework underpinning the issues is required as a foundation for presenting research discussion, to be an analytical tool of the research findings, and finally to deliver comprehensive research conclusions. Consider that the existing arguments in the literature did not sufficiently shed analytical light on the "incentive" and "threat" in the credit risk management and banking operation by Indonesian Islamic banks. As such, in order to provide a theoretical framework underpinning the issues and to provide analytical tools for the research questions, we borrow the traditions of Institutional Economics (IE) which are concerned about the rules or mechanisms of creating the incentive and threat to the economic players. Under this presumption, economic institutions would matter as the determinant for economic development and economic efficiency. In particular, we use the theoretical framework of "financial sector rent" (bank rent) to justify the creation

of "rent (surplus) opportunity" to be captured by banks as the incentive of making them become more prudent fund providers (Hellman, et. al., 1997; Khan, 2000; Suzuki; 2011; Suzuki & Uddin, 2014). Thus, this research intends to adopt the financial restraint model introduced by Hellman, et al. (1997) in order to examine the hypothesis that the bank rent theory exists as the root in the occurrence of the phenomena of the extraordinarily low of Islamic financial deepening and the recent trend of slow-pace growth of the Indonesia's Islamic banking.

In this context, the banks rent framework will provide necessary incentives for the banking sector to encourage banks to implement prudent business practices. Therefore, it is worth emphasising that the availability of adequate bank rent in the banking industry will help prevent the occurrence of moral hazards (especially collusive behaviours and adverse selection), internally in the behaviour of the bank manager; and in banking relationships with bank customers. As a direct result of the practicing of bank business with sound business manner, the financial performance and return to the bank will increase. The ability to generate profit and capital accumulation in the long run, in turn, it will enable the bank to expand its operational expansion through the opening of new branches, strengthening the banking infrastructure, and investing in new technology. Furthermore, adequate incentive in the financial markets will create a sound banking system and encourage the rapid growth of the banking industry, which in turn will increase financial deepening in the economy at the end (Wanniarachchige, 2017; Suzuki, 2011; Suzuki & Adhikary, 2009; Hellman, Murdock & Stiglitz, 1997). Thus, it is noticeable that the financial authority and the whole stakeholders' of the Islamic bank should concern on the theoretical framework of "financial sector rent" (bank rent) to justify

the creation of "rent (surplus) opportunity" to be captured by banks as the incentive of making them become prudent fund providers (Hellman, Murdock & Stiglitz, 1997; Khan, 2000; Suzuki, 2011; Suzuki & Uddin, 2014).

An interesting approach is introduced by Suzuki and Uddin (2014) to analyze incentive mechanisms and the role of financial rents in Islamic banking business operations. Suzuki and Uddin (2014) propose the concept of "Islamic bank rent" as an institutional approach to analyzing the phenomena that occur on Islamic banks economics behavior in order to monitor rents and generate income to preserve its franchise value.

Thus, it is arguable that Islamic banks need to earn an extra profit to maintain their franchise value as prudent *Shariah*-compliant lenders due to the existence of unique characteristics within the Islamic bank business operation; in particular, the profit-and-loss sharing risk and the displaced commercial risk. In this context, Suzuki and Uddin (2014) explain that the Islamic banks are also exposed to the general uncertainty, so the Islamic banks also must charge the risk-adjusted risk premium covering the measurable risk plus accompanying uncertainty as commonly charged by the conventional banks.

Accordingly, if we refer to one of the important recommendations of Suzuki and Uddin (2014)'s study, it is imperative to the banking regulator (government) in providing an appropriate Islamic banking architecture to encourage an efficient competition climate. In this Islamic financial landscape the monitoring rent opportunity will match with the sufficient incentive mechanisms in the Islamic banking industry in ensuring a sound of the Islamic financial system.

Suzuki, Uddin, Pramono, & Khan (2017) admits that Islamic bank rent circumstance as an important factor which determines the economic behavior of Islamic banks in Indonesia to perform monitoring rents in the Islamic financial industry. Under this situation, the interactions that take place between the banking regulator (government) and Islamic bank as a financial institution will shape the direction and to what extent of the supervisory mechanism implemented. Also, it will in turn influence how the patterns of financial intermediation are engaged by Islamic banks. This mutual interaction will determine the extent to which the level of efficiency and the competition climate created in the Islamic bank's business environment are conducive for the development of Islamic banking. Furthermore, the individual responses of Islamic bank under this circumstance will certainly accumulate in the aggregate behavior of the Islamic banking industry to construct the direction and performance of Islamic development bank in Indonesia.

It is worth noting, as explained by Hellman et al. (1997), that financial sector rents, as incentive for portfolio monitoring, will bring the impact of rent effect in terms of increasing the returns to financial intermediation function in which banks have strong incentive to increase their own deposit bases. In this case, from the perspective of bank rent theory, we can propose a critique on the Lai's (2014) "infant industry" argument, as his proposition is not sufficient enough to explain the extraordinary low market share in Islamic bank development in Indonesia. Nevertheless, we can use 'the rent effect theory' (Hellman, Murdock & Stiglitz, 1997) to explain that the Malaysia's Islamic banking industry can optimize rent effect in the market as a determinant factor to boost Islamic bank development.

Moreover, in analysing the influence of rent effect for the Islamic banking development, we borrow the approach used by Khan (2000) to see the process of institutional (state) failure in applying economic policies to the development of the banking sector. Khan's approach (2000) is helpful in describing the interaction between the financial authorities and market players in response to the creation of three mechanisms of rent seeking in the financial industry. This covers monopoly rent, monitoring (financial) rent, and rent for learning. Under this bank rent framework, it is perceived that the rent effect will become an important mechanism for the banking sector for realizing financial deepening objective and ensuring a sustainability growth.

1.7 Limitations of the Study

This research is focused on explaining the phenomena of extraordinarily low Islamic financial deepening and the recent trend of slow paced growth of the Indonesian Islamic banking from the perspective of the Islamic bank rent theory. Acknowledging that this research can be categorized as an initial study in employing the bank rent theory as an approach to examining the development of the Islamic banking development in Indonesia, there have been some identified limitations in regard to this research, which largely defines the scope of analysis. Firstly, this research focuses on the Islamic bank as the research object in considering that the Islamic banking sector is the most dominant sector in the Indonesian Islamic finance industry. Consequently this research does not provide an analysis of the non-bank Islamic financial institutions and Islamic micro finance development in Indonesia. Secondly, in comparing the efficiency performance of

the Islamic banks in Indonesia and Malaysia, the main purpose of this research is to obtain a relative efficiency performance level comparison between Islamic and conventional banks in each country. As a result, this research is not used to conduct a direct examination with the DEA method in comparing the efficiency performance measurement of the Indonesia's and Malaysia's Islamic banks. This research is more focused on presenting a comparison between the efficiency of Islamic and conventional banks as an indication of the success in optimizing the rent effect on their banking business.

1.8 Significance of the Research

This research is expected to contribute important feedback for policy makers related to the establishment or relaxation of policies, in particular regulatory based incentives for Islamic banking regulations aimed at accelerating growth and improving the quality of the Islamic banking industry.

In this sense, this research will shed light on the problem of slow paced growth and stagnancy in the Indonesia Islamic bank market with a relatively new approach from the Institutional Economics (IE) that focuses on how to improve the market structure by maintaining the bank rent opportunity as an incentive mechanism to encourage market players to expand their banking business.

This research will provide analysis and empirical results as an assessment of the Islamic bank market concentration in order to get empirical findings on the concentration, competition, and efficiency levels in the context of the current development of Indonesian Islamic banks.

In addition, this research will contribute to the Islamic banking literature in several ways. First, it will contribute to a better understanding of the theoretical framework and practices of the Islamic bank rent theory. Second, this research aims to enhance “theory development” for the unique characteristics inherent to Islamic bank rent theory, especially in the case of Indonesia.

1.9 Organization of the Dissertation

This research will be divided into nine chapters. Chapter 2 will present a depth discussion of the birth and initial development of the Indonesia’s Islamic banking in the context of social, political and economic dimension of Indonesia. Chapter 3 primarily aims to present the phenomenon of Islamic financial growth in the global landscape of the financial industry. Then, it will shed light on the facts and findings in the current development of the Indonesian Islamic banking industry and underline the phenomena of the extraordinarily low level of Islamic financial deepening and the recent trend of slow-pace growth of the Indonesian Islamic banking.

Chapter 4 presents a theoretical background and review on related literature. This chapter mainly discusses theoretical considerations and reviews of the literature on the phenomena of the extraordinarily low level of Islamic financial deepening and the recent trend of slow-pace growth of the Indonesia’s Islamic banking in comparison with the other Muslim countries. In addition, this chapter also introduces the concept of Islamic bank rent as a theoretical framework for explaining the slow pace growth of Indonesia Islamic bank development.

Following this, Chapter 5 provides a comparative study of Islamic banking

regulatory frameworks in Indonesia and Malaysia. In this chapter, we will present a comparative study of the genesis and regulatory frameworks of the Indonesian and Malaysian Islamic banking industry for the purposes of having a better understanding of Indonesia's and Malaysia's Islamic banking history, socio-economic background, and regulatory frameworks.

Chapter 6 presents analyses on the profitability and stability of Indonesia's Islamic banks compared to conventional banks. Then, to having a better understanding of the bank rent circumstances in Islamic bank operations, this chapter will present quantitative and qualitative evidence from Indonesia's Islamic bank in comparison to Malaysia's and Bangladesh's Islamic banks.

Chapter 7 will present analyses of the dynamic concentration and competition level in the banking sectors of Indonesia.

Following this, Chapter 8 will provide a comparative analysis of the operational efficiency between Islamic banks and conventional banks in Indonesia by discussing the "rent effect" experienced by the Islamic banks in Indonesia. The discussion will also include a review of various literature that has discussed the empirical results of the efficiency level of the Malaysian Islamic banking industry.

Chapter 9 discusses the occurrence of structural dilemma in the Indonesia's Islamic banking industry and observe the process of institutional (state) failure in applying economic policies to the development of Indonesia's Islamic banks.

Finally, Chapter 10 concludes by discussing the results of the dissertation, making recommendations for policy implication, and presenting some insight for the future research.

CHAPTER 2
THE INDONESIA’S ISLAMIC BANKING: *SHARIAH* IMPLEMENTATION, GENESIS, AND SOCIO-POLITICAL CONTEXT

2.1 Introduction

This chapter is aimed to present an overview of the birth and initial development of the Indonesia’s Islamic banking. For this purpose, this chapter will shed light on the implementation of Shariah in the economy, the genesis and social-political context of the Indonesia’s Islamic banking.

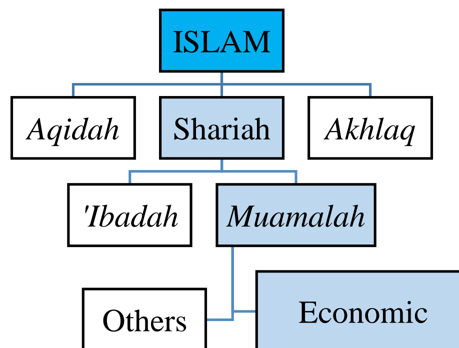
The rest of this chapter is organised as follows. Firstly, the implementation of Shariah as the roots of Islamic banking operation is discussed in Section 2.2. Then, section 2.3 presents a history background of the genesis as an initial development of Islamic Banking in Indonesia. In addition, this section also provides a brief discussion of the initiative of the Islamisation of economics movement in the Muslim world and the development of Islamic banking and finance in the Western countries. Later on, an extensive discussion of socio-political context of Islamic Banking in Indonesia is presented in Section 2.4. Finally, Section 2.5 summarises the Chapter.

2.2 Shariah Implementation in the Economy

In principle, Islam as the religion which revealed by Allah the Almighty consist of three grand rules as a comprehensive guidance in all aspects of the Muslim life (Ismal, 2013; Laldin, 2006; Antonio, 2010). Firstly, the aspect of *Aqidah* that carries out fundamental relationship between God and His creatures

(sanctions relating to beliefs). Secondly, *Shariah* as the manifestation aspect of the beliefs (sanctions relating to God's laws). Thirdly, *Akhlaq* as the morals aspect which provide attitude and ethics guidance for the mankind (sanctions relating to moral and ethics) (See Figure 2.1 below)

Figure 2. 1 Shariah in a Comprehensive Worldview of Islam



(Source: Ismal, 2013, p. 3)

The word of *Shariah* was derived from its root of *shin, ra,* and *'ayn* in Arabic letters. Literally, the meaning of *Shariah* is "the road to the watering place, the straight path to be followed" (Laldin, 2006). *Shariah* as the tools of do's and don'ts in Islamic law, consists of two basic elements such as (1) rituals (*Ibadat*), by which the way people worship their God, and (2) relationship and dealing between man and the other creatures (*Muamalat*) including the way a man perform their economic and noneconomic activities in their life (Antonio, 2010, Ismal, 2013).

The main purpose of Shariah as explained by classical Islamic scholar Abu Hamid Al-Ghazali (dead in 1111) in his famous book *Al Mustasfa* (in Chapra, 2001 p. 124):

"*... to advance the welfare of mankind by protecting five essential values in*

human life which are protecting the religion (al-dien), protecting of life (al-nafs), protecting of dignity or lineage (al-'ird), protecting of intellect (al-'aql) , and protecting of property (al-mal)"

In brief, we conclude that the purpose of the implementation of Shariah in human life basically is closely related to the concept of *maslahah* (public interest or benefit) *inter alia* are happiness, prosperity, and justice for all mankind in the world and the hereafter.

Furthermore, *Shariah* can be regarded as the guidance source of the Islamic economic contracts, particularly by the *Shariah-muamalah* principles. Concisely, we could outline some basic principles which provide economic transactions guidance from the Shariah perspective (Ainley et. al., 2007; Ismal, 2013) as follow:

Firstly, Islam strongly encourages and recognizes the right of every individual to achieve personal economic wellbeing, however *Shariah* provides clear guideline and limitation in what kind of commercial activities allowed and prohibited. For example, Islam encourages economic transactions and business-related activities. However, the religion to alcohol, pork, gambling, pornography and other socially detrimental actions are prohibited.

Secondly, one of the *Shariah* principles in economic activities is the prohibition of riba (interest/usury). Included in this category is exchanging interest payments within the conventional banking system as one type of *Riba* (usury). Therefore, modern Islamic finance and banking institution promote an economic model which is based on a risk and profit-sharing (and loss-bearing) under *Shariah*-based *mudaraba* (trust based contract) and *musharaka* (partnership/ equity based) contracts. Besides, Islamic banking and finance also offers their services through

Shariah-compliant trading based transaction in the form of *murabaha* (mark-up), *bai-muajjal* (variant of *murabaha*), *bai-salam* (forward sale contract), and *ijara* (leasing) contracts.

From the perspective of important role of the banking sector in the economy, we admit that the prohibition of interest (usury/*riba*) and Islamic banking services indeed will play a crucial role in facilitating the Muslim depositors and investors to conduct their investment and economic transactions. These particular Muslim depositor and investor have a conviction that the interest from banking business (usury/*riba*) are not allowed based on *Shariah* principles. Therefore, according to *Shariah* opinion (*fatwa*) this return or yield from interest-based banks should be 'purified' and separated from their income and letting the earnings to go to the charity or *Zakah* institutions (Bakar, 2008). Consequently, it makes sense that there is less incentive for utilizing interest-based bank by the Muslim who committed to obeying the Shariah principles in the economics (please see our further discussion in this issue in Chapter 4).

2.3 The Genesis and Development of Islamic Banking in Indonesia

Islamic economics studies and initiatives to implement the establishment of Islamic financial institutions particularly Islamic banks in the Muslim world was begun in the 1970s. An important event that was perceived as the trigger on this momentum is the organising of the first Islamic Economic Conference in Mecca, Saudi Arabia in 1970 (Sardar, 1988; Haneef & Furqani, 2009; Wibisono, 2009).

The conference can be seen as an essential starting point of the emergence of various strategic initiatives that can be labelled as 'Islamic economy project' in various Muslim countries (Choiruzzad, 2012). From the perspective of the

construction of social institutions, what constitutes 'Islamic economy project', was called the spirit of "Islamisation" in the economy by Muslim scholars in the 1980s.

The idea of Islamisation of economics was initially manifested in the form of various publishing activities, conference centers and the establishment of Islamic economics at different universities in the Islamic world (Sardar, 1988). These strategic efforts did not end at the stage of conceptual ideas, the movement of Islamisation of economics also implemented concrete measures in the form of experiments to establish financial institutions based on the principles of Islam with distinctive characteristics that operate without interest and encourage the practice of profit and loss sharing in banking operations.

According to Iqbal and Mirakhor (2007), this effort in establishing interest-free financial institutions by the pioneers of Islamisation of economy project in the Muslim world was driven by Muslim scholars who were conscious of the prohibition of interest (*riba*). They also recognised that the credit system practiced by the conventional banks in the spirit of capitalism has had an adverse impact on the national economy. In this sense, Lewis and Algaoud (2001) conclude that the main objectives of establishing the Islamic bank in a Muslim society are (1) to eliminate interest (*riba*) in the banking business; (2) to create a fair redistribution of wealth, and (3) to achieve economic development goals.

Initiative to establish Islamic banks began in 1963, in Mit Ghamr, Egypt. It was intended as a pilot project for a rural saving banks. Entering the era of 1970s, following the establishment of the Islamic Development Bank in 1975, a number of Islamic financial institutions began flourishing in the Muslim world, among others, the Dubai Islamic Bank in Dubai (1975), Faisal Islamic Bank in Egypt and

Sudan (1977), and Kuwait Finance House in Kuwait (1977). Meanwhile, in the Southeast Asia region, the Malaysian government set up the Pilgrimage Fund Board in 1969 and Bank Islam Malaysia Berhad (BIMB), in 1983 (Ascarya & Yumanita, 2008; Wibisono, 2009).

This last decade, Islamic financial industry is acknowledged as one of the fastest growing segments in the global financial system (FSA, 2015; IFSB, 2015). In 2014, the global Islamic finance industry indicated total assets amounts reached USD 1.8 trillion recorded. Furthermore, according to IFSB (2015), the Islamic banking and finance industry projected to accomplished a compound of annual growth rate (CAGR) of 15% to 20% until 2015.

This interesting phenomenon of the global Islamic finance growth not only occurred in the Muslims majority countries, but also in the Western countries with non-Muslim population as majority. For example, total assets of Islamic banking and finance industry in Europe, North America, and Australia worth at 42,729.5 Million USD in 2010, recorded a double growth from 21,475.7 Million USD in 2007 (Caple and DiVanna, 2010). Thus, it is worth to note the facts that even with the negative image of Islam in numerous Western Hemisphere countries, as a direct impact of the 9/11 tragedy in 2011, the Islamic banking and finance industry continue to grow in the West as an alternate to the conventional financial system (Henry and Wilson, 2004; Choiruzzad, 2012).

In this context, the United Kingdom (UK) can be discerned as an interesting example in the developments of Islamic banking and finance industry. Acknowledged as one of the reputable international financial centers; hold about 3% of Muslim population, currently UK's government has promoted London as an

emerging global ‘hub’ for Islamic finance industry. According to UK’s Financial Services Authority (Ainley et. al., 2007) that the existence of *Shariah* compliant transactions in the London financial markets started since 1980s using Commodity *Murabaha* type transactions through the London Metal Exchange that used to give liquidity to Middle Eastern institutions and other investors which increased the development of a wholesale market in the UK. After that, in 1990s, a limited retail Islamic finance products introduced for the first time in the UK together with various banks that came from the Middle East and South East Asia that offered simple Islamic financial products such as home financing services with accordance to the Islamic principles. In this early phase, the retail Islamic finance products of course become less competitive and unfavourable with their conventional equivalents, including their uncompetitive pricing and less consumer protection under the comprehensively financial regulation. Therefore, in this circumstance the growth of the retail market remained slow throughout the 1990s and early 2000s. Furthermore, we recorded a numerous initiative strategies by the UK’s government to develop and support the Islamic financial industry. For instance, in 2010, the Financial Services and Markets Act 2000 Order 2010 was introduced by Treasury to support Islamic finance and the issuance of corporate *sukuk* (Islamic bonds) within the UK and in 2012, the UK’s government launched an Islamic Finance Task Force with the aim of securing London’s status as the Western hub for Islamic finance market. It is not strange then, that right now London seen by the main global market players, including Islamic as well as non-Islamic, as an increasingly important global center for Islamic finance that massively and fully support the development of Islamic Finance in banking sector as well as in market exchange

instrument (Ainley et al., 2007).

In this UK case, we can record various factors that significantly influence the growth of Islamic Financial Industry (Ainley et al., 2007), such as:

(i) The fact that the growth and the expansion in Islamic finance and banking industry had significantly happened. Right now there are at least 300 financial institutions around the world that offer *Shariah* products with certain prospective growth. This fact of course will influence UK's financial and banking market in its time.

(ii) London's position as one of the leading international financial centers of course has its appeal for "global trend and hub" in financial industry. London is acknowledged for its competitive benefit that has "deep and liquid markets and the exchanges" for global financial institution and "market and skill bases" to support this industry.

(iii) A number of global financial market players such as Citi, Deutsche, and HSBC had built base market and operation in the Middle East and South East Asia countries. Therefore, this international financial institution already had extensive knowledge and experience from the local markets including Islamic financial products. Hence, to facilitate the new and growing demand for Islamic financial products, this banking and financial institution had built their own business lines known as 'Islamic windows' that give excellence service for its customers.

(iv) Distinctively we had seen the increase of oil price in early 2000s that resulted in excess liquidity and an upwelling in demand for conventional financial assets also financial assets based on *Shariah*

compliant transactions in the Middle East countries which is main producer of oil in the world.

Accordingly, the development of Islamic finance and banking in secular countries with non-Muslim majority population can be understood as a part of dynamics of demographic change in which the proportion of Muslim in the population changed significantly in Western European states and the United States. The genesis of Muslim middle class with increasing affluence was coupled with their rising awareness towards applying Islamic values in various aspects of their lives, leading to their preference of using non-interest based banking system and their demands for *halal* industry, including Muslim friendly food and fashion. Not less important is the need of diversifying investment of petrodollar in the western countries as a strategic move in response to the change of oil and gas industry in the global financial industry. Therefore, it make sense to conclude like Hefner (2008), that the development of Islamic banking in the Western countries is a form of positive response towards a prospective business opportunity in Islamic finance, rather than as a change in political economic constellation between the secular countries and the Islamic world.

After four decades, we have witnessed that Islamic banks play a driving force in leading the Islamisation economy project in Muslim countries and become a significant issue in the current global financial system. In Indonesia, this trend also become an interesting issue for academics and decision makers in financial and banking industry.

Why is the Indonesia's case considered as an important point to the contemporary Islamic banking and finance literature? There are two reasons why

observing the genesis and development of Indonesia Islamic banking and finance is considered as an important point to the contemporary Islamic banking and finance literature. First, Indonesia is the most populous Muslim country in the world. In 2013, it was estimated that the total population was 248.8 million people and the Muslim proportion was about 87.18% (BPS, 2014; Bappenas, 2014). Therefore, recognising the potential of plentiful natural resources, the large number of Muslim population and area of the country, Indonesia should become a magnet for the development of Islamic banking and financial markets. Second, the occurrence of the extraordinarily low Islamic financial deepening (the market share of Islamic banks) and the recent trend of slow-pace growth in the period 2005 to 2014 of the Indonesian Islamic banking. In fact, this phenomena are important to be scrutinised because they will determine the future direction of policy and strategy in developing of the Islamic bank in Indonesia by the financial and banking authorities in order to provide an optimal contribution to the national economy.

In Indonesia, efforts in pioneering the establishment of Islamic financial institutions has been initiated by the inception of a number microfinance institutions and cooperatives which operated on Islamic principles. These grass root institutions mainly provided Islamic microfinance financing dedicated to serving poverty alleviation and developing small and medium enterprises (SMEs) in the 1980s. The inception of Baitut Maal wat-Tamwil (BMT) Ridho Gusti at Masjid Salman, Institut Teknologi Bandung (ITB) in Bandung and Baitut Maal wat-Tamwil (BMT) Insan Kamil in Jakarta (Ascarya & Yumanita, 2008) are some examples of such institutions.

In fact, the idea of establishing a full-fledged Islamic bank in accordance with banking regulations in Indonesia can be traced from the event of a Symposium by Indonesia Ulama Council *(Majelis Ulama Indonesia/MUI)* on 18-20 August 1990 with the theme of "The Problems of Prohibition of Interest and Banking". The symposium highlighted the basic idea of Muslim scholars on the issues of Islamic economy and banking which was later presented at the 4th Annual Congress of MUI on 22-25 August 1990.

This Congress resulted in recommendations in preparing a blueprint for establishing the first Islamic commercial bank in Indonesia. Consequently, the establishment of the first Islamic commercial bank in Indonesia was driven jointly by the Indonesian Ulama Council *(Majelis Ulama Indonesia/MUI)*, the Association of Indonesian Muslim Intellectuals *(Ikatan Cendekiawan Muslim Indonesia/ICMI)*, the Muslim businessman, and the government of Indonesia. Then, in 1991, it was the beginning of the historical development of the modern Islamic bank in Indonesia with the inception of the first Islamic bank, namely PT. Bank Muamalat Indonesia (BMI). BMI operated officially beginning in May 1992 after the enactment of the 'Banking Act No. 7 Year 1992' and Government Regulation *(Peraturan Pemerintah/PP)* No. 72 of 1992 on Profit and Loss Banking System provided a breakthrough opportunity in establishing the first Islamic bank in Indonesia with "profit and loss banking system" (Ascarya and Yumanita 2008).

2.4 Socio-Political Context of Islamic Banking in Indonesia

It is not possible to observe the development of Islamic bank in Indonesia separate to relational pattern between the state and Islam. In this context, it is

interesting to see ebb and flow of the dynamics between 'government' as the holder of authority within a nation state, and the Islamic *ummah* as an element of the civil society with inherent basic rights to actualize their religious identity as well as economic democratization which they aspire for (Choiruzzad, 2012; Choiruzzad and Nugroho, 2013).

Throughout the New Order period (1966-1998) under Suharto's rule, the state did not always have positive response towards the interest of Muslims in Indonesia. Indeed, there was a tendency that the state acted repressively against Islamic political groups considered detrimental to the political status quo dominated by military elites and secular stakeholders of the bureaucracy. This was reflected at least through the political antagonism between Islamic groups represented by Islamic scholars and political parties with military elites and a group of economic policymakers known as the 'Berkeley Mafia,' prominent Indonesian economists who got their degree from University of California, Berkeley in the United States (Baswir, 2006).

However, there was a change of direction in Indonesia's political pendulum towards the end of Suharto's rule from late 1980's to late 1990's (Choiruzzad, 2012; Choiruzzad and Nugroho, 2013; Lindsey, 2012). Suharto's political conduct and policy embraced Islam-oriented groups, in this case represented by scholars like the late Prof. Dr. Nurcholis Madjid and Prof. Dr. B.J. Habibie through the Association of Indonesian Muslim Scholars (Ikatan Cendekiawan Muslim Indonesia, ICMI) (Latif, 2005).

This shift of Suharto's political orientation actually owed to clash of interest between Suharto-loyalists backed by his children who just went into the business

world and the established military elites and Indonesian Chinese businessmen.

This friction forced Suharto to look for another group of backers other than the old elites to maintain his position and political power. The Islamic groups were chosen because Suharto saw in them a potential in the coming political battle under the transforming Indonesian political constellation, due to their resilience over his regime's previously repressive stance. On the other side, we could observe that economic and social development under the New Order regime had unwittingly created a new batch of Muslim middle class—marginalized at the start of the regime, characterized by their commitment towards Islamic principles.

Suharto's political attitude then became very accommodative towards the political Islam groups. Under this context, we saw Suharto softened towards, and even supported the 'Islamization of economy movement'[1] which later paved the way for Indonesia's first experiment with Islamic bank in 1992. It is worth to note that some relevant initiatives were sponsored by Suharto's children and cronies, *inter alia* Humpus Group owner Tommy Suharto and Nusamba Group ower Bob Hasan, who were competing for reputation and business against a group of Indonesian Chinese who started to part way with Suharto's policy.

It is interesting to look at the socio-political context of the development of Islamic bank in Indonesia from Hefner's (2008) point of view, who concluded that

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[1] Choiruzzad and Nugroho (2013, p. 258) defined 'Islamization of economy' movement as "organized individuals, groups or movements which call and struggle for the Islamization of the economic system." This definition is congruent to Hefner (2006, p. 17) who defined Islamic economics as "a modern movement which assert that traditions of law and organization provide a more just and equitable model for economic growth than do rival systems of Western capitalism and socialism."

the dynamics of Islamic banking development in many Muslim countries have s similar pattern in which the proponents of Islamic finance and banking needed to go through a process of coalition building with three main elements of the society: (1) Islamic scholars (*ulama*), (2) Muslim capital owners and (3) "prominent actors within the state" who see political interest in it. In Indonesian context, this process went through at least three phases. First is the friction that happened between Suharto and some military elites and Indonesian Chinese businessmen who started to oppose his political and economic policies.

In the second phase, Suharto shifted his politics from being authoritarian and not friendly to the Muslim to being authoritarian but friendly to them. This shows that initializing the Islamization of economy through the founding of the first Islamic bank was part of Suharto's bid to win political support from a new source, the political Islam.

The third phase went over the fall of Suharto's New Order regime in 1998, going through the economic reform and democratization era, which entailed economic democratization for Islamic groups and a more open market for Islamic banking. This gave main players of banking and financial market, capital owners, incentive to take the opportunity in the up and coming Islamic bank. In this regard, we also saw that policymakers in Bank Indonesia (the central bank), Ministry of Finance and Financial and Services Industry (FSA) became more accommodative and supporting towards the development of Islamic bank in Indonesia. Such accommodative stance was reflected in prominent banks, both state-owned and private, facilitating the establishment of some Islamic banks as their subsidiaries.

Another important thing to stress here is that, although the development of

Islamic banking in Indonesia is admittedly a bottom-up process initiated by civil society elements like ICMI and Indonesia Ulama Council (Majelis Ulama Indonesia, MUI), this does not mean that the establishment of Islamic bank was purely due to demand force of previously excluded Indonesian Muslim as potential customers. Indeed, we could also see the development as Indonesia's Muslim ummah's endeavor to actualize or project their religious identity into their economic life. The bid to establish Islamic bank can be seen as a way to facilitate Muslims who believed that they could not obtain return from banking transaction which would otherwise involve *riba* (usury, in this context bank interest). Furthermore, a *fatwa* (Islamic legal opinion) which says that Muslims may not enjoy income from banking interest, and instead must channel them for *Zakat* and charitable activities permitted under the *Shariah* to be used for community development, means that Muslims would have less economic incentive in placing their money in the interest-based system. Establishing Islamic banking would encourage previously hesitant Muslim potential customers to contribute to the system. This could, in turn, open up the way to increase the inclusion of banking sector amidst Indonesian society which is still admittedly low, and could contribute towards the society's economic welfare in general.

We should also underline that the civil society movement to realize Islamic banking in Indonesia reflected a pressure-group activity by political Islam groups as part of their struggle for social justice in spirit and practice towards Muslims who were marginalized politically and economically throughout the New Order period.

In the context of a political economy that occurred in Indonesia, the development of Islamic banking has been perceived by the proponent of the

Islamisation of economics movement as an attempt to create social and economic justice for the people of Indonesia. It is conformed to the view that the capitalistic and neoliberalism economics policy is taken by the New Order government has created worsen economic inequality and poverty problem (Damanhuri, 2010). Thus, the establishment and development of the Islamic banking in Indonesia are expected to contribute in improving low level of financial deepening and creating economic justice through wealth creation and wealth transfer in accordance with the *Shariah* principle (Bakar, 2008) (further discussion in relating to welfare of economics notion will be provided at Chapter 4).

2.5 Summary

In line with the objective of the Islamisation of economics movement, the establishment of the Indonesia's Islamic banking has put in place Shariah principle as the guidance source in realizing of Islamic economics practices. As interest from banking business (usury/*riba*) are not allowed based on *Shariah* principle, accordingly this return or yield from interest-based banks should be separated from their income and donate to the charity or *Zakah* institutions in Islamic economics frameworks (Bakar, 2008).Thus, the establishment of Islamic banking will play a crucial role to facilitate the Muslim depositors and investors in their investment and economic activities.

It is worth to note that the development of Islamic banking in Indonesia is admittedly a bottom-up process initiated by civil society elements, although this does not mean that the establishment of Islamic bank was purely due to demand force of previously excluded Indonesian Muslim as potential customers. In fact,

efforts in pioneering the establishment of Islamic financial institutions has been initiated by the inception of a number microfinance institutions and cooperatives which operated on Islamic principles. These grass root institutions mainly provided Islamic microfinance financing dedicated to serving poverty alleviation and developing small and medium enterprises (SMEs) in the 1980s. Furthermore, the establishment of the first Islamic commercial bank in Indonesia was driven jointly by the Indonesian Ulama Council *(Majelis Ulama Indonesia/MUI)*, the Association of Indonesian Muslim Intellectuals *(Ikatan Cendekiawan Muslim Indonesia/ICMI)*, the Muslim businessman, and the government of Indonesia. In May 1992, after the enactment of the 'Banking Act No. 7 Year 1992' and Government Regulation *(Peraturan Pemerintah/PP)* No. 72 of 1992 on Profit and Loss Banking System provided a breakthrough opportunity in establishing the first Islamic bank in Indonesia in which the the first Islamic bank in Indonesia, namely PT. Bank Muamalat Indonesia (BMI) was officially operated (Ascarya and Yumanita, 2008).

In addition, it makes sense to admit that the development of Islamic banking in the Western countries is a form of positive response towards prospective business opportunity in Islamic finance and dynamic demographic change; rather than as a change in political economic constellation between the secular countries and the Islamic world.

Obviously, it is not possible to observe the development of Islamic bank in Indonesia separate to relational pattern between the state and Islam. We underline Hefner's (2008) point of view, who concludes that Islamic banking development in many Muslim countries have s similar pattern in which the proponents of Islamic finance and banking needed to go through a process of coalition building with three

main elements of the society: (1) Islamic scholars (*Ulama*), (2) Muslim capital owners and (3) "prominent actors within the state" who see political interest in it. It is recognised that throughout the New Order period (1966-1998) under Suharto's rule, the state did not always have positive response towards the interest of Muslims in Indonesia. Nevertheless, there was a change of direction in Indonesia's political pendulum towards the end of Suharto's rule, in which Suharto's political conduct and policy embraced Islam-oriented groups (Choiruzzad, 2012; Choiruzzad and Nugroho, 2013; Lindsey, 2012).

Furthermore, from political economy perspective, the development of Islamic banking has been perceived by the proponent of the Islamisation of economics movement as an attempt to create social and economic justice for the people of Indonesia through wealth creation and wealth transfer in accordance with the *Shariah* principle (Bakar, 2008).

CHAPTER 3
CURRENT DEVELOPMENT OF THE INDONESIA'S ISLAMIC BANKING: IMPORTANT FACTS AND FINDINGS

3.1 Introduction

Nowadays we are witnessing an interesting phenomena in the global financial services landscape. In the past four decades, Islamic finance and banking have experienced rapid expansion with a vigorous performance of financial indicators (IFSB & ADB, 2015; IFSB, 2015; Iqbal & Mirakhor, 2007). The purpose of this chapter is to present the phenomena of the growth of the Islamic finance in the global landscape of the financial industry. Then, it will specifically shed light on the facts and findings in the current development of the Indonesia's Islamic banking.

In many discussion of the literature, it is argued that the Indonesia's Islamic banking has demonstrated progressive growth performance over the past two decades (Ismal, 2011; Ismal, 2014; Bank Indonesia, 2014; FSA, 2015; Sukmana & Kuswanto, 2015, Alamsyah, 2012). This is reflected in a quite robust performance that includes a strong financial intermediary function and relatively a sound financial ratios indicator. In addition, a relatively stable performance in terms of funding and financing activities have been turned into a sustainable source of growth for the industry.

However, further scrutiny is required to analyze the current achievement and outline the main problems faced by the Indonesia's Islamic banking amid the dynamics of the Islamic banking market at the global and domestic scales. It is

worth to note that the phenomena of the extraordinarily low level of Islamic financial deepening and slow pace of growth of the Indonesia's Islamic banking have occurred. In terms of market share, it is noticeable that market share of Indonesia's Islamic banks has been stagnant at about 3-5 % of the total market share in the Indonesia banking industry during the period 2011-2014. Moreover, early in the first decade of the 2000s, especially in the periods of 2005 to 2014, the slow pace of growth of the Indonesia's Islamic bank was obvious (Bank Indonesia, 2015; FSA, 2015). Thus, it is important to analyze the financial indicators of the Indonesia's Islamic banks to elaborate their profitability, efficiency, quality of the assets, and financial intermediary function performances. In this regard, we will present a comparative analysis with the conventional banks in the Indonesian banking industry on the ratios of Return on Assets (ROA), Operational Expenses to Operational Incomes (OEOI), Non Performing Loans/Non Performing Financing (NPL/NPF), and Loan to Deposit Ratio/Financing to Deposit Ratio (LDR/FDR). In addition, we also scrutinise the growth of the institutional and infrastructure development of the Indonesia's Islamic bank especially after the enactment of 'Act No. 21' concerning Islamic Banking in 2008.

The overall discussion of this chapter portrays the extraordinarily low level of Islamic financial deepening and slow pace of growth of the Indonesia's Islamic banking. This chapter presents the facts and findings on the current performance of the Indonesia's Islamic banks. In fact, this condition is a seemingly self-evident that the Indonesia's Islamic banks have inadequate profit to develop their business. Thus, it is arguable to conclude that there is less incentive for the Islamic banks for increasing their stake and their accelerating growth in the banking industry.

The rest of this chapter is organized as follows. Firstly, section 2.2 begins with a brief discussion of global development of Islamic finance. Then, section 2.3 presents the critical review on current development and performance of the Indonesia's Islamic banking. Section 2.4 summarizes the chapter with a conclusion.

3.2 A Brief Discussion of Global Development of Islamic Finance

According to IFSB's Islamic Financial Services Industry (IFSI) Stability Report 2014 (2015), the global Islamic finance has shown an impressive growth trajectory during the period of 2009-2013. The global Islamic finance industry indicated total assets amounts reached USD 1.8 trillion recorded assets with double-digit compound annual growth rate (CAGR) of 17% between 2009 and 2013. Global Islamic financial institutions operate in approximately 70 countries and cover about more than 300 Islamic financial institutions around the world (Amirzadeh & Reza Shoorvarzy, 2013, p. 66; Johnes, Izzeldin, & Pappas, 2014).

It is obvious that the Islamic banking sector is the dominant segment of the global Islamic finance industry. Global Islamic banking assets (covering full-fledged Islamic banks, subsidiaries, and *Shari'ah* windows) amount to about US$1.48 trillion in mid 2014. The sector has grown at a CAGR (cumulative annual growth of rate) of 16.89% between 2008 and 2013, and grew by 16% in 2013 y-o-y. Nevertheless, it is noticeable as the overall global banking grows, the assets of the top 1000 global banks grew by only 4.9% in 2012 and 0.6% in 2013 (IFSB, 2015).

IFSB (2015) exposes interesting figures that the Islamic financial deepening is generally observed only in the Gulf Cooperation Countries (GCC) and a limited number of Asian Muslim countries. Furthermore, apart from Iran and Sudan, the

countries with fully *Shari'ah*-compliant banking systems exist only in seven countries with dual banking system in place (i.e. Brunei, Kuwait, Malaysia, Qatar, Saudi Arabia, the United Arab Emirates (UAE) and Yemen). 'Systemic importance' is categorized by some countries when Islamic banking has achieved at least 15% market share of total banking assets, and hold more than 5% of the total global Islamic banking assets. Categorization used by IFSB (2015) to determine whether an Islamic bank is classified as a 'global systemic bank' in fact merely takes into account the size of the Islamic bank. Nevertheless, according to the Bank for International Settlements (BIS, 2013), a categorization of 'global systemic' bank should include selected indicators that reflect the bank's size, interconnectedness, substitutes or financial institution infrastructure, cross-jurisdictional activity, and operational complexity. By monitoring those particular indicators, each bank is categorized as a global systemical bank. It should be then able to anticipate potential externalities and failures as this will have a systemic impact on the financial system as a whole.

However, being systemically important as defined by the IFSB (2015) basically does not reflect the dominance of the Islamic banking in the market share of national banking industry. Further observations on countries in this category (IFSB, 2015) indicates that only in Saudi Arabia, the Islamic bank is slightly dominant with 51.3 % of the total domestic banking assets. In the remaining countries, the share of the Islamic bank as a proportion of the total domestic banking sector is as follows: Brunei 41% ; Kuwait, 38%; Malaysia, 21.9%; Qatar, 25.1%; UAE, 17.4%; and Yemen, 27.4%, respectively.

It is worth noting that even though Islamic finance is approximately less than

1% of the global financial asset, its rapid growth and superior performance during the last two decades can be seen as a promising alternative in the global financial system (IFSB, 2015; ADB & IFSB, 2015). ADB and IFSB (2015) expect Islamic finance - operated in accordance with *Shari'ah* principles - would bring a new spectrum that can be used to provide a competitive advantage in banking. This advantage comes from the role played by the Islamic financial institutions that encourage risk-sharing in the financial contracts between the lenders and borrowers in the modern financial system. In addition, as the Islamic finance comes with the risk-sharing paradigm and real-asset-underlaid transactions, it can contribute significantly to the greater integration with the real economy and improve the overall economic balance between finance sectors.

At the end of 2014, Islamic banking had booked its total assets at Rp 242 trillion with total deposits of Rp 183 trillion, and total financing of 184 trillion. During the years 2000-2012, Islamic banking in Indonesia has grown progressively with annual growth rate of about 35-50%. This growth was much higher compared to the global Islamic banking growth rate at 10-20%.

Such optimism on Indonesia's potential to develop Islamic banking is based on a number of arguments (Ismal, 2013; Alamsyah, 2012): (1) Indonesia has a large Muslim population as potential customers of the Islamic banking industry; (2) Indonesia has experienced promising economic growth and relatively stable political circumstances over the last two decades; (3) Indonesia has successfully increased its sovereign credit rating to investment grade that would encourage prospective investors in investment projects; and (4) Indonesia has abundant natural resources as a base for underlying assets of the Islamic financial transactions.

Nevertheless, in terms of market share, it is noticeable that market share of Indonesia's Islamic banks has been stagnant at about 3-5 % of the total market share in the Indonesia banking industry during the period 2011-2013 (FSA, 2015, Sukmana & Kuswanto, 2015; Ismal, 2014; Ismal, 2013; Ismal, 2011).

From the brief facts and figures of Islamic banking above, we conclude that even though Islamic banking is a very attractive market with promising growth, the overall Islamic banking still occupies only a small niche in the market share of the national banking industry.

Compared to the other Muslim countries, Table 3.1 below highlights the extraordinarily low level of Islamic financial deepening in Indonesia considering that it has the largest Muslim population.

Table 3. 1 Comparation of Islamic Bank Market Share and Muslim Population in Selected Muslim Countries in 2014 (in Million)

Countries	Resident Muslim Population	Percentage in Population	Islamic Bank Market Share (%)
Indonesia	218.68	88	4.8
Saudi Arabia	30.10	100	51.3
Bangladesh	154.91	90	17
Malaysia	18	60	21.9

Source：IFSB (2015), World Muslim Population (n.d.)

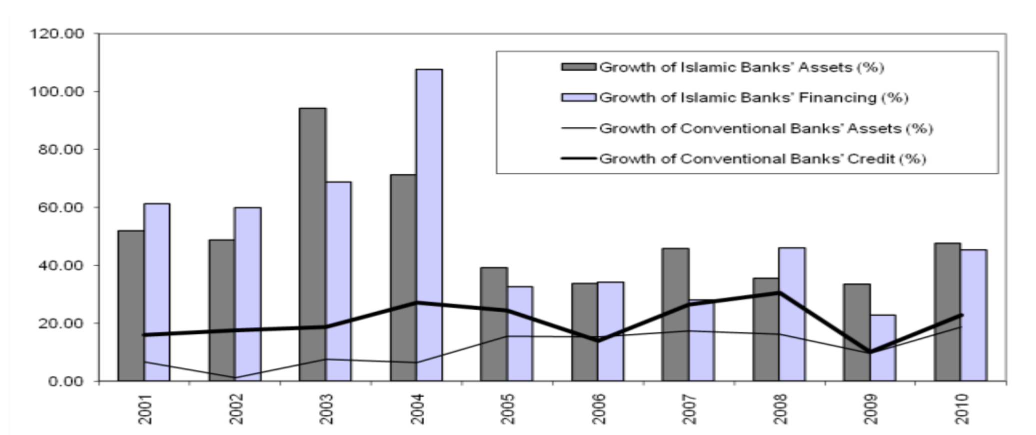
Evidently, the Islamic banking market penetration is relatively small, hence it has an insignificant impact on the economic scale and contribution to the national economy. Thus, it should be the main concern of the stakeholders of the Indonesia's Islamic banking sector to encourage the Indonesia's Islamic banks to further carry out market penetration of banking industry in order to have an optimum economy

of scale operation in the financial system.

3.3 Critical Review of Current Development and Performance of Indonesia's Islamic Banking

Based on Figure 3.1, during the period of 2001-2010, the growth of Islamic bank attained a higher level in comparison to the growth of the conventional banks. Specifically, Alamsyah (2012) asserts that Islamic banking in Indonesia has an average growth rate of 40.2% per year during of 2007-2011 period, which was much higher than the conventional banking growth of 16.7% per year. Nevertheless, we noted that during the period 2005-2014, the growth of both asset and financing in Islamic bank had slowed down. Still it is placed in a higher position than conventional banks (Ismal, 2011).

Figure 3. 1 Comparison of Islamic Bank and Conventional Bank Growths



Source: Ismal (2011, p. 7)

Table 3.2 shows details of the growth of Islamic banking in Indonesia in terms of total assets, total financing, and total deposits and market share for the period 2003-2014. This table reveals that the significant increase of a nominal term of the Islamic bank asset does not automatically mean significant increase of percentage market share in the total banking assets. Table 3.2 also shows that in overall

performance during the period 2003-2014, Indonesia's Islamic banking experienced the decreasing growth trend in terms of assets, financing, and deposits. Further scrutiny of the data in Table 2.2, show that after seven years of the enactment of the Islamic Banking Act No. 21 in 2008, the annual growth in total assets of the Islamic banks in Indonesia was only 35.7% on average, which is substantially lower in comparison with the period of 2003-2007 when it attained at 55.2%. It is worth to underline that evidently in the period 2004, the asset, financing, and deposit of the Islamic bank only attained 12%, 8% and 19% of growth, respectively.

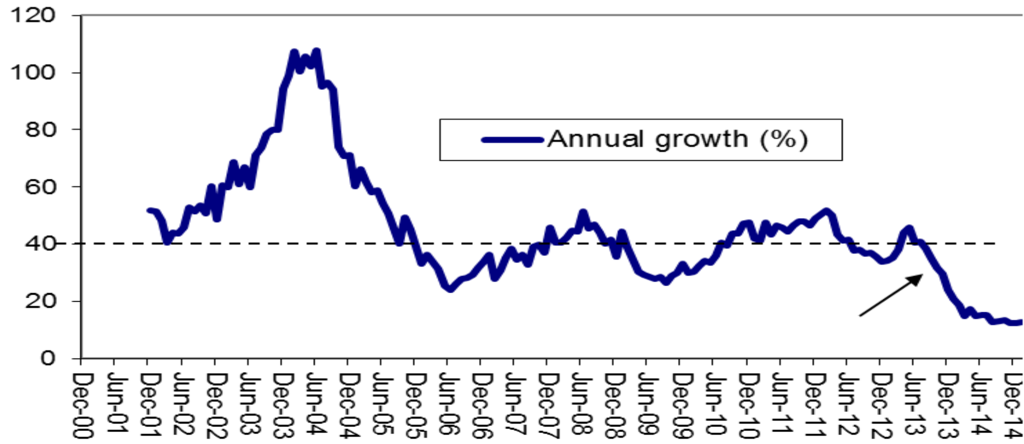
Table 3. 2 Indonesia's Islamic Banking Growth Performance 2003-2014

Year	Percentage of Market Share	Total Asset (in Trillion Rupiah)	Total Financing (in Trillion Rupiah)	Total Deposit (in Trillion Rupiah)	Growth (in percentage)		
					Asset	Financing	Deposit
2003	0.65	7,944	5,561	5,759	96	70	97
2004	1.20	15,210	11,324	11,718	91	104	103
2005	1.42	20,880	15,232	15,581	37	35	33
2006	1.58	26,722	20,445	20,672	28	34	33
2007	1.66	33,016	26,149	25,473	24	28	23
2008	2.14	49,555	38,199	36,852	50	46	45
2009	2.61	66,090	46,886	52,271	33	23	42
2010	3.24	97,519	68,181	76,036	48	45	45
2011	3.63	132,462	102,655	115,415	36	51	52
2012	4.58	195,018	147,505	147,512	47	44	28
2013	4.89	242,276	184,122	183,534	24	25	24
2014	4.85	272,343	199,330	217,858	12	8	19

Source **:** Statistics of the Indonesia's Islamic Banks (*Bank Indonesia*, various years); Sukmana & Kuswanto (2015)

Furthermore, a careful observation over a longer period, indicates that the Islamic banks in Indonesia have a declining trend in the rate of growth (see Figure 3.2).

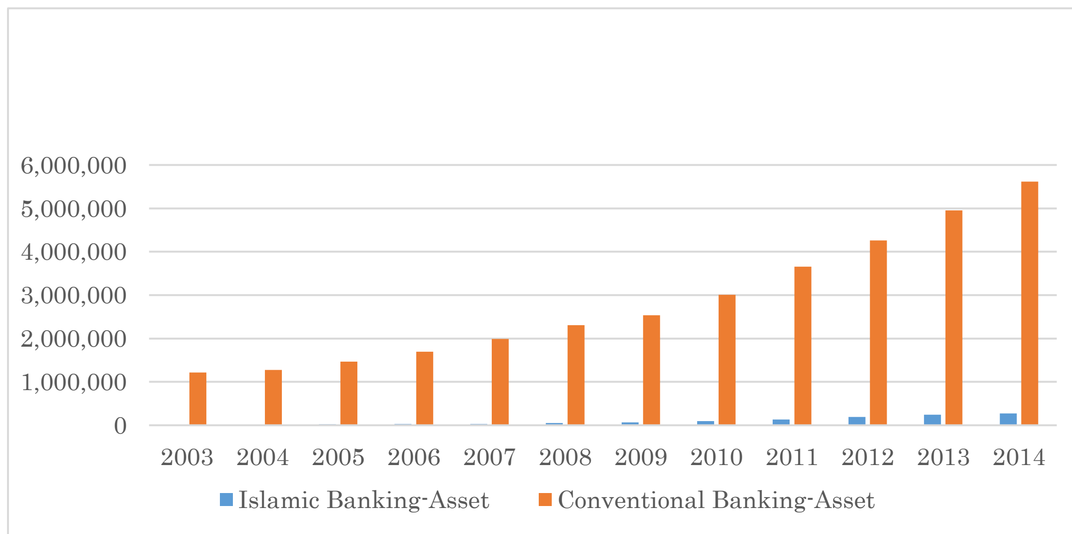
Figure 3. 2 Trend of Growth of Indonesia's Islamic Banking



Source: *Bank Indonesia* (2015, p. 3)

Figure 3.3 shows a comparison of total assets of Islamic banks and conventional banks for the period 2003-2014.

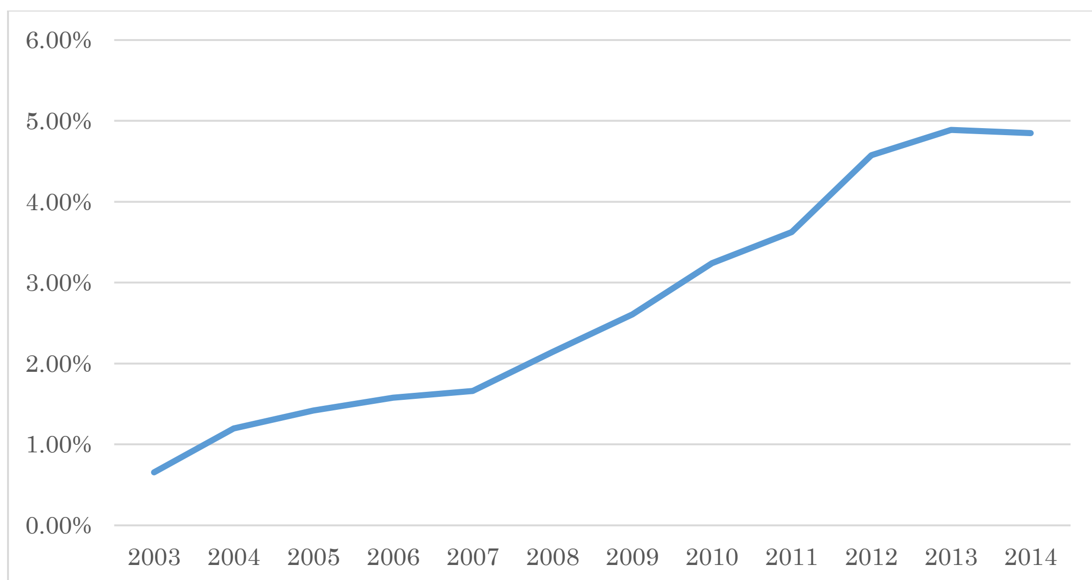
Figure 3. 3 Comparison of Total Assets of Indonesia's Conventional and Islamic Banks in Period of 2003-2014 (in Trillion Rupiah)



Source **:** Statistics of the Indonesia's Islamic Bank (*Bank Indonesia*, various years), constructed by author.

Regarding market shares, it is noticeable that the market share of Indonesia's Islamic banks have been at stagnant level of about 3% to 4 % of the total market share of the Indonesian banking industry. Figure 3.4 below shows the long run trend by comparing the Islamic banks' market share for the periods of 2003-2014.

Figure 3. 4 Indonesia's Islamic Banking Market Share 2003-2014



Source **: S**tatistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

With regard to the growth performance of the market share of the Islamic banks, *Bank Indonesia* (BI), formerly a regulatory and supervisory authority for banking industry, issued a number of strategic policy documents to provide guidance for all the stakeholders.Thus include, among other, the *Blue Print of the Development of Islamic Banking Industry* (BI, 2006), *Market Development Strategic Program*, and *Outlook of Islamic Banking* (BI, in various years), and the *Islamic Banking Accelerated Programs* (*Bank Indonesia*, 2006) (further discussion of these particulars strategic documents are presented in Chapter 4). One of the most important among these documents was the *Islamic Banking Accelerated Programs*

which included as policy package in the *Islamic Banking Outlook 2007*. This accelerated program was basically aimed at achieving the quantitative target of increasing market share of the Islamic banking to 5.25% at the end of 2008.

Nevertheless, as we see in Table 3.2, this quantitative target to achieve of 5.25% market share in the banking industry was not reached by the end of 2008 (actual market share by the end of 2008 was 2:14%). In fact, Table 2.2. also shows that by the end of 2014; six years after the target was declared, the actual market share of the Indonesia's Islamic banking achieved only 4.85%, which did not attain 5.25% of projected target in the *Islamic Banking Accelerated Programs*.

Hence, this empirical evidence shows the crucial findings in highlighting that the extraordinarily low level of Islamic financial deepening and slow pace of growth of the Indonesia's Islamic banking have occurred in the current development of the Islamic banking in Indonesia. In this sense, we can also propose a hypothesis that a number of strategic policy document issued by the financial authority in Indonesia, however, has not been effectively implemented to boost the growth of market share of the Indonesia's Islamic banking.

Furthermore, to get a comprehensive picture of the slow growth phenomena of Islamic banking in Indonesia, we need to do an analysis of financial performance and fragility of Indonesia's Islamic banks. In this sense, the performance of the banks themselves are often closely tied to the robustness of bank performance based on financial indicators (Prasojoharto, 2012). According to Act No. 7 of 1992 on banking article 29 which stated that *Bank Indonesia* has the right to stipulate the provision of a bank's health level, with regard to the capital, asset quality, earnings, liquidity, solvency, and other aspects related to the business of the bank.

Furthermore, *Bank Indonesia* issued a Director's Decree of *Bank Indonesia* No. 30/277/KEP/DIR dated 19 March 1998 that governs how to assess the health level of a bank. As for Islamic banks, based on *Bank Indonesia* Circular Letter No. 9/24 / DPbS concerning the Rating System for Commercial Banks based on *Shari'ah* principles came into effect on 30 October 2007. The rating of commercial banks based on *Shari'ah* principles take into account CAMELS' indicators (capital adequacy, asset quality, management quality, earnings and liquidity capability), by measuring the financial factors and management factors (non-financial) effect on the bank's performance.

Accordingly, we apply a number of financial ratios using *Bank Indonesia* Circular Letter No. 9/24 / DPbS concerning the Rating System for Commercial Banks based on *Shari'ah* principles in analyzing the performance of Islamic banks. This includes ratios of ROA (Return on Assets), OCOI (Operational Cost to Operational Income), NPF (Non Performing Financing), FDR (Financing to Deposit Ratio), and Net Profit Margin (NPM).

Table 3.3 presents a comprehensive number of financial performance indicators of the banking industry in Indonesia for the period 2005-2014. In order to anlyse the financial performance and fragility of the Indonesia's Islamic banks, we provide a comparative data with the financial performance indicators of the conventional banks. By employing this comparative data of the banking industry in Indonesia, we intend to draw a conclusion in assessing the robustness of Islamic banking in Indonesia.

It is worth to note, as shown in Table 3.3 that the Indonesia's Islamic banks have a lower level of overall financial performance in comparison to conventional

banks. Apparently, only in terms of Financing to Deposit Ratio (FDR), the Islamic banks have slightly a better performance in comparison to the conventional banks' Loan to Deposit Ratio (LDR). However, we notice that the conventional banks' LDR show a slightly higher performance in comparison to the Islamic banks'FDR at the end of 2014.

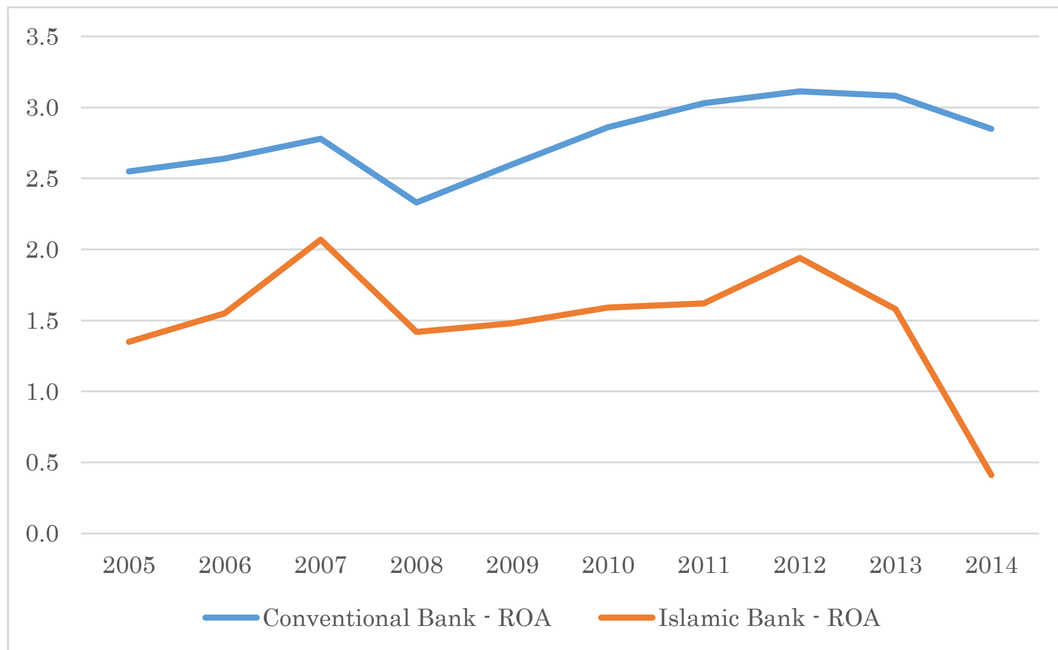
Table 3. 3 The Indonesian Banking Financial Performance Indicators 2003-2014

Financial Indicators	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Return on Asset (ROA)										
Conventional Bank	2.6	2.6	2.8	2.3	2.6	2.9	3.0	3.1	3.1	2.9
Islamic Bank	1.4	1.6	2.1	1.4	1.5	1.6	1.6	1.9	1.6	0.4
Operating Cost to Operating Income (OCOI)										
Conventional Bank	89.5	87.0	84.1	88.6	86.6	86.1	85.4	74.1	74.1	76.3
Islamic Bank	78.9	76.8	76.5	81.8	84.4	82.4	81.7	76.4	82.2	81.3
Non Performing Loan/Financing (NPL/NPF)										
Conventional Bank	7.6	6.1	4.1	3.2	3.3	2.6	2.2	1.9	1.8	2.2
Islamic Bank	2.8	4.8	4.1	4.0	4.0	3.0	2.5	2.3	2.6	4.3
Loan/Financing to Deposit Ratio (LDR/FDR)										
Conventional Bank	59.7	61.6	66.3	74.6	72.9	75.2	78.8	83.6	89.7	89.4
Islamic Bank	97.8	98.9	99.8	103.7	89.7	87.6	91.4	120.7	95.9	86.7
Net Interest/Profit Margin (NIM/NPM)										
Conventional Bank	5.6	5.8	5.7	5.7	5.6	5.7	5.9	5.5	4.9	4.2
Islamic Bank	NA	NA	NA	NA	NA	1.8	1.2	2.0	1.8	2.9

Source : Performance statistics on Islamic Banks in Indonesia (*Bank Indonesia*, various years), constructed by author.

In analysing the trend that occurred on the financial performance indicators according to Table 3.3, we will discuss and perform a comparative analysis on each financial performance measurement.

Figure 3. 5 Comparison of Return on Assets (ROA) of the Conventional and Islamic Banks in Indonesia 2005-2014

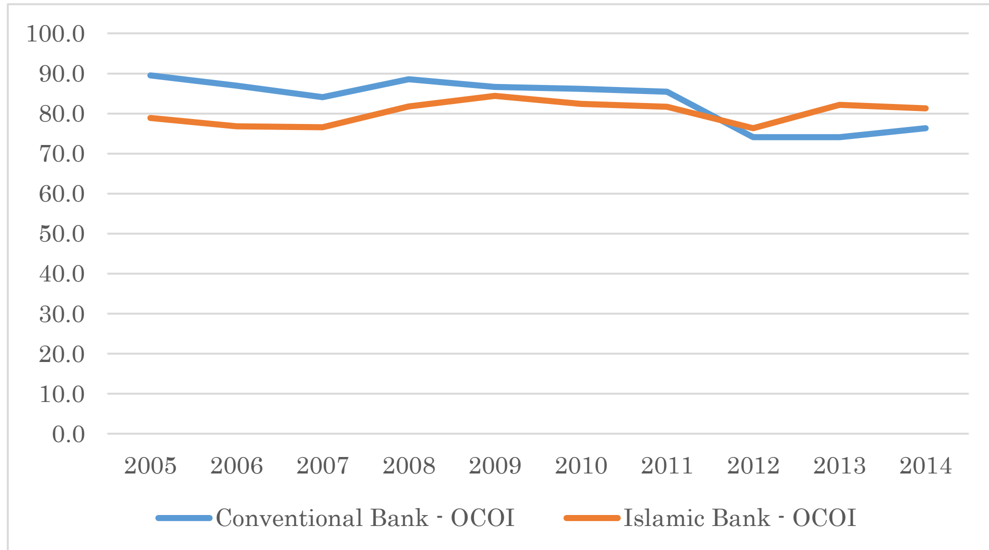


Source **:** **S**tatistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Figure 3.5 shows that during the period from 2005 to 2014, Return on Assets (ROA) of the Islamic banks were lower than in conventional banks. In fact, we see from the trend that gaps between the Islamic banks and conventional banks have gotten wider. This indicates a strong evidence that the Islamic banks were having difficulties in generating high income from their financing activities in comparison to conventional banks.

Following, we portray the level of efficiency that is reflected in 'Operational Cost' to 'Operational Income' (OCOI) indicators. Figure 3.6 presents the data of OCOI of conventional and Islamic banks for the period 2005-2014.

Figure 3. 6 OCOI (Operational Cost to Operational Income) of the Indonesian Conventional and Islamic Banks for the Period 2005-2014



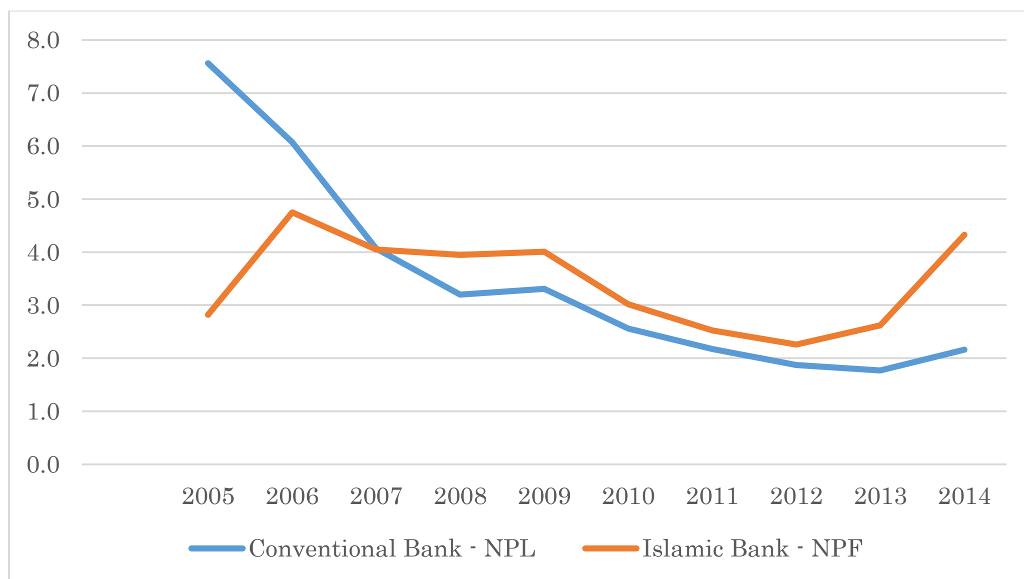
Source **:** **S**tatistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Based on Figure 3.6, we can see that in the period 2005 to 2014 the conventional banks have a declining trend of OCOI, meaning that the conventional banks have successfully managed in increasing their level of efficiency. Meanwhile, the Islamic banks have an increasing trend of OCOI, even we note in the period of 2012-2014 there was a consistent pattern that OCOI of the Islamic banks was higher than the conventional banks in which the average OCOI of the Islamic banks recorded at 79.9%, whereas the average of OCOI of the conventional banks at 74.8%. Thus, in general, this empirical fact proved that Islamic banks have a lower efficiency level in comparison to conventional banks.

Next, it is acknowledged that one of important financial performance in assessing the robustness of the banking business is the asset quality of credit or financing activities of the banks as indicated on Non Performing Loan (NPL) and

Non Performing Financing (NPF) for conventional banks and Islamic banks, respectively. Figure 3.7 presents the data NPL and NPF of the conventional and Islamic banks for the period 2005-2014.

Figure 3. 7 Non Performing Loan/Financing (NPL/F) of the Conventional and the Islamic Banks in Indonesia for the Periods 2005-2014

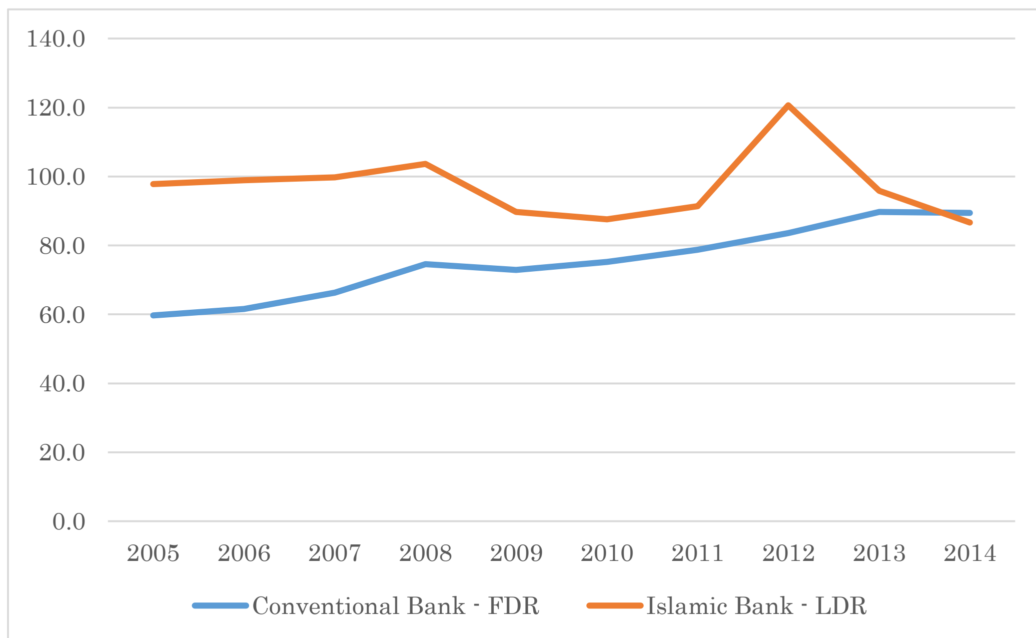


Source **:** Statistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Based on Figure 3.7, we can conclude that the level of NPF of the Islamic banks were higher than the conventional banks' NPL. We also noted that the conventional banks have a decreasing trend in NPL, whereas the Islamic banks have an increasing NPF trend during the period of 2005-2014. In this sense, we admit that the conventional banks seem to have improved the ratio of NPL, meanwhile, the Islamic banks apparently have a tendency to have a higher ratio of NPF during the period 2005-2014. It should also be noted that there was a wider gap in the trend between NPL of the conventional banks and the NPF of the Islamic banks.

Consequently, we will look at the ability of the conventional and Islamic banks in Indonesia in conducting financial intermediary functions. This particular performance will be indicated by Loan to Deposit Ratio (LDR) of the conventional banks and Financing to Deposit Ratio (FDR) of the Islamic banks. Figure 3.8 presents LDR and FDR data of the conventional and Islamic banks for the period 2005-2014, respectively.

Figure 3. 8 Loan/Financing to Deposit Ratio (L/FDR) of the Conventional and Islamic Banks in Indonesia for the Period 2005-2014



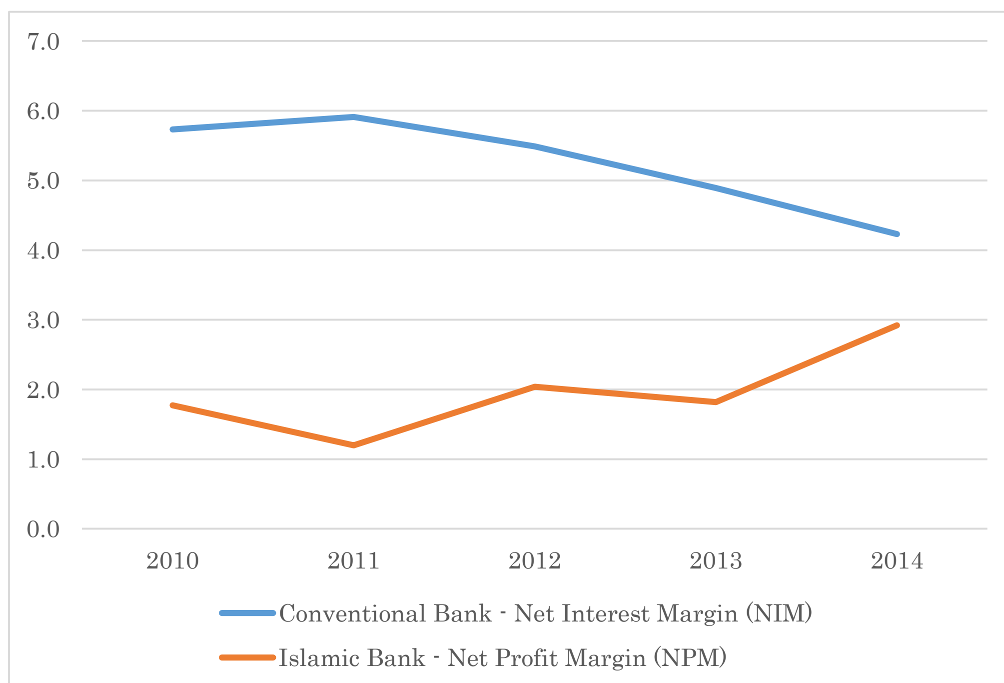
Source **:** Statistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Figure 3.8 clearly shows that the conventional banks have an increasing trend of LDR, while the Islamic banks have a more volatile pattern of FDR and a declining trend of FDR. Based on Figure 3.8, we conclude that during the period of 2005-2014, the conventional banks have an improving LDR performance result in

accomplishment a better financial intermediary function, while the Islamic banks show a deteriorated performance of their FDR.

Finally, another indicator that we need to consider in assessing the financial performance indicator of banking industry is ‘Net Interest Margin’ (NIM) for the conventional banks, which measures the ratio of interest spread generated by the conventional banks to the total productive assets owned by the bank, and the ‘Net Profit Margin’ (NPM) for the Islamic banks which describes the ratio of profit and loss margin of the Islamic banks’ profit sharing business to the total productive assets owned by the Islamic banks. Figure 3.9 below presents NIM and NPM of the conventional and Islamic banks for the period 2005-2014, respectively.

Figure 3. 9 Net Interest/Profit Margin (NI/PM) of the Conventional and Islamic Banks in Indonesia for the Period 2015-2014



Source : Statistics of the Indonesia’s Islamic bank (*Bank Indonesia*, various years), constructed by author.

Figure 3.9 above shows that the conventional banks have a higher NIM in comparison with the NPM of the Islamic banks. Thus, we conclude that the conventional banks have a higher rentability performance in comparison to the Islamic banks in the period 2005-2014.

Alternatively, one of the crucial challenges of Indonesia's Islamic banking development is the size of capital in comparison to their conventional peers (Bappenas, 2014). Table 3.4 below shows a relatively low level of 'Capital Adequacy Ratio' (CAR) for the Islamic banks in comparison with conventional banks. This feature indicates a relatively capital insufficiency faced by the Indonesia's Islamic banking in doing their business competitively in comarison with the conventional banks.

Table 3. 4 Comparison of the Capital Adequacy Ratio (CAR) between the Conventional and Islamic Banks in Indonesia for the Period 2005-2014

Banks	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Conventional Bank - CAR	19.30	21.27	19.30	16.76	17.42	17.18	16.05	17.43	18.13	19.60
Islamic Bank - CAR	12.41	13.73	10.67	12.81	10.77	16.76	15.37	14.14	14.42	15.70

Source **: S**tatistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Based on *Bank Indonesia* regulation No. 14/26/PBI/2012 (*Bank Indonesia*, 2012), *Bank Indonesia* classifies the commercial banks based on core capital and stipulates permitted activities for each classification namely *Bank Umum berdasarkan Kegiatan Usaha* (BUKU/Commercial Bank Based on Business Activities). For that reason, *Bank Indonesia* regulation No. 14/26/PBI/2012 restricts the commercial banks' authorized business activities, maximum credit/financing

limits, and office network expansion based on the amount of core capital maintained by banks. Detailed Bank Based Business Activities (BUKU) classification of commercial banks is shown in Table 3.5, as follows.

Table 3. 5 Classification of the Commercial Banks in Indonesia by Types of Commercial Bank Based Business Activities (BUKU)

BUKU	Core Capital Amount	Products and Activities Coverage
1	Less than Rp 1 Trillion	1. Basic Rupiah intermediary functions for deposit and distribution, trade finance,
		limited agency/cooperation, limited electronic banking and payment systems,
		temporary capital participation for credit based or other services, and limited foreign exchange
		2. Branches only within Indonesia
		3. No capital participation in other financial institutions
		4. Must distribute 55% of total credit/financing to productive business
2	Rp 1 – 5 Trillion	1. Same business activities as BUKU 1, but with higher transaction value
		2. Branches only within Indonesia
		3. Capital participation in other Indonesian financial institutions, up to 15% of capital
		4. Must distribute 60% of total credit/financing to productive business
3	Rp 5 – 30 Trillion	1. All types of business activities, in Rupiah and foreign currency
		2. Branches and representative offices in Indonesia and Asia region
		3. Capital participation in Indonesian and other Asian financial institutions, up to 25% of capital
		4. Must distribute 65% of total credit/financing to productive business
4	At least Rp30 Trillion	1. All types of business activities, in Rupiah and foreign currency
		2. Worldwide branches and representative offices
		3. Worldwide capital participation in other financial institutions, up to 35% of capital
		4. Must distribute 70% of total credit/financing to productive business

Source: *Bank Indonesia* (2012), this summary of *Bank Indonesia* Regulation No. 14/26/PBI/2012 explanation of is cited from Akset Law Firm's regulation news (http://aksetlaw.com/news-event/newsflash/new-bank-indonesia-regulation-on-multiple-licensing-policy/)

According to the Indonesia's Islamic Banking Statistics 2014 (FSA, 2015) as of 31 December 2014, most of the full fledged Islamic banks were in BUKU 1 and 2 category. Hence, as the Islamic banks have a lower level of BUKU classification and CAR compared to their conventional counterparts, consequently it constrained the Islamic banks' capacity to engage in corporate sector financing, infrastructure

projects, and high-end business which are usually capital intensive ventures. Therefore, it is an important concern for regulators and market players of the Islamic banking to enlarge the capital base of the Islamic banks in order to increase their growth and enhance their competitiveness against the conventional banks.

Furthermore, funding and financing activities are other important operational performance for the Indonesia's Islamic bank that should be analysed. Following, we present and discuss the comparison between the deposit mobilization and financing disbursements of the conventional banks and the Islamic banks in Indonesia for the period of 2005-2014.

Table 3.6 below presents the comparison between the deposits collected by the conventional banks and the Islamic banks in Indonesia for the period of 2005-2014.

Table 3. 6 The Comparison between Deposits of Conventional and the Islamic Banks in Indonesia for the Period of 2005-2014

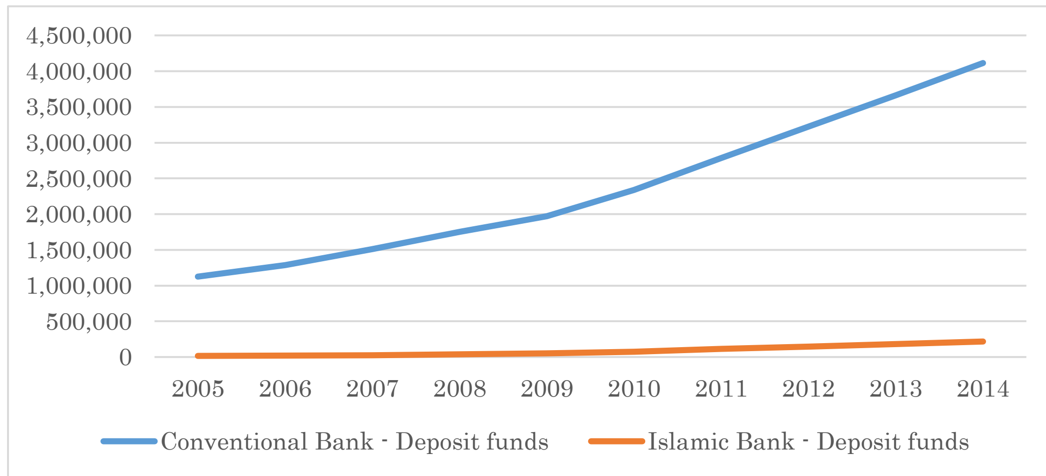
Banks	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Conventional Bank - Deposit funds	1,127,937	1,287,102	1,510,834	1,753,292	1,973,042	2,338,824	2,784,912	3,225,198	3,663,968	4,114,420
Islamic Bank - Deposit funds	15,581	20,672	25,473	36,852	52,271	76,036	115,415	147,512	183,534	217,858

Source : **S**tatistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

It is worth to note that the market penetration in terms of deposits held by the conventional and Islamic banks was completely different for the period 2005-2014. By the end of year 2014, the conventional banks managed about 95% of the deposits in the banking industry whereas the Islamic banks managed the rest. In addition Figure 3.10 shows that the trends of deposit fund collected by the conventional

banks was increasing significantly, however, the trend of the deposit fund collected by the Islamic banks was growing slightly during the period of 2005-2014.

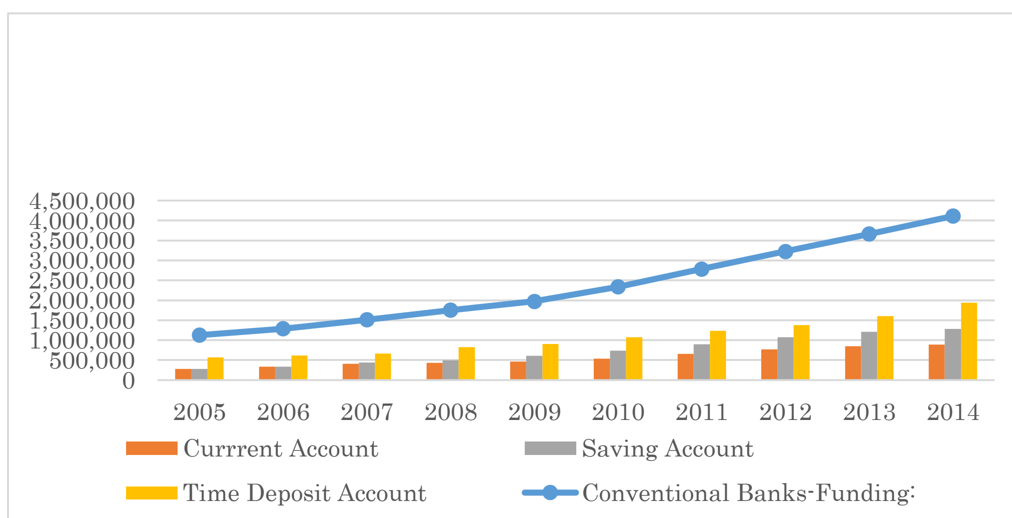
Figure 3. 10 The Growth of the Deposits by the Conventional and Islamic Banks in Indonesia for the Period of 2005-2014



Source **:** Statistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

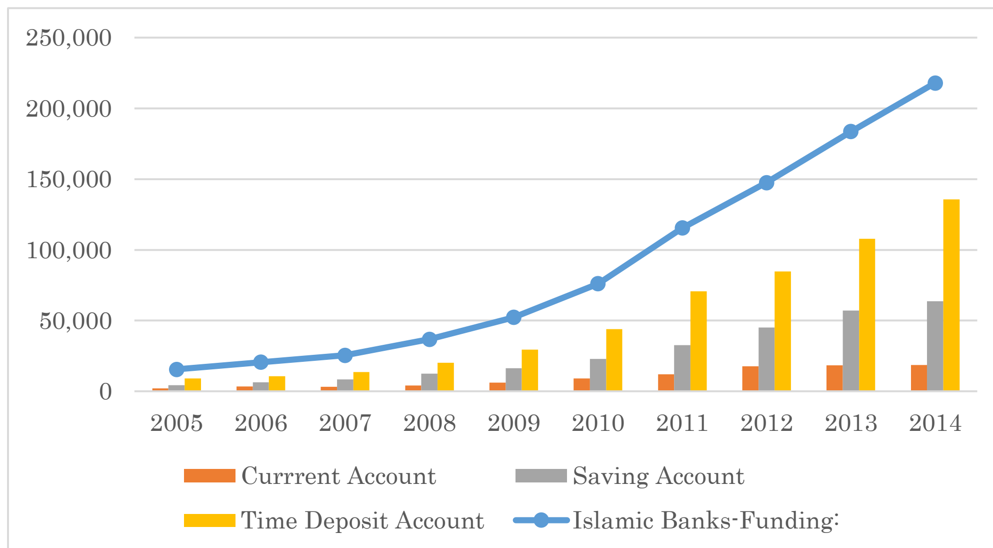
Figure 3.11 and 3.12 below present the composition of funding source for conventional and Islamic banks for the period 2005-2014, respectively.

Figure 3. 11 The Conventional Banks-Funding Composition for the Period of 2005-2014 (in Trillion Rupiah)



Source **:** Statistics of the Indonesia's Islamic Bank (*Bank Indonesia*, various years), constructed by author.

Figure 3. 12 The Islamic Banks-Funding Composition for the Period of 2005-2014 (in Trillion Rupiah)



Source **:** Statistics of the Indonesia's Islamic Bank (*Bank Indonesia*, various years), constructed by author.

Based on the data presented above, we find that both the conventional and the Islamic banks have the increasing trend in term of deposit collection capability as their source of funding. However, we underline that the funding source in the form of Time Deposit account is the highest portion of both the conventional and the Islamic banks in the period 2005-2014. Further observation of the funding composition showed that the Time Deposit portion owned by the Islamic bank showed a relatively higher trend in comparison to the conventional banks. For instance, as of 31 December 2008 and 2014, the portion of the Time Deposit hold by the conventional banks is 47.03% and 47.16%, while the portion of the Time Deposit owned by the Islamic bank is 54.65% and 62.25%, respectively. In fact, this condition has a disadvantageous impact on the funding structure owned by the

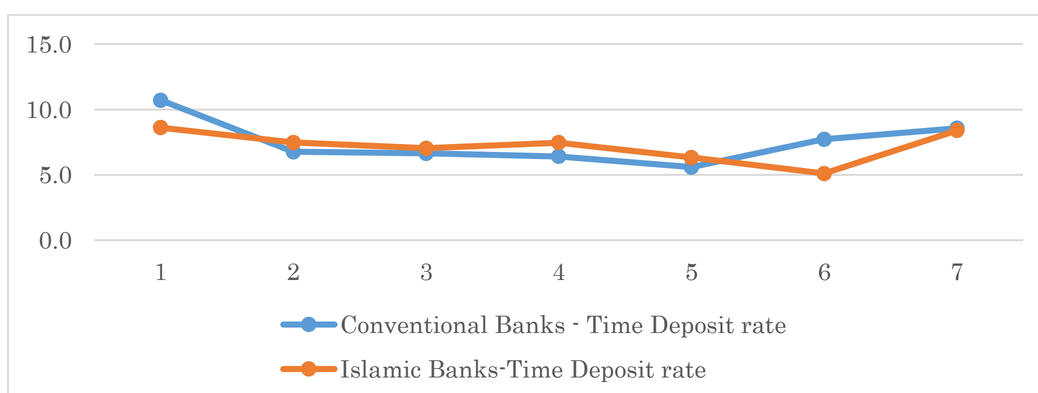
Islamic banks since it will result in high cost of funds faced by the Islamic banks in comparison with the conventional banks. We present a comparison of the rates for the deposit funds consist of saving account, current account, and time deposit collected by the conventional and the Islamic banks for the period 2005-2014 at Table 3.7 below. In particular, we describe the trend of rate of the deposit rate in terms of time deposit fund in Figure 3.13.

Table 3. 7 Comparison of the Rates for Deposit Funds Collected by the Indonesian Conventional and the Islamic Banks for the Period of 2005-2014

Type of Deposit	2008	2009	2010	2011	2012	2013	2014
Saving Account:							
Conventional Banks - Saving Account rate	3.1	2.8	2.9	2.4	1.9	2.0	2.0
Islamic Banks - Saving Account rate	3.6	2.8	3.1	3.2	2.4	5.7	3.6
Current Account:							
Conventional Banks - Current Account rate	2.9	2.4	2.2	2.4	2.1	2.1	2.3
Islamic Banks-Current Account rate	1.2	1.0	1.3	2.2	1.0	0.7	0.7
Time Deposit:							
Conventional Banks - Time Deposit rate	10.7	6.8	6.6	6.4	5.6	7.7	8.6
Islamic Banks-Time Deposit rate	8.6	7.5	7.0	7.5	6.3	5.1	8.4

Source : Statistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Figure 3. 13 A Comparison of the Trend of Rates for the Time Deposit Collected by the Indonesia's Conventional and the Islamic Banks for the Period of 2005-2014



***Source* : S**tatistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

As observed in Table 3.7, the rate of deposit funds offered by the Islamic banks apparently at the higher rate in comparison with the conventional banks' ones. Specifically, for the saving account product the Islamic banks always have a higher rate in comparison to the conventional banks as the method to attract the customers for the Islamic banking services. Meanwhile, for the current accounts, it seems that the Islamic banks tend to hesitate offer this kind of account to the corporate sector as there is limited liquidity interbank instrument to manage volatile placement in large amount and usually the Islamic bank merely provide a return in this particular account with a simple bonus (*hadyah* in Islamic jurisprudential terminology) for the depositor. However, as shown in the Figure 3.13, for the time deposit account, the Islamic banks have a relatively higher rate offering to the depositors. We note that although the rate fluctuated, in the period 2009-2012, the Islamic banks have offered a higher rate in comparison with conventional banks. It is our presumption that this was due to the Islamic banks having put in efforts to attract the depositor for the higher return in time deposit product competitively to the conventional banks.

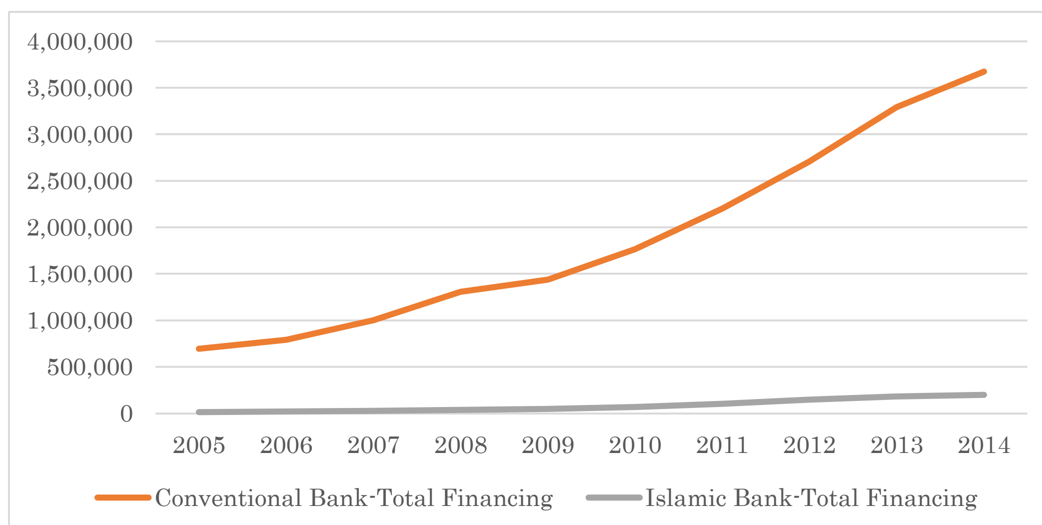
From the financing activities side of the banking industry in Indonesia, Table 3.8 and Figure 3.14 present a comparison of the financing disbursement and the trend of financing growth of the conventional and the Islamic banks for the period of 2005-2014, respectively.

Table 3. 8 Comparison of Total Financing of Conventional and Islamic Banks in Indonesia 2005-2014

Total Financing	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Conventional Bank-Total Financing	695,648	792,297	1,002,011	1,307,689	1,437,930	1,765,844	2,200,093	2,707,862	3,292,874	3,674,309
Islamic Bank-Total Financing	15,232	20,445	27,945	38,195	46,886	68,181	102,654	147,505	184,120	199,330

Source **:** Statistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Figure 3. 14 Financing of Conventional and Islamic Banks in Indonesia for the period of 2005-2014



Source **:** Statistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Based on Table 3.8 and Figure 3.14 above we conclude that the financing activities of the Islamic banks was substantially lower in comparison to conventional banks. Also, we see that the trends of financing disbursement of the conventional banks was increasing significantly, but the trend of the financing disbursement by the Islamic banks was growing slightly during the period of 2005-2014. As of the end of 2014, the conventional banks owned 95%, whereas the Islamic bank only held about 5% of of total financing in the banking industry.

On the other hand, Figure 2.15 and Figure 2.16 below present the composition of credit and financing disbursements made by the conventional and the Islamic banks, respectively. The composition of credit in the conventional banks in the period 2005-2014 showed that the credit channeled into working capital credit was dominant, followed by consumer credit, and lastly investment credit. Meanwhile, in the Islamic banks financing activity, the composition of financing in the period 2005-2014 shows a trend that the consumer financing activities becoming a dominant portion, followed by working capital financing, and lastly investment financing. For a comparison, at as of 31 December 2008 and 2014, the share of consumer credit compositions that are owned by the conventional banks was 28.07% and 27.58%, while the composition of the consumer financing portion held by the Islamic bank was 25.48% and 39.97%, respectively. This reflects the condition that the Islamic bank is more focused on consumer banking products with *murabaha* contracts[2]. As we have discussion on the issues of funding activities of the Islamic banks above, in fact the Islamic banks have a relatively higher cost of fund in comparison to the conventional banks. Hence, this situation was resulting in which the Islamic banks seemingly have no opportunity except to disburse the funds into the financing products that can generate higher return and mostly short tenor for their customers through the consumption segments using *murabaha*

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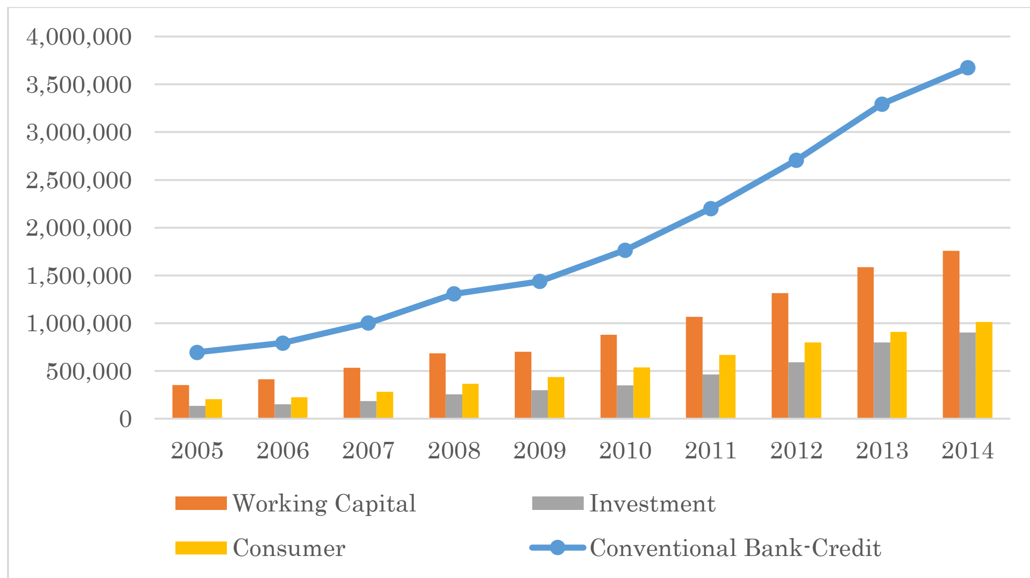
[2] *Murabaha* financing contract is one of financing products in the Islamic bank's business which is categorised under *Shari'ah*-compliant asset-based financing modes. Basically, *murabaha* financing agreement will offer asset-resaling transactions with a determined-profit; for example the Islamic bank will purchase a certain asset and sells it to the bank customer on the basis of a cost plus mark-up profit principle.

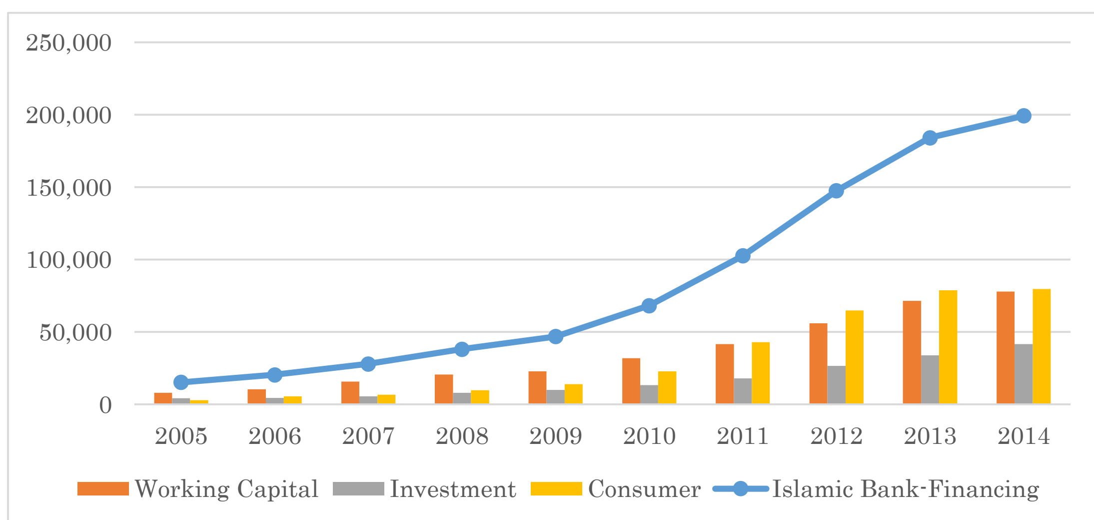
contracts. In addition, with the limited fund collected and lower banking capability, it caused the Islamic banks were hesitate taking corporate risk financing.

Figure 3. 15 The Conventional Bank Credit Composition in 2005-2014 (In Trillion Rupiah)



Source **:** Statistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Figure 3. 16 The Islamic Bank Credit Composition in 2005-2014 (In Trillion Rupiah)



Source **:** Statistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Table 3.9 presents comparison of the rates for the types of financing conducted by the Indonesian conventional and the Islamic banks for the period 2005-2014. As shown, in the Table 2.17, we conclude that in terms of working capital and investment financing obviously that the Islamic banks charged relatively higher rates in comparison with the conventional banks. However, in terms of consumption financing, the Islamic banks offered a lower rate for their customers. Thus, it seems that Islamic banks are still keeping their competitive edge only in the consumption segments.

Table 3. 9 Comparison of Rates for Types of Financing Conducted by the Indonesian Conventional and the Islamic Banks for the Period of 2005-2014

Type of Financing	2008	2009	2010	2011	2012	2013	2014
Working Capital:							
Conventional Bank-Working Capital rate	14.6	13.3	12.4	12.0	11.5	12.1	12.8
Islamic Bank-Working Capital rate	19.3	17.2	17.0	15.7	14.6	13.7	18.3
Investment:							
Conventional Bank-Investment rate	14.0	12.6	11.9	11.7	11.3	11.8	12.4
Islamic Bank-Investment rate	18.0	14.2	14.8	14.7	14.4	13.3	15.4
Consumption:							
Conventional Bank-Consumption rate	15.8	15.8	13.8	13.4	13.6	13.1	13.6
Islamic Bank-Consumption rate	14.3	11.4	10.5	10.0	10.7	11.2	11.9

Source : **S**tatistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

As office network and infrastructure outreach of the banks are crucial for the banking business, we discuss this issue on Islamic banking development in Indonesia. As of 31 December 2014, pertaining the institutional and office networks infrastructure development, the Islamic banking industry has recorded 12 Islamic banks (full fledge) (*BUS/Bank Umum Syariah),* 22 Islamic banks have division (*UUS/Unit Usaha Syariah*), and with total office network, reached 2,471 branch offices throughout Indonesia (*Bank Indonesia*, 2015) (See Table 3.10 below).

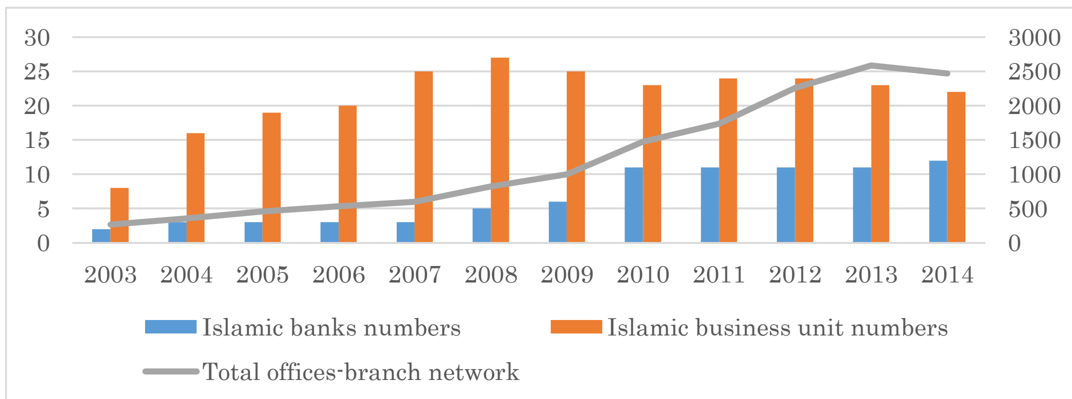
Table 3. 10 Number of Islamic Banks, Islamic Banks Division, and Office Networks in Indonesia

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Islamic banks numbers	2	3	3	3	3	5	6	11	11	11	11	12
Islamic business unit numbers	8	16	19	20	25	27	25	23	24	24	23	22
Total offices-branch network	265	355	458	531	597	822	998	1477	1737	2262	2588	2471

Source **:** **S**tatistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

However, from the aggregate view, as shown in Figure 3.17 below, we underline that the growth of the institutional and office networks infrastructure development for Islamic banks in Indonesia is experiencing a stagnancy phase during the period 2012-2014. For instance, at the end of 2014, total office networks of the Islamic banks is only about 12% of total owned by the conventional banks (total office networks of the conventional banks is 19,948 offices). Thus, it is an obvious presumption that the Indonesia's Islamic banks have a limited outreach to reach the potential bank's customers and left behind of the conventional banks in terms of networks infrastructure development.

Figure 3. 17 Growth Numbers of the Islamic Banks, Islamic Business Unit/Division, and Office Networks in Indonesia



Source **:** **S**tatistics of the Indonesia's Islamic bank (*Bank Indonesia*, various years), constructed by author.

Based on the findings that have been discussed above, we highlight some recent performance of the Indonesia's Islamic banking.

Firstly, we acknowledge the high growth during the early development the Indonesia's Islamic banking since the first establishment of the Islamic bank in 1992. However, it is useful to note that the phenomena of the extraordinarily low level of Islamic financial deepening and slow pace of growth of the Indonesia's Islamic banking have occurred. In terms of market share, it is noticeable that market share of Indonesia Islamic banks has been stagnant of only about 3-5 % of the total market share in the Indonesia banking industry during the period 2011-2014. Moreover, entering in the first decade of the 2000s, especially in the periods of 2005 to 2014, the slow pace of growth of the Indonesia's Islamic bank was obvious (*Bank Indonesia*, 2015; FSA, 2015). Moreover, we underline that in terms of the market share and the network infrastructure growths, Islamic banks failed to achieve further market penetration during the period 2010-2014.

Secondly, our discussion on the current performance of the Indonesia's Islamic banks has shown that overall financial performance indicators of the Islamic banks are lower than the conventional banks during the period of 2005-2014. Obviously, these findings revealed that the Indonesia's Islamic banks have a lower profitability performance and a deteriorating trend of financial performance indicator in comparison with the conventional banks during the period 2005-2014.

Thirdly, besides having a gloomy trend in key financial indicators, the Islamic banks have faced a structural dilemma of funding and financing their activities. Evidently that the Indonesia's Islamic banks have relatively a higher cost of funding since the Islamic banks were relying more on time deposit account as the source of

deposit fund by offering a higher rate of return in comparison to the conventional banks. On the other hand, as the consequence of the higher cost funding situation, the Islamic banks seemingly have no opportunity except to disburse the funds into the financing products that can generate a higher return and mostly short tenor for their customers through the consumption segment financing. Moreover, under the condition of a limited fund collected and lower banking capability, it caused the Islamic banks hesitated to take the corporate risk financing. In addition, we note that as the Islamic banks have a lower level of commercial bank based business activity (BUKU) classification and Capital Adequacy Regulation (CAR) in comparison with the conventional banks, consequently it constrained to the Islamic banks' capacity of engaging corporate sector financing, infrastructure projects, and high-end business in which usually will be capital based intensive banking business.

Accordingly, the deteriorating financial performance indicators show that the Indonesia's Islamic banks have insufficient profit to develop their business. In this regard, we admit that an adequate profit level is important for the banking business. Thus the worst current performance of the Islamic banks in Indonesia has proved that there is less incentive for the Islamic banks in expanding their business and accelerate their growth in the banking industry.

3.4 Summary

Islamic banking in Indonesia shows a remarkable performance in the last two decades. However, it is worth noting, that after three decades of development of Indonesia Islamic banks, the Islamic banks still occupy only a small market share in the national banking industry.

It should be a concern for all stakeholders of the Indonesia's banking industry

that the phenomena of the extraordinarily low level of Islamic financial deepening and slow paced growth of the Indonesia's Islamic banking. Furthermore, our discussion throughout this chapter has exposed that a lower profitability performance and a deteriorating trend of the financial performance indicator of the Indonesia's Islamic banks in comparison with the conventional banks during the period 2005-2014.

Moreover, we acknowledge that the deteriorating financial performance indicators of the Indonesia's Islamic banks is becoming self-evident. The Indonesia's Islamic banking has experienced inadequate profit earning to develop their business. As an adequate profit level is important for the banking business, the worsening performance of Islamic banks in Indonesia has proved that there is less incentive for expanding their business and accelerate their growth in the banking industry.

In conclusion, the phenomena of extraordinarily low level of Islamic financial deepening and slow pace of growth should be a concern for all stakeholders of the Indonesian banking industry. The extent of support by the regulatory framework, revamping market structure which provides sufficient incentive mechanisms for market players, improving competitiveness and efficiency, will maintain the sustainability and future development of Islamic banks in Indonesia.

CHAPTER 4
THEORETICAL BACKGROUND AND REVIEW OF RELATED LITERATURE

4.1 Introduction

The phenomena of the extraordinarily low rate of Islamic financial deepening and the recent trend of slow-paced growth of Indonesia's Islamic banking is becoming an essential topic to be elaborated in finance and banking.It will contribute empirical findings in developing the Islamic banking in Indonesia. These are crucial objectives to be analyzed as research findings show a relatively different trend for global Islamic finance and banking which has experienced rapid expansion with a vigorous performance.

In this regard, our discussion throughout Chapter 3 has presented findings which revealed a lower profitability performance and a deteriorating trend in the financial performance indicators of Islamic banks in comparison with conventional banks during the period 2005-2014. Moreover, we acknowledged that the deteriorating financial performance indicators of Islamic banks is becoming self-evident in showing that the Indonesia's Islamic banks have experienced inadequate profit earnings.

For the purpose of this analysis a theoretical framework underpinning the issues is required as a basic requirement for presenting the research discussion, an analytical tool for the research findings, and finally delivering the research conclusion.

While acknowledging that several approaches have been attempted to explain the extraordinarily low development of Islamic financial deepening and the recent trend of slow-pace growth of Islamic banking in Indonesia (Kasri & Kasim 2009; Lindsey, 2012; Sari, Bahari & Hamad 2016), we perceive that the existing arguments in the literature do not sufficiently shed analytical light on the "incentive" and "threat" in the credit risk management and banking operation by Indonesia's Islamic banks. As such, in order to provide a theoretical framework underpinning the issues and analytical tools for the research questions, we intend to borrow the traditions of Institutional Economics (IE) which are concerned about the mechanisms of incentive and threat to the economic players. Under this presumption, economic institutions would be the determinant for development and economic efficiency. In particular, we use the theoretical framework of "financial sector rent" (bank rent) to justify the creation of "rent (surplus) opportunity" to be captured by banks as the incentive of making them become prudent fund providers (Suzuki & Uddin, 2014; Suzuki; 2011; Khan, 2000; Hellmann, Murdock, and Stiglitz, 1997).

Thus, it is a challenge to adopt the financial restraint model in order to examine the hypothesis that Indonesia's Islamic banks fail to earn adequate profits to maintain the franchise value. According to the theory, insufficient rent opportunity could have been the cause of the occurrence of the phenomena of extraordinarily low Islamic financial deepening and the recent trend of slow-paced growth of the Indonesia's Islamic banking.

This chapter aims to discuss the theoretical background on the issues that contribute to a better understanding of the phenomenon of the extraordinarily low

Islamic financial deepening and the recent trend of slow-paced growth of Islamic banking in Indonesia. The rest of the chapter will be organized as follows: Section 4.2 will introduce the theoretical underpinnings associated with the bank rent approach. Discussion of the bank rent theory will shed light on financial restraint framework for understanding the mechanisms of banks as financial institution performing such functions as capital lenders and monitoring the credit channeled in the financial market. Next, the discussion will highlight the complex interrelationship between the role of bank rent, which is to create incentives for individual banks to operate as long-run agents that aim to monitor borrowers effectively. A comprehensive understanding of the bank rent theory is expected to be a theoretical argument about the importance of government and financial authority to provide the banking industry with an adequate incentive (including rent opportunity) for ensuring their role in attaining financial deepening. In section 4.3, we focus on the new conceptualization of Islamic bank rent perspective as introduced by Suzuki and Uddin (2014) to analyze the existing pattern of financing of Islamic banks and as a lens of analysis to the performance of Islamic banking development. Section 3.4 of this chapter will review the role of the rent effect as a mechanism to explain how the banking industry should be able to earn sufficient profits while maintaining the franchise value and reputation in order to maintain their profitability performance. In addition, we also review the discussion of underlying causes on market concentration and bank‘s competition and efficiency levels in the literature. Finally, Section 4.5 summarizes major contribution the chapter’s.

4.2 The Bank Rent Theory

Intrinsically, the financial market is perceived to have a different character in comparison to the commodity market. Firstly, we realized that the market mechanism is inattentive to clear imbalances in the financial market. Thus, this condition impulses for a special attention of the smoothing of financial market functions (Stiglitz, 1994). Secondly, it is recognized that the transactions in the financial market between debtors and creditors obviously contain a substantial degree of information asymmetry and imperfection of market mechanism (Aoki, 1994; Suzuki, 2011).

This imperfect condition of financial market has been highlighted in many studies that have examined the market mechanisms that govern it. Among others, Stiglitz and Weiss`s (1981) initial study has raised critical analysis on this topic. They argue that market failure is unavoidable in the financial market embedded with a substantial degree of information asymmetry. Thus it is impossible to clear imbalances using market mechanisms in the credit market. Subsequently, the imperfection of credit market is considered the main obstacle to attaining an efficient financial resource allocation particularly in developing economies with serious asymmetry of information among the players.

Recognizing that market mechanisms do not apply effectively in the financial market which is naturally imbalanced (Stiglitz, 1994; Wanniarachchige, 2017), we can consider implementing incentive based approach in the financial industry (Wanniarachchige, 2017). In this context, incentive based approach will rely on self-enforcement of market players with appropriate incentive mechanisms in the financial industry. From a public policy perspective, preparing policies and

regulations based on the incentive approach will be carried out with consideration of the changes affecting "the cost and benefit" faced by regulated entities. In this manner, the purpose is aimed to encourage responses to the incentives provided to the parties for the desired behavior set by the regulator (Mankiw, 2009). In this approach, the regulator does not necessarily force the entity to follow the desired behavior of the regulator, but the regulator offers a particular benefit if the regulated entity follows the desired behaviour. In other words, regulator directs the entity's behavior towards the desired behavior by creating the conditions in which the choices on undesirable behavior becomes more expensive or inefficient.

Nevertheless, it is worth noting that the financial intermediary function played by the banking institution faces a substantial degree of information asymmetry and market imperfection which can further lead to adverse selection (*ex-ante*), coordination (interim), and moral hazard (*ex-post)* problems in the financial market (Aoki, 1994).

Accordingly, we should underline that there are at least three crucial problems which will arise as a result of asymmetric information and imperfection of the financial market (Aoki, 1994; Suzuki & Adhikary, 2009; Suzuki, 2011):

1. The existence of asymmetric information between regulators and companies, where regulators have less information than companies, will cause adverse selection problem;
2. The occurrence of collusive behavior among the regulated entity or with the regulator as free rider action to gain advantages of the loop hole in the regulation, may cause coordination problem; and
3. The creation of opportunistic behavior for the regulated entity to pay less

attention to the compliance of regulations since their behavior is not fully observed by the regulator. This is termed as moral hazard problem.

Moreover, from the perspective of the principal agent theory, we can highlight the absence of information asymmetry and imperfect information inherent in the relationship between the shareholders of the bank (principal) and the bank manager (agent) in the banking business. As the consequence of ownership separation and control of contemporary firm`s proprietorship settlement, it makes sense, as the shareholders of the bank (principal) do not directly run the bank business, but merely delegate authority and rely on the function of the manager (agent) in monitoring the process of the bank operation. Therefore, under the situation that information is costly in conducting this monitoring effort. Appropriate incentive mechanisms should be provided to encourage the managers to conduct their performance well (Suzuki, 2011).

Alchian and Demsetz (1972) admit that this situation raises a prevailing “residual claimant” outcome. In which, inherently incentive mechanisms will exist at the rights of the shareholders‘ monitoring function on the manager performance in order to get an optimum residual claimant through pursuing higher dividend payment. Suzuki (2011) admits that such a condition of residual claimant is an explanation for justification of Alchian and Demsetz (1972) to bring the capitalist firm model as a solution to overcome the 'shirking problem'. By this, the involved parties in such business contracts will tend to have shirking behavior when moral hazard problem is accompanying the situation of asymmetric information in a business environment. Offering a significant incentive for the parties could be perceived as the solution in this circumstance.

This situation confirms Stiglitz's (1994) description of information economics analysis in understanding the market failure in the financial market with information asymmetry condition. With consideration that in conducting financial intermediary function, the bank will perform its main activities to accomplish assessment and monitoring of loans. Therefore, this function should be equipped with considerable information input.

Suzuki (2011) concludes that from the perspective of institutional economics, incentive approach becomes imperative as it will provide a proper incentive for banks to have qualified management and realize the optimum allocation of funds in the financial market. In other words, it is arguable that the bank should receive a sufficient "rent" in terms of surplus in running their business. Bank rent theory became a new analytical tool in economics and finance employing the institutional economics approach in elaborating the important role of the bank as a financial intermediary institution performing monitoring in delivering credit (Khan, 2000; Suzuki & Adhikary, 2009; Suzuki, 2011; Wanniarachchige, 2017, Suzuki, Miah, and Wanniarachchige, 2017).

Therefore, as pointed by Hellmann et al. (1997) the availability of adequate rent (surplus) opportunity is considered as an effective way for the well-functioning of the financial market. Given that market mechanism is absent as an instrument in clearing imbalances in the financial market adequate rent (surplus) opportunity can be put forward as one important aspect to accomplish an effective financial market function.

In a broad sense Khan (2000, p. 21) defines “rent” as follows:

“*More precisely, a person gets a rent if he or she earns an income higher than the minimum that the person would have accepted, the minimum being usually defined as the income in his or her next-best opportunity*”

As a result, the "bank rent" opportunity in the banking industry is considered as a tool to give bank managers the incentives to maintain 'franchise values' necessary to keep the bank's long term performance. The terminology of franchise value as defined by Demsetz et al. (1996, p. 2) as “*the present value of the future profits that a firm is expected to earn as a going concern.”* Thus, in this sense, the franchise value becomes an important element as 'the cost' of ensuring the bank's management to provide good management assurance (Hellmann, Murdock, and Stiglitz, 1997; Suzuki, 2011, p. 24).

Acknowledging that availability of adequate rent opportunity in the banking market will create incentives for the banks to carry out prudential banking business in maintaining their future income stream, Suzuki and Adhikary (2009) admit that a sufficient incentive becomes an essential factor for the banking industry in three aspects. First, creation of franchise value is the important element in ensuring that the bank managers conduct their obligations to the banking operation. As the long term agents, they need to perform prudent banking operation, and ensure the availability of advanced capability in monitoring their credit portfolio. Second, avoiding the collusive behaviour in banking financial intermediary operation. This in turn will affect positively in increasing profit earnings of the banks. Finally, this conducive business environment will support improving the financial deepening as

the banks will have more enthusiasm in expanding their branch networks, collecting deposits, maintaining proper screening and monitoring of their credits, and eventually increase the resilience of the banking and financial system in the economy.

In conclusion, adequate rent opportunity in the financial market will provide necessary incentives for the banking sector to encourage banks to implement prudent business practices. Hence, in pursuing longer term business objectives, the bank manager will manage a sustainable business profit as their main motivation in responding to bank rent opportunities through optimizing accessible incentives. The manager need to implement sound business practices in order to maintain the banks' franchise value for the customers. From the perspective of the 'bank rent' framework, it is worth to emphasis that the availability of adequate bank rent in the banking industry will contribute to preventing the occurrence of moral hazard (especially collusive behavior and adverse selection). This improves the behavior of the bank manager within the bank and in banking relationships with bank customers. As a direct result of the application of sound business within the bank the financial performance and returns to the bank will increase. The ability to generate profit and capital accumulation in the long run, in turn, will make the bank to expand its operational expansion through the opening of new branches, strengthening the banking infrastructure and investment in new technology. Furthermore, adequate incentive in the financial markets will create a sound banking system, encourage the rapid growth of the banking industry, which in turn will help increase financial deepening in the economy (Hellmann, Murdock, and Stiglitz, 1997; Suzuki & Adhikary, 2009; Suzuki, 2011; Wanniarachchige, 2017).

Unfortunately, the necessary condition above is not always created in financial industry in various countries, thus it becomes crucial for the financial regulator to create sufficient bank rent opportunities as an incentive to strengthen the financial system.

Nevertheless, we underline the important notion of Stiglitz and Weiss' model (1981) that the credits in the financial market are intrinsically rationed due to asymmetric information problems. Their argumentation is that the banks cannot perform the selection process of the right borrowers ex-ante and monitor the behaviour of borrowers ex-post perfectly and without costs. In other words, this conclusion proves that the price mechanism does not clear the excess demand for funds. Hellmann, et al. (1997) expand this theory by introducing the financial restraint model. The financial restraint model puts in place such robust assumption that the government can intervene market player interactions in the credit market. This model, helps the government in focusing on the effort of rent creation opportunities for the banks. By this extra income of rent opportunities, banks will be encouraged to manage the information cost and perform loan monitoring effectively (Wanniarachchige, 2017).

Accordingly, the government through its' financial authority can intervene in the banking sector by implementing a number of policy and supervisory instruments in order to provide adequate incentives in the market. For instance, controlling and targeting policy on the inflation rate will make the bank acquire the real positive margin spread as favourable rent. In addition, by regulating the deposit interest rate, banks will have adequate possibility to capture rents. Consequently, adequate rents will encourage banks to improve their expertise in monitoring and intermediary

capacity of loans to borrowers, thus enhancing the efficiency of financial resources allocation (Suzuki & Adhikary, 2009).

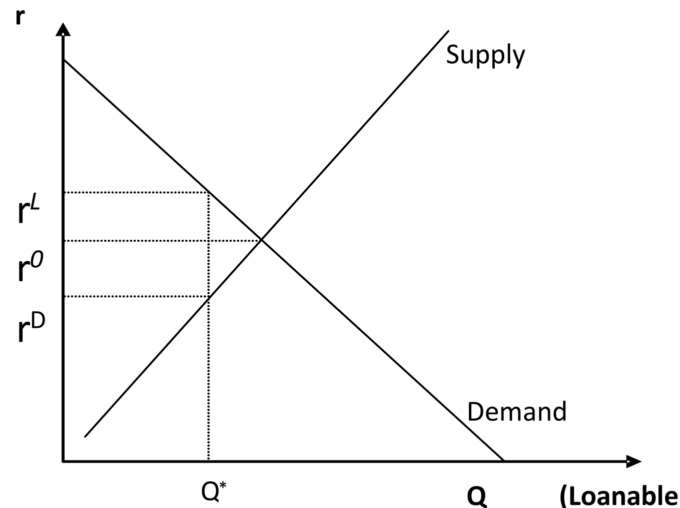
In this sense, financial restraint model becomes a market enhancement tool used by governments through regulatory incentive policies in the financial industry (Hellmann, Murdock, and Stiglitz, 1997; Stiglitz and Weiss, 1981, Suzuki & Adhikary, 2009; Wanniarachchige, 2012, Suzuki, Miah, and Wanniarachchige, 2017). In this regard, the government sector will have a mutual symbiosis with the private sector in a complementary function. Such common instruments could be applied in the financial restraint policy, i.e. deposit rate ceiling, entry barriers in the financial industry, and control of the lending rate of the bank.

We will now describe an illustration of the financial restrain credit policy in a market equilibrium. Firstly, under financial restraint framework (Hellmann, Murdock, and Stiglitz, 1997), the economic actors and their roles are as follows: the household sector supplies funds, the corporate sector is a user of funds, and banks act as financial intermediaries. Furthermore, as shown in Figure 3.1, an equilibrium point is reached at the intersection point of the supply curve of household funds and demand curve of corporate funds at interest rate ***r0***. If then the government intends to engage such financial market intervention, for instance by issuing a series of regulations on the deposit rate of interest, the policy will bring expected impact for the banks, as the financial intermediaries can capture rents. Accordingly, the regulated deposit rate will be at ***rD***, so the new lending rate will be ***rL***. As shown, the shaded area in Figure 3.1, shows the gap that arises between the regulated deposit rate (***rD***) and the market lending rate (***rL***) is the source of the bank rent. It is important to note that, as explained by Khan (2000, p. 58), the rent

will continue to be available for banks, only if the banks' portfolio of assets and liabilities is proper in maintaining to protect the portfolio to remain solvent.

Suzuki (2011) underlines the essential notion of the financial restraint policy implementation. First, the elasticity in the interaction of supply and demand funds in the above model is very low. Although the savings may respond favourably to higher interest rates, this will not have a significant impact. Second, the financial restraint model assumes that the amount of savings depends on the available infrastructure for deposit collection, in particular on the extent of the bank's branch network and the efficiency of services-provided to the customers. Thirdly, by increasing the returns through intermediation, banks have strong incentives to increase their own deposit bases. Thereby, the model considers the possibility that the "rent effect" on savings is enormous as reasons for greater deposit security and/or increased investments in improving the deposit infrastructure and facilitating access to the formal financial sector. Finally, if this scenario is running effectively, under the condition that the rent effect is large relative to the interest-elasticity of savings, then it is possible that the total volume of funds intermediated through the formal financial sector will be larger under the financial restraint policy compared to the case under free market regulation. Clearly, this will be reflected in the shifting of the supply curve of funds to rightward ain Figure 4.1

Figure 4. 1 Financial Sector Rents as Incentives for Portfolio Monitoring



Source: Suzuki and Adhikary (2009, p. 7)

Noticeably, in the contemporary policymakers concerns, the financial restraint model has contributed to the banking system development, as it endorses a strong foundation for providing adequate bank rent opportunities in terms of interest spread as reliable incentives for the banks in enhancing financial development (Hellmann, Murdock, and Stiglitz, 1997; Wanniarachchige, 2017).

It is worth noting, with regard to shedding light on the phenomena of the extraordinarily low deepening Islamic finance and the recent trend of slow-paced growth of Indonesia's Islamic banking, that our discussion throughout Chapter 2 has presented the findings which revealed a lower profitability performance and a deteriorating trend of the financial performance indicator of the Indonesia's Islamic banks in comparison with the conventional banks during the period 2005-2014. Moreover, we acknowledge that the deteriorating financial performance indicators of Indonesia's Islamic banks noticeably is becoming a self-evidence that the Islamic banks have experienced insufficient profit earning to develop their business. These

findings obviously ascertain that the recently worsening performance of the Islamic banks in Indonesia has proved that there is less incentive for them in expanding their business and accelerate their growth in the banking industry. Accordingly, we can expand the hypothesis that Indonesia's Islamic banks are not given adequate bank rent opportunity in the financial market which prevents them from further developing their branch networks and investing in banking infrastructure.

This research intends to adopt the financial restraint model introduced by Hellman, et al. (1997) in order to examine the hypothesis that Indonesia's Islamic banks fail to earn enough profits to maintain their franchise value. We hypothesize that this insufficient rent opportunity may have been the root cause for the occurrence of the extraordinarily low Islamic financial deepening and the recent trend of slow-paced growth of the Indonesia's Islamic banking.

4.3 A Need for the Islamic Bank Rent Theory Perspective

Several approaches have attempted to explain the phenomena of the extraordinarily low Islamic financial deepening and the recent trend of slow-paced growth of the Indonesia's Islamic banking. Some studies are concerned about the proportionality (positive correlation) between economic growth and financial deepening (Sastrosuwito 2012; Abduh & Omar 2012). In general, Abduh and Omar (2012) admit that studies to examine the nexus of financial development upon economic growth propose at least three directions, which are (1) finance drives growth or "supply-leading" view; (2) growth drives finance or "demand-following" view; and (3) bi-directional. Acknowledging that their study is limited in the context of the Islamic bank, Abduh and Omar (2012) conducted a study to examine the

correlation in the short term and the long term between Islamic banking development and economic growth in Indonesia. Their research proves that the development of Islamic bank has a positive and significant correlation with economic growth and capital accumulation in the long run and with typical of bi-directional relation. Abduh and Omar (2012) admit that there is strong evidence that Islamic banking has contributed to the economic growth, and in the reverse direction that the economic growth is a factor that determines the development of Islamic banking itself.

On the other hand, in the context of the Islamic bank specifics, we acknowledge that the bank's customer preference and saving behaviour is a factor that can determine the Islamic bank development. Kasri and Kasim (2009) have observed the Islamic banks' customer behaviour in Indonesia. In their research, they try to elaborate the real rate of return on Islamic deposit, the interest rate on conventional deposits, the real income and the number of Islamic bank branches as the factors which have influences at the level of savings in the Islamic banks.

Kasri and Kasim (2009) show that the conventional interest rate is the influential factor on the level of savings of Islamic bank. The research finding proves that the level of Islamic bank deposit positively correlates with the rate of return and negatively with interest rate. In addition, Kasri and Kasim (2009) assert the situation of displaced commercial risk existing between the Islamic and conventional banks, in which the Islamic banks' depositors moved their funds to the conventional banks when the rate of return by Islamic banks is significantly lower than conventional bank's rate of interest. This typical depositor explains the specific segment of customers namely “rational Muslim depositors behaviour" (Kasri and

Kasim, 2009). Accordingly, Kasri and Kasim (2009) raise an important finding that should be the concern of financial authorities and the Islamic bank. Initiatives that predominantly aim to co-opt the Muslim community as their potential customers merely using the excellence of *Shariah* compliance matter (Lindsey, 2012) will not be an effective business strategy to grab the market as the Muslim's preference in choosing the Islamic banking services will be laid on the "rational Muslim depositors behaviour"

Kasri and Kasim's (2009) argument is interesting to observe as it explains the potential occurrence of displacement commercial risk (DCR) of Islamic banks in Indonesia causing a pragmatic customer behavior. However, their research findings cannot fully explain the extraordinarily low level of Islamic financial deepening in Indonesia, partly because Indonesia's Islamic banks may have attracted their depositors by maintaining a competitive level with conventional banks' offering rate.

Meanwhile, studies conducted by Febrian (2008) and Zubair (2008) have focused on the role of regulation aspects, products innovation, and public awareness of the Islamic banking services as the key factors in fostering the growth of Islamic banks in Indonesia. A study on similar issues also has been conducted by Sari, Bahari, and Hamad (2016). They admit that factors such as a lack of trust among consumers and overall consumer misunderstanding of Islamic banking, and public awareness are responsible for the gaps in the growth of the Indonesia's Islamic banking industry. In addition, Ismal (2015) conducted a study using econometric models to assess the growth Islamic banking industry by employing the Autoregressive Integrated Moving Average (ARIMA) model. Using this econometric tools, Ismal (2015) assesses the projection target of the Islamic

banking growth in the future and estimates the period when the target is going to be attained. Based on this projection modeling, the Indonesia's Islamic banking is forecast to achieve 5 percent of market share by 2013 with a 91.6 percent probability of occurrence. In fact, this estimation was not realized. In this sense, Ismal (2015) has emphasized his conclusion that this successful of the Islamic bank development programs should be supported by a strong commitment and involvement of all stakeholders of Islamic banking industry and the readiness of favourable economic conditions.

However, taking into consideration the reality in which the conventional banks have been constantly expanding their business under the same economic environment, this approach does not sufficiently explain the reason behind the extraordinarily low level of Islamic financial deepening. Some scholars point out that Indonesia's Islamic banks are still "infant", resulting in a failure of installing sufficient confidence and trust in Islamic banking to compete with conventional banks (Sari, Bahari & Hamad, 2016). This leads to higher "displacement risk" exposure of Islamic banks rather than conventional banks (Kasri & Kasim, 2009). However, these approaches do not sufficiently explain how Indonesia's Islamic banks are still infant. Moreover, these approaches do not sufficiently explain what caused the recent trend of slow-paced Islamic financial deepening.

On the other hand, Lai (2014) attempts to justify the Malaysian governmental initiative of incubating "infant" Islamic banks under a protective financial architecture in order to strengthen Malaysia's position as a key player in the international financial hub. However, this argument does not sufficiently address how to measure the economic benefit of the protective financial architecture and

does not clearly mention the duration of the protection period.

Given the above arguments, it appears that the Islamic banking industry will benefit by using the theoretical framework of "financial sector rent" (bank rent) to justify the creation of "rent (surplus) opportunity" to be captured by banks as the incentive for making them become prudent fund providers (Hellman, Murdock & Stiglitz, 1997; Khan, 2000; Suzuki, 2011; Suzuki & Uddin 2013).

Therefore, we propose to include the perspective of New Institutional Economics (NIE) to analyse the growth in the financial sector and its economic interactions involved among stakeholders. This perspective of the economic institution will refer to “rules that constrain economic activities and behaviors”. This approach aims to shed light on the incentive mechanism in the financial market. For that reason, reearchers employ this approach in analyzing the economic players in the financial industry (Stiglitz and Weiss, 1981; Hellman, Murdock & Stiglitz, 1997; Khan, 2000), Suzuki and Adhikary, 2009, and Suzuki, 2011).

Suzuki (2011), for example, presents a critical observation from an institutional perspective to explain the transition failure process in Japan’s banking system. This study sheds light on an institutional setting process within the framework of internalization and financialization in the financial sector in Japan, which has created ineffective monitoring of credit system and supervision mechanism in the banking sector. Conclusively, this absence of adequate alternative incentive for the market player has caused the occurrence of a prolonged financial and economic slump in the Japanese economy during the1990-2000 period. Another interesting study by Suzuki and Adhikary (2009), portrays the development of the banking system in Bangladesh from the perspective of 'bank

rent' as an institutional approach. Using the bank rent approach, this study implements the financial restraint model (Hellman et al., 1997) in explaining patterns of economic interactions between the financial institutions and the government (regulator) to create a favorable condition of 'rent opportunities'.

The NIE approach in Islamic economic studies has lately received attention from some scholars. Although such studies are limited, we can refer to studies conducted by Barbara (2006); Grais (2008); Haneef and Furqani (2009), Mirakhor (2009), Asad (2011), Farook and Farooq , (2011), Ahmed (2012), and Haneef and Mirakhor (2014).

Mirakhor (2009) can be seen as the initial valuable reference in discussing the strong correlation between Islamic economics paradigm and NIE's approach. He asserts that Islam as a religion prescribes "rules of behavior (institution)" in order to manage economic relations among human beings. Therefore, Mirakhor (2009, p. 32) defines Islamic economics as a discipline regarding:

> *" ... (a) the rules of behaviour (institutions) prescribed by as they relate to resource allocation, production and exchange, distribution, and redistribution; (b) economics of implication, the operations of these rules and policy recommendations for achieving rules compliance that would allow convergence of the actual economy to the ideal economic system envisioned by Islam..."*

Ahmed (2012) explicitly proposes the idea to adopt the NIE approach in the process of the Islamization of economics. He indicates that as a result of ignoring the institutional aspects of the Islamic economics discipline towards a comprehensive economy system can raise "rent seeking" and "opportunism" behaviour which distort the economic activities from the realization of the genuine

Islamic economics objective. He concludes that without the establishment of formal and informal rules and organization in accordance with Islamic principles, it is impossible to attain the ideal Islamic economic goals.

Therefore, Ahmed (2012) recommends that the process of transformation of Islamic economics should include four important factors in institutional economics, namely culture, institutions, organization and market/transactions in conducting economic analysis and policies. However, it is a stance taken by this research in using positive economic theory in which to concentrate on observing the phenomenon of Islamic banking development on the basis of facts and analysis in term of "formal" rules such as banking regulations of setting up the bank rent framework.

Meanwhile, Grais (2008) emphasizes the importance of setting up the regulatory and institutional frameworks appropriately in supporting the impressive growth of Islamic finance worldwide. He argues that policy and institutional challenges faced by the current development of Islamic bank include the preparation of a clear legal and regulatory framework, adequate availability of market information, and, an enabling broad institutional infrastructure (Grais, 2008, p. 22).

In this sense, related to the phenomenon of Islamic banks slow pace of growth in Indonesia, it is reasonable to borrow Suzuki's approach (2011) based on three fundamental reasoning as follow:

1. Referring to the traditions of the Post-Keynesian economics, in which it is strongly assumed that in the financial industry circumstance there is a monitoring process (between governments as regulators and banks as lenders).

All actors in this monitoring process are believed to be “working under conditions of uncertainty and bounded rationality” (Suzuki, 2011, p. 7).

2. Institutional approach is needed in analyzing the behavior of economic actors in an Islamic economic system. The interaction between banks as business organizations and policies taken by the government as the financial regulator will be optimal if the Islamic economic principles are included as institutional framework that should be considered when formulating rules and transactions between economic actors in the economy.

3. From this point of view, the analysis of the phenomena in Islamic bank practices in an Islamic economy will have benefits from the theoretical contribution of the New Institutional Economics (NIE) and transaction cost economics. In this context, institutional settings can be accommodated as a formal institution (policy, regulation) and the intangible institution in the Muslim society (belief in the Islamic faith, compliance to *Shari'ah* principles, etc.) inherently in the economy (Suzuki, 2011).

An interesting approach is introduced by Suzuki and Uddin (2014) to analyze incentive mechanisms and the role of financial rents in Islamic banking business operation. Suzuki and Uddin (2014) propose a fairly new concept of "Islamic bank rent" as an institutional approach to analyze the phenomena that occur on Islamic banks economic behavior in monitoring rents and generate income to preserve its franchise value. Here, Suzuki and Uddin (2014, pp. 6-7) define "Islamic bank rent" as:

“ ...the extra profits enough to compensate for the unexpected loss and the

displaced commercial risk to which Islamic banks are facing; in other words, as the excess profits required for maintaining their franchise value and reputation as prudent Shari'ah-compliant lenders…"

Accordingly, Suzuki and Uddin (2014) propose that the term "Islamic bank rent", denoted by "α" in the following equation.

Spread earned by Islamic banks = (risk-adjusted) risk premium + α

where *spread = rate of profit received – rate of profit paid*

Obviously, in this equation, the risk-adjusted risk premium is formulated similarly for both conventional and Islamic banks. It is recognized that the business model of the banking business face uncertainty in financial market, thus it is almost impossible to increase the bank's skill and capability skills in the short run. This makes sense accordingly that the banks will pursue the maximum effort to mitigate this un-measurable risk. It is worth to note that the financing modes practiced by the Islamic banks face problematic risks such as the potential of unexpected loss under the profit-and-loss sharing financial contracts. Besides, the Islamic banks are also being challenged by the occurrence of the displaced commercial risk which is associated with the possibility of withdrawal of funds by depositors due to higher loss in Islamic banks as compared to their conventional counterparts.

Thus, it is arguable that Islamic banks need to earn an extra profit to maintain their franchise value as prudent *Shari'ah*-compliant lenders due to the existence of unique characteristic of the Islamic bank business operation, especially related to the profit-and-loss sharing risk and the displaced commercial risk. In this context, Suzuki and Uddin (2014) explain that as Islamic banks are also exposed to the general uncertainty, so the Islamic banks must charge the risk-adjusted risk

premium covering the measurable risk plus accompanying uncertainty as commonly charged by the conventional banks. Accordingly, they define "α" as "Islamic bank rent" in terms of the extra profits to compensate the profit-and-loss sharing risk and the transaction cost for the *Shariah* compliance in order to maintain the franchise value as a prudent financial provider. Hence, this additional risk premium to cover the uncertainty plus "α" in the equation is perceived as Islamic bank rent in a comprehensive view. Moreover, it can be hypothesized that the spread margin earned by Islamic banks should be higher than that generated by conventional banks. In addition, Suzuki and Uddin (2014) emphasise that in the current financing practice of the Islamic banks, the banks have preference to select low-risk assets for their portfolio so far as the risk-adjusted return is still satisfactory under the asset-based financing modes dominantly using *Murabaha* contract, as they perceive that the asset-based financing modes contributes better in protecting their rents in comparison with fully *Shariah*-based financing modes under *mudaraba* and *musharaka* contracts.

Basically, from *Shariah* perspective there is no legal standing which define and restrict the rate of profit should be determined in a business transaction. Normatively, *Shariah* principle urges a guidance in economic transactions between two parties or more should be based on the consent of the parties involved. (Holy Quran 4:29 "…d*o not consume one another's wealth unjustly but only [in lawful] business by mutual consent…*")

In this regard, the *fatwa* issued by the Resolutions and Recommendation of the Council of the Islamic Fiqh Academy in State of Kuwait on 10-15 December 1988 (IDB & IFA : 2000, p. 93) explicitly stated:

> *"There is no restriction on the percentage of profit which trader may make in his transactions. It generally left to the merchants themselves, the business environment and the nature of the merchant and of the goods. Care should be given, however, to ethics recommended by Shari'a, such as moderation, contention, leniency and indulgence."*

In fact, the values of Islamic business ethics containing in Islamic economics is encouraging the economic activities which aimed for creation of economic welfare in the life of the mankind and also realizing the social and economic justice in the society. Thus, *Shariah* principle provide a foundation that the rent seeking activity could have its legitimacy as long as it based on the consent of the parties involved and also in the frame of Islamic business ethics such as moderation and fairness.

In this perspective, we perceive that the "financial sector rent" (bank rent) can find its justification from Shariah point of view. Since Islamic banking operation is structured based on trade and investment contracts which accordance with Shariah principle, this rent seeking effort is different from Marxist 'rentier' economic model.

Moreover, the basic concept of Islamic economic acknowledges the existence of market mechanism to create justice in the economy. Thus, it makes sense accordingly, Islamic economics could accept that equilibrium price in the market is should left to the market mechanism as long as it can ensure to attain *maslahah* (protection of the public interest) to the society as a whole.

Consequently, it can be understood from the *Shariah* perspective that the way

to control the market price is by analyzing the causes of disequilibrium in the market. In the condition that it is caused by purely the demand and supply factors, then the control mechanism is by intervening the market, i.e. through market operation policy. Conversely, if it is caused by the distortion of market mechanism such as imperfect market or asymmetry information condition then the control mechanism should be taken by removing the distortion causes factors and enforcing price intervention policy (Islahi, 1996; Karim, 2002).

It is interesting to examine further correlation between the availability of financial sector rent and the creation of economic welfare in the economy. In this sense, we can trace at optimistic hope that once exist among economists with the presence of welfare economics as a school of thought in economics discipline in 1930s. This welfare economics is expected to realize economic justice and optimalization of resource utilization as main concern in the economics discourse. Obviously, welfare economics is aimed to make sure that good and service are efficiently allocated in the economy. As consequence, economic resources should be allocated to the people who can gain the maximum utility. This situation is regarded as Pareto optimum, only if no individual can be made better off without giving bad impact to other people.

However, Chapra (2001) criticizes welfare economics on its free value judgement in actualizing economic welfare. His argument is that welfare economics repeats the fault of positive economics theory to limit welfare as merely self-interested preferences of individual and apart from altruism or direct interest on welfare of the whole society.

If we take a look at the important role of financial sector rent, how is the

mechanism of economic welfare creation can be realized? Borrowing the approach of New Institutional Economics (NIE) (Suzuki, Miah, Wanniarachchige, and Uddin, 2017; Khan, 2000); that has a contrary notion of neo-classical free market doctrine, NIE endorse that the market should provide and maintain sufficient rent for the development of financial industry.

Using the pattern of financing carried out by the Islamic banks in Bangladesh, Suzuki and Uddin (2014) prove that the trends in Islamic bank product that is mainly dominated by the *Shariah*-compliant asset-based financing (especially *murabaha*/mark-up contract) actually occur because the Islamic banks have preference to pursue some form of higher 'bank rent' opportunity to maintain its "franchise value" and "reputation" as *Shari'ah*-compliant lenders.

Accordingly, referring to one of the important recommendations of Suzuki and Uddin (2014)'s study, it is imperative to the government (regulator) in providing an appropriate Islamic banking architecture to encourage an efficient competitive climate. In this Islamic financial landscape, monitoring rent opportunity will match with the sufficient incentive mechanisms in ensuring a sound Islamic financial system.

Referring to Suzuki and Uddin (2014) and Suzuki, Uddin, Pramono, and Khan (2017) discussions, we can admit a proposition that Islamic bank rent is an important factor that determines the economic behavior of Islamic banks to perform monitoring rents in Indonesia's Islamic financial industry. Under this situation, the interactions that take place between the government (regulator) and Islamic banks will shape the direction to the extent of the implemented supervisory mechanism. In turn, this will influence the patterns of financial intermediation engaged by

Islamic banks. This mutual interaction will determine the extent to which the level of efficiency and the competitive climate created in the Islamic banking business environment. Furthermore, the individual response of Islamic banks under this circumstance will certainly be cumulative to the aggregate behavior of the Islamic banking industry to construct the direction and performance of Islamic bank in Indonesia.

Accordingly, in adopting the Islamic bank rent approach in analysing the slow growth of Islamic banking development phenomena in Indonesia, presumably, it will contribute to an emerging literature with relatively new perspective in examining current issues of Islamic banking development.

Firstly, from the perspective of institutional economics, we will have a comprehensive overview of Islamic banking industry landscape in Indonesia which is formed by the economic interactions between the government (regulators) and the Islamic bank. This will influence the factors of regulatory framework and unique characteristic of Islamic banks (i.e., the customer preference, *Shari'ah* compliance, etc.).

Secondly, we can elaborate the incentive mechanisms as one of 'bounded rationality' on the economic behaviour of Islamic banks in monitoring rents and developing the financial intermediary function.

Thirdly, through this approach, we can do a study to examine the extent to which the level of efficiency and competitive climate occur in the business environment of Islamic banks.

Nevertheless, many aspects and trade-offs should be evaluated with regard to the development of incentive mechanisms for Islamic banks. A number of crucial

issues need to be considered by the Islamic bank regulator, including the goal setting of developing Islamic bank's capital and market share, the objective to increase the portion of the projects based on profit and loss sharing (PLS) and equity based financing, and the enhancement of Islamic bank's strategic role in supporting Small and Medium Enterprises (SMEs) as the engine of growth in the economy (Siswantoro, 2007).

Meanwhile, the globalization of the financial sector will require forceful harmonization of international banking standards and codes of conduct as best practices. In this sense, the mainstream banking system that was adopted into a global banking standard is the conventional banking system. Thus, a wide variety of international banking standards issued by an international standard setter related to monetary and banking system, such as the Bank for International Settlements (BIS) which issued a framework for banking supervision by using conventional banking mind set.

4.4 Rent Effect and the Islamic Banking Development

Transactional relationships that occur between the borrower and the lender within the framework of the financial intermediary function will be greatly influenced by the information asymmetry and market imperfection that exist in the financial market (Stiglitz and Weiss 1981; Stiglitz 1994; Aoki, 1994; Davis 1995; Suzuki, 2011).

Referring to Aoki (1994), we can divide the monitoring and supervision performed by banks as lenders in three categories according to the timing of the transfer of funds to the borrowers. It consists of, firstly, ex-ante monitoring, as a monitoring that aims to get potential borrowers with a good track record and avoid

bad customers in the market. Essentially, this ex-ante monitoring is a process to diminish problems of adverse selection by screening bad borrowers from accessing the bank's credit, although these customers typically accept higher interest rate borne by the bank. The second one is called interim monitoring. This monitoring process is conducted after the disbursement of the loan to the borrower as an effort to avoid problems of moral hazard conducted by the borrower that could cause misuse or deviation from the purpose of the loan. Thirdly, ex-post monitoring, aims to verify financial results for the borrowers as an indication of repayment capabilities of the lender to the bank (Suzuki, 2011; Suzuki et al. 2013).

On the other hand, as a highly regulated industry, the banks too should become an important object of monitoring by the banking and financial authority in the economy. It is worth highlighting, from the regulators' perspective, monitoring the bank activities fundamentally is costly and imperfect since the difficulty faced by the regulator to detect and prevent the lenders' subjective probability of default as the uncertainty condition in credit channeling and also the occurrence of information asymmetries in the financial market conditioned by the banks high rent seeking behavior (Suzuki, 2011; Suzuki et al. 2013).

Suzuki (2011) argues that monitoring and supervision of the bank operation in the context of establishing a competitive financial market and a sound business environment in the banking activities actually need adequate incentive and sanction mechanisms inherent within the system. Thus, we find a crucial relationship in encouraging intermediary function of the banking sector with the availability of adequate incentive to the bank owner to conduct monitoring of their credit disbursement.

Initially, this proposition has been pioneered by Hellmann et al. (1997, pp. 171–174) in introducing 'rent' opportunities as an important factor to ensure the availability of the higher spread margin for the bank owner goal. Furthermore, this rent opportunities is the primary motivation for a bank to run its operating activities and expand their business by utilizing rent effect in maintaining their franchise value. Therefore, the presence of franchise value becomes important for the bank owner as this can provide incentives for the owners to monitor bank managers' performance and to retain sustainability of the bank profitability in the long run (Hellmann, Murdock, & Stiglitz, 1997; Suzuki, 2011)

Suzuki et al. (2013) describe the interactions of various institutions within regulatory mechanisms and monitoring of the banking sector in the financial market. In various economics system implemented by the government of a country, the role of institutions that covers all rules and values which entailed as common sense recognized in the community will affect the monitoring and supervisory mechanisms of the banking sector.

Suzuki et al. (2013) explain that the institutions which serve as guidelines in the community can be divided into two categories, namely formal institutions (i.e. rule, law, etc.) and informal institutions (i.e. conventions, customary practices, norms, rules emanating from culture, religion, etc.). Inclusively all the institutions of this system will adapt to specific economic circumstances in the country and determine the direction and nature of monitoring, as well as a supervisory mechanism in the banking sector.

Furthermore, Suzuki et al. (2013) opine that the informal institution that has great opportunities to influence transaction costs in the monitoring procedure as it

can create favorable condition with social capital. In this sense, by nurturing 'mutual trust' among the parties in the financial transaction could be an important factor in reducing the risk of Williamsonian 'opportunism' possibility.

In conclusion, the interactions and the regulatory and monitoring mechanisms of the banking sector play an important role in realizing an effective financial system by contributing to diversifying and absorption of the bank's uncertainty conditions.

Thus, how do the interactions, the regulatory frameworks, and monitoring mechanisms work in the Islamic banking business environment? Suzuki et al. (2013) observe how the process of rent opportunities through incentive and sanction mechanism in the Islamic bank financial intermediary function.

Fundamentally, the existence of the incentive and sanction mechanisms of the Islamic bank lies in a number of basic principles of the Islamic economic value in conducting business operation. The conformity to *Shariah* principles is reflected in a number of institutional framework establishment as the foundation for all business and financial contracts in the Islamic mode of banking should control the conduct of human beings in their individual and collective lives (Ayub, 2007; Suzuki et al., 2011). Simply, by raising the underlying inducement to invest or the need to avoid non-compliance, it will be a latent incentive and sanction mechanisms for the lender and borrower behaviors in the Islamic bank financial interactions.

From the perspective of the lenders, a number of incentives could be obtained as the Islamic banks can implement financial contracts under the principle of *Wakalah* (agency) and *murabaha* (asset-based trading) contracts to generate a certain amount of income that is pre-determined business margin so as to ensure the

sustainability of future business outcomes. Nevertheless, the Islamic bank should be concerned about threat and sanction mechanisms in order to implement such prudential monitoring arrangements. In this sense, well handling on the issues of compliance with *Shari'ah* principle, mitigation of the financing risks, and displaced commercial risk (DCR) will be the core sanction threat for the Islamic banks to prioritize low-risk assets for their portfolios and close-fitting borrowers their monitoring.

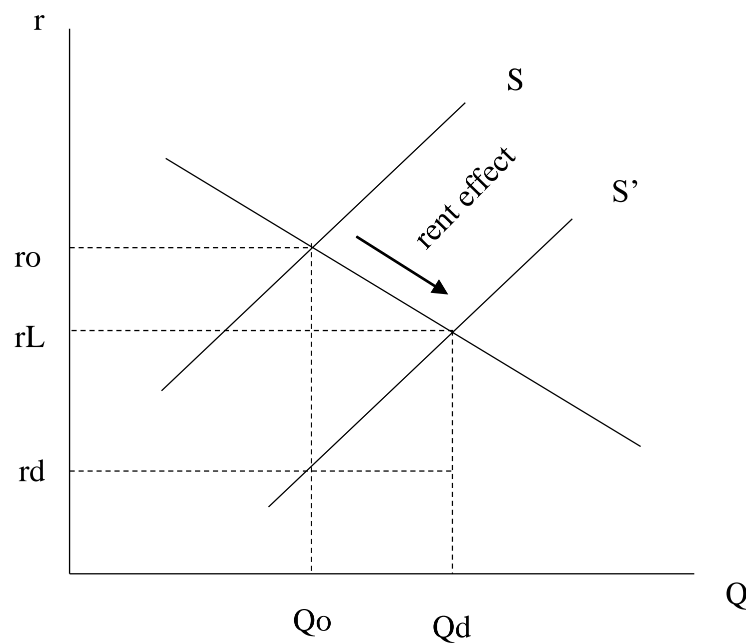
Meanwhile, from the borrowers point of view, a number of incentives will be gained using the Islamic bank services, for example, the lenders will have the opportunity to share on its business risk faced by Islamic banks when using profit and loss sharing (PLS) financing under *mudaraba* or *musharaka* modes .

Moreover, the threat of sanctions for the borrowers will prevent the tendency of borrowers to conduct shirking their responsibilities to fulfill their business objectives using the bank financing. This can be achieved because the Islamic banks will have a preference in enforcing such closer monitoring and encouraging Islamic business ethics to their borrowers (Ayub, 2007; Suzuki et al., 2011).

In contrast with the conventional bank which dealing with deal with risk-shifting only (Ariff, 2014), the Islamic bank's engangement Shariah-based financing products will involve in in risk sharing mode under mudharaba or musyaraka contracts. Also, Islamic banks are subject to severe information asymmetry and facing a tendency of higher transaction costs unless borrowers are ethical and fair (Suzuki, Uddin, Pramono, and Khan, 2017).

From the perspective of bank rent theory, we can critique the Lay‘s (2014) argument that, his proposition is not sufficient enough to explain the extraordinary low market share in Islamic bank development in Indonesia. Nevertheless, we can be using ‘the rent effect theory’ (Hellman et al, 1997), in which we can explain that Malaysia’s Islamic banking industry can optimize rent effect in the market as adequate incentive exists to boost Islamic bank development. The same scenario should be adopted in Indonesia for the future development of Islamic banking. (See Figure 4.4).

Figure 4. 2 Rent Effect in the Banking Sector



r = Rate

Q= Loanable funds

Source: Suzuki and Adhikary (2009, 7), modified by author.

As explained by Hellman et al. (1997), the financial sector rents are an incentive for portfolio monitoring will bring the impact of rent effect in terms of increasing the returns to financial intermediation function in which banks have strong incentive to increase their own deposit bases. With the assumption that the amount of savings depends on the availability of infrastructure for deposit collection (branch network and quality of service), the increased savings will shift the supply curve to the right (see Figure 4.4) (Suzuki and Adhikary, 2009).

Accordingly, from the perspective of institutional political economy, we adopt the approach used by Khan (2000) to observe the process of institutional (state) failure in applying economic policies to the development of the banking sector. Khan's approach is helpful in examining how the interaction between the financial authorities and market players in responding to the creation of particular three mechanisms of rent seeking in the financial industry covering monopoly rent, monitoring (financial) rent, and rent for learning.

Under this bank rent framework, it is perceived that the rent effect will become an important mechanism for the banking sector in realizing financial deepening objective and ensuring a sustainable growth. Firstly, within the case of monopoly rent circumstance, presumably the banks can accumulate such large profit in order to induce more investment and innovation in facing a rigorous market competition. Secondly, for the bank, in order to have an ability to preserve its sustainable growth, the banking sector should keep maintaining its franchise value through utilizing the monitoring rent mechanism. Thirdly, the banking sector can apply bank rent opportunity under the rent for learning mechanism using a process

of technology transfer and improving bank capability and capacity in the banking market.

In the context of the establishment and development of the Islamic banking in Indonesia, we can shed light on the important roles of Islamic banks which operate based on non-interest banking system in creating economic welfare.

Firstly, Islamic banking services will play a crucial role in facilitating Muslim depositors and investors in performing their investment and economic transactions through the banking system. Muslim depositor and investor who committed with the *Shariah* principles will have conviction that the interest from banking business (usury/*riba*) are prohibited. Thus, according to *Shariah*, this return or yield from interest-based banks should be separated from their income and donate to the charity or *Zakah* institutions to be benefitted for public interests (Bakar, 2008). Consequently, this Muslim's preference in utilizing Islamic banking system will make it makes sense that there is less incentive for utilizing interest-based bank by the Muslim who committed to obey the Shariah principles.

Secondly, the rate of financial deepening in Indonesia is categorized at the lower level in compare to other Southeast Asian countries. For example, based on *Financial Development Report 2009 (World Economic Forum*, 2009), national financial sectors (% of GDP) in Indonesia only has 124,2% of GDP. This is still far behind than other countries such as Singapore (472.7%), Malaysia (413.7%), Philippines (187.55), and Thailand (233.4%). Therefore, the effort to improve the financial deepening in Indonesia through the development of Islamic banks is relevant to capture of potential economic from Muslim depositor and investor that expected to contribute in creation of economic welfare.

Thirdly, the reality of the undesirable features is embedded in interest-based banking system in which transactions based on banking interest is perceived to violate the social justice between the borrowers and the lenders and discourage innovation and empowering small-scale enterprises. Thus, it is understandably; from Islamic economic perspective, that the utmost purpose of the establishment Islamic bank is to encourage wealth creation and wealth transfer accordance with Shariah principle. In this sense, operation of Islamic banking based on its underlying transaction; whether in the scheme of asset-based financing (murabaha contract) or equity-based financing (mudharaba and musharaka contract), will boost wealth creation and prevent bubble economy. In this sense, to bring at large benefit in the economy, this wealth creation should be followed by wealth transfer in the society. Consequently, with adherence of doing business which is in line with the Shariah principle (such as prohibition of *riba* (interest), *maysir* (gambling), *gharar* (ambiguity)), it is expected that Muslim will no longer in doubt to realize their wealth transfer in utilising Islamic banking services (Bakar, 2008).

4.5 Summary

The phenomena of the extraordinarily low Islamic financial deepening and the recent trend of slow-paced growth of Indonesia's Islamic banking are crucial objects to be analyzed. It exposes findings that show a relatively different trend in the midst of such argument which consider the global Islamic finance and banking have experienced rapid expansion with a vigorous performance.

However, we perceive that the existing arguments in the literature do not sufficiently explain the causes of the extraordinarily low Islamic financial deepening and the recent trend of slow-paced growth of Islamic banking in

Indonesia. In order to contribute to the existing debate, this thesis aims to shed analytical light on the "incentive" mechanism in the credit risk management and banking operations by Indonesia's Islamic banks. Because, we believe that while banks must earn profits to maintain the franchise value and reputation as prudent lenders, the regulatory banking policy has to create an appropriate incentives for banks to do so. We hypothesize that the Indonesian regulatory banking policy did not provide Indonesia's Islamic banks with an appropriate incentive, which may have discouraged them from expanding their lending business. In order to test the hypothesis, we reviewed the theoretical framework in the traditions of Institutional Economics (IE) which are concerned about rules or mechanisms for creating the incentive and threat to economic players. Specifically, we use the theoretical framework of "financial sector rent" (bank rent) to justify the creation of "rent (surplus) opportunity" to be captured by banks as the incentive of making them become prudent fund providers (Hellmann, Murdock, & Stiglitz, 1997; Khan, 2000; Suzuki; 2011; Suzuki & Uddin, 2014). Also the rent earned by banks can be used for expanding their branch network in the early stage of financial development. This positive "rent effect" can promote further market penetration and financial deepening (Hellmann, Murdock, & Stiglitz, 1997). It is a challenge in academic research to adopt the financial restraint model as introduced by Hellman, et al. (1997) to examine the hypothesis that Indonesia's Islamic banks fail to earn enough profits to maintain the franchise value, resulting in the occurrence of the phenomena of the extraordinarily low Islamic financial deepening and the recent trend of slow-paced growth of the Indonesia's Islamic banking.

The bank rent opportunity can be used as the incentives for the banking sector

to encourage banks to implement prudent business practices. The ability to generate profit and capital accumulation in the long run, in turn, will enable the bank to expand its operational efficiency through the opening of new branches, strengthening the banking infrastructure and investment in new technology. Furthermore, a sound financial deepening may encourage the rapid growth of the banking industry, which in turn will be increasing further financial deepening in the economy (Hellmann, et al., 1997; Suzuki & Adhikary, 2009; Suzuki, 2011; Wanniarachchige, 2017).

An interesting approach is introduced by Suzuki and Uddin (2014) to analyse the incentive mechanism and the role of financial sector rent in Islamic banking business operation. Suzuki and Uddin (2014) propose a fairly new concept of "Islamic bank rent" and hypothesize that Islamic banks need to earn an extra profit rather than conventional banks to maintain their franchise value as prudent *Shari'ah*-compliant lenders who have to absorb the unique risk and uncertainty embedded in Islamic banking, in particular, the profit-and-loss sharing risk and the displaced commercial risk.

We draw on the institutional political economy approach used by Khan (2000) to see the process of institutional (governmental) failure in applying economic policies to the development of the banking sector. Khan's approach (2000) is helpful in describing how the interaction between the financial authorities and market players in responding the creation of particular three mechanisms of rent seeking in the financial industry covering to monopoly rent, monitoring (financial) rent, and rent for learning. Under this bank rent framework, it should be argued how the regulator is responsible for creating appropriate incentives for banks

as well as for monitoring the positive rent effect which can contribute in realizing the financial deepening objective and ensuring a sustainable economic growth.

CHAPTER 5
COMPARATIVE STUDY OF ISLAMIC BANKING REGULATORY FRAMEWORKS IN INDONESIA AND MALAYSIA

5.1 Introduction

This chapter is aimed to, first, to present an overview of the genesis and the regulatory framework of Indonesia's Islamic banking industry. This will shed light on the history and social-economic background of the genesis of Islamic bank in Indonesia and review the main features of regulatory development in order to have a better understanding of Islamic banking landscape which operates in a dual banking regime implemented as part of a single financial and banking system in the national economy.

Secondly, this chapter attempts to present a comparative study of the overview on the Islamic banking industry in Malaysia in gaining a better understanding of the issues of the Malaysia's Islamic banking history and social-economic background, and regulatory framework. Specifically, the purpose of this comparative study is to have a brief review on how to successfully transform (Islamisation) of the Islamic banking industry as in the case of Malaysia.

Discussion and presentation of development of regulatory frameworks in this chapter hopes to resolve some issues raised in Puzzle 1, and to clarify the features (or constraints) in the Indonesian policies for the Islamisation of its banking industry. In addition, the discussion to compare Indonesian case with a relatively successful experience of Malaysian regulatory policies. As a close neighbouring Muslim

country, Malaysia will offer insights into incubating the Islamic banking industry as well as provide a plausible explanation of what causes are hindering the Islamic financial deepening in Indonesia. Consequently, it will answer some issues related to Puzzle 2. In this sense, we will learn of the influential factor of the rent effect in the case of Malaysia's Islamic banking development.

The rest of this chapter is organised as follows. Section 5.2 presents an extensive discussion of regulatory framework of Islamic banking in Indonesia. Section 5.3 will discuss the development and regulatory framework of Islamic banking in Malaysia. Section 5.4 provides a comparative perspective of important features on the Islamic banking development in Indonesia and Malaysia. Finally, section 5.5 summarises the chapter.

5.2 The Development and Regulatory Framework of Islamic Banking in Indonesia

In general, there are two models in conducting the Islamisation of economic programs through the development of Islamic banking in Muslim countries. Firstly, implementing the dual banking system. In this model the Islamic bank operates in parallel with the conventional banks in a national banking system. Among many countries using this model are Malaysia, Saudi Arabia, Bangladesh, Indonesia, Egypt, Jordan, Kuwait, and Bahrain. Secondly, restructuring the national banking system to become a single full fledged Islamic financial system. Thus only the Islamic banking system is applied, as in Sudan, Iran, and Pakistan (Wibisono, 2009; Chapra & Khan, 2000). Noticeably in both models, we recognise that the regulatory frameworks are a crucial factor in the initiation phase of the development of Islamic banking.

As pointed out by Wibisono (2009), the main reason in creating the regulatory framework for Islamic banking industry is systemic consideration which may occur over the financial and banking system implemented in the economy. Any failure of banking operation could create crucial implications on the stability of the financial system as a whole. In addition, the Islamic banking regulations are needed in protecting the bank customers interest. The banking regulation is the cornerstone in creating the rules of the game to enforce the banks to practice prudential management. In the context of the uniqueness of the Islamic bank, the Islamic banking regulation is expected to ensure the adherence of *Shariah* principles by the Islamic bank in running banking business. And lastly, the Islamic bank regulation is also important for Islamic banks that operate international banking business to meet the standards of international banking regulations.

However, Wibisono (2009), also admits that the Islamic bank regulations should not be formulated to be excessively tight which can inhibit the Islamic bank in performing business innovation, as this can increase the cost of compliance, transaction cost, and inefficiencies in the Islamic banking operations. For this purpose, the banking regulations should accommodate a balance between the goals of banking system stability and efficient banking business environment.

Therefore, we recognise that an adequate preparation of Islamic bank regulations is a challenge for the banking authority to strike a balance between effective supervision, creation of level playing field conducive to the banks, and encouraging the banking industry to grow optimally.

A number of studies have highlighted the role and initiative of the Indonesian government and the banking authority in preparing the regulatory frameworks to

support the development of Islamic banking industry (Ismal, 2013; Wibisono, 2009; Harahap & Basri, 2003). In the context of the development of Indonesia's Islamic banking, the presence of Islamic banking regulations is perceived as the most reliable legitimisation by all stakeholders, especially the Islamic banks' customers on the existence and operations of the Islamic bank.

A new stage began with the enactment of 'Act No. 10 Year 1998' on amendment to 'Act No. 7 Year 1992' which allowed the conventional banks to open Islamic banking windows/divisions (*Unit Usaha Syariah*/UUS). This new regulation subsequently triggered the expansion of Islamic banking industry significantly after stagnating for more than seven years and also officially recognised the acceptance by Bank Indonesia (BI) of the existence of Islamic banks in the dual banking system. In 2002, BI fixed rules on the Islamic banking windows/divisions (*Unit Usaha Syariah*/ UUS) through Bank Indonesia's Regulation (Peraturan Bank Indonesia/PBI) No. 4/1/PBI Year 2002 which regulates: (1) conversion of conventional banks into Islamic banks; (2) conversion of the conventional branch into the Islamic branch; (3) conversion of conventional cash office into the Islamic branch; (4) opening Islamic sub-branch in the conventional branch ; and (5) the opening Islamic units in the conventional branch.

'Act No. 23 Year 1999' by *Bank Indonesia* (BI, the central bank) defined the central banks responsibilities over regulation and supervision of the national banking system, including the Islamic banks and the Islamic Rural Bank (Bank Perkreditan Rakyat Syariah/ BPRS). According to 'Act No. 23 Year 1999', BI also had the authority to perform an Islamic-based monetary management. These main tasks have confirmed that *Bank Indonesia* has the mandate to develop the Islamic

banks by arranging appropriate regulations and set up infrastructure in line with Islamic banking principles.

Next, based on this authority, BI formed the Islamic Banking Bureau (*Biro Perbankan Syariah*) in 2001, which developed the organisation into the Directorate of Islamic Banking (*Direktorat Perbankan Syariah*) in 2004. In terms of Islamic monetary instruments, BI later introduced the instrument which is the Bank Indonesia's Wadiah Islamic monetary certificate *Bank Indonesia* (*Sertifikat Wadiah Bank Indonesia/SWBI*) in 1999. Later, in 2000, BI also made an innovation by introducing the Money Market Inter-bank based on *Shariah* Principles (*Pasar Uang Antar-bank Syariah/PUAS).*

We witnessed *Bank Indonesia* reinforcing its authority in 'Act No. 3 Year 2004' on the amendment of 'Act No. 23 Year 1999'. Furthermore, BI moved forward to drive the development of the Indonesian Islamic banks using the Islamic office channeling policy (basically to provide the Islamic banking products at the conventional banks) based on 'PBI No. 8/3/PBI of 2006', which allowed the cooperation mechanisms of depositor fund collection between the Islamic branch and the conventional branch under the same parent bank. Bank Indonesia's Regulation (*Peraturan Bank Indonesia*/*PBI*) was then refined through 'PBI No. 9/7/PBI Year 2007', in which requirement for the opening of the office channeling funds has been relaxed and expanded functions by allowing not only for depositor fund collection but also to serve the financing and financial services comprehensively to the bank' customers.

Eventually, on June 17, 2008, the Islamic banking industry in Indonesia officially had a specific regulation for Islamic banking namely 'Act No. 21 Year

2008'. A long process of the draft of Act was proposed in the House of Representatives (*Dewan Perwakilan Rakyat*/*DPR*) in 2005 and was finally enacted. A legislative process which is quite late considering the approximately sixteen years since the first Islamic bank was established in Indonesia in 1992 (Wibisono, 2009).

Besides laws concerning banking and the central bank, there are several regulations supporting the development of Indonesia's Islamic bank. Among many others are 'Act No. 38 of 1999' on Zakat, 'Act No. 41 of 2004' on Waqaf (Islamic Endowment), 'Act No. 24 of 2004' on *Lembaga Penjamin Simpanan* (Deposit Insurance Corporation), Act No. 3 of 2006 on *Peradilan Agama* (Religious Court), Act No. 40 of 2007 on *Perseroan Terbatas* (Limited Company), and Act No. 19 of 2008 about *Surat Berharga Syariah Negara* (SBSN, *Sukuk* Act).

In addition, to build a sound *Shariah* governance, Indonesian Council of Ulama (*Majelis Ulama Indonesia*/*MUI*) in February 1999 had established the National Sharia Board (*Syariah Nasional*/Dewan DSN) in accordance with Decree No. 754 /MUI /II/1999. This particular organisation acts as an independent body to provide *Shariah* regulatory support by issuing Islamic economic jurisprudential opinions (*fatwa Shariah*) to ensure *Shariah* compliance adherence in Islamic banking and financial institutions.

In a short period, initiatives to develop Islamic bank through the establishment of full-fledged Islamic bank increased, i.e. in 1999, *PT Bank Syariah Mandiri* (BSM) which is a subsidiary company of a state-owned bank *PT Bank Mandiri* (Persero) and several Islamic banking unit/windows in conventional banks (known as *Unit Usaha Syariah*/UUS). Meanwhile, in response to the public interest and the need for financial institutions supporting operations of Islamic banks, the

first Islamic insurance company was established namely *PT Syarikat Takaful Indonesia* (STI) in 1994 and in 1997 the first of Islamic mutual funds as a product of the Islamic capital market was launched by *PT Danareksa Investment Management* (DIM) in Indonesia.

Meanwhile, in providing the guidance for all stakeholders of the Islamic banking industry to determine their long-term strategic programs for expanding their market share in the banking industry, Bank Indonesia (BI) as banking authority in 2002 issued a series of strategic policy and initiatives in the *Blueprint of the Development of Islamic Banking Industry 2002 to 2015*. Subsequently, this strategic policy document was revised in 2005-2006 (Ismal, 2011). In general, this latest blueprint document proposes six initiative programs to be implemented within 10 years (2005-2015), which consists of (Bank Indonesia, 2006): (1) Increasing the Sharia compliance; (2) Increasing the quality of prudential banking operations; (3) Increasing the operational efficiency and competitiveness; (4) Increasing the stability of banking system; (5) Increasing the expertise and quality of human resources; (6) Optimising the social role of Islamic banks in developing small and medium enterprises (SMEs).

In 2008, Bank Indonesia (BI) issued another grand strategy for the development of Islamic banking industry, namely Market Development Strategic Program (MDSP) (Markplus and Bank Indonesia, 2008; Ismal, 2011). This particular document, basically containing the marketing strategy should be implemented by the regulators and the Islamic banks to boost the market share of the Islamic banking in Indonesia. MDSP (Markplus and Bank Indonesia, 2008) provides recommendations for marketing strategy that need to be implemented by

the regulators and the Islamic banks which are: (1) To position the industry as the most attractive one and the leader among the ASEAN countries in 2009 and 2010 respectively; (2) To create the new image of Islamic banks which are inclusive and universal; (3) To accurately map the Islamic banking potential market; (4) To develop the Islamic banking products; (5) To improve the banking services and; (6) To newly communicate the position of Islamic banks as being beyond banking.

In addition, we note that Bank Indonesia (BI) has also issued a number of the *Islamic Banking Outlook* reports in some years between 2006 to 2013. In these Islamic banking outlook documents, the central bank prepares and exposes policy and initiatives related to the Indonesia's Islamic banking development.

We acknowledge that one of the important policies related to efforts in increasing the market share of the Indonesian Islamic bank is the policy of Bank Indonesia's (BI) Islamic Banking Acceleration Programs 2007-2008 (*Program Akselerasi Perbankan Syariah*/*PAPBS*) which was included as a policy package in the *Islamic Banking Outlook 2007*. Basically, the purpose of the Islamic Banking Accelerated Programs 2007-2008 is the achievement of Islamic banking share of 5.25 % of the total assets in Indonesian banking industry by the end of 2008 while maintaining the prudent banking principles and adherence to Islamic principles. This policy focused on achieving quantitative targets through a groundbreaking package of policy and program initiatives that can provide bank asset growth changes significantly in the short term.

The Islamic Banking Accelerated Programs 2007-2008 has set six pillars (*Bank Indonesia*, *2006*), namely (1) Strengthening institutional aspect of the Islamic bank, (2) Developing Islamic bank's product and services, (3) Intensification of

public awareness and strategic alliance of the Islamic banking, (4) Increasing the role of government and strengthening the legal framework for Islamic Banking, (5) Strengthening Islamic bank's human resource, and (6) Strengthening the supervision of the Islamic bank.

Besides, this policy's objective concerning the issues of:

1. Encouraging the balanced growth of Indonesian Islamic bank in terms of supply and demand,
2. Strengthening the capital structure, bank management, human resource of the Islamic banking in Indonesia,
3. Optimising the role of the government in supporting Islamic banking development (financial and fiscal authorities),
4. Involving all stakeholders of Islamic banking in accelerated programs of Islamic banking development (bank's customers, National Shariah Board (*Dewan Syariah Nasional*/DSN), and academicians.

Bank Indonesia (*Bank Indonesia*, *2006*) describes, in a broad sense, the Islamic Banking Acceleration Programs 2007-2008 as conducted through three main functions. This consists of, firstly, the socialisation program of Islamic banking to the community should be more intensive in order to increase bank customer's understanding of Islamic banking and finance operation and product. Secondly, encouraging innovation and expanding Islamic bank's products and services to fulfill the demand in the society. Thirdly, the central bank will be more active in supporting the capital inflow of foreign investment funds through Islamic financial instruments.

Later on, after the enactment of ‘Act No. 21 Year 2011’ regarding the Financial Services Authority (FSA) on 17 October 2011, the new banking supervisory and authority for banking and financial industry in Indonesia has been moved under the FSA including the Islamic banking operation since 31 December 2013.

Thus, after the enactment of ‘Act No. 21 Year 2011’ regarding the Financial Services Authority (FSA), Bank Indonesia (BI) was to focus on macro-prudential policy that covers all the bank regulation related to (a) monetary policy, (b) payment system, (c) maintaining financial stability and lender of last resort.

According to Article 6 of ‘Act No. 21 Year 2011’, FSA will act as a regulator and supervisor of all banking regulations pertaining to individual banks to achieve and maintain the soundness of individual banks. With regard to Islamic banking operations, FSA will perform its functions to deliver the licenses and articles of association approval and maintain their soundness and prudential aspects of supervising the Islamic banks.

In 2015, Financial Services Authority (FSA) issued “the Roadmap of Indonesian Islamic Banking 2015-2019” (2015). Under this strategic document, the vision for the development of Indonesian Islamic banks was formulated as “Actualising Islamic banking that gives significant contributions to sustainable economic growth, equitable development, financial system stability, and high competitiveness”. Furthermore, this development vision has been translated into policy directions, work programs, and time schedule implementations. Accordingly, there are seven policy directions (FSA, 2015, pp. xv-xvi) that include:

(1) Strengthen policy synergy between the authority and government and

other stakeholders

(2) Strengthen capital and business scale as well as enhance efficiency

(3) Improve funding structure by supporting expansion of financing segment,

(4) Improve service quality and product diversity,

(5) Improve size and quality of Human Resource and Information and Technology,

(6) Enhancement of public literacy and preference,

(7) Strengthen and harmonize regulations and supervision

Table 5.1 below present the highlight of important milestones of policy and regulation on the development of the Indonesian Islamic banking.

Table 5. 1 Important Milestones of Policy and Regulations in the Development of the Indonesia's Islamic Banking

Year	Banking Policies and Regulations
1980s	Pioneering the establishment of Islamic financial institutions has been initiated by the inception of a number microfinance institution and cooperatives which operated based on Islamic principles.
1990	Indonesian Ulama Council (*Majelis Ulama Indonesia*/MUI) held a Forum on Interest & Banking, with the theme "The Problems of Prohibition of Interest and Banking".
1992	The enactment of the Banking 'Act No. 7 Year 1992' recognising Profit Sharing Banking.
1992	The first Islamic bank, namely PT. Bank Muamalat Indonesia (BMI) become officially operational.
1999	The establishment of National *Shari'ah* Board (DSN/Dewan Syariah Nasional) in accordance with Decree No. 754 /MUI

	/II/1999.
1998	The government approved dual banking system in Indonesia through the Banking Act No. 10 Year 1998, which allowed for *Shariah* window operation.
2003	Issuance of Fatwa by Indonesian Ulama Council on bank interest as considered as unlawful (prohibited) to the Muslim.
2008	The enactment of Islamic Banking 'Act No. 21 Year 2008'. It clearly endorses that the bank in Indonesia comprises of two types, which are conventional bank and Islamic bank.
2011	The enactment of 'Act No. 21 Year 2011' regarding the Financial Services Authority (FSA) on 17 October 2011. It become the new banking supervisory and authority for banking and financial industry in Indonesia.
2015	The FSA issues "the Roadmap of Indonesian Islamic Banking 2015-2019".

Source: From various sources, constructed by author

Our discussion about the genesis and the regulatory framework of Indonesia's Islamic banking above leads us to summarise a number of unique characteristics of Indonesia's Islamic banking industry in comparison to other countries (Bappenas, 2014; Ismal, 2013; Alamsyah, 2012; Wibisono, 2009).

Firstly, the impetus for Islamic bank establishment in Indonesia is rooted at a civil society push factor to realising Islamic financial institutions that based on 'free of interest banking system' and comply with the *Shari'ah* principles in business (Islamic jurisprudence/*al Fiqh al Muamalah*). By understanding the historical background of the Indonesia's Islamic banking establishment, we recognise that in many cases regulations and policies are frequently influenced by the bottom-up approach in which the society, the Muslim community in specific, had a role in

initiating or encouraging the Indonesian government to support the development of Islamic banking.

Additionally, we also acknowledge that product development carried out by Islamic banks are naturally market driven in meeting the Islamic bank's customers demand. For instance, providing a structured financing which is appropriately suitable for the development of Small and Medium Enterprises (SMEs) and the Islamic micro finance. Taking such innovations to implement a two-step *mudaraba* which allows Islamic banking to chanelling financing to the multifinance company. This is related to their consumer credit business. Typical Islamic banking business in Indonesia is in contrast to the development of Islamic financial institutions in some countries (such as Iran, Malaysia, and Saudi Arabia), in which the driving factors of the Islamic banking development are more due to regulatory support and top-down approach from the government to the Islamic banking industry. For example, initiatives in preparing regulations and supporting the development of Islamic banking dominantly came first from government policy, placement of government funds and state-owned enterprises within Islamic banks.

Secondly, with the condition that a large number of the Muslim population is a potential market as Islamic bank's customers, Indonesia's Islamic banks are more focused to penetrate the retail banking business and merely rely on domestic market demand. Indonesia's Islamic banks apparently hesitated to delve more in corporate financing market and enter investment banking business. Meanwhile, the Islamic financial market in the Gulf Cooperation Council (GCC) countries and Malaysia rely more on optimising the role of investment banking companies and the instruments of Islamic capital market. In particular Islamic bonds (*Sukuk*)

instrument which contributes significantly to the development of Islamic banking and finance industry. It should be underlined here that the penetration strategy of the Islamic banks in concentrating on potential domestic market demand apparently led to a misleading outcome. This was the creation of "the *Shariah* loyalist" bank customer who are a minority segment in the bankable population of bank customers in Indonesia (this will be discussed further in Chapter 7).

Thirdly, in the regulatory arrangement, the Indonesian government has taken initiative in setting up various regulations related to Islamic banking and financial institutions. However, it should be noted here that, these particular regulations are noticeably not well coordinated and have been disjointed preparation without a comprehensive direction among the governments bodies involved. We have seen that besides the 'Act No. 21 Year 2008' on Islamic Banking, the House of Representative enacted a number of Acts in regulating the Islamic economics and finance institutions. In fact, all these Acts must be derived and synchronised with the Government Regulation (*Peraturan Pemerintah*) and other subordinate regulations before these Acts could be effectively implemented. Obviously, in the case of the Islamic banking industry, this effort will involve some core government and industry bodies, such as Bank Indonesia (BI, central bank), Financial Service Authority (FSA), Ministry of Finance (MoF), Indonesia Deposit Insurance Corporation (*Lembaga Penjamin Simpanan/LPS*), National *Shariah* Board (*Dewan Syariah Nasional/DSN*), Ministry of Religious Affairs, National Zakat Board (*Badan Amil Zakat/Baznas*), and the Indonesian Institute of Accountants (IAI). An example of a problematic dispute for regulating Islamic banking in Indonesia in this situation is the case of double tax imposition for a *murabaha* transaction. In fact;

after approximately seventeen years since the first Islamic bank was established in 1992, finally double tax imposition for *murabaha* transaction in the Islamic bank operation finally can be abolished with the enactment of 'Act No. 42 Year 2009' on Tax Neutrality. This condition is of course very detrimental to the Islamic bank's business as about 50% of the revenue was generated from the Islamic banks *murabaha* financing mode (Wibisono, 2009). In this context, our interview with a senior researcher at Bank Indonesia, also concludes that in the case of regulatory frameworks for the Islamic bank, we have seen that the process of "interests bargaining" among some core government and industry bodies has created a delay in public policy implementation in the Islamic financial sector.

Fourth, in setting up the *Shariah* governance issues, in 1999 the Indonesian Ulama Council (*Majelis Ulama Indonesia/MUI*) has established the National *Shariah* Board (*Dewan Syariah Nasional/DSN*) in accordance with the Decree No. 754/MUI/II/1999. The main responsibility of the National *Shariah* Board is to prepare *Shari'ah* regulatory support to the Islamic banking and finance industries. Thus, the National *Shariah* Board has an important role in creating public trust and awareness of the *Shari'ah* compliance matters of the Islamic banking industry. It is worth to note that National *Shariah* Board is an independent body from Bank Indonesia (Central Bank) or Financial Service Authority (FSA) interventions. This situation is different from the Islamic banking's *Shari'ah* regulatory arrangement practiced in a number of other countries in support of the Islamic banking. For instance, in Malaysia, the National *Shari'ah* Advisory Council (NSAC) as *Shariah* standards and regulatory body is placed under the control of Bank Negara Malaysia (BNM, the central bank), so that the NSAC is not an independent body from the

BNM's policy intervenes. Meanwhile, in a number of countries of the Middle East, *Shariah* regulatory support in the form of *Shariah* opinion (fatwa *Shariah*) may be endorsed personally by a *Shariah* scholar (*Shari'ah* expert/Ulama). Therefore, this common circumstance in Middle East countries causes the possibility of divergence in the *Shariah* opinion and practice of the *Shariah* compliance possibly becomes very wide (Alamsyah, 2012).

Fifth, Indonesia also demonstrates features and support in developing Islamic micro finance institutions. As of 31 December 2013, according to Islamic Bank Statistics (Bappenas, 2014; Bank Indonesia, 2013), Indonesia records to manage 163 Islamic rural banks (*Bank Pembiayaan Rakyat Syariah/BPRS*) and about 5,000 informal Islamic micro finance institution in the form of *Baitu Maal wat-Tamwil (BMT)* or Islamic Cooperative around the country.

5.3 The Development and Regulatory Framework of Islamic Banking in Malaysia

According to Lai (2015), in general the development of Islamic finance and banking in Malaysia has gone through an evolutionary process from the emergence phase and infant industry protectionism (1980s-1990s), the expansionary phase and take-off stage (1993-2010), and the consolidation of market and becoming a key player as international financial hub for global Islamic finance (2011-present). A number of essential points should be given concern at this long development process.

Table 5.2 below presents important milestones of policy and regulation on the development of the Malaysian Islamic banking.

Table 5. 2 Highlight of Important Milestone of the Malaysia Islamic Banking Policy and Regulation

Year	Banking Policies and Regulations
1983	On 7 April 1983, the Malaysia government enacted the Islamic Banking Act (IBA). The first Islamic commercial bank in Malaysia was established Bank Islam Malaysia Berhad (BIMB).
1983	The Malaysia government has ratified the Government Investment Act (GIA) which authorizes the government to be able to issue government investment facility based on *Shariah* principles.
1984	The Malaysian government issued Takaful (Insurance) Act.
1993	On 4 March 1993, the Malaysian government introduced the Interest Free Banking System (IFBS, Skim Banking without Benefit / SPTF). Under this policy, the conventional banks are allowed to offer Islamic banking products.
1994	On 4 January 1994, the government has established the Islamic Interbank Money Market (IIMM).
1997	On 1 May 1997, the government has established the National *Shari'ah* Advisory Council (NSAC).
2001	The government issued the Financial Sector Master Plan that covered the period of 2001–2011.

2011	The government issued the Financial Sector Blueprint that covered the subsequent decade 2011–2020.

Source: From various sources, constructed by author

Initially, the initiative to establish the Islamic financial institution in Malaysia is a response to the demands of its Muslim population for a mechanism that would facilitate personal savings for the religious pilgrimage (the *Hajj*) to Mecca, one without interest rate charged and obeying the Islamic values.

At this point, we may perceive the establishment of the Islamic bank seemingly a bottom up approach in the form of civil society encouragement to the Government in realising the Islamic financial institution based on the Islamic economics principles. However, in further observation, we see that the establishment and the development of the Islamic banking in Malaysia is a government driven strategic policy in supporting Islamisation agenda in social and political spheres. This strategic policy was exposed by the government as a proven alignment and commitment to gain the Islamic credentials from public. Accordingly, the issue of Islamisation in the national economic system especially to eliminate the interest in the financial system, is becoming a crucial political economic issue which accompanies the struggle for political influence and rivalry between opposition political parties and the ruling party in Malaysia (Lai, 2014; Venardos, 2006; Jasin, 1995 in Lai, 2014).

Therefore, it makes sense that in the subsequent stages of the Islamic banking development in Malaysia are dominated by the top down approach in the form of intervention policies initiated by the Government, especially in the preparation of the regulatory frameworks and the strategic policies in supporting the growth of the

Islamic banking.

Chronologically the development of Islamic banking and finance industry in Malaysia is supported by a series of regulations and government policies as taken by the Malaysian government.

On 7 April 1983, the Malaysian government enacted the Islamic Banking Act (IBA). Under the IBA, the government has authorised the Bank Negara Malaysia (BNM, the central bank) to act as an authority and supervisor for the Islamic banks operation. Also in 1983, the Malaysian government ratified the Government Investment Act (GIA) which authorises the government to be able to issue government investment facility which is a type of marketable securities based on Sharia principles.

In 1983, concurrently with the enactment of the Islamic Banking Act, the first Islamic commercial bank in Malaysia namely Bank Islam Malaysia (BIMB) was established. In fact, BIMB is considered as a semi-public sector financial institution as its initial paid-up capital was raised from a variety of state financial sources, such as the Government of Malaysia, Lembaga Tabung Haji, state religious councils, state religious agencies and other federal agencies, as well as Muslim community welfare organisations (Lai 2014).

Then, in 1984, the Malaysian government issued Takaful (Insurance) Act, which became the foundation of the Islamic insurance industry operated according to Shariah principles. The Malaysian government believes the Islamic insurance industry is one of the important sectors in supporting the development of the Islamic banking sector.

Until the end of the emergence phase and infant industry protectionism period

(1980s-1990s), we conclude that the direction of the Malaysian's government policy of the Islamic banking development characterised with incubating the infant industry and providing intervention policy in the form of protectionism for the new Islamic bank just established. Hence, at that time we have seen that the first Islamic bank had an effective monopoly in the market (Lai, 2014).

From early 1990, the development of the Islamic banking in Malaysia had moved toward the expansionary phase and take-off stage (1993-2010). As pointed out by Lai (2014), by the early 1990s, Bank Negara Malaysia (BNM, the central bank) was confident in the viability of the Islamic banking system and began preparing for further expanding the market. According to Lai (2014), at that time BNM actually had two other options in expanding the market: (1) opening the opportunity to give consent to the new free-standing Islamic banks establishment, or (2) taking the policy to allow the existing commercial banks to set up branches or subsidiaries which offer the Islamic banking services to their customers. In facing these two options in this expansionary strategy, Bank Negara Malaysia (BNM, the central bank) took a keen interest to make a breakthrough in monopoly market condition of the Islamic bank with choosing to adopt the Islamic windows scheme as this is leveraged on the existing branch network and infrastructure of the conventional banks and is cheaper and faster way in facilitating the growth of Islamic banking (Lai, 2014).

On 4 March 1993, the Malaysian government introduced the Interest Free Banking System (IFBS, Skim Banking without Benefit / SPTF). Under this policy, the conventional banks are allowed to offer Islamic banking products. This synergised model is known as the Islamic bank windows. Obviously, this policy

effectively promotes the growth of the Islamic banking industry in Malaysia since the conventional bank branches and networks can be used to serve the products of Islamic banks. However, as we witnessed that the government's policy in this regard is conducted by a prudent and gradual manner, for instance in encouraging the Islamic windows program through the Interest Free Banking System (IFBS, Skim Banking without Benefit / SPTF), in which the government's preliminary emphasis was on removing the element of interest from banking rather than the implementation of a systematically fleshed out Islamic financial system to the national economy. In fact, this the Interest-Free Banking Scheme policy was eventually retitled as the Islamic Banking Scheme in 1998 (Bank Negara Malaysia, 1999), further accompanied by a set of guidelines in directing the participating banks of the urgency the development of Islamic finance in the national financial system.

Furthermore, the Malaysian government took such institutional development initiatives which is significantly important to the Islamic banking and finance industry, which are the establishment of the Islamic Interbank Money Market (IIMM) on 4 January 1994 and National *Shari'ah* Advisory Council (NSAC) on 1 May 1997.

The next progress is related to the occurrence of the Asian financial crisis in 1997, which also hit the Malaysian's economy. This financial crisis, in fact, brought the effect on further development of the Islamic banking in Malaysia. Accompanying that the Malaysian government worked to increase the contribution of foreign direct investment (FDI) as an important driver of its economic growth and to organise the mix of financial sector reform in the wake of the crisis.

Apparently this effort pushed the policy-makers and the financial authority to identify the Islamic banking sector not only as a means to re-energise its financial system but also a new source of wealth for the domestic economy (Lai, 2014; Lai 2012). In line with this perspective, Prime Minister Mahathir Muhammad gave his support for the operational method of Islamic finance to bring the ideal of more equitable and fair practices, with the criticism against speculative activities and asset bubbles in the conventional financial system. In this regard, we can note that the Malaysian government gives a significant opportunity to the Islamic banking sector as a functional reaction to the weaknesses of conventional finance and the need for new sources of economic growth for the Malaysian economy. (Lai, 2014; Case 2005). In addition, the development of the Malaysian Islamic bank obtained its' momentum from the Malaysian political situation brought by the leadership of the former Prime Minister Mahathir Muhammad. The Malaysian government had obviously provided very substantial support and privileges to the interests of the Malays as a protection for the "the Bumiputera welfare" (economic welfare of the Malays in Malaysia).

In the next development stage, Bank Negara Malaysia (BNM, the central bank) issued the license for a second full-fledged Islamic bank in 1999, Bank Bumi Muamalat (BBM). Similarly in the case of the establishment of BIMB, the first Islamic bank in Malaysia, the Malaysian government was actively involved in the establishment of Bank Bumi Muamalat (BBM). Substantially, Bank Bumi Muamalat (BBM) was the result of a merger of two conventional banks which are Commerce Asset-Holding and Bank Bumiputra Malaysia, a government-owned bank. These newly merged banks were spun off into a new Islamic commercial bank

(Lai, 2014).

In addition, the Malaysian government also completed the infrastructure market for Islamic financial instruments. Simultaneously development of the Islamic bank also received support related to the Islamic financial market instruments and the non-bank Islamic financial institutions, such as the market for Islamic bond (*Sukuk*) had begun to operate in 1990, the money market for the Islamic bank was also established in 1994, and then followed by the operation of *Shariah* equity markets in 1995. It is argued that developing the Islamic capital market will boost the growth of the financial sector as a whole. In this regard, the Malaysian government also put efforts to develop the Islamic capital market based on Islamic finance tenets. For instance, Wilson (2009) in Lai (2014) highlights that in 2002 the Malaysian government issued the world's first sovereign *sukuk* amounting USD 600 million by which the investors from the Gulf Cooperation Council (GCC) had dominantly subscribed to it. Another example, as reported in *Asian Wall Street Journal* (2006), is *Khazanah Nasional*, one of the government agencies which in 2006 had made innovation of Islamic financial products by issuing the world's first exchangeable *Sukuk,* with which it managed to attract the Middle-Eastern investors successfully.

Up to this point, we have witnessed a very convincing expansion process of the development of Islamic banking in Malaysia. As pointed out by Lai (2014), by the end of 2007, the Malaysia's Islamic banking had about 15% of market share in the national banking industry, which had significantly increased from 6% in mid-1990. Thus it showed a relatively a stronger foothold in the Malaysia's banking system. Moreover, we admit that the Islamic banking in Malaysia had gone through

stages of take-off after successfully achieving the target in accordance with the Financial Sector Masterplan that covered the period of 2001-2011, in which the projected growth of the Islamic banks was targeted to attain 20% of total industry assets by 2010. It is noticeable that as of 31 December 2010 according to Bank Negara Malaysia (BNM, 2012) the total assets of the Islamic banks in Malaysia was 20.7%.

It is worth to emphasise as highlighted by Krasicka and Nowak (2012) that at least there are two key success factors behind the significant increase of the Malaysian Islamic bank's market share under a dual banking system where full-fledged Islamic banking system operates in parallel with a full-fledged conventional system. *Firstly*, achieving economy of scale in which the utilisation of the common platform of the conventional bank's infrastructure and network by the Islamic banking windows gave substantial impact on an acceleration of the Islamic bank's services at the lowest cost and within the shortest time frame. In this sense, the Malaysian government has been successful to develop a strategic program by the massive opening Islamic banking windows/division under the conventional banks infrastructure and network in order to improve efficiency in infrastructure investment in the initial stage of the Islamic bank establishment and increase rapidly the outreach of the Islamic banking service to bank customers. *Secondly*, preparing and offering the widest range of Islamic banking products and services to the customer. Under a dual banking system, the full fledged Islamic bank and Islamic banking windows are required to provide all services which are offered by the conventional banks. Otherwise the customers will shift back to the conventional banking system. Noticeably, in this purpose the Malaysian government supported the Islamic bank

with substantial tax and fiscal incentives. For instance, the Malaysian government made clear and immediate policies to enforce implementation of the avoidance of double tax and stamp duties for the Islamic bank’s transaction and products/services (for detailed explanation, please refer to Table 5.3).

Following, the development of Islamic banking, Malaysia entered the market consolidation stage (2011-present). In this stage, a number of policy and regulations were issued by the Malaysian government for the purposes of market consolidation and to make Malaysia a key player in becoming a international financial global hub for Islamic finance (Lai, 2014). For this purpose, the Malaysian government reintroduced a long-term strategy document to strengthen the development of Islamic banking and finance through the Financial Sector Blueprint that covered the subsequent decade (2011-2020) in which the Islamic bank was expected to account for 40 per cent of total financing by 2020 (Bank Negara Malaysia 2011). This strategic document was meant to be a replacement for the previous document, namely that the Financial Sector Masterplan that covered the period of 2001-2011. We noted that a number of policies were taken by the banking and financial authority in supporting the policy direction of the Financial Sector Blueprint. Listed below are some of the policies:

Firstly, Bank Negara Malaysia (BNM, the central bank) had been aggressively issuing permits for the establishments of several new full-fledged Islamic banks which were mostly foreign-owned entities, including three new full-fledged Islamic banks in 2004, four full- fledged Islamic banks in 2010, and one full-fledged Islamic bank in 2011. Moreover, this progressive and selective liberalisation of Malaysia's financial sector which is in favor of the Islamic banking

industry was also equipped with regulations related to the ownership limit imposed on financial institutions. The foreign equity participation of up to 49% was further relaxed to 70% in 2009. This discretion was permitted only for Islamic banking subsidiaries and new *Takaful* companies in Malaysia. This was not given to the conventional bank that only had authorisation for ownership limits for foreign investors up to 30% (Lai, 2014).

Secondly, there are important incentive policies that were given by the Malaysian government to the Islamic finance industry as part of the country's strategy to realise the vision of Malaysia as the International Islamic Finance Centre (MIFC) (Chang, 2009; PWC, 2006). These covered:

1. Tax incentives for Islamic banks

The Malaysian government provided Income Tax Exemption for 10 years (effective since 2007) for banks/windows formed under the Islamic Banking Act 1983 for income derived from the activities of Islamic banking in foreign currencies, including transactions with Malaysian citizens. Furthermore, the tax-free income can be repatriated to the bank's shareholders as a tax-free dividend. The bank's shareholders in the form of corporations can once again repatriate that income as tax-free dividends to shareholders (second tier tax exempt dividend).

In addition, benefits are paid by Islamic banks or Islamic windows to customers who are not citizens of Malaysia (non-residents). They are also given tax exemption (tax and withholding tax exemption).

In order to increase the use of banking transactions based on *musharaka* and *mudaraba* contracts, the government also released financing using the contract of liability tax returns effective since 2007. Previously it was a liability for transactions

based on partnership, which is the essence of *musharaka* and *mudaraba* being included in the definition of business partnership.

2. Tax incentives related to human resource development

At the individual level, the Malaysian government gave relief up to RM 5,000 per year in tuition for Islamic finance programs at local colleges approved by Bank Negara Malaysia and the Securities Commission, including the International Centre for Education in Islamic Finance (INCEIF).

For corporations, effective since 2007, the incentives were given in the form of a double deduction on expenses for the employees in terms of Islamic Banking and Finance courses at national Universities which have been approved by Bank Negara Malaysia and Securities Commission, including in INCEIF.

3. Fiscal incentives

Additional stamp duty exemption (stamp duty) of 20 per cent were given to the instruments used in the financing of *Shariah*. These instruments must be approved by BNM or the Securities Commission. This incentive is effective from 2 September 2006 until 31 December 2009.

In addition, exemption of stamp duty (up to 100 per cent and is valid for 10 years) is given on instruments denominated in foreign currency held by Islamic banks and foreign exchange instruments relating to *Shari'ah* securities denominated in ringgit or foreign currency.

4. Incentives for the Islamic bank products innovation

The Malaysian government also provided tax exemptions to the consultancy fees received by foreign experts who provided consultancy services for Islamic Finance. The foreign experts must be verified by the International Islamic Financial

Centre (MIFC) based in Malaysia. This incentive is effective from 2007 until the end of 2016.

In addition, issues related to the Islamic banking industry market consolidation also became concerns of the whole stakeholders of the Malaysia's Islamic banking industry. At least we noted a number of important topics raised in this context and had received a response from the Malaysian banking authority to ensure the sustainability of the growth of Islamic banking. First, the emergence of the need to revisit the implementation of the Islamic banking windows model in the Malaysian banking system as many academics have criticised this system as having the potential risk to violate Islamic principles since the parent company did not conduct strict supervision of the *Shariah* compliance in its business processes. In addition, a number of industry players were also starting to question the equality of level playing field and fairness of cost advantages enjoyed by the Islamic banking windows while utilising the conventional banking infrastructure. In this regard, Bank Negara Malaysia (BNM, the central bank) responded to this problem by issuing a regulation in 2007 to impose on Islamic banking windows to be transformed in their articles of association into a full subsidiary bank entity of the conventional bank. Although there are no changing in its banking business operation as the Islamic banking windows are allowed to do leveraging with the conventional banking infrastructure owned by the holding company. Another issue related to *Shariah* governance which received the attention from the public that the Malaysian Islamic banking should uphold the genuineness of the Islamic finance characteristics. This can be understood by the argument that the public, especially

the bank's customers believed that the implementation of the Islamic banking operation ultimate aimed to adhere to the principles outlined in the *Shariah* that distinguishes it from the interest burden (*riba*) and speculative (*gharar*) activities in the conventional banking sector. In response to this matter, Bank Negara Malaysia (BNM, the central bank) announced a *Shariah* governance framework in October 2010 to replace the previous Guidelines on the Governance of *Shari'ah* Committees for Islamic Financial Institutions (2004) (Bank Negara Malaysia, 2011).

5.4 A Comparison of Important Features on the Islamic Banking Development in Indonesia and Malaysia

To conduct a comparative study of the important features of the Islamic banking development in Indonesia and Malaysia, first of all, we will briefly review the major milestones on the development of the Islamic banking in Indonesia and Malaysia as outlined in Table 5.1 and 5.2 above. Second, we present a comparison of some important regulations and incentives for the development of the Islamic banks in Indonesia and Malaysia, as presented in Table 5.3. Third, we will clarify a number of successful approaches of the Malaysian Islamic banking development through interviews with academics and practitioners of the Islamic banking in Malaysia to have a better understanding of the conducive business environment provided to the Malaysian Islamic banks.

In general, based on the above discussion, we note that the Malaysian government undertook a comprehensive approach in the process of establishment and the regulatory frameworks for Malaysia's Islamic bank. In this approach, we are cover aspects of preparing advanced regulatory and supervisory mechanism, providing adequate and clear incentive provisions, implementing a pragmatic

policy to support the achievement of objectives which have been set in the long term development strategy by the Malaysian government. Meanwhile, the Indonesian government noticeably did not well prepare the regulatory framework support comprehensively, in fact, the regulatory support in the case of Indonesian Islamic bank was often too late in supporting the Islamic banking operation. In addition, the Indonesian Islamic bank did not provide an adequate incentive mechanisms to the Islamic banks in the early stages of the establishment of the Islamic bank in Indonesia. Besides, we also found that the policy issued by the financial authorities in Indonesia tend to be conservative in providing policy supports for the development of the Islamic banking in Indonesia.

Next, we summarise some important differences that can become lessons to be learnt in the development of Islamic banking in Indonesia and Malaysia in terms of regulations and incentives as described as follows:

1. The Indonesia was late in preparing a comprehensive regulatory framework for the development of Islamic banking. As shown in Table 5.5, officially the Islamic banking industry in Indonesia merely have a specific regulation of Islamic banking namely 'Act No. 21 Year 2008' on Islamic Banking after sixteen years since the first Islamic bank established in Indonesia in 1992; namely Bank Muamalat Indonesia (BMI) after the Act enacted by the House of Representatives (*Dewan Perwakilan Rakyat*/DPR) on June 17, 2008. Apparently, in this context, we perceive that there was a state failure omission condition in form of the lack of regulatory framework of the Islamic bank in Indonesia. In contrast, the Malaysian government immediately supported in enacting the regulatory framework for the Islamic banking development. For

instance, in terms of regulatory support, the Malaysian government has been prepared and enacted the Islamic Banking Act (IBA) as a specific legal framework for the operation of the Islamic bank before the establishment of BIMB (Bank Islam Malaysia Berhad); the first Islamic bank in 1983.

2. The Indonesian Islamic banking was unsuccessful in implementing the strategic program in massive opening the Islamic banking windows/division (*Unit Usaha Syariah/*UUS) in order to leverage the conventional banking infrastructure. In this regard, we underline that the policy issued by the financial authorities in Indonesia tend to be conservative in providing support for the development of the Islamic banking in Indonesia, in which although the Indonesian government carries out a dual banking system and provides opportunity for the conventional banks to open the Islamic banking windows/division, the Islamic banking windows/division (*Unit Usaha Syariah*/UUS) in Indonesia cannot be fully able to use the conventional banking infrastructure since the Islamic banking windows/division (*Unit Usaha Syariah*/UUS) in Indonesia is only allow to operate at the Islamic branches and should be separated from the conventional branches. In contrast, the Malaysian Islamic banking has successfully developed the Islamic bank's market share through opening the Islamic banking windows which effectively utilising the conventional bank infrastructure. This strategy can be viewed as being a very successful breakthrough to accelerate the growth of the assets of Islamic banks in Malaysia as well as to improve efficiency in infrastructure investment in the initial stages at the Islamic bank because it has cost less and can utilise the network infrastructure already established in the Malaysian conventional banks.

3. The Indonesian Islamic bank did not provide an adequate tax and fiscal incentives facilities to the Indonesian Islamic banks in the early stages of the establishment of the Islamic bank in Indonesia. For example, in this case of the double tax burden on *murabaha* transactions which very harmful for the Islamic bank. The Indonesian government is very delayed in resolving this dispute in the banking industry; approximately after seventeen years since the first Islamic bank established in Indonesia, eventually through 'Act 42 Year 2009' on Tax Neutrality then double tax for the Islamic banking services can be abolished. Meanwhile, the success of the development of the Islamic banking in Malaysia was also supported by the Malaysian government by providing a number of incentive packages which are in favor for the Islamic bank that includes the avoidance of double tax and stamp duties, exemption from paying income tax if the Islamic bank pay the *zakat*that qualifies for tax exemption, and as well as giving significant incentives by providing tax neutrality and tax exemptions for the Islamic banking industry. Moreover, the Malaysian government also provides additional tax incentives with the aim to encourage foreign participation in Malaysia's Islamic finance and realise Malaysia's potential as an international Islamic financial hub. Therefore, we can conclude that this aggressive incentive package to the Islamic banking in Malaysia has enabled the Malaysian Islamic bank to accumulate rent effect to support their further penetration in the banking market.

In order to clarify some issues pertaining to the Malaysian government policies related to regulations and incentive supports for the development of the Islamic banks, we have conducted the interview through telephone conversations

to a member of the National *Shari'ah* Advisory Council, Bank Negara Malaysia (BNM), a researcher of the International *Shari'ah* Research Academy (ISRA), Malaysia, and a senior banker at the Malaysian Islamic bank.

There are several interesting findings that could be attributed to the pivotal experiences of the development of Islamic banking in Malaysia:

Firstly, the interviewees confirmed that, overall, the role of a comprehensive regulatory framework, financial sector strategic planning, and market incentives by the Malaysian government were the determinants for the excellence of the Malaysian Islamic banking. In specific, the interventionist policy by the Malaysian government effectively contributed to boost the Malaysian Islamic banking growth and significance of market share in the industry. The interviewees argue that on the condition of the advanced regulatory support for the Islamic bank has emerged the high level of trust from the Islamic bank customers and ensured the high safety of the Islamic bank financial transactions. On the other hand, this robust regulatory framework also increases the industry players to rely on regulatory certainty in performing the Islamic banking business.

Secondly, the interviewees agreed that the strategy in utilising the conventional bank networks and infrastructure under the Banking and Financial Instittion Act (BAFIA) in 1993 for the conventional to offers the Islamic bank products is the key success factor of Malaysia's Islamic bank development in attaining a significant market share in the industry. Under this strategic policy, from the perspective of practitioner, based on interview with a bank manager of Malaysia's Islamic bank, who admitted that a clear direction and guidelines by Bank Negara Malaysia (BNM) is a crucial factor. That the conventional banks have been

encouraged to offer Islamic banking products to their customers in utilising their leveraged factor of branch networks and infrastructures is an important factor. This successful strategy of utilising the conventional bank infrastructure favors the Islamic bank as the Islamic banks can substantially increase their outreach to the bank customers with low cost and promote the Islamic banks' services rapidly in the Malaysian banking system.

Moreover, there are interesting findings revealed in the interview with a senior banker at the Malaysia's Islamic bank. In each of the conventional banks that implement Islamic banking windows in Malaysia, it was implied that these particular banks had the same vision and mission to promote the growth of Islamic banking industry. Accordingly, the banks' staff did not hesitate to promote the Islamic bank's product to their customers. This conducive circumstance actually has manifested in the system operational procedures of the bank in which was noticeably stated that the bank's staffs assigned to perform the Islamic bank transaction will also be included their performance evaluation as the key performance indicator (KPI) on their contribution to the company.

In contrast, a different outcome occurred in the case of the Indonesian Islamic bank experience in optimizing the conventional bank's infrastructure and network under office channeling policy issued by Bank Indonesia (BI) which was not successful to boost the development of Islamic banking in Indonesia significantly.

Office channeling is a terminology that refers to practice of the Indonesian Islamic bank in utilising the conventional bank's office-networks by the *Unit Usaha Syariah* (UUS/Islamic business unit)/the Islamic windows branch to offer the Islamic banking product/service to the bank's customer. The implementation of this

office channeling policy is based on Bank Indonesia Regulation (PBI/Bank Indonesia Regulation) No. 8/3/2006, although this particular regulation does not explicitly expose office channeling terminology. The official terminology used is *Shari'ah* Services (*Layanan Syariah*) which has been defined as:

> "*... the fund raising activities conducted in branch offices or sub-branch offices for and on behalf of the Islamic windows branch office from the identical conventional bank…*".

Obviously, the office channeling policy aims to increase market share and service accessibility of the Islamic banks in Indonesia. Technically, this office channeling practice which is applied by *Unit Usaha Syariah* (UUS/Islamic business unit)/the Islamic windows branch have some prerequisites, i.e.: the conventional branch offices must be placed in the same operational working area at the provincial administrative of the Islamic windows branch, having separate accounting report from the conventional bank branch offices, apply the Islamic banking accounting standard, and consolidate the accounting report of Islamic windows branch in accordance with its Islamic windows branch assignment authority.

Based on interview conducted with a senior banker at the Indonesian Islamic bank, one of the causes of failure of the office channeling implementation was the resistance in behaviour by staff when the Islamic bank's services are offered through the conventional branch. The bank's staff are less likely to support and hesitate to promote the Islamic bank's services. This is due to the perception of bank staff that their contribution in the form of Islamic bank transaction will not be included in key performance indicator (KPI) on their performance evaluation as a bank officer. Whereas, interview conducted with a Senior Researcher at Bank Indonesia has

confirmed the failure of the office channeling implementation in Indonesia basically. There are two main reasons which is the lack of a well-founded key performance indicator (KPI) for the bank staff's evaluation and the lack of "a strong political will" from the top executive of Islamic banks to enforce a synergised vision with its conventional bank's manager in attaining the Islamic bank growth.

According to a senior banker at the Malaysian Islamic bank, he reported that in terms of operational and financial performances, the Islamic bank windows are relatively dominant and better compared to the full-fledged Islamic banks in Malaysia. Table 5.3 presents some indicators in comparison of the Islamic banking window (May Bank Islamic Berhad) and the full-fledged Islamic bank (Bank Islam Malaysia Berhad) to show the advantageous and relatively better performance by the Islamic bank window of the conventional banks.

Table 5. 3 Performance and Advantageous Leverage Comparison of full-fledged Islamic bank and Islamic banking windows in Malaysia (in Million RM)

Banks	2014	2010	2014	
			Number of Employees	Number of Branches
Bank Islam Malaysia Berhad (full-fledged) - Total Asset - Total Income - Profit before Tax	45, 829 1,498 701	30,398 2,431 343	4,242 people	142
May Bank Islamic Berhad (Islamic window) - Total Asset - Total Income - Profit before Tax	135, 567 4,057 1,047	47,512 1,126 401	150 people	402

Source: Annual Reports of the banks, respectively

Thirdly, the interviewees also confirmed that the support from the Malaysian government in providing a number tax and fiscal incentives to the Islamic banking industry is an important factor for the successful development of Islamic banking in Malaysia. This tax and fiscal incentives include avoidance of double tax and stamp duties and exemption from paying income tax if the Islamic bank pays the *zakat* that qualifies for tax exemption. Obviously, this tax and fiscal incentives have contributed to the Islamic banking operation to become cost efficient and competitively offering their product to the customers in comparison to the

conventional bank products. In conclusion, the interviewees confirmed that incentive package from the Malaysian government has made Islamic banks to accumulate the rent effect for further penetration in the banking market. This finding is in line with Lai's (2014) argument that the regulatory support and incentive mechanism for the conventional branch network and infrastructure is one of the key success in Islamic banking development in Malaysia. This is shown by the total banking assets increase from about 6% in the mid-1990s to just over 24% in mid-2013.

Certainly, the comparison of the Islamic banking sector development between Indonesia and Malaysia above should be understood in the context of the relationship between government's economic policy and the different aspects of social, political and religious backgrounds in both countries.

In the context of the modernization/secularization process in the 1950s and early 1960s which are considered to encourage the decline of the role of religion in society; Along with the development program implemented in many Muslim countries, it is important to note that Haneef (2001) maintains that policy and institutional reforms in Malaysia had the four necessary elements, namely, political will from the government, articulated initiators and communicators of Islamic reforms from national leaders, progressive establishment of Islamic economic and

financial institutions, and supporting regulation and institutional transformation undertaken in a relatively accommodative and flexible manner.

From the perspective of implementation of religious values and Shariah principle, Malaysia can be categorized as a country that clearly put forward the "symbolic element of Islam" in the social, political and cultural context in the society. For example, according to Constitution of Malaysia, Article 3: The State Religion declares that “(1) Islam is the religion of the Federation; but other religions may be practised in peace and harmony in any part of the Federation” (Fernando, 2006). Indonesia has different experience. With regard to the implementation of religious values in social, political and cultural aspects, we perceive that Indonesia is a country which put "substantial values of Islam."

The history has proven that in preparing Indonesia's independence in 1945, the founding fathers of the Republic of Indonesia have deeply and intensively discussed political discourse to prepare the philosophical thought of a new nation-state for all Indonesian people, disregarding their racial, ethnic, or religious background. This conceptual base is later known as *Pancasila*. *Pancasila* consists of five principles and contends that they are inseparable and interrelated. Philosophical terminology which was chosen to describe that Indonesia is neither a

religious state nor a secular state as stated in the first principle of *Pancasila*, namely "*A Divinity that is an ultimate unity*" (Madjid, 1987). .

On the other hand, we notice that the patronage of political power and control of the business sector in Malaysia is not a recent phenomenon. At least since the 1970s, when UMNO's hegemony in the *Barisan Nasional* (National Front, a coalition of the ruling political parties in Malaysia) holds the control of political constellation in Malaysia, these political parties have controlled wide range of business venture (Gomez, 1990; Gomez and Jomo, 1997). Noticeably, the condition does not just occur in Malaysia. In Indonesia, the three political parties, *Partai Nasionalis Indonesia* (PNI), *Partai Sosialis Indonesia* (PSI) and the *Majelis Syuro Muslimin Indonesia* (Masyumi) once held business enterprises in the 1950s, although since the emergence of military rule and later suppression of these political parties led to the discontinuation of their involvement in business. Then in the New Order era 1996-1998 under President Suharto, the political elite of the ruling political party, *Golongan Karya* (Golkar) established an alliance of business forces with Indonesian Chinese conglomerates, the military elites, and bureaucrats elites (Robison, 1986).

This nexus dynamic between politics and business is important for us to understand the formulation and implementation of policy in the development of Islamic banking in Indonesia and Malaysia. In the case of Malaysia for example, we see that the attempts to encourage the development of Islamic economics and banking are clearly aimed at conducting the Islamization of economy which provides an opportunity for the state to design the national economy in accordance with Sharia principles. In addition, the supporting policy of Islamic banks is expected to facilitate Muslims to actualize the values of Islamic teachings in economic activity by conducting business dealing through financial institutions that adhere to *Shariah* principles. Consequently, it should be noted that the government's policy to support Islamic banks cannot be separated from the government's preference for the economic interests of *Bumiputera* (ethnic Malay people) which in line with the objectives of the implementation of the New Economic Policy (NEP) in 1970-1990s. NEP is the dominant economic policy prepared by the government in which their targets are formulated and implemented in accordance with *Bumiputera* or non-*Bumiputera* category to achieve the goal of "national unity". In addition, a high level of attention by the government to support the development of Islamic banking is a very strategic topic to become a campaign tool

for political parties to increase their voters from *Bumiputera* which dominated by Muslim population (Haneef, 2001; Lai, 2015).

Meanwhile, in the Indonesia’s context, we underline that the economic policies taken by the ruling government since the Old Order during 1945-1965 under President Sukarno to the New Order during 1966-1998 were never intended to design a national economy based on Islamic principles and implement massively such policy of economic development according to the *Bumiputera* or non-*Bumiputera* targeted basis. Particularly during the New Order period, the dominance of economic thought and policy controlled by the 'Berkeley Mafia' group, which is primarily characterized by capitalism and neoliberalism school of thoughts, did not put in place Islamization of economy and the development of the Islamic banking as a vital economic instrument to contribute into the national economy (Robison, 1990, Baswir, 2006). Furthermore, after the fall of President Suharto in 1998 and the implementation of economics reform agenda, the elites of bureaucratic el and economic decision makers in Indonesia are still dominated by "Berkeley Mafia" which in this case despite already having concerns about the development of the Islamic banking were still skeptical and nonaligned toward further government intervention to support the Islamic banking. In addition, the

majority of political party elites and members of the House of Representatives (Parliament) in Indonesia do not consider the development of Islamic banking critical because they think this is not an important issue for their constituents and will not boost their votes in general election. In this perspective, to some extent, the politicians in Indonesia admit that there is no adequate incentive or "rents" that they will gain by defending for alignment with the Islamic banking development.

As consequence, the most important strategy for the proponents of the Islamic economic and banking in Indonesia is to intensively conduct a series activities like seminars, publications, and raising public awareness to disseminate the Islamic economics and banking notions. Continuing these activities, the proponents of the Islamic economics and banking subsequently take persuasive steps to the elites of politicians and economics decision makers to ensure that the Indonesian government would have the political will to support the Islamic banking development since Islamic banking sector is supposed to have its potential contribution in the process of economic development and increasing social justice for the national economy.

5.5 Summary

After having the discussion concerning the regulatory framework and the development of the Islamic banking in Malaysia and Indonesia, this section will

summarise a number of unique characteristics of Indonesia's Islamic banking in comparison to the Malaysia's Islamic banking industry.

Firstly, at the initial stage, the impetus for the Islamic bank establishment in Indonesia is rooted at civil society level. We also recognise that in many cases, regulations and policies of Islamic banking development are frequently influenced by the bottom-up approach in which the Muslim community encourages the Indonesian government to support the Islamic banking industry. This typical Islamic banking development is in contrast to the development of Islamic financial institutions in some countries (such as Iran, Malaysia, and Saudi Arabia), in which the driving factors of the Islamic banking development are more due to regulatory support and top-down approach from the government to the Islamic banking industry. For instance initiatives in preparing of regulations and supporting the development of the Islamic banking dominantly came initially from government policy, placement of government funds and state-owned enterprises in Islamic banks. Comparing Indonesia's Islamic banking establishment to Malaysia, we note that although the initial initiative to establish the Islamic financial institution in Malaysia is a response to the demands of Muslim population for a mechanism that would facilitate personal savings for the religious pilgrimage (*the Hajj*) which could avoid interest (*riba*) --and hence a bottom-up phenomenon. Our further observation shows that the establishment and progress of the development of Islamic banking in Malaysia is a government driven strategic policy in supporting Islamisation agenda in social and political spheres. This strategic policy was pursued by the government as prove of alignment and commitment to gain the Islamic credentials from the public. Moreover, the issue of Islamisation of the national economic

system, especially regarding elimination of interest in the financial system, is becoming a crucial political economic issue accompanied with struggle for political influence and rivalry between opposition political parties and the ruling party in Malaysia (Jasin, 1995 in Lai, 2014; Venardos, 2006; Lai, 2014). Accordingly, it is worth to note that a number of strategic initiatives and policies implemented by the Malaysian government relates to regulations and incentives for the development of Islamic banking can be perceived more as an intervention model in public policy.

Secondly, in setting up and preparing the regulatory framework to support the Malaysian Islamic bank, the Malaysian government implemented a comprehensive approach. In this sense, this approach is covering aspects of preparing an advanced regulatory and supervisory mechanism, providing adequate and clear incentive provisions, implementing a pragmatic policy to support the achievement of objectives which have been set for the long term development strategy by the Malaysian government. In terms of regulatory support, the Malaysian government supported the enacting of regulatory framework for the Islamic banking establishment. From the beginning the Malaysian government has prepared and enacted the Islamic Banking Act (IBA) as a specific legal framework for the operation of the Islamic bank. This was done before the establishment of the first Islamic bank in 1983. In the meantime, the Indonesian government noticeably did not do well in preparing the regulatory framework supports comprehensively. In fact, the regulatory supports in the case of Indonesian Islamic bank are often late in supporting the Islamic banking operation. For instance, officially the Islamic banking industry in Indonesia merely have a specific regulation of Islamic banking namely ‘Act No. 21 Year 2008’ on Islamic Banking after sixteen years since the

first Islamic bank was established in Indonesia in 1992. The Act was enacted by the House of Representatives (Dewan Perwakilan Rakyat/DPR) on 17 June 2008. Apparently, in this context, we perceive that there was a state failure of omission of the lack of regulatory framework for the Islamic bank in Indonesia.

Thirdly, the policy issued by the financial authorities in Indonesia tend to have a conservative outlook in providing policy support for the development of Islamic banking in Indonesia. It resulted in the failure of Islamic banking in implementing the strategic program in massive opening the Islamic banking windows/divisions (*Unit Usaha Syariah/UUS*) in order to leverage the conventional banking infrastructure as they could not fully use the conventional banking infrastructure due to being allowed to operate only at the Islamic branches and should be separated from the conventional branches. This is in contrast with the Malaysian Islamic banking situation. Malaysia's Islamic banks successfully developed the market share through opening of Islamic banking windows which effectively utilised the conventional bank infrastructure. Thus, this leveraging strategy can be viewed as being a very successful breakthrough to accelerate the growth of the assets of Islamic banks in Malaysia as well as to improve efficiency in infrastructure investment in the initial stages at the Islamic bank as it cost less and utilised the network infrastructure already established in Malaysian conventional banks.

Fourthly, it should be emphasised that the Indonesian Islamic banking industry did not provide an adequate incentive mechanism to the Islamic banks in the early stages. For instance, the Indonesian government delayed resolving the case of double tax burden on *murabaha* transactions. It was about seventeen years since

the first Islamic bank was established in Indonesia, that eventually through ‘Act 42 Year 2009’ on Tax Neutrality’ double tax for Islamic banking services could be abolished. Meanwhile, the Malaysian government actively provided a number of incentive packages in favor of Islamic bank so they included the avoidance of double tax and stamp duties, exemption from paying income tax if the Islamic bank pays the *zakat* and giving significant incentives by providing tax neutrality and tax exemptions for the Islamic banking industry. Moreover, the Malaysian government also provided additional tax incentives with the aim to encourage foreign participation in Malaysia's Islamic finance and make Malaysia an international Islamic financial hub. Therefore, it is concluded that this aggressively incentive package for Islamic banking in Malaysia had made the Malaysia’s Islamic bank accumulate the rent effect to being capable in further penetration in the banking market.

CHAPTER 6
ANALYSES OF FINANCIAL PERFORMANCE AND STABILITY OF THE INDONESIAN ISLAMIC BANKS: *THE BANK RENT APPROACH*[3]

6.1 Introduction

This chapter will present further analysis of the Indonesian Islamic bank performance with reference to the extraordinarily low level of Islamic financial deepening and their slow paced of growth. In addition, a comparative analysis will be carried out to demonstrate overall performance of the Islamic banking in Malaysia and Bangladesh.

Furthermore, in order to examine the Islamic bank rent hypothesis, this chapter will present an analysis of financing activities and financial performance indicators as reflected in the Islamic banking operations in Indonesia, Malaysia, and Bangladesh. In this chapter, we examine the *murabaha* practice as applied by the Islamic banks in these three countries. Specifically, this chapter sheds light on the Islamic bank rent theory with some empirical evidence through a comparative approach to analyzing the performance of Islamic banks with conventional banks. For this purpose, we aim to draw upon the bank rent approach to making sense the existing pattern of financing modes in Indonesia's Islamic banks. Furthermore, to have a better understanding of the bank rent circumstances in the Islamic banking operations, this chapter presents the quantitative and qualitative evidence from

[3] The main idea and issues of this Chapter have been discussed and published in Suzuki, Uddin, Pramono, and Khan (2017).

Indonesia's Islamic banks for a comparison with Islamic banks in Malaysia and Bangladesh.

Following, this chapter will present the practice in modes of financing of the Indonesian Islamic bank, in which the financing proportion under *mudharabah/musyaraka* contracts are relatively higher in comparison to the proportion practiced by the Islamic banks in Malaysia and Bangladesh. Nevertheless, we admit that this practice in Indonesia's Islamic bank mode of financing is a quasi-*murabaha* financing as it does not conduct purely *mudharabah/musyaraka* financing. Indeed, they have applied the two step *mudharabah/musyaraka* mode of financing contracts. Substantially this is a *murabaha* type financing in nature.

Thus, through a comprehensive discussion in Chapter 6, it is expected to support the Islamic bank rent hypothesis to explain the extraordinarily low level of Islamic financial deepening and slow pace of growth of Indonesia's Islamic banking. This will help explain the phenomena as occurring due to an adequate rent opportunities to maintain their rent franchise value and reputation in running their business.

The rest of this chapter is organized as follows. Section 6.2, will discuss bank rent opportunities of the different financing modes circumstance of the Islamic banks. Section 6.3 presents an overview of Islamic banking sector in Indonesia, Malaysia, and Bangladesh. Section 6.4 deals with the important evidence from the banking sector of Indonesia, Malaysia, and Bangladesh related to performance indicator and existing pattern of financing modes, and the tendency of the Islamic bank rent opportunity captured by the Islamic banks in each country. Moreover,

from the perspective of the bank rent theory, this section will elaborate the structural dilemma faced by Indonesia's Islamic bank as the cause of constraining the Islamic banks from further penetration in the banking market. Finally, Section 6.6 summarizes the chapter.

6.2 Understanding Bank Rent Opportunities of the Different Financing Modes Circumstance

Cizacka (2011) divides Islamic financing modes into two categories, namely *Shari'ah* compliant and *Shari'ah*-based financing contracts. Included in this category of *Shari'ah* compliant mode is a sale-based contract with a predetermined return or mark-up financing, such as *murabaha*, *ijarah*, and *salam* contracts. Whereas, the *Shari'ah*-based mode usually recognises the genuine profit and loss sharing financing which are applied under *mudaraba* and *musharaka* financing contracts.

In the context of financing mode practiced by the Islamic banks, Chapra and Khan (2000) recognize that in principle the sales-based contract in the form of *murabaha* (mark-up based contract) financing is allowed by the *Shari'ah* principles and it is distinctive from the interest-based credit. However, if we look at it from the perspective of socio-economic benefits of the Islamic financial system then we endorse that the profit and loss sharing based financing under and *mudaraba* (trust based contract)/*musharaka* (partnership/equity based contract) contracts is the ideal form.

Under this financing categorization (Suzuki, Uddin, Pramono, & Khan, 2017) admit that in the aspect of incentive and sanction mechanisms embedded in *Shari'ah* compliant products are likely to be similar to the conventional banking as

these products have many similarities to the conventional financial transaction while featuring *Shari'ah* principle and business ethics. Thus, it becomes highly relevant to emphasize Hellmann, Murdock, and Stiglitz's argument (1997) that a bank will pursue to capture the rent opportunity to keep its 'franchise value' as an incentive not only for the bank owner to monitor the bank managers but also in supporting the bank. It will enable the banks to have a strong incentive to manage their loan portfolios. In this context, Suzuki, Barai, and Uddin (2013) underline that the incentive and sanction mechanism under the Islamic banking operation plays an important role in the process of monitoring (from the financial institution to the Islamic bank's customers) and supervising (from the financial authority/regulator to the Islamic bank). For instance, from the Islamic bank's perspective, implementation *musharaka* and *mudaraba* contract will provide an incentive to encourage a greater opportunity for the Islamic bank to conduct a closer monitoring as the capital owner or the shareholder of the investment project. Whereas, from the perspective of the Islamic bank's customers, implementation of *musharaka* and *mudaraba* contracts will impose informal sanctions on the borrower for enforcing complianceof *Shari'ah* principles and Islamic business ethics. On the other hand, in the process of supervising, the Islamic bank will receive additional sanction to not only comply with the regulation from the financial authority/regulator but also for conducting the banking business in accordance to the *Shari'ah* principles based on the *Shari'ah* Supervisory Board's (SSB) rules (fatwa/*Shari'ah* opinion).

Thus, under the *Shari'ah*-based *mudaraba,* the Islamic banks will have an inclination to face severe information asymmetry and high transaction costs as long as the borrowers have unethical and unfair business conduct. This is because, under

mudaraba contracts based on profit and loss sharing, the borrower and the lender relationship will be fully based on trust in performing their business agreement. Meanwhile, under *Shari'ah* based *musharaka* mode of financing, in theory, this financing mode exposes less information asymmetry and lower transaction costs since the Islamic banks have the opportunity to participate in supervision and monitoring of the business performance (Abdul-Rahman, et al., 2014).

However, in practice we find a complex situation in realizing the ideals of profit and loss sharing under *Shari'ah*-based financing. A number of obstacles appear to be the cause for various outcomes:

1. The Islamic bank's depositor has behavior to not accepting the loss sharing risk in the case of business or investment failure. Meanwhile, the Islamic banks will face the displacement commercial risk if the rate of return that is distributed to the depositors is lower than the market rate benchmarking (Abdul-Rahman, et al., 2014; Kasri & Kasim, 2009). Consequently, the Islamic banks remain concerned about the after effect of losses from their modes of financing and prefer to engage in less risky projects for avoiding risk sharing in their financing activities.
2. The legal framework for Islamic bank is still dominated by the conventional banking regulations which are in many cases inconsistent with the nature of the Islamic bank's products. The resulting situation is discouraging for applying profit and loss sharing (PLS) contract. For instance, there is no specific judicial court suitable for profit and loss sharing (PLS) contract default (Chapra & Khan, 2000).
3. The Islamic banks have been urged to absorb two types of risks in

financing; not only credit risk and but also *Shari'ah* risk. Consequently, the difference between the rates of profit received and profit paid cannot guarantee necessary rent for Islamic banks. Accordingly, in order to protect their franchise values, Suzuki and Uddin (2014) emphasize that the Islamic banks have to manage an extra cushion for capturing unwanted losses against *Shari'ah* compliance, which has been denoted "α" in their definition of "Islamic bank rent" (see for a further explanation at section 3.3 in Chapter 3).

4. The well-functioning of the profit-and-loss sharing mode is relying more on the well-structured system of the property rights and the tax allowance method (Abdul-Rahman, et al., 2014). Accordingly, debt is considered as tax deductible whereas equity is not. Thus, from the demand-side perspective, the Islamic bank's customer will have unwillingness toward the equity-based mode of financing.
5. As the tendency of *Shari'ah* compliance guidelines is not to request a kind of collateral under *mudaraba*and *musharaka* financing, the Islamic banks refrain from collateral for reducing credit risk under profit and loss sharing mode which is a common phenomena for the under asset-based financing modes. Hence, from the banker's perspective, this becomes a factor that does not support the implementation of equity-based financing mode (Zaher & Hassan, 2001).
6. The situation which requires the Islamic banks to continuously monitor and supervise their financing disbursement under equity-based

financing along with the periodic determination of profit-and-loss sharing ratio will accelerate the transaction costs in the Islamic bank business operation (Sundararajan & Errico, 2002).

7. The Islamic bank's products also require a deposit insurance scheme in accordance with the *Shari'ah* principle to encourage the Islamic banks in offering profit and loss sharing (PLS) contracts competitively with conventional bank products (Chapra & Khan, 2000).

6.3 Overview of Islamic Banking Sector in Indonesia, Malaysia, and Bangladesh

The banking sector is vital for the economic prosperity of Indonesia、Malaysia, and Bangladesh. In Bangladesh, the size of the banking sector relative to gross domestic product (GDP) was 69.96 percent in 2010 compared to 32.79 percent of the stock market (Uddin & Suzuki, 2015, p. 123). Whereas in Malaysia, the size of the banking sector relative to GDP was 303.83 percent in 2010 compared to 165.85 percent of the stock market (BNM, 2014). As for Indonesia, using this particular indicator, the market penetration of the banking sector relative to GDP in 2010 was 44.50 percent, whereas the size of the stock market was 47.7 percent (FSA, 2014).

It is worth considering that chronologically the operation of the first Islamic bank was started in 1983 in Bangladesh and Malaysia, while in Indonesia, it was begun formally from 1992. The comparative position demonstrated in Table 5.1 exhibits entirely different scenario of the position of Islamic banking sector in both countries.

In Indonesia, by the end of 2012, the number of full-fledged banks were

11 and the number of conventional banks with Islamic banking windows/branches were 24, leading to a total of 35 banks with Islamic banking operations. These banks represented 29.17 percent of the banking sector and in aggregate they constituted 4.57 percent and 5.41 percent of the banking sector deposits and credits, respectively. On the other hand, by the end of 2012, there were 7 full-fledged Islamic banks and 16 conventional banks doing Islamic banking by maintaining separate windows in Bangladesh. That is out of 47 banks, 48.94 percent engaged in Islamic banking either fully or partially. These banks aggregately held 18.86 percent and 21.07 percent of the banking sector deposits and credits, respectively. Meanwhile, by the end of 2012, there were 16 of the Islamic banks in Malaysia which held the full fledged Islamic bank license from Bank Negara Malaysia (BNM, the central bank). They comprised 5 of the full fledge Islamic banks and 11 of the Islamic window banks. The current regulation of the Islamic bank license in Malaysia is quite unique as BNM requires every single bank that will offer Islamic bank's product and service must hold a full fledged Islamic bank license whether it will operate as a full fledged Islamic bank entity or as the Islamic windows entity under the conventional bank. This Islamic banking sector in Malaysia as of the end of December 2012 represented 28.57 percent of the whole banking sector and in aggregate, it constituted 25.60 percent and 25.80 percent of the total deposits and credits of the banking sector, respectively.

Table 6. 1 Comparative Position of the Islamic Banking Sector in Indonesia, Malaysia, and Bangladesh by End of December 2012

Indonesia				
	Islamic Banks	**Banks with Dual Banking**	**Islamic Banking Sector**	**Banking Sector**
No. of Banks	11 (9.17)	24 (20.00)	35 (29.17)	120
Deposits	117,817 (3.65)	29,695 (0.92)	147,512 (4.57)	3,225,198
Credits/Financing	112,396 (4.12)	35,109 (1.29)	147,505 (5.41)	2,725,674
Malaysia				
	Islamic Banks	**Banks with Dual Banking**	**Islamic Banking Sector**	**Banking Sector**
No. of Banks	5 (8,93)	11 (19.64)	16 (28.57)	56
Deposits	66,658 (4.41)	319,538 (21.19)	386,196 (25.60)	1,508,578
Credits/Financing	39,605 (3.24)	275,386 (22.56)	314,973 (25.80)	1,220,825
Bangladesh				
	Islamic Banks	**Banks with Dual Banking**	**Islamic Banking Sector**	**Banking Sector**
No. of Banks	7 (14.89)	16 (34.04)	23 (48.94)	47
Deposits	961.2 (17.81)	56.7 (1.05)	1,017.9 (18.86)	5,396.0
Credits/Financing	858.9 (19.89)	51.2 (1.19)	910.1 (21.07)	4,318.6

Source: Constructed by the authors based on Bank Indonesia's Indonesian Banking Statistics and Islamic Banking Statistics in 2012; BNM's The Financial Stability and Payment Systems Report 2014; the annual report 2012-2013 of Bangladesh Bank.

Notes: All currency values are in the respective national currencies: Rupiah, Taka, and Ringgit. Figures in parantheses are percentage values.

6.4 Evidence from the Banking Sector of Indonesia, Malaysia, and Bangladesh

Table 6.2 provides a comparative summary of two performance indicators, namely, return on assets (ROA) and non-performing loan (financing in Islamic banks) (NPL) of the Islamic banking sector and the banking sector as a whole in Indonesia, Malaysia, and Bangladesh during the period 2007-2012. The ROA of the Islamic banking sector of Bangladesh was higher than the overall banking sector in almost all years during the period under study. On the other hand, the NPL of the Islamic banking sector was lower than that of the overall banking sector during the whole period. However, the scenario is entirely reverse in Indonesia's Islamic banks. In both cases, the overall banking sector was performing better than Islamic banks during almost the whole period by presenting higher ROA and lower NPL. Meanwhile, in Malaysia, we note that the ROA of Islamic banking sector is slightly lower in comparison with the banking sector as whole. In terms of NPL, we see that NPL of Islamic banks in Malaysia are more fluctuating and have slightly lower tendency than that of the banking sector. These results indicate a high differences in the lending patterns of Islamic banks in these countries.

Table 6. 2 The Averages of ROA and NPL of Islamic Banks in Indonesia, Malaysia, and Bangladesh

	2007	2008	2009	2010	2011	2012
Indonesia						
ROA (in %)	2.07 (2.78)	1.42 (2.33)	1.48 (2.60)	1.67 (2.86)	1.79 (3.03)	2.14 (3.11)
NPL (in %)	4.05 (4.07)	3.95 (3.20)	4.01 (3.31)	3.02 (2.56)	2.52 (2.17)	2.22 (1.87)
Malaysia						
ROA (in %)	1.3 (1.50)	1.00 (1.50)	1.30 (1.20)	1.30 (1.50)	1.00 (1.60)	1.40 (1.60)
NPL (in %)	3.30 (3.20)	2.30 (2.20)	2.20 (1.80)	2.10 (2.30)	1.60 (1.80)	1.20 (1.40)
Bangladesh						
ROA (in %)	1.27 (0.90)	1.44 (1.20)	1.67 (1.40)	2.26 (1.80)	1.40 (1.50)	1.62 (0.60)
NPL (in %)	3.38 (13.20)	2.68 (10.80)	2.17 (9.20)	2.33 (7.30)	2.15 (6.10)	2.98 (10.00)

Source: Constructed by the authors based on Bank Indonesia's Indonesian Banking Statistics and Islamic Banking Statistics in 2012; BNM’s The Financial Stability and Payment Systems Report 2014; the annual report 2012-2013 of Bangladesh Bank.

Notes: Figures in parentheses represent the averages of the banking sector. *In case of Bangladesh, 6 Islamic banks are considered for the computation.

To have an idea about the lending patterns of Islamic banks in Indonesia, Malaysia, and Bangladesh, Table 6.3 displays the income from *murabaha* and

equity-based/profit-and-loss sharing *mudaraba* and *musharaka* modes during 2008 to 2012. Even though equity-based financing in Indonesia's Islamic banks created significantly higher contribution in their income generation than in Malaysia and Bangladesh during the period of study, *murabaha* financing obviously still placed a dominant financing mode in these three countries of Islamic banking operation. Thus, the case of the Islamic banks in Bangladesh can be regarded as the *murabaha* syndrome. Such an approach helps the Islamic banks to uphold the leading position in the banking sector in terms of performance, as signified by ROA and NPL. In addition, it is worth noting, that financing contracts in Malaysia's Islamic banks are being dominated by sales based transaction especially *murabaha* and *bai bithaman ajil* (deferred sales) contract even though Malaysia is recognized as one of the pioneering countries which has long period in developing Islamic banking and finance since 1983 and placed its country's achievement of one of the Islamic financial hub in the international financial market. Accordingly, it can be viewed that the Malaysia's Islamic banks are experiencing the *murabaha* syndrome as well.

Table 6. 3 Income from Murabaha (in percentage) of Different Islamic Banks in Indonesia, Malaysia, and Bangladesh

Name of the Bank	Year				
	2008	2009	2010	2011	2012
Indonesia					
PT. Bank Syariah Mandiri	47.00 (41.00)	45.00 (39.00)	49.00 (36.00)	58.00 (32.00)	66.00 (26.00)
PT. Bank Muamalat Indonesia	45.00 (50.00)	43.00 (47.00)	43.00 (49.00)	47.00 (43.00)	48.00 (42.00)
PT. Bank Mega Syariah Indonesia	81.00 (6.00)	86.00 (4.00)	88.00 (3.00)	88.00 (2.00)	85.00 (0.00)
PT. Bank Rakyat Indonesia Syariah	87.00 (11.00)	66.00 (18.00)	66.00 (26.00)	59.00 (16.00)	66.00 (18.00)
PT. Bank Negara Indonesia Syariah	NE	NE	51.00 (11.00)	51.00 (13.00)	56.00 (13.00)
PT. Bank Central Asia Syariah	NE	NE	5.00 (9.00)	31.00 (14.00)	36.00 (27.00)
Malaysia					
Bank Islam Malaysia Berhad	55.26 (0.08)	69.08 (0.08)	59.66 (0.04)	59.66 (0.04)	59.10 (0.04)
Bank Muamalat Malaysia Berhad	41.57 (0.07)	36.47 (0.21)	40.46 (0.41)	41.67 (0.31)	49.43 (0.00)
Al Rajhi Banking and Investment Corporation (Malaysia) Berhad	99.88 (0.00)	99.90 (0.00)	99.91 (0.00)	99.90 (0.00)	99.93 (0.00)
Bangladesh					
Islami Bank Bangladesh Ltd.	60.00 (1.70)	54.82 (2.58)	54.25 (3.63)	58.20 (4.13)	58.68 (3.78)
First Security Islami Bank Ltd.	77.78 (0.00)	81.36 (0.00)	79.83 (0.00)	75.22 (0.00)	75.22 (0.00)
Export Import Bank of Bangladesh Ltd.	22.82 (0.00)	21.48 (0.00)	38.98 (0.00)	42.51 (0.00)	40.09 (0.00)

Shahjalal Islami Bank Ltd.	NA	20.32 (0.00)	15.39 (0.00)	15.63 (0.00)	17.10 (0.00)
Social Islami Bank Ltd.	NA	20.74 (0.74)	18.41 (0.66)	6.03 (0.42)	4.63 (0.41)
Al-Arafah Islami Bank Ltd.	34.74 (0.01)	29.98 (0.01)	35.15 (0.01)	25.66 (0.00)	15.93 (0.00)

Source: Calculated by the authors based on the annual reports of respective banks.

Notes: Figures in parentheses represent the income from profit-and-loss sharing *mudaraba* and *musharaka*. NA and NE respectively stand for not available and not established. As the proxy of percentage calculations of incomes from these particular contracts are based of the percentages outstanding financing according the type of contracts since there is no disclosure of income based on the financing contract in the annual report in Malaysia.

Nevertheless, compared to the Islamic banks' financing portfolio in Bangladesh, Islamic banks in Indonesia have a relatively higher share of equity-based financing in their financing portfolio. To be specific, the total equity-based financing portfolio remained at 27-36 percent of the total financing in Indonesian Islamic banks, whereas that of *murabaha* was more than 50 percent during the period 2008-2012 (see Table 6.4). In contrast, the highest share of equity-based financing modes of the largest Islamic bank in Bangladesh was only 3.13 percent in 2011 whereas the remaining Islamic banks disbursed a very insignificant portion in these modes (Suzuki & Uddin, 2015). Thus, unlike Bangladesh, higher engagement in equity-based/profit-and-loss sharing modes in Indonesia may result in lower ROA and higher NPL found in Table 6.2.

Table 6. 4 Composition of Murabaha and Profit-and-Loss Sharing Mudaraba and Musharaka in Indonesia's Islamic Banks

Type of Financing	Year				
	2008	2009	2010	2011	2012
Murabaha In Percentage	22,486 59%	26,321 56%	37,50 8 55%	56,365 55%	88,004 60%
Mudaraba and *Musharaka* In Percentage	13,616 36%	17,009 36%	23,255 34%	29,189 28%	39,690 27%
Others In Percentage	2,093 5%	3,556 8%	7,418 11%	17,101 17%	19,811 13%
Total Financing	38,195	46,886	68,181	102,655	147,505

Source: Constructed by the authors based on *Bank Indonesia's Statistics* and *Islamic Bank Indonesia's Statistics* of the Bank Indonesia (the central bank)

Note: Amounts are in Trillion Rupiah.

In relation to Islamic bank rent opportunity captured by the Islamic banks, we observed the spread margin of conventional banks that maintain both Islamic and non-Islamic windows/branches simultaneously in Indonesia, Malaysia, and Bangladesh (6 banks in Indonesia, 3 banks in Malaysia, and 9 banks in Bangladesh).

This approach aims to compare the ratio of interest paid to depositors against interest received from borrowers in conventional banking with the ratio of profit paid to depositors against profit received from borrowers in Islamic banking on a non-risk-adjusted basis. Thus, presents an idea of the gross value of any bank rent opportunity. In a broad sense, it can be concluded that the *riba*-free banking done by the Islamic banking windows/branches of these banks is associated with a lower ratio than the *riba*-based banking in conventional branches (see Table 6.5). Hence,

this finding reveals the likelihood of a prevailing higher bank rent opportunity under the asset-based financing in Islamic banking sector, particularly under the dominant *murabaha* financing in Islamic banks in these three counties Indonesia, Malaysia, and Bangladesh.

Table 6. 5 Cost to Income Ratio in Riba-based Banking[a] and Islamic Banking[b] of Conventional Banks

Name of the Bank	Year					
	2007	2008	2009	2010	2011	2012
Indonesia						
PT. Bank BTN	53.01 (46.96)	56.24 (35.26)	60.02 (38.05)	48.18 (44.39)	50.79 (48.59)	48.67 (42.79)
PT. Bank DKI	43.06 (23.11)	51.92 (15.05)	52.29 (19.02)	41.70 (19.82)	40.53 (20.34)	41.81 (12.29)
PT. Bank Danamon	37.00 (31.49)	36.41 (36.77)	33.25 (26.66)	24.73 (16.33)	26.32 (18.01)	23.34 (21.42)
PT. Bank BII	45.41 (30.24)	44.40 (30.47)	36.77 (33.85)	32.01 (35.39)	35.50 (32.69)	35.08 (19.36)
PT. Bank Permata	34.26 (36.95)	42.11 (40.28)	46.80 (31.04)	39.86 (18.31)	44.55 (20.27)	47.02 (14.39)
PT. Bank BTPN	31.31 NE	40.98 (16.68)	41.13 (35.69)	36.02 (27.34)	37.05 (16.33)	34.30 (10.44)
Malaysia						
Hong Leong Bank Berhad	59.18 (57.08)	55.31 (54.39)	53.83 (53.66)	45.91 (46.51)	49.95 (58.02)	52.19 (55.22)
Affin Bank Berhad	57.71 (54.18)	54.33 (58.89)	45.12 (45.51)	50.33 (50.41)	56.85 (55.96)	60.27 (59.12)
CIMB Bank	N/A	49.38	39.23	38.67	44.92	45.84

Berhad	N/A	N/A	(49.77)	(53.94)	(55.01)	(52.48)
Bangladesh						
Prime Bank Ltd.	75.07 (62.79)	80.29 (65.22)	80.42 (59.84)	64.74 (53.88)	75.76 (64.72)	76.69 (65.98)
Bank Asia	73.86 NE	75.18 NE	72.13 (50.15)	65.11 (45.15)	75.59 (67.22)	73.47 (69.38)
The City Bank Ltd.	78.16 (54.11)	68.02 (57.65)	63.43 (81.44)	49.27 (81.75)	52.75 (104.39)	61.29 (73.20)
Dhaka Bank Ltd.	NA NE	71.05 (86.78)	73.58 (83.45)	67.14 (60.07)	76.06 (75.20)	77.90 (110.93)
Jamuna Bank Ltd.	NA NE	82.30 (58.78)	78.07 (58.79)	72.67 (58.69)	75.25 (60.89)	81.27 (68.61)
Premier Bank Ltd.	79.68 (77.93)	75.50 (78.97)	77.30 (84.95)	69.48 (72.43)	77.52 (70.31)	81.09 (69.18)
Southeast Bank Ltd.	76.51 (68.88)	84.04 (70.30)	86.55 (66.97)	75.09 (64.32)	86.81 (67.85)	90.11 (71.95)
AB Bank Ltd.	72.69 (72.75)	72.49 (71.63)	67.49 (67.11)	61.99 (59.10)	76.21 (70.67)	77.11 (73.57)
HSBC Bank Ltd.	45.41 NE	45.37 (0.00)	48.71 (0.00)	40.92 (1.47)	35.51 (7.36)	41.12 (10.36)

Source: Calculated by the authors based on the annual reports of respective banks.

Notes: Figures in parentheses represent the ratio from Islamic banking operations. NA and NE stand for not available and not established, respectively.[a] (Interest paid/Interest received) $\times 100$.[b] (Profit paid/Profit received) $\times 100$.

In addition to examining the issue of sustainability of the Islamic bank rent, we compare the ratio of operating expenses to interest received from conventional banking with the ratio of operating expenses to profit received from the Islamic banking for all of the sample banks reported in Table 6.5. This particular indicator is shown in Table 5.6 with interesting findings. Whereas in Malaysia and Bangladesh, it seems that the ratio is lower in *riba*-free banking than that of *riba*-based banking during the whole period, but in Indonesia, the ratio tends to be higher with the fluctuation in between the periods. It seems that the Islamic banks in Indonesia face relatively higher competition within the banking sector and these sample banks have been operated at a lower level of efficiency as the operating expenses have increased during the period.

Table 6. 6 Ratio of Operating Expenses to Income in Riba-based Bankinga and Islamic Bankingb of Conventional Banks

Name of the Bank	Year					
	2007	2008	2009	2010	2011	2012
Indonesia						
PT. Bank BTN	34.44 (38.55)	32.37 (36.52)	31.46 (47.49)	38.36 (52.89)	36.01 (5.61)	38.21 (31.50)
PT. Bank DKI	46.97 (64.56)	38.35 (86.60)	43.00 (54.08)	52.96 (73.00)	43.75 (43.20)	45.31 (83.34)
PT. Bank Danamon	36.62 (50.96)	47.89 (39.18)	52.33 (45.71)	50.64 (51.44)	50.72 (55.25)	54.65 (102.12)
PT. Bank BII	51.25 (49.10)	50.42 (40.17)	64.64 (49.27)	60.91 (111.70)	57.73 (24.71)	53.57 (31.14)
PT. Bank Permata	51.29 (60.00)	42.43 (24.45)	37.05 (29.62)	47.99 (41.68)	45.02 (54.10)	47.93 (68.28)

PT. Bank BTPN	42.58 NE	36.60 (112.61)	42.68 (56.00)	44.11 (140.70)	39.78 (123.21)	41.16 (81.57)
Malaysia						
Hong Leong Bank Berhad	26.12 (17.75)	27.86 (17.16)	29.91 (17.60)	31.63 (21.14)	32.21 (19.28)	30.18 (17.92)
Affin Bank Berhad	31.88 (20.65)	33.75 (25.42)	37.77 (33.77)	35.12 (32.77)	29.72 (24.22)	28.78 (19.51)
CIMB Bank Berhad	N/A N/A	36.74 NA	50.70 (27.98)	57.58 (16.68)	50.37 (18.86)	52.80 (22.28)
Bangladesh						
Prime Bank Ltd.	25.29 (6.35)	24.77 (6.32)	31.49 (5.39)	33.91 (6.78)	28.12 (5.37)	24.25 (5.85)
Bank Asia	18.55 NE	19.86 NE	24.36 (50.45)	29.79 (18.42)	22.00 (12.18)	21.43 (9.54)
The City Bank Ltd.	32.58 (12.49)	38.66 (13.58)	37.85 (8.57)	45.61 (28.29)	39.33 (30.48)	34.75 (6.40)
Dhaka Bank Ltd.	NA NE	21.08 (4.48)	20.82 (4.45)	24.44 (7.03)	21.21 (5.27)	17.01 (7.60)
Jamuna Bank Ltd.	NA NE	26.90 (11.99)	29.56 (9.81)	27.86 (9.06)	25.81 (9.07)	23.25 (6.56)
Premier Bank Ltd.	22.54 (8.91)	25.04 (9.40)	27.50 (8.25)	42.82 (6.03)	54.43 (3.30)	41.19 (3.29)
Southeast Bank Ltd.	15.71 (9.32)	15.40 (8.56)	15.68 (7.80)	19.00 (8.31)	16.87 (6.85)	15.22 (5.32)
AB Bank Ltd.	26.74 (4.32)	26.91 (3.64)	29.40 (3.56)	36.57 (6.50)	28.54 (4.02)	27.71 (3.33)
HSBC Bank Ltd.	21.76 NE	23.40 (9.32)	28.04 (6.56)	31.72 (2247.27)	32.84 (39.23)	27.68 (15.38)

Source: Calculated by the authors based on the annual reports of respective banks.

Notes: Figures in parentheses represent the ratio from Islamic banking operations. NA and NE stand for not available and not established, respectively.[a] (Operating expenses/Interest received) ×100.[b] (Operating expenses/Profit received) ×100.

What have Islamic banks in Indonesia attained in sanctioning higher percentage of equity-based financing compared to that of Malaysia and Bangladesh? Based on interviews with the directors and managers of Islamic banks in Indonesia, some interesting findings can be noted:

First, innovation of a two-step *mudaraba* and *musharaka* financing: Acknowledging the huge demand for the consumer products in the Muslim community of Indonesia, Islamic banks have made a strategic alliance with non-bank Islamic financial institution. Under this strategic financing, Islamic banks arrange *mudaraba* and *musharaka* contract with the non-bank financial institution and then consumer financing company will channel this fund to the end users by using *murabaha* financing contract. This type of financing is reported by Islamic banks under *mudaraba*/*musharaka* mode.

Second, flexibility in Islamic opinion (*fatwa*) in developing Islamic banks' products: The National *Shari'ah* Council (Dewan Syariah Nasional/DSN) in Indonesia as the highest authority in the functioning of the *Shari'ah* Supervisory Body (SSB) for Islamic financial institutions turns out to have a policy that is quite accommodating and flexible to encourage the development of *mudaraba*/*musharaka* financing products in Islamic banks. In the context of method in performing of *fatwa* (*Shari'ah* opinion from the jurist) by National *Shari'ah* Council in Indonesia (DSN), according to in-depth interview conducted with a member of DSN and the International *Shari'ah* Research Academy for Islamic Finance (ISRA) Council of Scholar, Malaysia on 17 March 2016, instead of the fatwa applied by a number of Muslim countries, the fatwa method of DSN can be categorized as a method of selecting *washotiyah* (moderation) approach. Within this

moderate school of thought, a fatwa on *Shari'ah* compliance will be taken by prioritizing moderate attitude between such contextual contained in the text of the sources of Islamic law and consideration of the contemporary realities in daily Muslims life. This basic principle in issuing a fatwa by DSN hence encourages a quite accommodating and flexible approach in developing *mudaraba*/*musharaka* financing products in Indonesia Islamic banks.

At least, we underline two progressive practices of Islamic banks in Indonesia which have obtained approval from the National *Shari'ah* Council. Firstly, application of the penalty to the *mudaraba*/*musharaka* financing in the case of business due to negligence or moral hazard. The imposition of this penalty will be reported in Islamic banks' accounting treatment as "non-*halal* (impermissible) income" and will be donated to the *Zakat* organization (DSN, *Fatwa* no. 17). Besides, Indonesia's Islamic banks perform an innovative *mudaraba*/*musharaka* financing in the construction of projects by using working capital financing, which can be categorized as "project during construction" after a certain period of time. This type of transaction is also reported under *mudaraba*/*musharaka* financing. When the projected is completed, the financing will be reconverted into *murabaha* financing by a refinancing contract between the Islamic bank and the entrepreneur (DSN, *Fatwa* no. 89).

Third, encouragement for the development of small and medium enterprise (SME) by Islamic associations: Stakeholders of Islamic associations in Indonesia, especially Indonesia Islamic Economist Association (IAEI) and Indonesia Islamic Banking Association (ASBISINDO), have considerably encouraged Islamic banks in developing various SME oriented products.

After presenting the analysis of financial performance and financing activities as indicated in the Islamic banking operations in Indonesia, Malaysia, and Bangladesh above. To examine the Islamic bank rent theory hypothesis, next we will focus on the analysis and further elaboration on the plausible causes of the occurrence of the extraordinarily low level of Islamic financial deepening and slow pace of growth of the Indonesian Islamic banking from the bank's perspective rent theory perspective.

As explained in Chapter 3 that the market penetration in terms of deposit of funds held by the conventional and Islamic banks was completely different for the period 2005-2014. It is reflected at the end of period 2014 of the conventional banks which owned about 95% of the deposit funds in the banking industry whereas the Islamic banks only held about 5%. We also found an important fact that the funding source in the form of time deposit account is the highest portion of both the conventional and the Islamic banks in the period 2005-2014. We underline that as of 31 December 2008 and 2014, the portion of the time deposit held by the conventional banks is 47.03% and 47.16%, while the portion of the time deposit owned by the Islamic bank is 54.65% and 62.25%, respectively. It is worth to emphasize that for the time deposit account, the Islamic banks have offered a higher rate in comparison with the conventional banks in the period 2009-2012. This business strategy had to be done by the Islamic banks to attract the depositor by featuring the higher return of time deposit product competitively in comparison with the conventional banks. Obviously, it results in a detrimental impact on the funding structure owned by the Islamic banks since it will result in high cost of funds faced by the Islamic banks in comparison with the conventional banks. On

the other hand, in the financing activity, we found that portfolio held by the Islamic banks was substantially lower in comparison with the conventional banks. As of the end of 2014, the conventional banks owned 95%, whereas the Islamic bank only held about 5% of total financing in the banking industry.

However, we noted the important findings in the composition of credit/financing based on the purpose of the credit/ financing disbursement made by the conventional and Islamic banks in the period 2005 and 2014 (see Figure 5.1 below). For the conventional bank, in 2008 the percentage composition of the working capital of 52%, consumer of 28%, and investment of 20%, whereas in 2014 the percentage composition of the working capital of 48%,consumer of 28%, and investment of 24%. Meanwhile, for the Islamic bank, in 2008, the percentage composition of working capital of 54%, consumer of 25%, and investment of 21%, whereas the percentage composition of the working capital in 2014 of 39%, consumer of 40%, and investment of 21%.This showed the condition that the Islamic bank as more focused on consumer banking products with *murabaha* contracts in the financing activities.

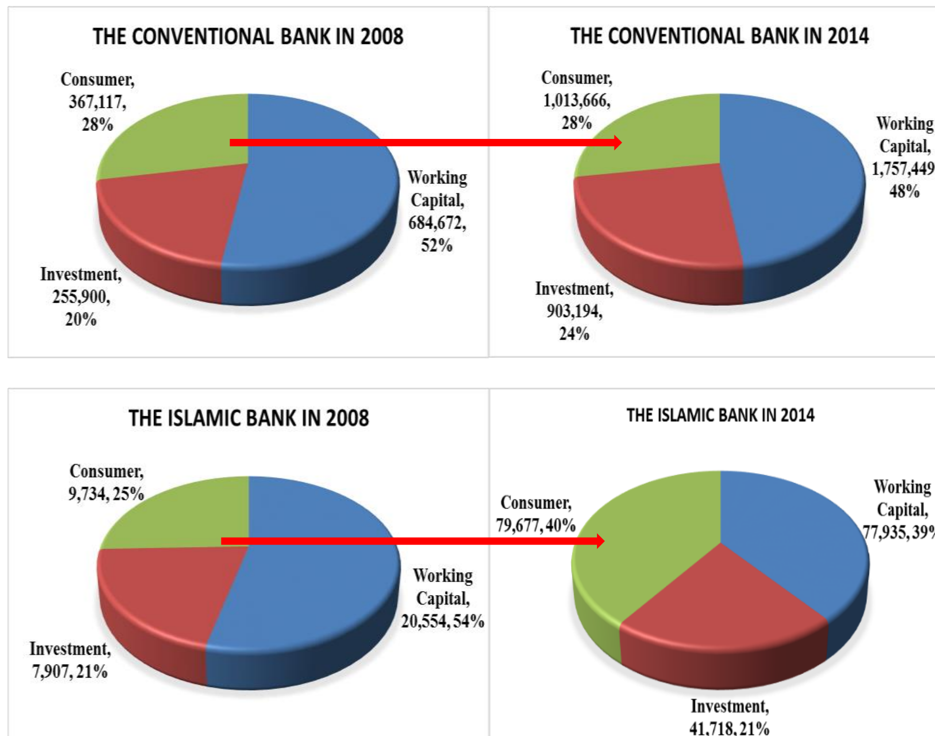
And if we explore further, we acknowledge that in terms of working capital and investment financing obviously that the Islamic banks charged relatively higher rates in comparison with the conventional banks. However, in terms of consumption financing, the Islamic banks offered a lower rate for their customers. In this sense, we admit that the Islamic banks have no alternative just to concentrate their financing to the consumption segments and providing a competitive rate for their customers.

Noticeably, these facts illustrate the severe situation faced by the Islamic

banks in their financing activities. As we realize that the Islamic bank has a relatively higher cost of fund in comparison to the conventional banks. Hence, this situation was resulting in which the Islamic banks seemingly have no opportunity except to disburse the funds into the financing products that can generate a higher return and mostly short tenor for their customers through the consumption segments using *murabaha* contracts.

As the Islamic banks face high competition with conventional banks in the consumer financing segment; they cannot impose a higher rate to the potential bank's customer. In addition, with the limited funds collected and lower banking capability, it makes sense that the Islamic banks are hesitant to take the corporate risk financing.

Figure 6. 1 Comparison of Composition of the Conventional and Islamic Banks' Credit/Financing in 2008 and 2014



Source: Constructed by the authors based on *Bank Indonesia's Indonesian Banking Statistics* and *Islamic Banking Statistics* (various year)

From the above discussion, it is evident that the Islamic banking industry in Indonesia is facing a structural dilemma in its funding and financing activities. In terms of funding, the Islamic banks encounter the problem of high cost of funding. This is caused not only as the Islamic banks' ability in collecting deposit fund is left behind the conventional banks, but also because the Islamic banks have a higher portion of funding source composition in the form of time deposit than the savings or current account. Moreover, the Islamic banks have no choice just to offer a higher rate of return for the type of time deposit account as their strategy to attract the

depositors competitively to the conventional banks. Furthermore, unfavorable conditions have clearly impacted on the Islamic banks financing activities. As the cost of fund structure is more expensive, consequently the Islamic banks only have the opportunity to disburse their financing in the market segment which can generate higher returns and mostly of short tenor. Thus, we have seen that the Islamic bank financing activity is mainly focused on the consumer market and has a dominant mode of financing under *murabaha* contracts. Accordingly, we underline that the Islamic bank's financing activity confirms a prevailing higher rent bank opportunity under the asset-based financing in Islamic banking business. Moreover, as the consequence of severe competition with the conventional bank in the same market segment, the Islamic banks offer a lower rate to the bank's customer as a strategy to attract the potential bank's customers competitively. Indeed, this strategy causes a detrimental impact on the level of income earning of the Islamic banks as it has decreased profitability and squeezed the banks rent opportunity.

It is worth noting that the limited fund collected and lower banking capability to serve the corporate sector in comparison with the conventional bank, has made Islamic banks reluctant to take up corporate risk financing. Consequently, the Indonesia’s Islamic banks have relatively higher portion of *mudaraba* and *musharaka* financing through the two-step *mudaraba/musharaka* financing. Essentially this financing strategy is a quasi-*murabaha*, as this particular mode of financing is not a dominant feature of the total Islamic bank's financing disbursement. As a result, it does not have a significant impact on increasing the profitability performance of the Islamic banks. In addition, as the Islamic banks are

hesitant to take up corporate financing segment due to lack of capital and limited skills in corporate risk mitigation, the Islamic bank charges a higher rate to their corporate segment financing customers. Thus, it increases the opportunities for attracting risky customers. In this sense, this situation raises the risk in the performance of financing portfolio monitoring by the Islamic bank. This proven condition in which at the turn is reflected on the NPL level of the Islamic bank that was deteriorating and to be higher than the conventional banks' NPL level in the period of 2007-2014.

Therefore from the perspective of the bank rent theory, we conclude that the causes of the extraordinarily low level of Islamic financial deepening and slow paced of growth of the Indonesia’s Islamic bank are rooted on the structural dilemma in funding and financing activities of the Indonesian Islamic bank. This structural dilemma led to the Islamic banks not to have adequate profit-base to maintain its 'franchise value' to ensure the sustainability of its future income earnings. Consequently, this unfavorable situation emerges as in adequate incentive for the Islamic bank's manager in performing a robust monitoring of the financing portfolio performance in order to realize further penetration in the banking market.

Accordingly, there is a need to provide solution to the structural dilemma faced by the Islamic banks in Indonesia. A number of incentive mechanisms that allow the Islamic banks to optimize the bank rent opportunities in the banking industry. If not, this situation will hinder the efforts in resolving the problem of the extraordinarily low level of Islamic financial deepening and slow paced of growth of the Indonesia’s Islamic banking. This difficult circumstance should be the main concern of the Indonesian financial authorities.

In this regard, we recognize the contribution of Small and Medium Enterprises (SMEs) as a specific case. As SMEs are an engine for economic growth in many developing countries like Indonesia, it is essential for the banking regulatory authorities to assure sufficient incentives and legal framework for the Islamic banks in promoting *mudaraba* and *musharaka* financing for the entrepreneurs. One alternative strategy could be promoted by the financial authorities in Indonesia in the current financial liberalization circumstance is conducting directed credit policy for the development of small and medium enterprises (SMEs) in the economy (Ghosh, 2005). Through this, the financial authorities will be able to control and encourage the allocation of financing of the Islamic banks to utilize *mudaraba* and *musharaka* financing contracts in order to support the SMEs development (Chapra and Khan, 2000; Wibisono, 2009; Ascarya and Yumanita, 2006). Such a policy, among others, can advance the following recommendations:

1. Abolishing unfair tax treatments, which treat profit from the Islamic bank's transaction as taxable and interest as non-taxable items,
2. Providing bank pricing subsidy for a deposit insurance scheme in accordance with the *Shari'ah* principle for *mudaraba* and *musharaka* financing contracts,
3. Eliminating the regulation on the level of collectability of profit and loss sharing (PLS) financing which implemented to be unfair and burden to Islamic banks' financing portfolio monitoring,
4. Establishing a certainty for specific judicial court suitable for profit and loss sharing (PLS) contract default..

6.5 Summary

The financing pattern of Islamic banks still remains a concern for academics and stakeholders of Islamic banking, as they are predominantly concentrating on the asset-based financing mode especially under *murabaha* contract rather than purely *Shari'ah*-based financing modes such as *mudaraba* and *musharaka* contracts. By using the financial sector rent approach, this chapter highlighted the evidence from the Islamic banking sector in Indonesia, Malaysia, and Bangladesh. Suzuki, Uddin, Pramono, and Khan (2017) admit that in the aspect of incentive and sanction mechanisms embedded in *Shari'ah* compliant products are likely to be similar to conventional banking as these products have many similarities to the conventional financial transaction with the featuring of accordance to *Shari'ah* principle and business ethics. Thus, it becomes highly relevant to emphasize Hellmann, Murdock, and Stiglitz's argument (1997) that a bank will pursue to capture the rent opportunity to keep its 'franchise value' as an incentive not only for the bank owner's to monitor the bank managers but also in supporting the banks becoming steady financial institutions with a strong incentive to manage their loan portfolios.

Thus, from a different perspective, this chapter discussed a "microeconomic" perspective on the performance of Islamic banks, especially in profitability and stability in carrying out financing activities. For this purpose, the discussion in this chapter drew upon the bank rent approach to making sense of the existing pattern of financing mode in Indonesia's Islamic banks and made a comparative analysis of the experiences of Islamic banks in Malaysia and Bangladesh.

Obviously from the empirical result of cases studies of Islamic banking in

Indonesia, Malaysia, and Bangladesh, the financing patterns still remain a concern as they are predominantly concentrating on the asset-based financing modes rather than purely *Shari'ah*-based financing modes.

It is evident that Islamic banks in Malaysia and Bangladesh rely almost entirely on asset-based *murabaha* financing modes for upholding their continuous stream of bank rent opportunity. In contrast, Islamic banks in Indonesia engage in equity-based *musharaka* financing at a relatively higher extent, even though asset-based financing modes are still prevalent in their asset portfolios.

This difference between the financing patterns of Islamic banks in Indonesia, Malaysia, and Bangladesh is reflected in the contrasting results documented by the two performance indicators ROA and NPL. The ROA of the Islamic banking sector of Bangladesh was higher than the overall banking sector in almost all years during the period under study. On the other hand, the NPL of the Islamic banking sector was lower than that of the overall banking sector during the whole period. However, the scenario is entirely reverse in Indonesia's Islamic banks. In both cases, the overall banking sector was performing better than Islamic banking almost during the whole period by presenting higher ROA and lower NPL. Meanwhile, in Malaysia, ROA and NPL performances of the overall banking sector during the whole period were slightly better than Islamic banks.

Interestingly, the nature of the *musharaka* financing adopted by Islamic banks in Indonesia is not the type of purely "participatory" financing. Rather, it is a unique variant approach of *musharaka* financing mode. Thus, we observe the *murabaha* syndrome in the Islamic banking sector in Bangladesh and Malaysia. In specific, we highlight interesting findings of the quasi-*murabaha* syndrome as

practiced by Indonesia's Islamic banks. Thus, the challenge of a pure *mudaraba* and *musharaka* mode of financing by Indonesia's Islamic banks undoubtedly creates a breakthrough for extending the equity-based participatory financing, which in turn encourages innovative and flexible adoption of Islamic *fatwa* (opinion) while developing financing products for Islamic banks.

Apparently, even a variant approach to *musharaka* financing generates less rent opportunity for Islamic banks in Indonesia. This indicates the severity of information asymmetry and transaction costs inherent in pure *Shari'ah*-based financing modes. Ironically, without assuring sufficient rent opportunity for Islamic banks, it is unjustified to ask them to accelerate pure *Shari'ah*-based financing in this liberalized and competitive market framework.

Noticeably, the stakeholders in Indonesia have pushed Islamic banks to accelerate *mudaraba* and *musharaka* financing in response to their efforts for developing such a unique approach of *musharaka* mode. Apparently, this effort could be categorized as a market driven approach in developing Islamic banking in Indonesia. Interestingly, even a variant approach to *musharaka* financing generates less rent opportunity for Islamic banks in Indonesia. This indicates the severity of information asymmetry and transaction costs inherent in pure *Shari'ah*-based financing modes. Ironically, without assuring sufficient rent opportunity for Islamic banks, it is unjustified to ask them to accelerate pure *Shari'ah*-based financing in this liberalized and competitive market framework.

Accordingly, from the perspective of the bank rent theory, we conclude that the causes of the extraordinarily low level of Islamic financial deepening and slow pace of growth of the Indonesian Islamic bank are rooted on the structural

dilemma in funding and financing activities of the Indonesian Islamic bank. This structural dilemma has led Islamic banks not to have adequate profit base to maintain their 'franchise value' to ensure the sustainability of their future income earnings. In this sense, the Islamic banking market does not provide sufficient incentive for the Islamic bank's manager to monitor the robustness of the financing portfolio performance in order to realize further penetration in the banking market. Therefore, without providing a profound solution to the structural dilemma faced by the Islamic banks in Indonesia with a number of incentive mechanisms that allow the Islamic banks to optimize the bank rent opportunities in the banking industry. This situation will hinder the efforts in resolving the problem of the extraordinarily low level of Islamic financial deepening and slow pace of growth of the Indonesian Islamic banking.

Moreover, recognizing the contribution of Small and Medium Enterprises (SMEs) as an engine for economic growth many developing countries like Indonesia, it is considerable to provide adequate incentives for the Islamic banks in promoting *mudaraba* and *musharaka* financing for the entrepreneurs. Through this policy, the financial authorities will be able to control and encourage the allocation of financing by Islamic banks to utilize *mudaraba* and *musharaka* financing contracts in order to support the SMEs development (Chapra and Khan, 2000; Wibisono, 2009; Ascarya and Yumanita, 2006).

CHAPTER 7
ANALYSIS OF THE DYNAMIC CONCENTRATION AND COMPETITION LEVEL OF THE ISLAMIC BANKING SECTOR IN INDONESIA

7.1 Introduction

This chapter aims to assess and analyse the market structure, concentration over time, and competition configuration in order to have a better understanding of Islamic banking industry in Indonesia. It will test the hypotheses proposed in this research that the Indonesia's Islamic banks face "severe" competition with conventional banks (also among Islamic banks) in the banking industry, causing Islamic banks to have inadequate profits for financial deepening while maintaining their franchise value and reputation. To do so, this chapter conducts analyses on the dynamic concentration and competition level of the Islamic banking sector in Indonesia.

The rest of this chapter is organized into four sections. Section 7.2 introduces theories supporting market concentration and competition level of the banking sector. This discussion introduces us to a background of discourses on the market structure and competition issues faced by the contemporary development of Islamic banking in order to have a better understanding of the occurrence of slow paced growth in Indonesia's Islamic banks. Then, section 7.3 discusses the concentration measurement methodologies in examining the market concentration and competition levels of Islamic banking business environment. Section 7.4 attempts to present analysis and empirical results as an assessment of Islamic bank market

concentration in order to get empirical findings on the concentration and competition levels in the context of the current development. This part provides information from the practitioners through several interviews with Islamic bank regulators and bank managers. Finally, Section 7.5 presents a discussion on concentration and competition issues in order to to make a summary about the market‘s structural dilemma currently faced by Indonesia’s Islamic banking industry.

7.2 Market Concentration and Competition Level

At this point, the pros and cons of enhancing banking market concentration have become the crucial debate in the public realm. In this sense, a review of extant literature is presented here, showing the two-fold issues that are relevant in examining the impact of the market structure of the banking industry on profitability and financial stability.

A study conducted by Mirzaei, Liu, and Moore (2011) demonstrates that in a developing economy, market power has no significant impact on a bank’s profitability, in contrast with the impact of market power in an advanced economy. Meanwhile, Beck et al. (2006) argue that the concentrated market of banking favors a more stable and resilient banking industry when facing financial crisis.

On the other hand, some criticisms appear to oppose a policy that encourages a banking concentrated market. Calem and Carlino (1991) pointed out that less-concentrated banking market structure creates a higher level of competitiveness in the banking, but it will be less prone to crisis, more competent, and equitable. Moreover, Abbasoglu et al. (2007) argue that a concentrated market seems to increase the revenue for the banks, but is not beneficial for bank’s customers.

According to Sastrosuwito (2012), there are two important issues when discussing the impact of the competitive level in the banking industry. We can categorize the discourses into two-fold topics, namely (1) the Bank's competitive level and efficiency; and (2) the Bank's competitive level and stability. The following section discusses a number of research findings on these issues.

7.2.1 Bank's Competitive Level and Efficiency

The unique characteristics of the financial market and banking industry have led to a debate on the controversial issues of the relationship between bank's competitive level and efficiency. Nevertheless, studies that present the empirical results on this particular issue are still relatively rare (Beck, Demirguck-Kunt, & Levine, 2006; Hellman et al., 2007; Sastrosuwito, 2012).

In general, the literature categorizes theories about the correlation of competition and efficiency into two hypotheses, namely the competition-efficiency hypothesis and the competition-inefficiency hypothesis (Sastrosuwito, 2012). Based on the competition-efficiency hypothesis, we assume that the increased competitive situation will have an impact on the acceleration of efficiency. Some studies present essential discussions of this hypothesis as follows.

The basic arguments for the competition-efficiency hypothesis are constructed on the "quiet life hypothesis" proposition suggested by Hicks (1995) in Sastrosuwito (2012), which states that monopolistic market power tends to deteriorate efficiency as the bank managers relish the comfort zone of the lesser competitive market (Casu & Girardone, 2008; Sastrosuwito, 2012).

Systematically, Well (2003) describes the mechanism of "welfare effect" in the competitive market as the source of efficiency. In this typical market circumstance, such created conditions push the banks to lower the offering lending rate; thus, the market provides incentives for the banks to engage in the minimum cost of operations. In turn, it will enhance investment and stimulate economic growth for the whole economy.

The empirical findings which is in line with the competition-efficiency hypothesis shown by Wanniarachchige and Suzuki (2010) indicate that increased competition in the Sri Lanka banking industry in the period 2003-2007 resulted in higher efficiency of the banking system which successfully managed technological and managerial improvement. Also, Sastrosuwito (2012) shows that the competition in the Indonesian banking sector increased due to the policies of banking and finance authorities after the period of oppression. Thus, intensified competition had a positive impact on efficiency of the banking sector.

These empirical findings support the argument of the competition-efficiency hypothesis as the policy to increase competitive level in improving efficiency. Thus, increasing competitive level will have a direct impact on a bank's profitability and performance. In turn, this condition forces the bank managers to enhance their performance in maintaining profitability and sustainability objectives.

On the other hand, the competition-inefficiency hypothesis argues that the increasing climate of competition leads to inefficiency in the banking industry. Sastrosuwito (2012) underlines the rationale behind this hypothesis as a tendency of less stable and shorter relationships between the bank and the customers. This argument can be upheld under the competitive market of the banking industry in

two ways. Firstly, as a consequence of higher probability of customers moving to the alternate banks due to the better prices offered (Chan et al., 1986; Boot & Schemits, 2005; Sastrosuwito, 2012). Secondly, it seems that the banks encounter loss of value of information about their customers as a consequence of a short-term relationship. As a consequence, the banks must bear a higher cost of information to maintain their existing customers and attract new customers. The competition-inefficiency hypothesis underlines the issue of asymmetric information, and screening and monitoring problems in the relationship between the bank and the debtor.

The study by Kumbhakar et al. (2001) shows an empirical result in support of this particular hypothesis. Their study proves that increased competition in the Spanish market is a result of banking regulatory reforms introduced in Spain that have caused a deterioration of bank efficiency. Their argument on the impact of a strategy based on vigorous interest rate, competition, and over-expansion in the market can be put forward to explain the finding of this research.

Uddin and Suzuki (2014) investigated the impact of competition level in Bangladeshi banks on bank performance, focusing on return on assets (ROA) and bank efficiency indicators. Their finding shows that increased competition level in a banking industry has a negative correlation with bank profitability and efficiency. This study underlines the need for a reconsidered direction of banking structural transformation in Bangladesh in order to ensure the necessary incentives for the banks to improve their performance in a competitive environment.

7.2.2 Bank's Competitive Level and Stability

Mainstream literature argues that the relationship between competition and

stability of the banking industry is negatively correlated. The condition of a competitive banking market increases the fragility of the banking system (Berger et al., 2008; Beck, 2006) is also known as competition-fragility or concentration-stability hypothesis. It argues that increased competition leads to decreased rent opportunities, declines franchise value and intensifies moral hazard behavior, which pushes the occurrence of bank failure to a higher possibility. Otherwise, concentration in a banking market will enhance the market power of the banks in realizing the banking stability as this condition will maintain the franchise value and proper cushion for the banking industry (Sastrosuwito, 2012).

Demsetz et al. (1996) explain that franchise value can be measured by calculating the difference between the market value of a firm with its replacement cost (the current cost to create the company). Acknowledging that maintaining franchise value is essential behavior in a bank rent circumstance, it is important to review relevant literature as the theoretical considerations.

Keeley (1990) points out that excessively increased competition in the US banking industry is a consequence of a financial liberalization policy that caused the banking crisis in the 1980s. Further, Keeley (1990) explains that severe competition decreases rent opportunities and lessen the incentive for the banks to conduct prudent banking practices. It can be concluded that the higher market power caused by concentration markets with less competition gives the banks a higher franchise value and offers a higher opportunity cost of bankruptcy, as it will prevent risk taking activities (Keeley, 1990; Sastrosuwito, 2012).

Accordingly, in a competitive banking market, Helmann et al. (1997) opine that if the deposit rate is freely determined in the market, it will create incentives

for banks to increase their deposit rates in order to expand their deposit base with a compromise on eroding profits, diminishing franchise value, and increasing risk taking behavior. In line with this notion, Suarez (1994) emphasizes that if banks face decreased market power as a consequence of increased competition and reduced franchise value, higher solvency problems will arise due to the higher risk taking condition in the market.

In contrary to the mainstream argument above, the competition-stability or concentration-fragility view argues that the concentration of the banking market will tend towards the fragility in the banking system (Boyd & De Nicolo 2005; Boyd et al. 2006).

Referring to the credit rationing hypothesis of Stiglitz and Weiss (1981), the competition-stability or concentration-fragility can be explained through the creation of the lending rate, which under competitive banking market is lower and leads to more credit rationing policy (Koskela & Stenbacka, 2000; Sastrosuwito 2012). A direct impact of the lower lending rate is the decline of such moral hazard and adverse selection behaviors. A further effect is the reduction in bad borrowers who obtain loans in the credit markets. In this sense, the risk default of credit could be reduced, and the financial system will tend to stabilize.

Uddin and Suzuki (2014) highlight the importance of conducting assessments on banking competition levels and analyses on its impact on bank performance for the following reasons. First, the competitive banking level will be beneficial to design the appropriate public policy in improving economic prosperity. Secondly, the banking deregulation programs conducted in many countries have a significant impact on competitiveness of banking circumstances, and thus, to realize the

objectives of banking deregulation comprehensively, the competitive aspects of the banking business environment should be considered one of the key factors by which successful programs will be attained. Thirdly, regulation and financial authority require relevant empirical results on the analysis of banking competitiveness and performance levels in evaluating the further direction of deregulation programs. Fourthly, banking competitiveness and performance levels are acknowledged to have long-term implications on the possibility of a financial crisis in the economy.

In the case of Islamic banking experience in the concentration and competitiveness of the market, among others, there have been two substantial studies conducted by Ariss (2010) and Mirzae (2011). Aris (2010) explores the significance of the competitive condition on bank profitability over conventional and Islamic banks in 13 countries over the period between 2000-2006. This study concludes that in a conventional bank, market power will increase the profitability of the bank; however in an Islamic bank this result is not proven. Meanwhile, Mirzae (2011) conducts a study to examine the effects of market power on the stability and performance of Islamic and conventional banks in 12 Islamic countries of Middle East over the period between 1999 and 2008. This study incorporates two main hypotheses as a background for the relationship between market structure and performance of the banks, namely the structure–conduct-performance (SCP) and the relative-market-power (RMP) paradigms. Mirzae (2011) shows that for the Islamic banks, market concentration has no significant impact on a bank's profitability and stability. On the other hand, for a conventional bank, the result indicates that SCP hypothesis is proven as market concentration has an important impact on bank stability and profitability performances.

In the context of the phenomena of extraordinarily low level of Islamic financial deepening and the recent trend of slow-paced growth of Indonesian Islamic banking, it is important to explore the market structure and concentration issues to have a better understanding of the Indonesian Islamic banking landscape and its competition configuration. The banking literature affirms that an ideal market structure of the banking industry is a key factor in achieving optimal performance for banks; therefore, it matters for stability in the financial system (Berger, 1995).

Especially when we acknowledge the Structure Conduct Performance (SCP) paradigm, it is hypothesized that the concentrated market structure is a fortunate aspect in reducing the competitive level in the banking sector (Bikker & Haaf, 2002; Uddin & Suzuki, 2015). In this regard, Helmann et al. (1997) admit that a concentrated market for banking is necessary because the bank will gain appropriate incentive in maintaining the franchise value to retain its market penetration.

7.3 Concentration Measurement Methodologies

This research adopts the Structure Conduct Performance (SCP) paradigm in examining market concentration and competition level in the Indonesia's Islamic banking business environment. In attaining this objective, this study applies two concentration measurement methods, which are *k*-Bank concentration ratio and Herfindahl-Hirschman index (HHI).

7.3.1 The k-Bank Concentration Ratio

This method is the most common and is frequently used to measure market concentration with simplicity and limited data requirement (Meilak, 2008; Uddin & Suzuki, 2015). The ratio is calculated by summing the market shares of the *k*

largest banks in the industry for the particular periods. Symbolically, it can be formulated as follows:

$$CR_k = \sum_{i=1}^{n} s_i$$

Where *Si* is the market share for a particular bank and *k* is the number of the banks in the industry. There is no exact rule for determining the value of *k*, thus, the numbers of the bank included will be an arbitrary decision. Accordingly, the *k*-bank concentration ratio will range between zero to one (Tushaj, 2010; Suzuki & Uddin, 2014).

7.3.2 The Herfindahl-Hirschman Index (HHI)

The Herfindahl-Hirschman Index (HHI) will be adopted, if we consider that bank market concentration should be measured by weight, the larger bank should be attributed to greater weights (Tushaj, 2010; Uddin & Suzuki, 2015).

Accordingly, in calculating this index, the market share of each bank is squared and summed in each period. The HHI is defined as follows:

$$HHI = \sum_{i=1}^{n} s_i^2$$

Where *Si* is the market share of bank i and n is the number of banks in the industry. It is concluded based on this formula $(1/n) < HHI < 1$, meaning that the maximum concentration in the unity will be attained in a monopoly market, whereas the minimum of concentration (i/n) happens when each bank has an equal market share in the industry. HHI is also known as the full information index because it

features the whole distribution of the existing bank sizes in the industry. In this sense, the HHI is sensitive to unevenness of market share of the banks. This also considered to be a favorable reason in alternate to the *k*-bank concentration ratio. Meanwhile, the HHI is acknowledged as an important measurement for the process of antitrust law enforcement in the United States banking industry (Tushaj, 2010; Suzuki & Uddin, 2014).

7.4 Analysis and Empirical Results

In accordance with Act No. 10 Year 1998 about banking, the Indonesian government has introduced the dual banking system. This Act categorizes the types of banking business based on interest bank system and on *Shariah* principles. *The Indonesian Banking Architecture* (Arsitektur Perbankan Indonesia/API) (Bank Indonesia, 2004) explains that the development of Indonesia's Islamic banks is carried out within the framework of the dual-banking system for the purposes of providing a relatively wide-ranging banking service to bank's customers in Indonesia. With this particular policy, it is expected that the conventional and Islamic banks will jointly support the mobilization of public funds in financing productive sectors of the national economy.

In this sense, we admit that the development of banking regulations and supervision under the dual banking system was taken by the Indonesian government aimed to create a co-existent approach based on the two types of banking business. This approach, in fact, has formed a specific market structure for the banking industry in Indonesia, in which the banking business has unity within the market playing field.

As a general overview of financial and banking sector contribution in the economy, we notice that as of 31 December 2010, market penetration in the banking sector relative to gross domestic product (GDP) was 44.50 percent, whereas the size of the stock market was 47.7 percent. This condition does not change significantly when we find that market penetration in the banking out sector relative to gross domestic product (GDP) was 54.11 percent as of December 31st, 2014, whereas the size of the stock market was 47.5 percent (*Bank Indonesia*, 2015; World Bank, 2015).

In addition, the banking market in Indonesia is highly dominated by the conventional banks. Therefore, to depict an overall picture of the market structure of overall banking industry, this research applies k-Bank concentration ratios (three-banks and five-banks) in measuring the concentration level of the Indonesian banking industry in terms of total assets, total credit/financing, and total deposits during the period between 2006-2014.

According to the Indonesia's Banking Statistics 2014 (*Bank Indonesia*, 2015), there are seven commercial banks included in the five top biggest banks replacing in this particular period 2006-2014, consisting of Bank Mandiri, Bank BCA, Bank Negara Indonesia, Bank Rakyat Indonesia, Bank Danamon, Bank CIMB Niaga, and Bank Permata. It is worth noting that the dominant key players of the banking industry are captured by the three biggest banks in Indonesia which are Bank Mandiri, Bank BCA, and Bank Rakyat Indonesia. These three banks hold about 36-39% of total asset, 28-36% of total credit, and 38-41% of total deposit in the banking industry. In addition, it is obvious that the state owned banks (Bank Mandiri, Bank Negara Indonesia, and Bank Rakyat Indonesia) are still held a

dominant market share in the industry for these periods.

Table 7. 1 Concentration Ratio Based on Total Asset, Total Credit, and Total Deposit of the Indonesian Banking Industry

Based on Total Asset	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
CR-*k* 3	36.2%	37.3%	36.8%	39.2%	39.2%	38.4%	38.2%	37.5%	39.3%
CR-*k* 5	50.2%	51.0%	50.2%	52.4%	52.2%	51.2%	50.7%	49.7%	50.9%
Based on Total Credit	2006	2007	2008	2009	2010	2011	2012	2013	2014
CR-*k* 3	28.5%	31.4%	32.6%	34.9%	35.2%	35.3%	35.6%	35.9%	36.1%
CR-*k* 5	43.9%	44.4%	45.5%	48.4%	48.2%	47.8%	47.8%	47.9%	48.2%
Based on Total Deposit	2006	2007	2008	2009	2010	2011	2012	2013	2014
CR-*k* 3	38.4%	39.9%	39.9%	41.6%	40.6%	39.2%	38.0%	38.8%	40.2%
CR-*k* 5	52.3%	53.4%	53.5%	55.5%	53.9%	52.3%	50.3%	51.0%	51.7%

Source: Annual Report of Each the Banks and Bank Indonesia`s Indonesian Banking Statistics for the period 2006-2014

Table 7.1 above shows k-3 and k-5 concentration ratios in the periods of 2006-2014 calculated on the basis of total asset, total credit/financing, and total deposit and make it clear that the values vary across ratios as well as within in these specific periods.

However, overall, Table 7.1 also presents an obvious conclusion that the concentration ratio during these periods has a tendency to go flat smoothly with the concentration ratio CR-k3. The total asset that was recorded was about 36-39% and CR-k 5 was about 49-52%. Meanwhile, in terms of total credit, the concentration ratio CR-k3 was recorded about 28-36% and CR-k 5 was about 49-52%. On the other hand, in terms of total deposit, the concentration ratio CR-k3 was recorded to be about 38-41% and CR-k 5 was about 50-55%.

In this sense, we can deduce that during the periods between 2006-2014 it seemed that there was no significant changing in the competition circumstance of

the banking industry in Indonesia and the market shares of the banks were enjoyed primarily by the top five biggest banks.

In order to have a better understanding of Indonesia's Islamic banking landscape and the configuration of its competition, this study uses the Herfindahl-Hirschman Index (HHI) to assess the Islamic banking market structure and concentration. The sample of this study includes the entire population of full-fledged Islamic banks and Islamic bank business division (Unit Usaha Syariah/UUS) for the periods 2004-2014. In conducting measurements, we categorized the data of Islamic banks under the categories of Islamic bank-related government (state owned and district government owned banks) and private Islamic banks. The reasoning for this specific period of the sample was that this empirical result should show the Islamic bank market structure for the years before and after the enactment of Islamic Banking Act No. 21 in 2008.

As brief description of the configuration of the total assets, the third party fund/deposit, and total financing of Islamic banks in Indonesia are shown below in Tables 7.2, 7.3, and 7.4 respectively. These tables are categorized as Islamic bank and Islamic bank windows under two types of ownership criteria as state/district owned or private owned entities.

Table 7. 2 Total Assets of Islamic Banks and Islamic Bank Windows for the Period of 2004-2014

Year	Total Assets							
	In Millions Rp				Percentage			
	IBSDO	IBPO	IBWSDO	IBWSPO	IBSDO	IBPO	IBWSDO	IBWSDO
2004	6,869,949	5,610,675	1,878,846	966,527	45%	37%	12%	6%
2005	8,272,965	8,323,956	2,851,475	1,431,453	40%	40%	14%	7%
2006	9,554,967	10,715,534	4,238,426	2,213,103	36%	40%	16%	8%
2007	13,146,607	13,762,097	6,789,943	1,838,990	37%	39%	19%	5%
2008	17,548,836	16,298,971	9,329,555	6,377,760	35%	33%	19%	13%
2009	31,065,740	22,739,503	6,594,727	5,690,030	47%	34%	10%	9%
2010	47,663,651	31,312,970	9,584,375	8,958,004	49%	32%	10%	9%
2011	71,189,111	67,557,671	13,565,742	15,042,922	43%	40%	8%	9%
2012	83,203,072	63,376,223	20,058,257	27,710,651	43%	33%	10%	14%
2013	100,769,867	56,362,626	25,573,431	35,705,807	46%	26%	12%	16%
2014	112,868,728	91,493,953	28,828,412	39,151,907	41%	34%	11%	14%

Note:
- IBSDO: Islamic Banks State/District Owned
- IBPO: Islamic Banks Private Owned
- IBWSDO: Islamic Bank Windows State/District Owned
- IBWSPO: Islamic Bank Windows Private Owned

Table 7. 3 Total Third Party Fund/Depositors of Islamic Banks and Islamic Bank Windows for the Period of 2004-2014

Year	Total Assets							
	In Millions Rp				Percentage			
	IBSDO	IBPO	IBWSDO	IBWSPO	IBSDO	IBPO	IBWSDO	IBWSDO
2004	5,725,007	4,610,300	1,038,801	583,149	48%	39%	9%	5%
2005	7,037,506	6,572,152	1,347,756	833,821	45%	42%	9%	5%
2006	8,219,267	8,995,533	2,110,639	2,220,733	38%	42%	10%	10%
2007	11,230,705	11,186,962	4,054,172	1,539,831	40%	40%	14%	5%
2008	14,940,138	12,895,102	5,277,803	3,739,105	41%	35%	14%	10%
2009	25,871,536	18,906,314	3,590,148	4,353,002	49%	36%	7%	8%
2010	41,119,992	24,722,601	3,194,242	6,287,749	55%	33%	4%	8%
2011	60,840,674	51,115,981	8,665,583	10,831,823	46%	39%	7%	8%
2012	70,569,761	48,707,658	12,176,792	18,118,165	47%	33%	8%	12%
2013	85,983,346	42,350,595	15,705,075	24,537,877	51%	25%	9%	15%
2014	97,714,581	75,664,290	16,141,624	28,337,505	45%	35%	7%	13%

Note:
- IBSDO: Islamic Banks State/District Owned
- IBPO: Islamic Banks Private Owned
- IBWSDO: Islamic Bank Windows State/District Owned
- IBWSPO: Islamic Bank Windows Private Owned

Table 7. 4 Total Financing of Islamic Banks and Islamic Bank Windows for the Period of 2004-2014

Year	Total Assets							
	In Millions Rp				Percentage			
	IBSDO	IBPO	IBWSDO	IBWSPO	IBSDO	IBPO	IBWSDO	IBWSDO
2004	5,209,757	4,359,197	1,178,546	742,433	45%	38%	10%	6%
2005	5,720,912	6,520,342	1,876,546	1,114,142	38%	43%	12%	7%
2006	7,153,908	8,607,690	2,687,459	1,995,850	35%	42%	13%	10%
2007	10,112,645	10,369,343	4,595,263	2,867,060	36%	37%	16%	10%
2008	15,679,517	12,663,440	6,786,994	3,065,023	41%	33%	18%	8%
2009	28,235,835	10,916,418	4,347,090	3,386,657	60%	23%	9%	7%
2010	33,692,938	21,628,198	7,427,538	4,209,195	50%	32%	11%	6%
2011	51,706,324	49,718,449	8,856,687	6,658,262	44%	43%	8%	6%
2012	65,131,763	45,619,553	12,888,787	15,080,819	47%	33%	9%	11%
2013	77,948,065	38,614,417	19,365,381	17,797,521	51%	25%	13%	12%
2014	84,034,922	64,896,150	30,676,540	19,722,388	42%	33%	15%	10%

Note:
- IBSDO: Islamic Banks State/District Owned
- IBPO: Islamic Banks Private Owned
- IBWSDO: Islamic Bank Windows State/District Owned
- IBWSPO: Islamic Bank Windows Private Owned

In general, we conclude that throughout the decade (between 2004-2014), Indonesia's Islamic banks have been dominated by two types of Islamic banks in terms of total assets, these being Islamic banks owned by the state/the district government (holding about 35-46% of total asset) and Islamic banks owned by private companies (holding about 26-40% of total asset).

It should be noted here that the main players of full Islamic banks owned by the state/the district government comprise of three main players which are PT Bank Syariah Mandiri (BSM), PT Bank Rakyat Indonesia Syariah (BRIS), and PT Bank Negara Indonesia Syariah (BNIS). Obviously, these particular banks are subsidiary companies of each holding company, which are also recognized as main players in the conventional banking in Indonesia. Meanwhile, the Islamic banks owned by the private sector are dominated by PT Bank Muamalat Indonesia (BMI) which is recognized as the pioneer of the first Islamic bank in Indonesia. It is worth noting that the majority of shareholders of BMI are foreign investors.

On the other hand, in terms of the third party fund/deposit, such similar configuration could be found in two types of Islamic banks, which are Islamic banks owned by state/district government (holding about 38-55% of total third party fund/deposit) and Islamic banks owned by private companies (holding about 25-42% of total assets). These two types of banks have dominated in depositor funds in Islamic banking. In the meantime, financing activities carried out by Islamic banks were also dominated by two types of Islamic banks, which are Islamic banks owned by the state/district government (holding about 35-60% of total financing) and Islamic banks owned by the private companies (holding about 23-43% of total financing).

In addition, it is interesting to depict the trends of Islamic bank development in terms total asset, third party fund/deposit, and total financing during this particular period (2004-2014) as presented in Figure 7.1, 7.2, 7.3 below:

Figure 7. 1 Trend of Total Assets Growth in Indonesia's Islamic Bank and Islamic Bank Windows for the Period of 2004-2014

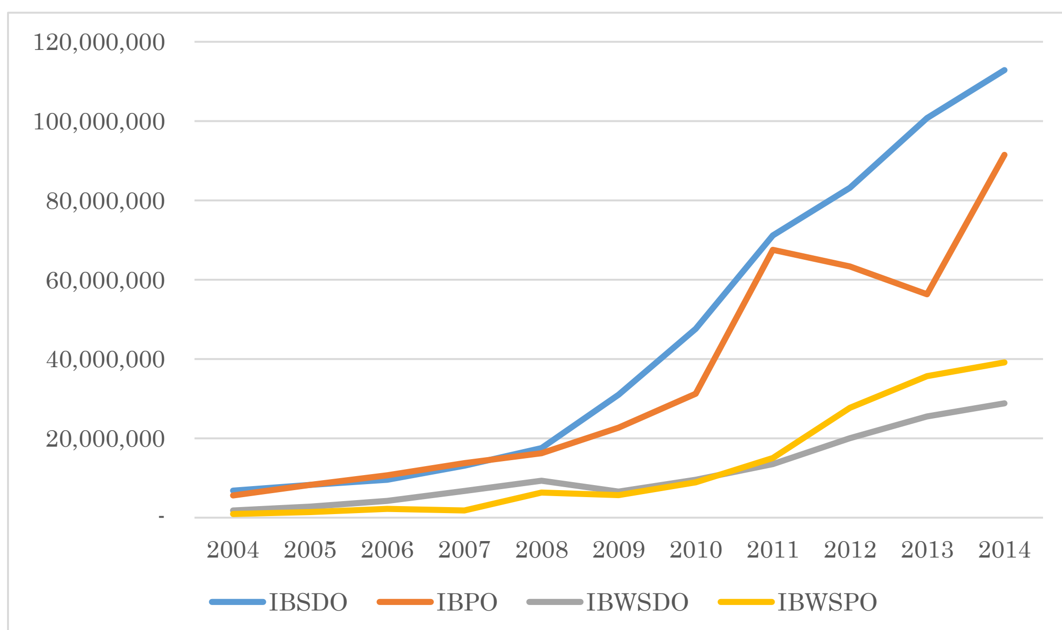


Figure 7. 2 Trend of Third Party Fund/Deposit Growth in Indonesia's Islamic Bank and Islamic Bank Windows for the Period of 2004-2014

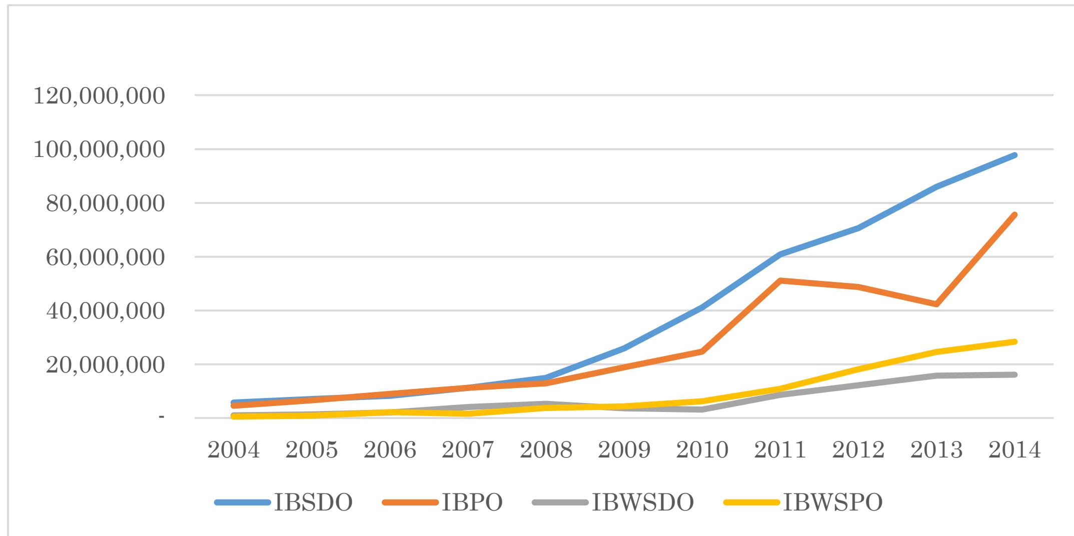
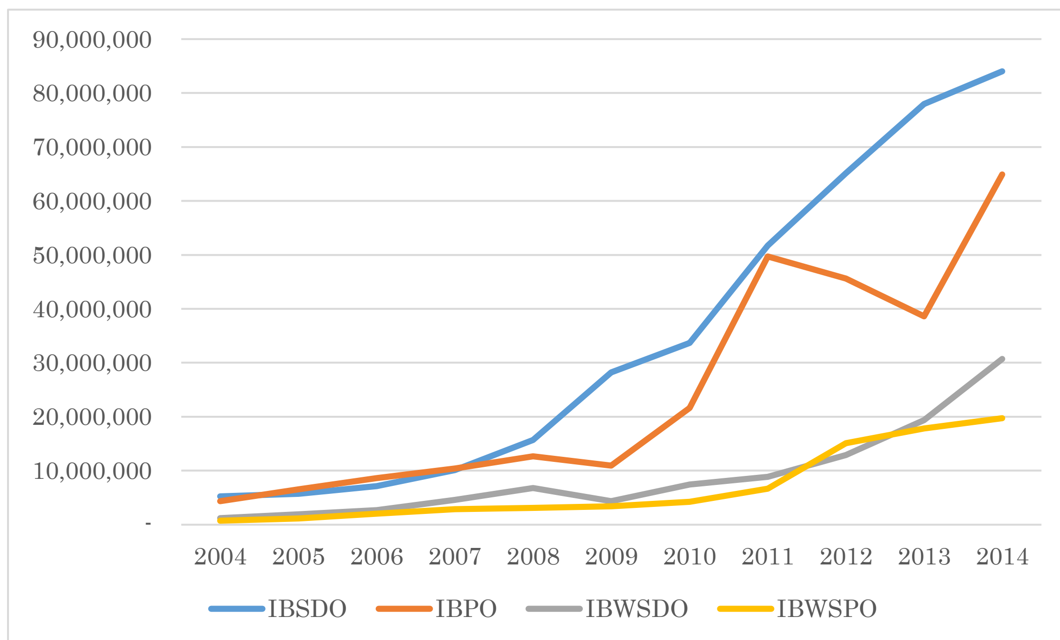


Figure 7. 3 Trend of Financing Growth in Indonesia's Islamic Bank and Islamic Bank Windows for the Period of 2004-2014



Looking at Figure 7.1, 7.2 and 7.3 above, we conclude that in four categories IBSDO, IBPO, IBWSDO, and IBWSP, in all types of ownership for the Islamic banks in Indonesia, the trends have shown a successful performance in realizing

such increased inclination in terms of total assets, third party fund/deposit, and total financing during the particular period between 2004-2014. However, we emphasize that the increasing trend created by IBSDO is always significantly higher as compared to the three other categories counterparts of the Islamic bank. Meanwhile, the growth trend experienced by IBPO, although it also increased, experienced considerable fluctuation, especially in the period between 2010-2014.

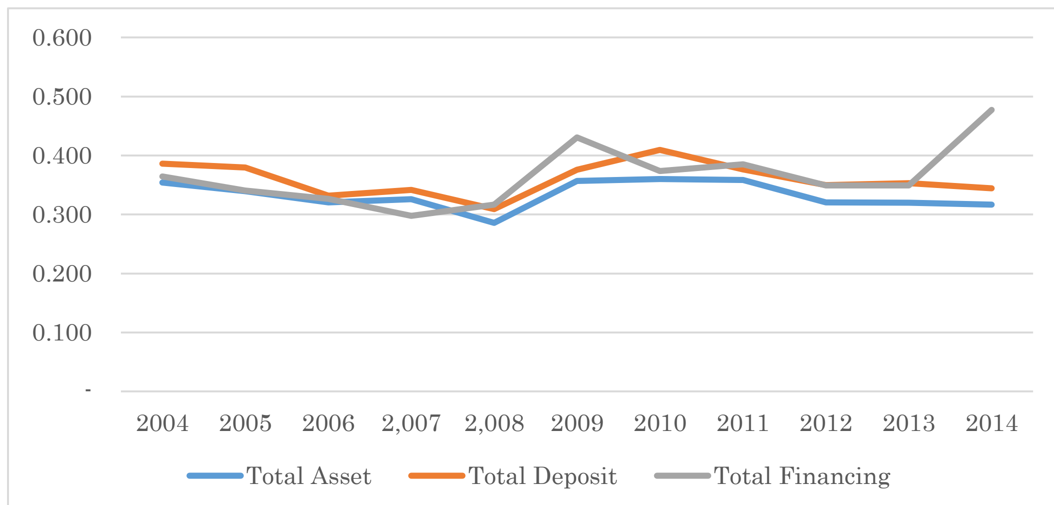
Next, Table 7.5 below presents a measurement of the Islamic bank concentration index using the Herfindahl-Hirschman Index (HHI) based on the total assets, the third party fund/deposit, and total financing of Islamic bank in Indonesia for the period of 2004-2014:

Table 7. 5 The Herfindahl-Hirschman Index (HHI) Concentration Based on the Total Assets, the Third Party Fund/Deposit, and Total Financing of Islamic bank in Indonesia for the Period of 2004-2014

	2004	2005	2006	2,007	2,008	2009	2010	2011	2012	2013	2014
Total Asset	0.354	0.339	0.321	0.326	0.286	0.357	0.360	0.359	0.321	0.320	0.316
Total Deposit	0.386	0.380	0.332	0.342	0.309	0.376	0.409	0.377	0.350	0.353	0.344
Total Financing	0.364	0.341	0.327	0.298	0.316	0.431	0.374	0.385	0.349	0.349	0.477

Figure 7.4 below describes the trend of the Herfindahl-Hirschman Index (HHI) concentration of the Islamic banks in Indonesia during the extended periods of 2004-2014.

Figure 7. 4 Trend of the Herfindahl-Hirschman Index (HHI) Concentration Based on the Total Assets, the Third Party Fund/Deposit, and Total Financing of Islamic Bank in Indonesia for the Periods 2004-2014



Based on Figure 7.4, we conclude that during the period of 2004-2008, the market concentration of Islamic banks based on the total asset, the third party fund/deposit, and total financing had a declining trend. However, we note that the period afterward during 2008-2012 that it had a tendency to become more fluctuated.

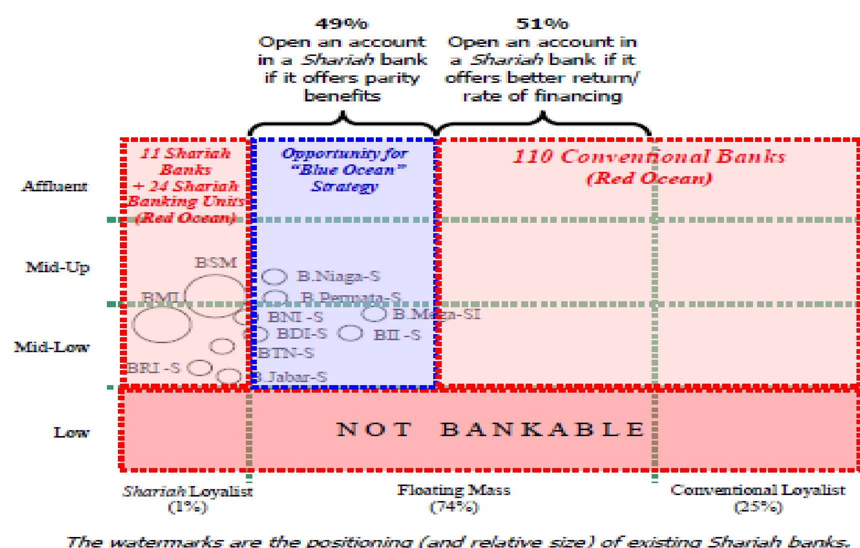
Interestingly, it is indicated that in the period 2012-2014, the concentration pattern according to HHI index showed a slightly declining trend. However, we find that concentration on total financing seemed to increase approaching the year of 2014. After further scrutiny of this situation, it can be argued that the financing activities have been dominated by the main players of the Islamic bank during the period, and there is the worst situation of the economy which caused the Islamic banks to face difficulties in channeling their financing.

From this perspective, we may hypothesize that the level of competition for the Islamic banks in Indonesia for this particular period has increased. A study

conducted by Bustaman (2014) describes the situation of the competitive levels of the business environment for Islamic banks in Indonesia. Refer to Figure 6.5 below, Bustaman (2014) shows that most of the Islamic banks pursue their targeted customers based on "*Shari'ah* loyalists" (1% of the bankable population) and ignore "the floating mass of potential customers" (74% of the bankable population). Even so, in the segment's floating mass, at least half of them also have a preference to choose *Shari'ah* compliant products if the Islamic bank provides the rate and services that are at least at par with conventional banks offerings.

IRTI (2016) reports a similar research finding in which there is a need to conduct such extensive education and socialization by the regulators and practitioners of Islamic finance to conduct market education. Based on surveys, only about 13 % of the public in Indonesia have a full understanding and preference to choose services offered by the Islamic financial institutions.

Figure 7. 5 Psychographic Segmentation of the Islamic Bank Customers in Indonesia



Source: Bustaman (2014, p. 7)

Such increased competitive level does not only occur among Islamic bank players but also in highly competitive climates with services offered by conventional banks. This situation suggests that Islamic banks in Indonesia fall into the "quasi-*murabaha*" syndrome practices (Suzuki, 2013; Suzuki & Uddin, 2014; Suzuki, Uddin, Pramono, & Khan, 2017). This condition also explains the dominance of modes of financing in Islamic banking products under the contract asset-based financing such as *murabaha* and its variations. Without adequate incentive preserved in the Islamic banking industry, it will be difficult for Islamic bank managers to improve the profit and loss sharing under *mudaraba* and *musharaka* financing contracts. Furthermore, the increasingly difficult conditions occur as Islamic banks are exposed to the severe competition in the same "hire purchase" with conventional bank credit markets as Indonesia is relying mostly upon Islamic banks in the retail banking business. According to the explanation from a senior banker at the Islamic bank in Indonesia, in the interview conducted on 18 March 2016, customers of Islamic banks in Indonesia are dominated by the retail banking and do not yet have the experience to provide service to the corporate sector. This is caused by a number of obstacles that are currently experienced by the Islamic banks, among which are small business scale that cannot compete with large banks, lack of capital, lack of capacity and experience in dealing with the corporate sector, and higher cost of funds for depositors as promised a higher return on time deposit from the customers. In addition, he admits that there has been severe competition in the retail sector and consumer banking, it does not occur merely among the Islamic banks, but also between the Islamic banks and the conventional

banks. In the meantime, the Islamic banks hesitate to carry out market penetration in corporate business due to the limitation of capital and the lack of capabilities. In addition, the severe competition amongst the Islamic banks is seen in the Islamic bank managers' behavior as they aggressively look for bank customers by offering refinancing products for customers who default on payment, often with the aim of meeting the marketing target. Then, in many cases, it is not rare for these bank managers not to comply with the coverage area of their banks work operations.

Therefore, it is arguable that the market structure faced by the Indonesia's Islamic banks is the cause of the increased competition level in the banking industry. This is indicated by a severe competition level to acquire third party funds (deposit) and offer competitive financing services caused by the strong level of liquidity and high benchmark interest rates in the market. This condition is experienced even more so by the Islamic banks as the Islamic banks only focus on market penetration of the loyalist Islamic bank consumer segment due to difficult barriers that prevent penetration in floating mass consumers.

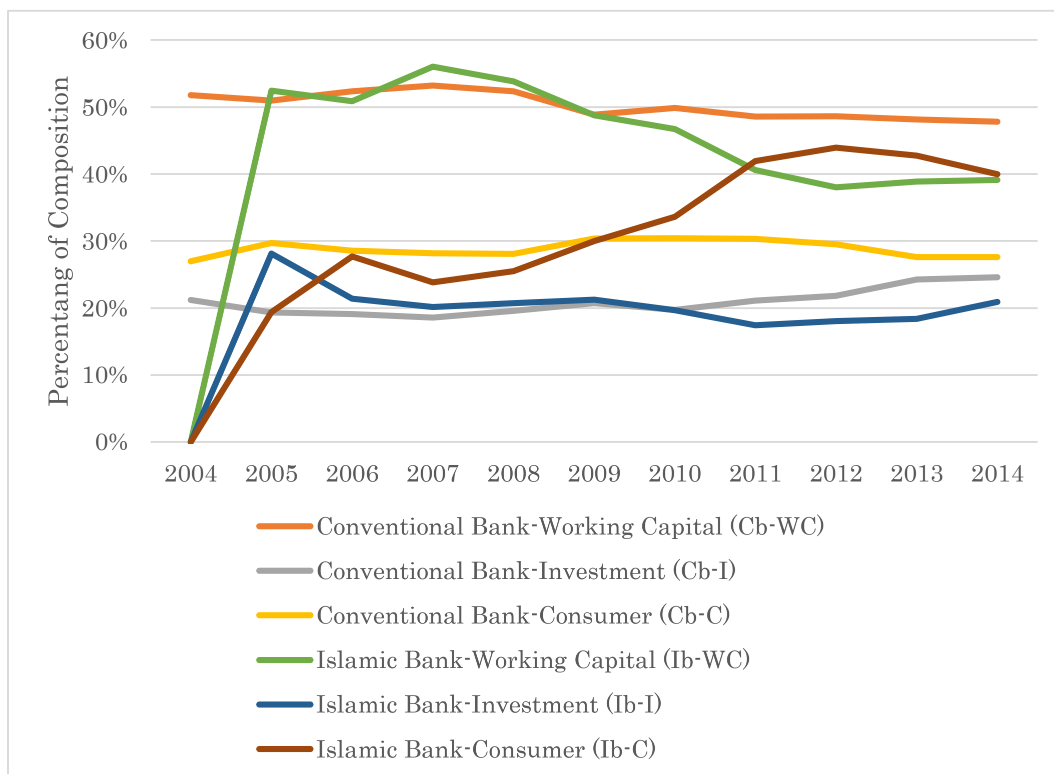
Thus, to clarify and provide further elaboration of the competition level in the banking industry under the retail sector and consumer credit activities, Table 7.6 shows the growth of credit allocation and financing of banks in Indonesia. This credit activity is divided into three categories of credit disbursement purposes, i.e. working capital, investment and consumer credits. Furthermore, Figure 6.6 presents a trend of credit allocation that occurred during this particular period of time for the conventional and the Islamic banks.

Table 7. 6 Comparison of Total Allocation of Credit and Financing among Conventional Banks and Islamic Banks for the Period of 2004-2014

Conventional Bank:	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Working Capital	289,666	354,557	414,749	533,240	684,672	703,002	880,208	1,068,676	1,316,689	1,585,659	1,757,449
Investment	118,723	134,400	151,209	186,218	255,900	297,939	348,518	464,262	591,425	798,157	903,194
Consumer	151,081	206,691	226,339	282,553	367,117	436,989	537,118	667,155	799,748	909,058	1,013,666
Total	559,470	695,648	792,297	1,002,011	1,307,689	1,437,930	1,765,844	2,200,093	2,707,862	3,292,874	3,674,309
Islamic Bank:	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Working Capital	N/A	7,988	10,405	15,656	20,554	22,873	31,855	41,698	56,097	71,566	77,935
Investment	N/A	4,288	4,374	5,637	7,907	9,955	13,416	17,903	26,585	33,839	41,718
Consumer	N/A	2,956	5,666	6,652	9,734	14,058	22,910	43,053	64,823	78,715	79,677
Total	N/A	15,232	20,445	27,945	38,195	46,886	68,181	102,654	147,505	184,120	199,330

Source: the Statistics of Indonesia Banking of Bank Indonesia (the central Bank of Indonesia) for the Years Respectively

Figure 7. 6 Trends of Credit and Financing Allocation of Conventional and Islamic Banks for the Periods of 2004-2014



From Table 7.6 and Figure 7.6, we can highlight some important findings:

Firstly, consumer financing is one of the types of credit which significantly takes part in credit activities in both of the Indonesia conventional banks and Islamic banks. Yet, for the conventional banks, the shares of consumer credits reach about 30% during the period. Meanwhile, for the Islamic banks, the consumer financing portfolios are not less than 20-45% in the period and are seemingly more fluctuated. Moreover, the trend of consumer financing for the Islamic banks has increased significantly and fluctuated. Meanwhile, the trend of consumer credit in the conventional banks has been more stable.

Secondly, consumer banking products in Islamic banks have become significant financing modes, and a rising trend of the consumer banking portfolio has confirmed the domination of *murabaha* financing and "quasi *murabaha*" in the Indonesian Islamic banks (Suzuki, 2013; Suzuki & Uddin, 2014; Suzuki, Uddin, Pramono, & Khan, 2017). This is understandable as the typical asset backed sales product in Islamic banks is being applied in order to avoid a method of profit and loss sharing (PLS) financing. Obviously, this pattern is caused by the conservative behavior of the Islamic bank's business managers, who are risk adverse in avoiding high risk financing based on PLS modes. This is understandable, as the inherent nature of PLS financing demands higher monitoring costs and has a higher risk of moral hazard and information asymmetric problems compared to a conventional banking business (Suzuki, 2013, Visser, 2013; Suzuki & Uddin, 2014).

Furthermore, to get a better description of the high level of competition in the consumer banking market, we will perform further observation on some financial

and operational indicators and the proportion of consumer credit (financing) portfolio from the selected conventional banks and the Islamic banks in the period 2008-2014 (as presented in Table. 7.7). The two main players of the Islamic banks, namely the Bank Syariah Mandiri (BSM) and the Bank Muamalat Indonesia (BMI), were selected randomly for our sample. In addition to this, two conventional banks were chosen as counterparts. These were Bank Bukopin (BB) and the Bank of Victoria (BV).

Overall, the research concludes that, firstly, consumer banking places a significant portion of the credit activities from all banks into the sample. The portion of consumer banking ranged between 15-67% during this particular period. In addition, BB which has customer base on the SMEs business and Cooperatives segments apparently has a bigger portion on this consumer banking as mostly in this period, with its consumer banking making up over of 60% of its total financing. Conversely, in the Islamic banks, it seems that BMI has a tendency portion of higher consumer banking as almost more than 40% of the total financing during this period.

Secondly, in terms of the ratio of Loan/Financing to Deposit Ratio (LDR), all banks show a significant ratio within the range of approximately 40-100%. This shows that all banks have conducted extensive credit disbursement throughout the period. Meanwhile, regarding the Non-Performing Loans/Financing (NPL), the overall performance of the conventional banks indicates a relatively lower NPL ratio compared to the Islamic banks. On the other hand, in terms of Net Interest Margin (NIM) ratio, it indicates that two of the conventional banks in the sample have a lower NIM ratio in comparison to the Islamic banks. This indicates the possibility that the Islamic banks were likely offering consumer banking products

with higher price level to the consumers as a result of the higher cost of fund structure owned by the Islamic banks compared to the conventional banks.

Thirdly, the occurrence of a tight competition level in the consumer banking has driven the Islamic banks to face difficult conditions to achieve promising performance due to a lack of economic scale and a lower efficiency level. In this severe competitive situation, the Islamic banks have suffered to acquire the depositors' fund and fall into a higher cost of fund for their business. In turn, this means that the Islamic banks have failed to get the bank rent opportunities to develop their businesses and have thus experienced stagnant growth in the period of 2008-2014.

Table 7. 7 Comparison of Some Financial and Operational Indicators of the Selected Conventional and Islamic Banks

		2008	2009	2010	2011	2012	2013	2014
Bank Syariah Mandiri								
	ROA	1.8%	2.2%	2.2%	2.0%	2.3%	1.5%	0.2%
	FDR	89.1%	83.1%	82,5%	86,0%	94,4%	89,3%	82,1%
	OCOI	78.7%	73.8%	78.0%	81.7%	79.8%	77.2%	83.8%
	NIM	6.7%	6.6%	6.6%	7.5%	7.3%	7.3%	6.2%
	NPF	5.7%	4.8%	3.5%	2.4%	2.8%	4.3%	6.8%
	% Consumer Financing	15.0%	20.5%	28.4%	43.7%	43.9%	43.3%	38.5%
Bank Muamalat Indonesia								
	ROA	2.6%	0.5%	1.4%	1.5%	1.5%	0.5%	0.2%
	FDR	104.4%	85.8%	91.5%	85.2%	94.2%	100.0%	84.1%
	OCOI	78.9%	95.5%	87.4%	85.3%	84.5%	93.9%	97.3%
	NIM	7.4%	5.2%	5.2%	5.0%	4.6%	4.6%	3.4%
	NPF	4.3%	4.7%	4.3%	2.6%	2.1%	4.7%	6.6%
	% Consumer Financing	45.7%	40.1%	41.4%	56.0%	56.3%	39.0%	52.7%
Bank Bukopin								
	ROA	1.7%	1.5%	1.7%	1.9%	1.8%	1.8%	1.3%
	LDR	83.6%	76.0%	71.9%	85.0%	83.8%	85.8%	83.9%
	OCOI	84.5%	86.9%	85.0%	86.9%	84.5%	82.7%	88.3%
	NIM	4.8%	4.1%	4.8%	4.6%	4.6%	3.8%	3.7%
	NPL	4.9%	2.8%	3.2%	2.9%	2.7%	2.3%	2.8%
	% Consumer Credit	67.0%	65.0%	63.1%	63.7%	47.6%	60.2%	62.4%
Bank Victoria								
	ROA	0,9%	1,1%	1.7%	2.7%	2.2%	1.9%	0.8%
	LDR	53.5%	50.4%	40.2%	63.6%	67.6%	73.4%	70.3%
	OCOI	92.2%	92.1%	88.2%	78.3%	78.8%	81.4%	93.3%
	NIM	2.6%	2.4%	1.8%	1.9%	3.1%	2.3%	1.9%
	NPL	2.5%	3.0%	5.0%	2.4%	2.3%	0.7%	3.5%
	% Consumer Credit	27.5%	26.9%	38.1%	40.9%	31.2%	32.5%	28.1%

Source: Annual reports of each banks for the particular periods.

In addition, we propose the hypothesis that, since the enactment of Islamic Banking Act No. 21 in 2008, the entry barrier and the licensing procedure for the establishment of new Islamic banks have encouraged the rapid growth of Islamic bank development in terms of total assets, third party funds/deposits, and total financing. As a consequence, currently, the Islamic banking sector faces an increasingly competitive market structure in their business operation.

From the perspective of Islamic bank rent theory, this competitive challenge indicates that Islamic banking industry should be equipped with a number of policies taken from the Bank Indonesia (Central Bank) and Financial Service Authority (FSA) which provide sufficient incentives to the Islamic banking development. The incentive mechanism is an important factor for the success of Islamic banks to achieve its specific business goals, such as banking intermediation in the transactions of profit or loss sharing (PLS) and optimizing the role of Islamic banks to support the development of the segment of Small and Medium Enterprises (SMEs) particularly.

Another important finding which is reflected in this empirical result and is related to the competition and efficiency levels faced by the Indonesian Islamic bank is the existence of market structural dilemma in the Indonesian Islamic banking market.

In general, the market structural dilemma began after the implementation of the dual banking system, in which the conventional and Islamic banks were expected to have unity in the market playing field and equal treatment within the framework of regulation and supervision of the banking and financial authorities in Indonesia. From the neo-classical economics framework, we perceive that this policy was taken under the hypothesis that the market mechanism will be effectively work in the financial market.

Obviously, the implementation of dual banking policy resulted in the crucial findings above, which indicate that the market structure of the banking industry is still primarily dominated by the conventional banks and suggests that the Indonesian Islamic banks have been left behind in comparison to the conventional

banks in regards to their capability and competency. In fact, this consequence has caused the Islamic banks to fail to compete with the conventional bank.

Furthermore, the growth in the number of new Islamic banks in the form of a full-fledged Islamic banks and Islamic banking units/divisions shows how the Islamic banking market has become highly competitive. These circumstances, in turn, created a severe level competition among the Islamic banks. Noticeably, this devastating situation has caused the Islamic banks to suffer from low levels of profitability.

Hence, the two-fold of unfavorable conditions experienced by the Islamic banks has been the reason for their lag in capability and competency, and worsening profitability performances have become the catalysts for lower level of efficiency and performance in the Indonesian Islamic banks.

This conclusion is also supported by the analysis of the performance measurements of the Islamic banks, in which we find that the current trend of the Islamic banks ROA and NPF are relatively low in comparison with the conventional banks as summarized in Chapter 6 before.

7.5 Summary

This chapter presented a background of discourses on the market structure and competition issues for the contemporary development of Indonesian Islamic banking, especially for the purpose of creating a better understanding of the occurrence of slow pace growth in Indonesian Islamic banks.

Based on the analysis and empirical results, it concludes that the banking market in Indonesia is highly dominated by conventional banks and the level of

competition for the Islamic bank in Indonesia for these particular periods has increased.

Moreover, we also underline the fact that the Indonesia's Islamic banks have experienced a high level of competition in the consumer banking market. Using a random sampling from the selected conventional banks and Islamic banks in the period between 2008-2014 (as presented in Table. 7.7), it can be concluded that; firstly, consumer banking places a significant portion of the credit activities at all banks into the sample, the portion of consumer banking ranged between 15-67% during this particular period. Secondly, in terms of the ratio of Loan/Financing to Deposit Ratio (LDR) of all banks, we see a significant ratio within the range of about 40-100% as a clear indication of an extensive credit disbursement conducted by the banks. Meanwhile, it should be noted that in the overall performance of the conventional banks, a relatively lower NPL ratio is seen compare to the Islamic banks. On the other hand, in terms of the Net Interest Margin (NIM) ratio, it seems that the conventional banks in the sample have a tendency a lower NIM ratio in comparison to the Islamic banks. This indicates the possibility that the Islamic banks were likely offering consumer banking products with higher price level to the consumers as a result of the higher cost of fund structure owned by the Islamic banks in comparison to the conventional banks. Finally, the occurrence of tight competition levels in consumer banking have caused the Islamic banks to face difficult conditions in order to achieve a favorable performance due to a lack of economic scale and a lower efficiency level. In this severe competitive situation, the Islamic banks have struggled to acquire depositors' funds and have fallen into a higher cost of fund in running banking business. In turn, the result has been that

the Islamic banks have failed to get bank rent opportunities to develop their businesses and experienced a stagnant growth between the years of 2008-2014.

The discussion on the market structure and concentration related to Indonesia's Islamic banks brings us the essential findings of the existing market structural dilemma in the Indonesian Islamic banking industry. Noticeably, this particular structural dilemma began after the implementation of the dual banking system, in which the conventional and Islamic banks were expected to have unity in the market playing field and equal treatment within the framework of regulation and supervision from the banking and financial authorities in Indonesia.

Under this circumstance, it is worth noting that the implementation of dual banking policy resulted in the Indonesian Islamic banks being left behind in terms of capability and competency in comparison with conventional banks. In addition, along with the remarkable increase in new Islamic banks in the form of full-fledged Islamic banks and Islamic banking unit/division establishment, these tough conditions have resulted in the Islamic banking market becoming a highly competitive market. Thus, it creates a severe level competition among the Islamic banks.

Noticeably, this devastating situation has caused Islamic banks to suffer with low levels of profitability. Accordingly, this conclusion is also supported by the analysis of the performance measurement of the Islamic bank, in which we find that the current trend within the Islamic banks ROA and NPF has been a relatively lower performance in comparison with the conventional banks.

CHAPTER 8
COMPARATIVE ANALYSIS OF THE OPERATIONAL EFFICIENCY OF CONVENTIONAL AND ISLAMIC BANKS

8.1 Introduction

The aim of this chapter is to measure and compare the efficiency of the conventional and Islamic banks in Indonesia for the period 2008-2014 using the nonparametric Data Envelopment Analysis (DEA) method. For this purpose, the period of 2008-2014 is chosen to carry out comparative analysis of the operational efficiency of conventional and Islamic banks. This is used to describe the rent effect that occurred in the period in which the slow pace of growth phenomenon became evident.

The discussion in this chapter will also make a comparison based on the studies that have been conducted on the efficiency performance of conventional and Islamic banks in Malaysia in the literature. This comparison is conducted to get a general description of the Islamic bank's efficiency level in Indonesia and Malaysia and to enable analysis of the influence of efficiency performance in the market share development in these two countries.

Basically, this chapter also tests the second hypotheses proposed in this research that the Indonesian Islamic banks face "severe" competition with conventional banks (also among Islamic banks) in the banking industry, causing Islamic banks to be unable to earn sufficient profits for financial deepening and maintain their franchise value and reputation. This chapter aims to resolve and

explain issues raised in Puzzle 2. In addition, this chapter also presents an extended discussion with appropriate comparative study through a review of some literature that have discussed the empirical results of the efficiency level in Malaysia's Islamic banking industry.

The rest of this chapter is organized as follows. Section 8.2 presents a discussion on the concept of efficiency. Section 8.3 discusses the measurement of efficiency and Data Envelopment Analysis (DEA). Section 8.4 presents a discussion on approaches to the measurement of bank efficiency. Section 8.5 reviews related empirical literature on the issue of banking efficiency. Section 8.6 deals with methodology and data description used in this research. Section 8.7 presents the result and analysis. Finally, section 8.8 concludes the chapter.

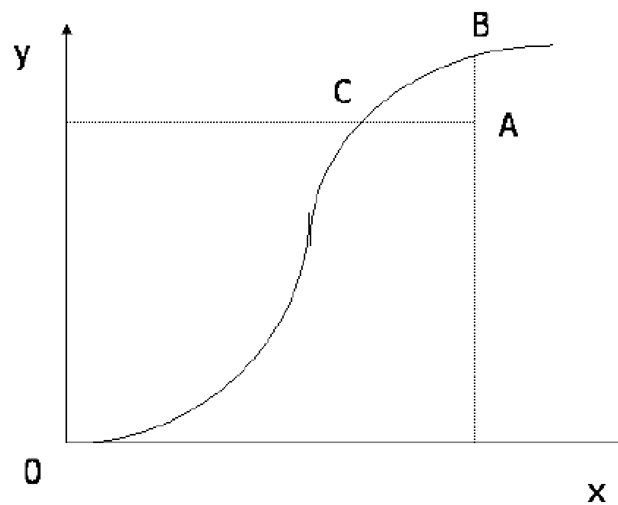
8.2 The Concept of Efficiency

According to Sarjana (1999) in Ascarya, Yumanita, and Rokhimah (2009) efficiency is conceptually categorized into two types based on economic theory, i.e. the technical efficiency and the economic efficiency. In this perspective, the economic efficiency is derived from a macroeconomics point of view, whereas, the technical efficiency originates from microeconomics standpoint. Consequently, measurement of the technical efficiency tends to be limited to technical and operational correlations in the process of converting inputs into outputs in a particular production function. On the other hand, assuming that price can be influenced by macroeconomic circumstances, the economic efficiency views that price is not a given variable in a production function.

In this sense, Ascarya and Yumanita (2008, p. 5) describe the production

frontier line (see Figure 7.1) which represents the maximum output resulted from a certain amount of using each input. In this frontier line model, the economics of scale production function should be considered as it also shows the technology level applied by the organization entity.

Figure 8. 1 Production Frontier Line



Source: Ascarya and Yumanita (2008, p. 5)

Meanwhile, referring to Farrell (1957) in Ascarya, Yumanita, and Rokhimah (2009) define the productive efficiency as the capability of an entity to produce a particular output with a minimum input. Moreover, Farrell (1957) in Ascarya, Yumanita, and Rokhimah (2009) divides the efficiency of the corporation as consisting of two elements, namely the technical efficiency and the allocative efficiency. The technical efficiency is the company's ability to produce output with a number of feasible input provided, whereas the allocative efficiency reflects the company's ability to optimize the use of inputs in its given pricing structure and technological capabilities. These two types elements of efficiency are recognized

as economic efficiency. Although, admitting that the technical efficiency is only the one of the overall economic efficiency elements, Kumbhaker and Lovell (2000) argue that to achieve the economic efficiency level, a company should be technically efficient. Consequently, to attain a maximum profit level under economic efficiency production function, a company should produce maximum output in utilising certain amounts of input (the technical efficiency) and produce outputs with an accurate combination using a certain price level (the allocative efficiency).

8.3 The Measurement of Efficiency and Data Envelopment Analysis (DEA)

Sastrosuwito (2012) underlines that there are two approaches to efficiency measurement, which are input-oriented and output-oriented. In this sense, the input-oriented approach will be focused on minimizing input as output is assumed as fixed. In contrast, the output-oriented approach will put the effort in expanding the maximum output without altering input used.

Bauer et al. (1998) assert that the measurement of financial institution performance is currently dominated by the implementation of the efficiency frontier or x-efficiency. Essentially, this approach measures deviations that occurred between the performance of financial institutions and "the best practice" which reflect the inefficient frontier under the assumption that financial institutions face the same market conditions. Accordingly, the use of frontier efficiency becomes important as the size of frontier efficiency using the technique of programming or statistics which removes the effect of differences in the price of inputs and other exogenous factors in the market which can affect the benchmark ratio (Bauer et. al., 1998; Ascarya, Yumanita, & Rokhimah, 2009).

Nowadays, various frontier methods have been used in efficiency measurement. In principle, the approach in this method can be categorized into two approaches, parametric approach and non-parametric approach (Ascarya, Yumanita, & Rokhimah, 2009).

There are three parametric approaches, namely (1) Stochastic Frontier approach (SFA), (2) Thick Frontier Approach (TFA), and Distribution Free Approach (DFA). According to Ascarya, Yumanita, and Rokhimah (2009), the main difference of these three approaches is the assumption based in forming the efficient frontier curve, treatment of its random error, as well as distribution over the inefficiency and random error.

Whereas, in the approach of nonparametric methods, there are two main approaches in the literature, which are the data envelopment analysis (DEA) and free disposal hull (FDH) (Sastrosuwito 2012). For the evaluation of multiple-input/multiple-output in the company, a nonparametric approach to measuring the efficiency of linear programming using a linear programming technique is utilized. Thus, the nonparametric method is categorized as a non-stochastic and tends to combine disturbance in inefficiency (Ascarya, Yumanita & Rokhimah, 2009; Sastrosuwito, 2012).

Data envelopment analysis (DEA) as a method using linear programing has been introduced by Farrell in 1957 and then reformulated by Charnes, Cooper, and Rhodes in 1978. DEA is acknowledged as successful for assessing the relative performance of a set of companies that employ a variety of identical inputs to produce a variety of identical outputs. (Ascarya, Yumanita, & Rokhimah, 2009; Sastrosuwito 2012). By using a mathematical linear programming, DEA measures

the relative efficiency level of decision-making unit (DMU) to its equivalent DMU under the condition that all these units are at or below the efficiency curve (Jemrić & Vujčić, 2002).

The advantage of using DEA is that this approach does not require an explicit assumption in creating an efficiency frontier formula. In other words, DEA is a relative efficiency measurement tool that does not need a preconsidered functional structure requisited in the data to determine the efficient units (Ascarya & Yumanita, 2008; Avkiran, 2013). Nevertheless, the weakness that may arise in DEA is the "self-identifier" and "near self-identifier". In addition, as in linear programming, it will depend upon the sample population that has a tendency to be far from error specification (Lovell, 1993). In other words, DEA constructs a benchmark from the best practice production function exclusively on the basis of observed data. However, it will possibly cause the main disadvantage of DEA, which is that the frontier is sensitive to extreme observations and measurement error (Ascarya & Yumanita, 2008; Avkiran, 2013).

DEA is a non-parametric, deterministic method for determining the relative efficient production frontier, based on the empirical data of chosen inputs and outputs of a number of DMUs. From the set of available data, DEA identifies reference points (relatively efficient DMUs) that define the efficient frontier (as the best practice production technology) and evaluate the inefficiencies of other, interior points (relatively inefficient DMUs) that are below the efficient frontier (Jemrić & Vujčić, 2002). Besides producing efficiency value for each DMU, DEA also determines DMUs that are used as reference for other inefficient DMUs.

According to Ascarya & Yumanita (2008), there are two well-known DEA

models being applied, which are CCR model (Charnes, Cooper, & Rhodes, 1978) and the BCC model (Banker, Charnes, & Cooper, 1984). Basically, both of these DEA models are varied in their treatments on the return to scale. The CCR assume each DMU operates with a constant return to scale, whereas the BCC accept each DMU can operate within a variable return to scale. Thus, the efficiency of DMU will be calculated under this equation:

$$Efficiency\ of\ DMU_0 = \frac{\sum_{k\ 1}^{p} \mu_k y_{k0}}{\sum_{i\ 1}^{m} v_i x_{i0}}$$

………….. (1)

Where:

DMU : decision making unit

N : number of DMU's evaluated

M : different inputs

xij : number of input i consumed by DMUj

p : different outputs

ykj : number of output k produced by DMUj

Furthermore, Ascarya and Yumanita (2008) explain that the efficiency score of CCR models for each DMU will not exceed the BCC models. This is to refer Jemric and Vujcic's (2002) view that applying the BCC analysis models will evaluate each DMU in perspective of "locality" (in this case, comparing to the subset of DMUs which operate in the same area of return to scale) rather than in the perspective of "global".

In addition, banks as a DMU possibly have similar characteristics in their business models and operations. However, it should be noted that probably banks diverge in terms of size and production level. Accordingly, this fact proves that size will matter in the relative efficiency measurement of the banks (Ascarya & Yumanita, 2008).

If doing so, Ascarya and Yumanita (2008) argue that the CCR model actually reflects the multiplication of pure technical and scale efficiencies, whereas the BCC model depicts technical efficiency only.

Thus, accrording to Ascarya and Yumanita (2008), the equation of relative scale efficiency could be defined as the ratio of CCR model and BCC model:

Sk = qkCCR/qkBCC ……………… (2)

In this case, we recognize that if the value of S = 1, this indicates that the DMU has operated in the best relative scale efficiency or worked in its optimal size. In contrast, if the value of S is less than 1, it means that such scale inefficiency (equal to 1-S) of the DMU still occurs. As a result, we understand that when a DMU is efficient under BCC model but inefficient under CCR model, so there is still a room to increase efficiency, as the DMU has scale inefficiency.

Ascarya and Yumanita (2008) describe this logical equation as follow:

OE = TE x SE, hence **SE = OE/TE**

OE: overall efficiency of CCR Model; TE: technical efficiency of BCC Model

8.4 The Measurement of Bank Efficiency

In measuring and analyzing the performance of financial institutions, especially the banks, we divide them into two main techniques. Firstly, the classical approach, that simply uses profit-cost analysis and financial ratios. Yet, this particular technique seems to fail to control factors such as input price, output price, and market exogenous variables. This hindrance has caused constraints to precisely measure their performance (Dong, 2009). Recently, research is more focused on the second technique, namely frontier efficiency technique, in which frontier efficiency will assess the deviation of the company performance from "the best practice entity" or "industry benchmark" under the efficient frontier, hence it is in line with that also do controlling for the effects of a number of exogenous factors (Sastrosuwito, 2012).

Nowadays, increasing attention on the subject of bank efficiency is caused by the trend of rapid globalization in banking and financial industry and the climate of high competition in the domestic and international financial markets (Sastrosuwito, 2012).

In this context, Ascarya, Yumanita, and Rokhimah (2009) opine that in measuring bank efficiency, emphasis should be put on observation in the measurement process. The banking industry is a sector that has a special character in business operation. For instance, the banking industry is different from the manufacturing industry in the aspects of its main business activities: the banking industry essentially carries out financial transactions and channeling financial resources from the financial surplus unit to the deficit of financial units. Meanwhile, the manufacturing industry has a specification in its major activity in order to

produce the physical products using a number of raw material inputs in the production process (Sastrosuwito, 2012).

In the literature, there are four approaches that dominate discussion in explaining the relationship process of input and output of bank activity items, namely production approach, the intermediation approach, revenue approach (income-based approach), and modern approach (Bergey & Humprey, 1997; Drake et al., 2009; Ascarya, Yumanita, & Rokhimah; 2009; Sufian 2011; Sastrosuwito, 2012).

8.4.1 Production Approach

In this approach, the bank is viewed primarily as a business unit that produces savings accounts and credit for their customers. Therefore, this approach defines the output of bank activity as the calculation of how large the bank accounts are provided by customers, thus deposits from customers will be treated as output. Whereas the input includes as to how to extend disbursements for human resources cost, capital investment on fixed assets and other tangible assets (Bergey & Humprey, 1997; Ascarya, Yumanita, & Rokhimah, 2009).

8.4.2 Intermediation Approach

Recognizing that the main role of banks as financial intermediary institutions that transform funds from the surplus spending unit to the deficit spending units, the intermediation approach puts this function as the bank's core activity that is reflected on the bank performance efficiency. In this purpose, this approach will treat deposits from the banks' customers, along with labor, physical and financial capital of the bank as the main inputs. In contrast, loans and outstanding credit, or financing disbursement as outputs (Ascarya, Yumanita, & Rokhimah, 2009;

Sastrosuwito, 2012).

8.4.3 Revenue (Income-Based Approach)

This approach recognizes that bank has the main function to generate income as the result of cost matching to revenue principle in their business activities. In this sense, total revenue of the bank (interest and non-interest incomes) will be calculated as outputs, whereas the total expenses disbursed (interest and non-interest expenses) will be considered as inputs (Drake et al., 2006; Sastrosuwito, 2012).

8.4.4 Modern Approach

According to Ascarya, Yumanita, and Rokhimah (2009), this approach attempts to improve the former approaches. In this approach, a paradigm in managing banking business provides considerable concern related to how the banks accomplish with regard to issues of asset management, the problem of information asymmetry, and risk management. Also, this approach tends to distinguish between the bank manager and the bank owner in their different behavior for profit maximization. Under the conditions in which the bank manager has no neutral risk behavior, it is possible that the bank manager will ignore the cost minimizing decision in determining the financial capital level of their business.

8.5 Empirical Literature

The study of efficiency in banks is becoming an important topic of academic research, following several banking crises in developed and developing countries in the last decade (Caprio, 1998; Sastrosuwito 2012). According to Sastrosuwito (2012), this new wave of interest among the researchers intend to re-evaluate the efficiency system and also the effectiveness of banking regulation and supervision.

A number of studies that use nonparametric DEA method to analyze the efficiency status of the banks in Indonesia, among others, are Hadad et al. (2008a), Haddad et al. (2008b), Ascarya & Yumanita (2008), Ascarya, Yumanita , & Rokhimah (2009), and Sastrosuwito (2012).

Hadad et al. (2008a) performed a study on 130 of the Indonesia banks in 2007. This study reports that in average the bank efficiency results are about 62-67 per cent. Noticeably, they find that the state-owned banks are the most efficient companies and the local banks are the least efficient banks. Moreover, Haddad et al. (2008b) conducted a study using nonparametric DEA method with the intermediation approach to examine monthly analysis of 24 banks which are listed in the stock exchange for the period 2006-2007. It is an interesting research finding that shows, in fact, foreign-owned banks have less efficient level compared to their domestic counterparts. Also, in their study, it is concluded that there is a positive correlation between efficiency and market values of the banks in the capital market.

Ascarya and Yumanita (2008) conducted measurement and comparison between the efficiency of Islamic banks in Malaysia and Indonesia using Data Envelopment Analysis (DEA) and applied the intermediary approach during the period of 2002-2005. This research found that during these years Indonesia's Islamic banks were more efficient compared to the Malaysia's Islamic banks in all three measurements: the technical, the scale, and the overall efficiency. In addition, it is to be noted that in Malaysia, the source of inefficiency is from financing activity, whereas in Indonesia, the human resource performance is a source of inefficiency.

Ascarya, Yumanita, and Rokhimah (2009) conducted a research using DEA with the intermediary approach in measuring and analyzing the efficiency level of

conventional and Islamic banks for the period 2002-2006. This study shows interesting findings during this observation period for further elaboration in which the Islamic banks have indicated a slightly higher level of efficiency compared to the conventional banks in terms of scale, technical, and overall efficiency measurements. However, conventional and Islamic banks demonstrate a convergence trend on the characteristics of their input and output business process. It seems that total revenue is the most efficient element, whereas human resource is a main source of inefficiency.

Sastrosuwito (2012) studied of bank efficiency measurement in Indonesia using the DEA method with the intermediation approach for 113 banks during the period of 2001-2008. In his study, Sastrosuwito (2012) found that the estimates of average efficiency for the banking system during this particular period is about a high level at 75.7 percent to a low level of 61.6 percent. Also, this research shows an increasing trend of efficiency in Indonesia's banking sector as certain for further improvement on banking performance.

8.6 Methodology and Data Description

This research will apply the intermediation approach as adapted from the Sufyan (2006), Ascarya and Yumanita (2008), Ascarya, Yumanita, and Rokhimah (2009), and Yudhistira (2003) that explore the core activity in the banking business. Accordingly, by doing a little bit adaptation, this research assumes outputs in conventional and Islamic banks as the credit/financing channeled (y1), total asset (y2), and total revenue (y3). On the other hand, the bank intermediary inputs for this function is the total deposit (x1), human resource expense (x2), interest/profit and loss sharing expenses (x3), and operational expenses (x4). There is a slight

difference in choosing input and output components from the previous studies in the literature. In this research, we ignore fixed asset variable as one of the inputs and make total asset variable as among the outputs in the calculation of the efficiency scale using DEA. In this sense, within this specific preference of this research options, we assume that the research will be focused on elaborating intermediation function of the banking business and avoid applying the bias of the model of manufacturing industry production function. In conducting this research, we have a preference to focusing on the asset of the bank as output in the intermediation approach as adopted from Yudhistira (2003), also focus to expose the asset of the bank frequently indicated to measuring market share of the bank in the banking industry as the whole.

The data used in this research is the individual data of banks accessed from the bank's financial statements on the website Financial Services Authority (FSA) and/or the annual reports published for the period 2008-2014. The total number of banks included as samples in this research are 68 of the conventional banks and 12 of the Islamic banks. The sample of banks covers 68.1% of the existing number of banks as of 31 December 2014.

Table 8.1 below illustrates the number of banks used as sample in the measurement of bank's efficiency over the period 2008-2014.

Table 8. 1 Total Numbers of the Selected Banks

Meanwhile inputs and outputs in the DEA measurement are presented in Table 8.2 below:

Banks	**Years**						
	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
The Conventional Banks	68	68	68	68	68	68	68
The Islamic Banks	7	9	11	11	11	11	12
Total	75	77	79	79	79	79	80

Table 8. 2 DEA Inputs and Outputs Data (in Million Rupiah)

Banks	Years						
	2008	2009	2010	2011	2012	2013	2014
The Conventional Banks:							
Financing	1,135,766,043	1,267,820,820	1,554,643,803	1,927,213,253	2,344,047,479	2,859,482,330	3,191,886,584
Total Assets	1,997,077,722	2,216,955,597	2,660,721,858	3,216,654,001	3,748,556,367	4,348,153,176	4,914,800,951
Deposit	1,562,018,579	1,766,213,791	2,095,235,122	2,490,809,149	2,873,705,442	3,246,936,258	3,622,583,308
Human Resource Expenses	32,373,982	36,296,076	40,332,128	45,653,533	55,520,118	63,311,174	70,466,554
Operational Expenses	71,455,803	78,182,307	168,413,484	159,228,417	178,307,287	202,227,137	234,286,373
Interest Expenses	75,918,975	91,505,936	96,650,016	107,633,043	100,344,131	114,897,304	163,238,713
Total Revenue	201,278,895	213,885,976	233,601,742	265,298,987	292,201,012	328,580,008	404,217,959
The Islamic Banks:							
Financing	32,069,042	43,863,505	55,321,136	101,424,773	110,751,316	116,562,482	148,858,000
Total Assets	39,592,831	54,393,018	78,976,621	138,746,782	146,579,295	157,132,493	204,362,682
Deposit	31,140,502	44,889,715	65,842,593	111,956,655	119,277,419	128,333,941	173,378,872
Human Resource Expenses	699,235	1,004,370	1,548,916	2,476,946	2,800,025	3,649,306	4,117,958
Operational Expenses	1,723,971	2,377,895	3,444,035	4,931,343	6,133,934	7,583,487	8,868,702
Interest Expenses	1,615,158	2,385,359	2,763,831	4,172,535	4,900,461	6,571,167	9,330,765
Total Revenue	4,542,530	5,982,100	8,022,912	11,806,081	14,783,331	19,049,556	23,009,368

8.7 Result and Analysis

The detailed the results of data processing by the DEA on efficiency performance of conventional and Islamic banks can be observed in Table 8.3, Figure 8.2, and Figure 8.3.

In the conventional banks, with regard to the overall efficiency measures, we

find that notwithstanding it was experiencing a slightly fluctuating period in 2008-2014 but in general the conventional banks indicate efficiency levels which tend to be stable with a range about 94-98 per cent. Meanwhile, in the technical efficiency measures, it appears that the conventional banks have a stable efficiency level and a slightly increasing trend in the efficiency levels during the period 2008-2014 with a range between 94-98 percent. In addition, in the scale efficiency measures, the conventional banks also recorded a stable performance and an increasing trend in the 2008-2014 period which range from 99-100 per cent. It is worth noting that in the period 2012-2013, the conventional banks recorded the maximum efficiency level of 100 per cent.

In the Islamic banks, we find that the situation of efficiency level is more fluctuating throughout the period of 2008-2014. In terms of overall efficiency measures, the Islamic bank shows that the level of efficiency is very volatile and has a declining trend with efficiency level range from 72-83 percent. However, with regards to the technical efficiency measures, it appears that the Islamic banks have fluctuating efficiency levels that range between 81-93 percent, and with a slightly ascending trend. On the other hand, in the scale efficiency measures, we find that the Islamic banks recorded a fluctuating efficiency level and possess a slightly declining trend in the 2008-2014 period with efficiency level range between 79-91 percent.

Table 8. 3 Summary of Nonparametric DEA Efficiency Level

Efficiency Measures	2008	2009	2010	2011	2012	2013	2014
Conventional banks							
(Overall Technical Efficiency)	0,95	0,94	0,93	0,96	0,98	0,97	0,96
(Pure Technical Efficiency)	0,96	0,95	0,94	0,97	0,98	0,97	0,98
(Scale Efficiency)	0,99	0,99	0,99	0,99	1,00	1,00	0,99
Islamic banks							
(Overall Technical Efficiency)	0,83	0,75	0,65	0,71	0,69	0,72	0,78
(Pure Technical Efficiency)	0,91	0,88	0,81	0,87	0,89	0,91	0,93
(Scale Efficiency)	0,91	0,85	0,82	0,82	0,79	0,81	0,84

Figure 8. 2 Efficiency Level of the Conventional Banks

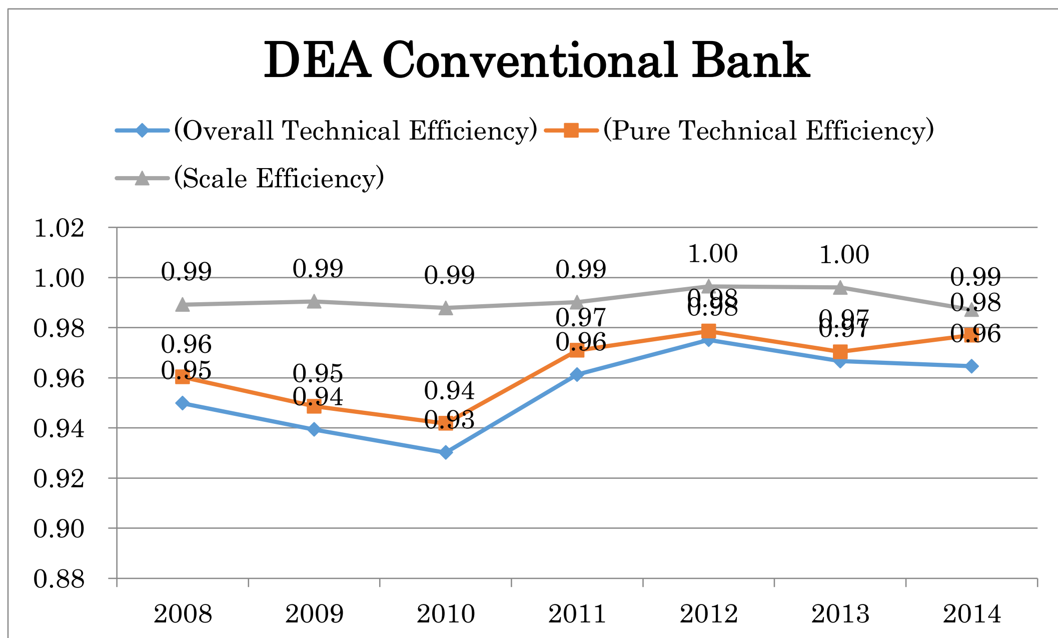
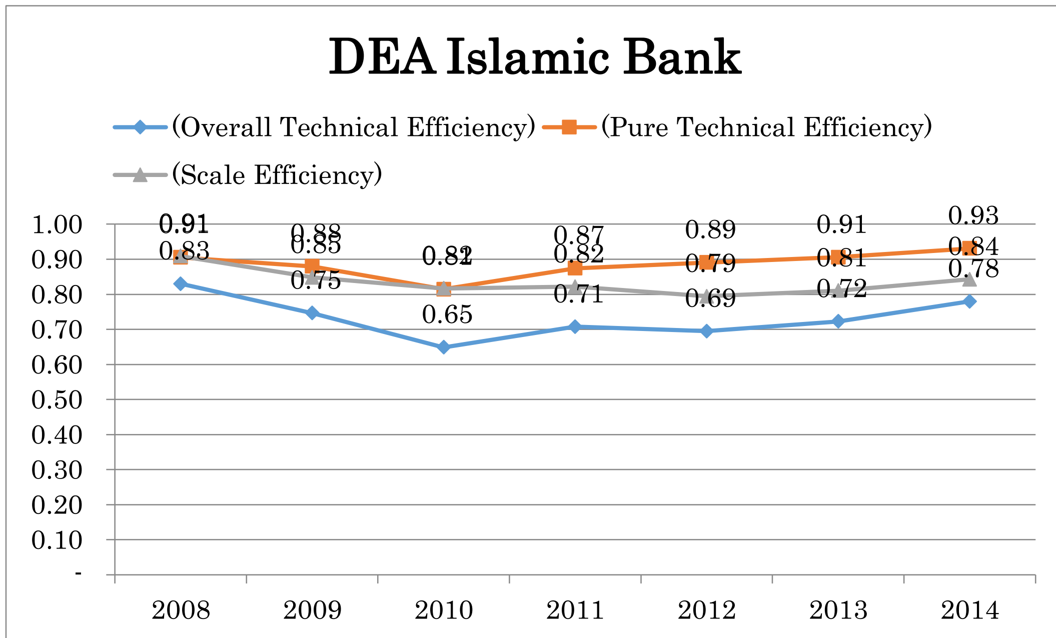


Figure 8. 3 Efficiency Level of the Islamic Banks



Overall, our analysis concludes that during the observation period of 2008-2014, efficiency levels of the conventional banks have a tendency to be higher than the Islamic banks in all sizes of overall efficiency, technical efficiency and scale efficiency. It is noticeable that specifically in the overall efficiency and the scale efficiency measures, the Islamic banks have a slightly declining trend of efficiency level in the period of 2008-2014.

Furthermore, this lower efficiency level performance of Islamic banks compared to conventional banks can be interpreted in two ways. Firstly, this situation is confirming the deterioration of Indonesia's Islamic bank's financial and operational performances in the period of 2008-2014. It is reflected in the performances of Islamic banks in Non Performing Financing (NPF) and Operating Cost to Operating Income (OCOI) indicators, in which both indicators are inferior in performance to the conventional bank's performance on financial indicators for

the period of 2008-2014.

Secondly, this situation also proves the occurrence of tight competition level between conventional banks and Islamic banks wherein this situation drives the Islamic banks to facing difficult conditions to achieve satisfactory performance due to a lack of economic scale and a lower efficiency level. From the perspective of the bank rent theory, this unfavorable situation after a remarkable period of growth in the early development of Indonesia's Islamic banks, in 2008-2014, shows that the Islamic banks have failed to get the bank rent opportunities to develop their business. Thus, they experience such stagnant growth in this particular period.

It is interesting to compare the result with Malaysia's Islamic banks. A number of studies have been conducted in measuring and analysing efficiency level in the case of Islamic banks in Malaysia by using DEA method. Among others, Yudisthira (2003), Sufian (2006) and Tahir et al. (2009), show that, despite the difference in their measurement method, the Malaysia's Islamic banks have a higher efficiency in comparison with conventional banks.

Mohamad and Said (2013) performed an efficiency analysis of conventional and Islamic banks in Malaysia using DEA method for the years 2007 to 2010. The results showed that in general, Malaysia's Islamic banks have relatively higher scores in comparison to the conventional banks in terms of pure technical efficiency and scale efficiency. In terms of the scale of efficiency in all the years in 2007-2010, the Islamic banks indicated significant higher outcomes in comparison to the conventional banks. This is shown in Table 8.4 below.

Table 8. 4 Efficiency Performance of the Malaysian Banks

Efficiency Measures	2007	2008	2009	2010
Conventional banks				
(Overall Technical Efficiency)	1.09	0.89	0.85	0.85
(Pure Technical Efficiency)	1.29	1.24	1.29	1.19
(Scale Efficiency)	0.88	0,77	0,78	0,80
Islamic banks				
(Overall Technical Efficiency)	1.37	0.99	1.03	1.18
(Pure Technical Efficiency)	1.94	1.19	1.26	1.57
(Scale Efficiency)	0.91	0,81	0,91	0,89

Source: Mohamad and Said (2013, pp. 7-8)

Based on results of the simple comparison above, we can conclude that Malaysia's Islamic banking market has a higher level of efficiencies in terms of technical and scale efficiency in comparison with conventional banks. It is also an indication that the regulatory policy supports and incentives have helped to increase the competitive advantage for Malaysia's Islamic banking.

It is worth to note that the main purpose of this research is to obtain a relative efficiency performance level between Islamic and conventional banks in Indonesia and Malaysia. It is expected that this comparison of Islamic and conventional banks efficiency performance would reflect the successful achievement of the banks in optimising the rent effect in banking industry. Thus, this research is not purposed to conduct a direct examining using the DEA method in comparing the efficiency performance measurement between Islamic banks in Indonesia and Malaysia.

However, overall we can derive a crucial conclusion from the empirical data presented in these particular studies which have separately measured the efficiency level of Islamic banks in Indonesia and Malaysia. The findings show that Indonesia's Islamic banks failed to utilise the opportunity for leveraging the conventional infrastructure and networks, whereas Malaysia's Islamic banks have had success in leveraging this opportunity. Thus, the success to leverage on the conventional infrastructure and networks result in significantly improving the efficiency scale of Malaysia's Islamic banks. The results are relatively higher in comparison to the conventional banks. Besides, in further development, Malaysia's Islamic banks have successfully optimized this favorable condition to utilize rent effect that created in Malaysia's Islamic banking industry, an incentive for further development of Islamic banking in Malaysia.

8.8 Summary

In measuring and analyzing the performance of the banks, we divided the most frequently used techniques into two categories of approach. Firstly, the classical approach, that simply uses profit-cost analysis and financial ratios. Recently, academic research is more focused on the second technique, namely frontier efficiency technique, in which frontier efficiency will assess the deviation of company performance from "the best practice entity" or "industry benchmark" under the efficient frontier. Hence it is in line with those also doing controlling for the effects of a number of exogenous factors (Sastrosuwito, 2012).

This chapter presented the measured efficiency of the conventional banks and the Islamic banks in Indonesia for the period 2008-2014 using the nonparametric DEA method to carry out comparative analyses of the operational efficiency of the

conventional and Islamic banks. This was done to describe the rent effect that occurred in the period in which the slow pace of growth phenomenon became evident.

Overall, our analysis concludes that during the observation period of 2008-2014, efficiency levels of the conventional banks are higher than the Islamic banks. This was observed of overall efficiency, technical efficiency and scale efficiency. It is noticeable that in the overall efficiency and the scale efficiency measures, the Islamic banks have a slight down trend of efficiency level in the period of 2008-2014.

This findings explain at least two important conclusions. Firstly, this situation is confirming the occurrence of deterioration of Indonesia's Islamic bank's financial and operational performances in the period of 2008-2014. Secondly, this situation also proves the occurrence of tight competition level between conventional banks and Islamic banks wherein this situation drives the Islamic banks in difficult conditions to achieve satisfactory performance due to a lack of economic scale and a lower efficiency level.

From the perspective of the bank rent theory, this chapter derives a crucial conclusion from the empirical data measuring the efficiency level in each country. Indonesia and Malaysia have shown important findings in which Indonesia's Islamic banks failed to utilizing the opportunity for leveraging the conventional infrastructure and networks, whereas Malaysia's Islamic banks have had success in leveraging this opportunity. Thus, the success to leverage in the conventional infrastructure and networks result in efficiency scale of Malaysia's Islamic banks. They are relatively higher in comparison with the conventional banks. Eventually,

Malaysia's Islamic banks have successfully optimized this favorable condition in utilizing rent effect that was created in Malaysia's Islamic banking industry as an incentive for further development of Islamic banking in Malaysia.

CHAPTER 9
STRUCTURAL DILEMMA OF INDONESIA’S ISLAMIC BANKING

9.1 Introduction

This chapter is aimed to discuss the occurrence of structural dilemma in Indonesia’s Islamic banking industry. We borrow the approach used by Khan (2000) to observe the process of institutional (governmental) failure in applying economic policies to the development of Indonesia’s Islamic banks. In this sense, we underline that a governmental failure of creating 'the same level of playing field' between conventional and Islamic banks has caused extraordinarily low level of penetration and recent slow down of the Islamic banking in Indonesia.

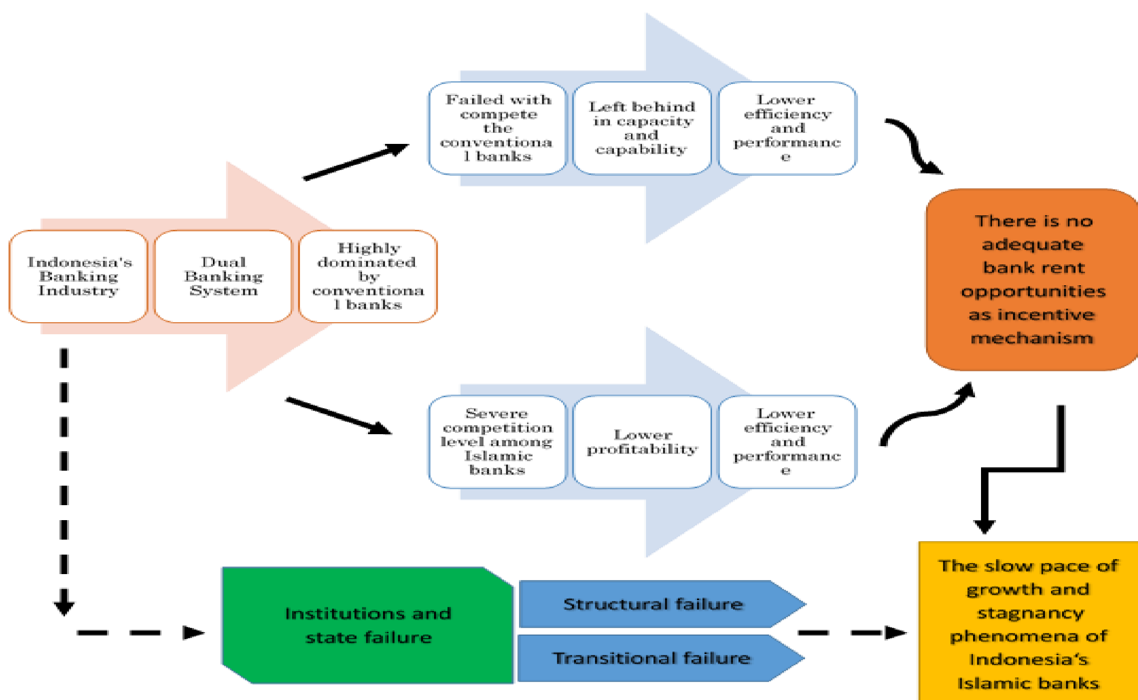
The rest of this chapter is organised as follows. Firstly, in Section 9.2, we portray an overview of structural dilemma in Indonesia’s Islamic banking. Then, Section 9.3 present a depth discussion of process of institutional (governmental) failure in applying economic policies to support the development of Indonesia’s Islamic banking. Section 9.3 summarises the Chapter.

9.2 Undertanding Structural Dilemma of the Indonesia’s Islamic Banking

Acknowledging the reality from the empirical results that Indonesia’s Islamic banks have lower efficiency level performance in comparison with conventional banks during the period 2008-2014, we borrow the approach used by Khan (2000) to observe the process of institutional (state) failure in applying economic policies to the development of Indonesia’s Islamic banks (See Figure 8.4). Khan’s approach

(2000) is helpful in describing how the interaction between financial authorities and market players in responding to the creation of particular mechanisms of rent seeking in the financial industry covering monopoly rent, monitoring (financial) rent , and rent for learning.

Figure 9. 1 Structural Dilemma underpinning the Islamic Banking Market



Source: Author constructed

In the initial stage, Indonesia's Islamic banks had the incentive of monopoly rents in the financial market for holding 'economic monopoly license' being *Shariah* compliant financial lenders.

As typical Islamic financial products should be in accordance with Islamic economic principles, Indonesia's Islamic banks had a comparative advantage compared to conventional banks. Apparently, with its monopolistic behavior, it expected that it will provide the potential advantageous for Islamic banks in

possessing “market power". In such a situation, Islamic banks can control the "price" offered to bank customers and generate a sufficient income to achieve a certain target of profit in their business. Nevertheless, we confess that this particular “comparative advantage” merely indicates potential “captive market” of the Islamic bank's customers in which “*Shariah* loyalist customers” will have a preference to choose Islamic banks as their financial service providers. Therefore, we acknowledge that the Indonesian Islamic banks actually did not hold “market power” of the bank's customers as “*Shariah* loyalist customers” who formed 1% of the bank using population. Furthermore, the rest of the bank's customers dominantly still held a conventional banking paradigm with risk averse behavior and they were still unable to accept the possibility of loss under the Islamic banks’ profit and loss sharing (PLS) system.

As we explored in Chapter 6, the structural dilemma faced by the Indonesian Islamic banks can be explained in two aspects which are in its funding and financing activities. In terms of funding, the Islamic banks encounter the problem of high cost of funding. This is caused not only by the Islamic banks’ inability in collecting deposit fund which is left over from the conventional banks, but also a higher portion of funding source come from time deposit, instead of savings or current accounts. Therefore, the Islamic banks have no other choice than to offer a higher rate of return for the type of time deposit account as their strategy to attract the depositors competitively with the conventional banks. This unfavorable condition certainly had a negative impact on the financing activity. As the cost of funds for the Islamic banks are more expensive, consequently the Islamic banks only have the opportunity to disburse their financing in the market segment which can

generate higher returns and mostly of short tenor. Thus, we have seen that the Islamic bank financing activity is focused on the consumer market and has a dominant mode of financing under *Murabaha* contracts. Moreover, as a consequence of severe competition with conventional banks in the same market segment, the Islamic banks offer a lower rate to the bank's customer as a strategy to attract the potential bank's customers competitively. Indeed, this strategy causes a detrimental impact on the level of income earning of the Islamic banks as it decreased profitability and squeezed the banks rent opportunity.

In fact, the Indonesian Islamic banks have enjoyed their monopoly rents as they hold such license for *Shariah* compliant financing lenders. However, this advantageous condition will be meaningless if the Islamic banks could not capture their business in comparison with the conventional banking sector in terms of competitiveness and efficiency.

Unfortunately, by having these comparative advantages and monopolistic circumstance for a relatively long period in its early developmental stage, Islamic banking in Indonesia, in fact, failed to significantly accumulate such adequate profits for their business. This circumstance is observably shown in two indicators underpinned their business environment.

Firstly, the Islamic banking industry has been increasingly become competitive due to the emergence of growing numbers of the Islamic banks in Indonesia. They have been penetrating similar consumer banking market as their conventional counterparts. Noticeably the Islamic banks had no ability to undertake cost reduction in performing their business operations. Our findings in examining the current development of Indonesia’s Islamic banks show a deteriorating financial

performance indicators, i.e. relatively lower ROA and higher NPL. Hence, this market competitive circumstance has shown a seemingly different situation with Khan's argument (2000) that within a competitive market business environment will provide incentive to the firms to carry out cost reduction efforts. Presumably, Indonesia's Islamic banks have a relatively high "X-efficiency", due to the inefficiency caused by higher costs under monopoly market situation.

This crucial conclusion can be observed in the relatively lower efficiency performance in Indonesia's Islamic bank when the Islamic bank faces higher level of competition. This finding is interesting as it is different from a number of empirical research findings from other studies related to the banking industry in Indonesia. A study conducted by Sastrosuwito (2012), for example, has proved that the increased competition level in conventional banks in the period 2001-2008 led to higher efficiency level.

It also means that within the framework of monopoly rent; from the standpoint of a benefit received by the Islamic bank customers, apparently, the actual social benefit of the Islamic banks is lower than deadweight welfare which occurred in a whole banking market.

Secondly, the Indonesia's Islamic bank under monopoly rent circumstance seemingly failed to accumulate a large profit in order to induce more investment and innovation in facing a rigorous market competition. In conclusion, it seems that Indonesia's Islamic banks have failed to take advantage of its comparative advantage in transforming their banking business. This is reflected in our discussion in Chapter 3 that the growth of institutional and office networks infrastructure development for Islamic banks in Indonesia was experiencing a stagnant phase

during the period from 2012 to 2014. Chapter 6 explained that due to limited funds collected and lower banking capability in mitigating corporate risk business, the Islamic banks hesitated to take on corporate financing segment.

Following, we will portray how Indonesia's Islamic banking responds to monitoring (financial sector) rent circumstance. The fundamental argument of this monitoring rent is based on the notion that banks as financial lenders must be able to generate adequate "rent" in monitoring their credit portfolios in order to maintain "the franchise value" to ensure sustainable profit and business development in the long term (Hellman, Murdock & Stiglitz, 1997). It is worth highlighting that the government can play an important role in creating sufficient rent opportunity for the financial sector.

Basically a number of specific market incentives related regulations issued by the financial and banking authority in Indonesia should be able to create rents for the banks to conduct monitoring their portfolio. Given the availability of monitoring rent for the Islamic bank, it is expected that Indonesia's Islamic banks will maintain their franchise value and improve their performance to ensure their sustainable of business growth.

In such a context, as pointed out by Hellmann, et al. (1997), this monitoring rent mechanism can be utilized by the banks through the rent effect instrument to improve their infrastructure networks and business capabilities. Correspondingly, Indonesia's Islamic banks have an opportunity to take advantage of this monitoring rent mechanism in order to maintain the level of profitability in the long term.

To refer back to our analysis and discussion in Chapter 6, the spread margin between conventional and Islamic bank unit/division can be compared. This

comparison has shown the ratio of spread margin enjoyed by conventional banks (interest paid to depositors against interest received from borrowers) and the Islamic bank unit/division (profit paid to depositors against profit received from borrowers for). The findings reflect the gross value of bank rent opportunity potentially received by the banking industry.

In this case, the empirical findings of the Islamic bank unit/division confirms a relatively lower ratio than its conventional counterpart. Thus, the Islamic banks unit/division have a prevailing higher bank rent opportunity to be exploited in developing their business. However, this advantage is not being optimized by Indonesia's Islamic banks as indicated by the deteriorating of financial and operational performance.

It makes sense to propose the presumption that there is insufficient monitoring rent in Islamic banking market as reflected in the relatively lower level of efficiency experienced by Indonesia's Islamic banks. It also has been-been shown in the analysis and discussion in Chapter 6, where a comparison of the ratio of operating expenses to interest (profit) received from conventional banking and the Islamic banking has indicated a relatively higher ratio for the Islamic banks.

In the meantime, it also confirms our conclusion that it seems that the Islamic banks have faced such relatively higher competition within the banking sector and operated with a lower level of efficiency indicated the operating expenses have increased during the period.

Unfortunately, the empirical results show that there is not enough incentive to encourage such better monitoring portfolio by Indonesia's Islamic banks. Thus, apparently this finding indicates that Islamic banks have failed in utilizing the

monitoring rent in the competitive banking market, and as a consequence, they have no ability to foster its sustainable growth.

Next, by observing the stagnation of development in the Indonesia's Islamic banks, and adopting rent for learning perspective (Khan, 2000), we opine that the stagnation in the development of the Indonesian Islamic banks are also caused by unsuccessful determination of regulations and incentives provided by the financial and banking authorities to encourage them to increase their capability and capacity to grow and expand their business.

This is caused by the inability of the Islamic banks to utilize the accumulated profit in improving product innovation and the financial intermediary know-how. For instance, although the Islamic banks have increased their equity based financing (under *mudaraba* and *musharaka* contracts), they also experienced *murabaha* characterized by risk adverse behaviour, focusing more on consumer financing, and to be conservative in implementing risk management to monitor their financing portfolio.

In addition, Indonesia's Islamic banks mainly engage in quasi *murabaha* financing through two-step *mudaraba*/*musharaka* financing contract to avoid high default risk in the pure equity based financing. Even though, we perceive that the two-step *mudaraba*/*musharaka* mode, to some extent, is also a form of innovation which was successfully applied in Indonesia. However, the Islamic banks failed to proceed the transfer of knowledge process in terms of banking capabilities in performing corporate financing that is usually dealing with project financing under equity-based financing contract as done by conventional banks.

The discussion above has shown the failures of Indonesia's Islamic banks to optimize bank rent opportunities in utilizing monopoly rent, monitoring rent, and rent for learning in the banking market. As a consequence of this, Islamic banks have had less competitive advantages compared to conventional banks.

9.3 Institutional (governmental) Failure and Slow Paced Growth of Islamic Bank in Indonesia

After describing the impact caused by market structure which does not provide adequate incentives for the Indonesia's Islamic bank, we will analyze the phenomenon of the slow pace of growth. We will use a model of institutional (govermental) failure introduced by Khan (2000), to explain structural and transition failures in the economy. New Institutional Economics (NIE) approach views this institutional failure as relying on the adherence of transaction costs. Transaction costs refer to the notion introduced in the Coase Theorem (Suzuki, 2011). It is becoming an important factor in the economic analysis when we discuss the market failure and how to perform an attainable set of alternative institutions. In this sense, Khan (2000, p. 74) admits that if transaction costs become a factor that inhibits the process of gainful transactions in the economy, it is root for the market failure and will create disadvantages for the net social benefit. According to the Coase Theorem, we acknowledge that institutions matter in Indonesia's Islamic banking development. It is noticeable that there is significant transaction cost in the Islamic banking market.

In this regard, the institutional failure that occurred in Indonesia's Islamic banking market began with the structural failure characterized by highly transaction costs. A number of indicators ascertain the occurrence of high transaction costs in

the Islamic banking market. Among other negative outcomes, the Islamic banks have experienced lower efficiency level compared to conventional banks, higher opportunity costs to maintain the franchise value embedded in the bank's *Shariah* compliance, more expenditure on high-cost investments as caused by mismatched investment requirements associated with the bank's scale of size.

Consequently, the Islamic banks failed to cover this higher transaction costs in doing business as market incentives provided by the financial and banking authorities turned out to be inadequate.

Another institutional failure is the existence of the transition failure. This transition failure is basically rooted in government's policy making process. It has failed to arrange for well-founded direction and develop policies that could help in improving the net social benefit. Referring to the explanation of Khan (2000), leadership dimension in regulation and policy making could be one of the key success factors in the process of better institutional transformation arrangement in the economy.

If we analyse the regulatory framework and strategic documents in the form of master plan of Indonesia's Islamic banking development used by financial and banking authorities in preparing direction of the Islamic banking development, it is worth to conclude that there are issues. Firstly, the enactment of 'Act No. 21 of 2008' concerning Islamic Banking is considered as being late given as an umbrella regulation in directing the growth of Islamic banking which has been established since 1992. Secondly, *Blue Print and Development Strategic* documents of the development of Islamic banking (Bank Indonesia, 2006; Bank Indonesia, 2008; FSA, 2015) also contain a number of fundamental weaknesses, especially in terms

of the urgent programs to encourage sustainability of the development of the Islamic banks.

If we scrutinize the *Roadmap of the Indonesian Islamic Banking Development 2015-2019* (FSA, 2015), this particular document does not present a detailed policy direction in terms of market structure and incentive mechanisms for Islamic banking under the dual banking system. Although it is crucial for Islamic banks in improving their market positioning which is currently only focusing on the *Shari'ah* loyalist customers and consumer banking products in order to face severe competition in the banking market.

In responding to the slow growth phenomenon, Financial Services Authority (FSA) issued the *Roadmap of Indonesian Islamic Banking 2015-2019* (2015). Under this strategic document, the vision for the development of Indonesia's Islamic banks is formulated as "Actualizing Islamic banking that gives significant contributions to sustainable economic growth, equitable development, financial system stability, and has high competitiveness". Furthermore, this development vision is translated into policy directions, work programs, and time schedule implementations. Accordingly, there are seven comprehensive policy directions (FSA, 2015, pp. xv-xvi) which include:

1. Strengthening policy synergy between the authority and government and other stakeholders,
2. Strengthening capital and business scale as well as enhancing efficiency,
3. Improving funding structure by supporting expansion of financing segment,
4. Improving service quality and product diversity,

5. Improving quality and quantity of Human Resource and Information and Technology,
6. Enhancement of public literacy and preference,
7. Strengthening and harmonizing regulations and supervision

Nevertheless, based on our further scrutiny, from this seven policy directions of the *Roadmap of the Indonesian Islamic Banking 2015-2019* period, we assume that only two of those policy directions which address the issue of slow pace of growth phenomenon of the Islamic banking industry in Indonesia have been implemented. These are namely (2) "Strengthening capital and business scale as well as enhancing efficiency", (3) "Improving funding structure to support expansion in financing segment".

Unfortunately, this official roadmap does not outline in detail how such focused strategy should be applied to achieve these particular policy directions. Despite the six priority policy programs in this policy direction , there are five priority programs which are categorised in focusing to resolve the deteriorating Islamic banking growth, which are in point (a) Optimizing the role and stepping up the commitment of conventional commercial bank (CCB) for developing Islamic banking services to reach a minimum share of 10% of parent CCB's assets; (b) Policy on and implementation of business process leveraging, (c) Development of roadmap for Islamic business unit spin-off, (d) Promote the establishment of State-Owned/District Government-Owned Islamic Banks to achieve targeted market share growth, and (e) Promote additional paid-up capital deposits by owners, Initial

Public Offerings (IPOs) as well as invite large-scale strategic partners/investors (FSA, 2015, pp. 50-53).

Meanwhile, referring to the official document of the Ministry of State-Owned Enterprises (SOEs), Republic of Indonesia “The SOEs 'Vision of Financial Services and Banking Sectors and SOEs' Road Map of Financial Services and Banking Sectors from 2015 to 2019”, we underline that the Ministry of State-Owned Enterprises, Republic of Indonesia has prepared a strategic program to conduct a merger policy for Islamic banks which are the subsidiary company of state-owned enterprises in 2017 to establish the Indonesian Islamic bank into the BUKU 4 category (Bank Umum Berdasrkan Kegiatan Usaha/Commercial Bank Based on Business Activities). This will help with the achievement of Islamic banking market share of 15% in 2019. The purpose of this policy is to strengthen the capital structure of Indonesia’s Islamic banks, invest Hajj fund placed from the banking sector into the productive sectors of the economy, and improve the efficiency and competitiveness of Islamic banks.

To clarify some issues related to policy directions that have been taken by the financial authority in Indonesia, we conducted in-depth interviews with a senior officer of Head of the Islamic Banking Department at Financial Services Authority (FSA) and a senior officer of the Ministry of State-Owned Enterprises (SOEs), on 15 March 2016. Based on our in-depth interview with the official decision making persons at Financial Services Authority (FSA) and Ministry of State-Owned Enterprises (SOEs), we conclude that there is no detailed planning and agreement between Financial Services Authority (FSA) and Ministry of State-Owned Enterprises (SOEs) in realising the priority programs of (a), (c), (d) and (e) above.

As the Minister of Ministry of State-Owned Enterprises (SOEs) has decided to encourage the Islamic banks business entities under government ownership to have preference in direct placement for potential investors in domestic or overseas financial market. In the meantime, for the point (b) priority program, it seems that there is no such precise target and incentive mechanism to achieve this objective. In this regard, based on our interview with a senior researcher at Bank Indonesia (the Central Bank), the policy will be taken by the Minister of Ministry of State-Owned Enterprises (SOEs) to encourage Islamic banks under controlled government ownership to choose direct placement scheme for potential investors in domestic or overseas financial markets. It is noticeably showing obsecure direction of incubation strategy held by the Indonesian government to develop Islamic banking in Indonesia. In addition, he also underlined that optimising the opportunities of *Hajj* fund and infrastructure projects are crucial for Islamic banking business with a prerequisite improvement of Islamic bank's capacity and skill capability that can be achieved through a merger policy of Islamic banks.

Meanwhile, under the policy direction to "Improve funding structure to support expansion in financing segment", we recognise that there are six priority policy programs in this policy direction which will provide progressive incentives to the Islamic banking market in encouraging the development of Islamic bank. These six priority policy programs include (a) Optimization of Hajj fund management through Islamic banking, (b) Recommendation and facilitation for the adoption of Islamic banking micro finance model in line with the needs of the government and priority economic sectors, (c) Optimization of the management of *waqaf*, *zaka*t, *infaq*, and *shodaqoh* funds and at the same time enhancement of the

integration of social function into Islamic bank business activities, (d) Promote involvement of Islamic banks in the management of the funds of central/district governments and state-owned/district-owned enterprises, (e) Promote placements of funds, resulting from *sukuk* emission at Islamic banks, and (f) Formulation of an incentive framework for expansion of productive financing in corporate and long-term (infrastructure) sectors (FSA, 2015, pp. 54-57). Nevertheless, we did not find any comprehensive explanation in detail for specific regulation and incentive mechanism that will be prepared to achieve the target of this priority programs.

Specifically, if we scrutinize the *Roadmap of the Indonesian Islamic Banking Development 2015-2019* (FSA , 2015), this particular document does not present a detailed policy direction in terms of market structure and incentive mechanisms for the Islamic banking under the dual banking system. Although it is a crucial factor for the Islamic banks in improving their market positioning which is currently focusing only on the *Shari'ah* loyalist customers and consumer banking products in order to avoid severe competition in the banking market. In conclusion, to the best of our concern, the official document of the *Roadmap of Indonesian Islamic Banking 2015-2019"* (FSA, 2015) has not extended the policy making process to bring the particular regulation and incentive mechanism that will provide the rent effect for encouraging the Islamic bank's sustainable development.

Moreover, this strategic document does not provide sufficient incentive mechanisms for the Islamic banks in preparing the strategy of organic growth with penetration of the broader market and network infrastructure that improve competitive advantage in the early growth and also continuing to achieve inorganic

growth through strategic business efforts such as merger and acquisition and improving the cost of fund structure in their financing activities.

Accordingly, we find that in the growth of the Islamic banking business, Indonesia’s Islamic bank has failed to make the process of technology transfer, especially in responding to rent for learning mechanism to increase its capability and competence in facing severe competition in the banking market.

As a matter of fact, this seemingly unsuccessful institutional transition is reflected in the inferiority of innovation and extensive market penetration of the Islamic bank performance, especially for entering into the corporate banking market through suitable financing contracts and services. On the other hand, the lag in the development of banking infrastructure and technology capabilities of Indonesia’s Islamic banks will result in failure to increase its penetration in a very competitive consumer banking market and offering affordable financings scheme for SMEs compared to the conventional banks accomplishments.

One important aspect that cannot be ignored in setting up Islamic banking regulations in Indonesia is the creation of conditions for the same level of playing field for conventional banking and Islamic banking to compete in a free and fair market circumstance (Wibisono, 2009). In fact, the development of the Indonesia's Islamic banks has not attained its optimum level of economics of scale in the banking industry. To that end, government intervention in terms of creating the same level of playing field becomes essential to ensure the existence of fair competition in the banking market in Indonesia (Ismal and Haryati, 2013).

Generally, there are three main phases of government or regulators’ policy responses in supporting the development of Islamic bank in Indonesia. The first

phase, in the 1990s along with the weakening of the political power of former President Suharto, in the initial development of the Islamic banking, we witnessed that the government and regulators' response was “incidental” and “political coalition” to embrace the political power of Islamic groups .

The second phase, since the beginning of the reform era after President Suharto fell down was marked by the birth of ‘Act No. 10 Year 1998 'as a revision of ‘Act no. 7 Year 1992’ which allows the conventional bank to open Unit Usaha Syariah (UUS/Islamic Banking Division). In this phase it can be seen that government and regulators are starting to give more attention to the development of the Islamic bank. The government and regulators have laid down the basic policy principles of the same level playing field to foster the development of the Islamic bank. This is reflected in the fact that *Bank Indonesia* (the central bank) issued a number of regulations and policies for the Islamic bank such as bank licensing, operational coverage, and bank supervision provisions, generally having equal treatment with the conventional bank.

Nonetheless, the policy taken by the government so far has not been comprehensive to provide support to the Islamic banking. This is proved, for instance, by the very slow pace of government taking a decision to settle the "double tax burden" dispute over *murabahah* products in the Islamic bank. In fact, in accordance with the applicable law, it has been affirmed that all credit products or financing banks are not charged with the value added tax. The direct result of the absence of this "tax neutrality" policy is obviously very detrimental to the Islamic bank, since this *murabahah* financing activity is dominant in the Islamic banking business. In this context, we can argue that the government and policy makers in

banking industry in Indonesia are still in the process of learning in developing the Islamic bank and still have this mindset that the Islamic bank is only a complementary in the national banking system and is an "inferior bank" compared to the conventional bank.

The third phase was marked by the birth of ‘Act No. 21 Year 2008’ about Islamic Banking on 17 June 2008. After the previous phases the Islamic bank has proven to survive and demonstrate impressive growth performance. 'Act no. 21 Year 2008 'is very important in providing legal certainty and ensuring the business continuity aspect of the existence of the Islamic banking in Indonesia. In the policy perspective of the same level playing field, we argue that this policy has created "the free competition business environment" for the Islamic bank, but it seems we have not been able to state that 'the fair competition' has been created in the banking industry in Indonesia.

However, the reality that we find behind the enormous potential that the Islamic banking sector can contribute, the market penetration of the Islamic banking is still in the low state which is less than 5% in the national banking industry market. Thus in the scale of the economy and its capacity to contribute with significant impact in the economy is not optimal. Therefore the free competition that occurs between Islamic and conventional banking is not a fair competition because it resemble a fight between “a small baby” against “huge figure of a giant”. This situation can also be described as a race, in which the contestants are required to sprint but with the different start point. One of the contestants received a favorable condition for starting earlier, while the other participants were left behind and

having a lack of capacity and competency compared to their competitors who were already in the safety zone.

Further we find that the policy of the same level of playing field taken by the government and regulators in Indonesia to support the development of Islamic banking has not been able to provide an opportunity for the Islamic bank to optimize its potential in penetrating the market of the national banking industry. From the point of view of the government and regulators of the banking industry we can underline that one of the jargon that is echoed to place the same level of playing field policy for the banking industry is the co-existence between the conventional and the Islamic banks. However, this jargon seems inadequate because the reality in the banking industry shows that the condition of the Islamic bank is less competitive than the counterpart which is the conventional bank.

Therefore, if the government and regulator of banking sector in Indonesia believe that the potential of the Islamic banking to contribute has significant impact in the economy then it is necessary to have a comprehensive affirmation policy through the policy of the same level playing field that has the alignment to support the development of the Islamic Banking. This affirmation policy is expected to create a sufficient financial sector rent to encourage Islamic bank to compete healthily and thus expand its business. In this context, we can take on the argument of Chang and Grabel (2004) which state that to achieve the development goals there is no harm to the government to adopt interventionist economic policies and reject the hypothesis that free market competition will always have a productive impact on the development of financial sector. Governmental intervention in this case, is not based on the argument that the Islamic bank is still in the infant industry stage.

Since its birth in 1992 and then more than two decades after, certainly the Indonesia's Islamic bank is not in infant stage anymore. However substantively we will agree that the Indonesia's Islamic banking cannot be categorized as a mature industry in the aspect of economic of scale or aggregate capacity it has in the economy. We can propose a number of affirmation policies that can be an alternative for the Indonesia's Islamic banking to have an economic of scale and greater capacity to accelerate the development of Islamic bank, for instance:

(1) having one big state-owned conventional bank to be converted into an Islamic bank. This is with the consideration that the top five largest banks in Indonesia is still dominated by the state owned conventional banks, meaning that the Indonesia's banking sector is basically under controlled and influenced by the government;

(2) involving the Islamic banks in the government's financing infrastructure project,

(3) placing the *ummat* savings fund for Hajj (the Pilgrim to Mecca) only on Islamic bank.

Then, a question arises on whether the affirmation policy that provides support to this Islamic banks does not become a burden to the government and detrimental to the interest of national economic? In this case we can propose the conceptual economic view of the Islamic banking industry having the potential to provide significant benefits in encouraging economic growth and increase financial inclusion for the Indonesian economy. In addition, the existence of Islamic banking industry is very important for the Indonesian economy because of the large Muslim

population. Muslim who believe that the interests from the banking business is prohibited, the consequence is that the profits derived from conventional banks according to *Shariah* opinion (*fatwa*) should be 'purified' by letting the earnings to go to *Zakah* or charity institution. Therefore, the existence of Islamic banking is expected to play a major role in creating an appropriate incentive and safety for the Muslim investors to deal with their investment activities.

With such consideration, we can propose an economic justification for the occurrence of burden that may be inevitable in the short term by the government for intervening support of the growth of the Islamic bank. However, in the long term, the benefits received will be greater to the overall economic development along with an increasingly large contribution played by the Islamic banking sector. Thus, the potential of the Islamic bank to promote economic growth, support the development of SMEs, and create social justice is expected to provide benefits to the whole society, not only for the Muslim population.

Undoubtedly, the affirmation policies should be done meticulously by the Indonesian government. For example, the affirmation policy should be implemented gradually and have a long-term comprehensive vision for preparing the regulatory tool, capacity and capability of human resources, and adequate technology support that is reliable from the Islamic banking industry. In this case, the Indonesian government can take lessons from the Malaysian government who has succeeded in implementing the same level playing field policy and prepared a detailed strategy to create an adequate financial sector with incentive mechanisms that support the development of Islamic banking, among others, with an integrated policy strategy through Malaysia International Islamic Financial Center (MIFC,

2013) and Financial Sector Blueprint 2011-2020: Strengthening Our Future (BNM, 2011) (please refer to our depth discussion on the fortune facilities of the Malaysian government's alignment to incubate the Islamic banking in Chapter 5).

9.4 Summary

Conclusively, the discussion above has shown the failure of Indonesia's Islamic banks in utilizing bank rent opportunities under the frameworks of monopoly rent, monitoring rent, and rent for learning in the banking market. Thus as a consequence of this circumstance placed on the Islamic banks, they are less competitive compared to conventional banks. Accordingly, the institutional failure that occurred in Indonesia's Islamic banking market began with the occurrence of structural failure as market structure shape was characterized by high transaction costs.

On the other hand, we see another institutional failure which is the existence of the transition failure. This transition failure basically is rooted in government's policy making process. The economy failed to arrange for well-founded direction and develop policies that can perform transformation of the institutions in improving net social benefit.

In this sense, process of growth of the Islamic banking business, the Indonesian Islamic bank has failed to make the process of technology transfer, especially in responding to rent for learning mechanism to increase its capability and competence in facing of severe competition in the banking market.

From the perspective of Islamic bank rent theory, these competitive challenges indicate that Islamic banking needs a number of policies from the Bank Indonesia (Central Bank) and Financial Service Authority (FSA). They are

expected to provide appropriate incentives to the Islamic banking development. Without the adequate incentives in the Islamic banking industry, it will be difficult for Islamic bank managers to improve the profit and loss sharing under *mudaraba* and *musharaka* financing contracts.

The structural dilemma faced by Indonesia's Islamic banking is also becoming an important indication that the regulatory framework and market structure did not manage to provide an adequate incentive mechanisms for the Indonesia's Islamic bank industry. In conclusion, due to this particular structural dilemma, Islamic bank responds hesitantly in expanding their business which in turn led to the slow pace of growth and stagnancy.

It is worth to note that in the context of the Indonesia's Islamic bank, the governmental (regulatory) failure in preparing the same level playing field between conventional and Islamic banks has caused the Islamic bank to be less competitive and profitable in comparison to the conventional bank. Whereas, in the case of Malaysia, Malaysian government is successful to prepare the 'same level playing field' between conventional banks and Islamic banks through utilizing the conventional bank's infrastructure of the Islamic bank's holding company, tax and fiscal incentive, and increasing public awareness of *Shariah* products.

CHAPTER 10
CONCLUSION

10.1 Introduction

The basic question of this research is to study Islamic banking performance in Indonesia, a country with the largest Muslim population. At the end of 2014, it had total assets at Rp 242 trillion ($ 19,453 million), total deposits at Rp 183 trillion $ 14,710 million), and total financing was at Rp 184 trillion ($ 14,791 million). Alamsyah (2012) asserts that Islamic banking in Indonesia had an average rate of growth of 40.2% per year during of 2007-2011 period, which was much higher than the conventional banking growth of 16.7% per year. Nevertheless, we noted that during the period 2005-2014, the growth of both assets and financing in Islamic banks had slowed down. Thus, further scrutiny was required to analyze the current achievement and outline the main problems faced by Indonesia's Islamic banking amid the dynamics of the Islamic banking market at the global level. It is worth noting that the extraordinarily low levels of Islamic financial deepening and the slow pace of growth phenomena have occurred within Indonesia's Islamic banking industry. Unfortunately, in terms of market share, it is noticeable that Indonesia's Islamic banks had been stagnant at only about 1-4.9% of the total market share of Indonesia's banking industry during the period of 2003-2014 (Ismal, 2014; FSA, 2015).

In this regard, the objective of this research was to clarify the reasons or fundamental constraints behind the extraordinarily low level of Islamic financial

deepening and the slow pace of growth within Indonesia's Islamic banking. It also aimed to make sense of the recent trend of slow-pace growth in further market penetration by the Indonesia's Islamic banks.

The existing arguments in the literature do not sufficiently shed analytical light on the "incentive" mechanisms in credit risk management and banking operations done by Indonesia's Islamic banks. As such, in order to provide a theoretical framework to support the issues and analytical tools for the research questions, we borrowed from the traditions of Institutional Economics (IE), which are concerned about the rules and mechanisms that provide incentives and threats to the economic players. Under this presumption, economic institutions would matter as the determinant for economic development and economic efficiency. In particular, we use the theoretical framework of "financial sector rent" (bank rent) to justify the creation of "rent (surplus) opportunity" to be captured by banks as the incentive of making them become prudent fund providers (Hellman, et. al., 1997; Khan, 2000; Suzuki, 2011; Suzuki & Uddin 2014).

Accordingly, this research adopted the financial restraint model as introduced by Hellman, et al. (1997) to examine the hypothesis that Indonesia's Islamic banks fail to earn enough profits to maintain their franchise value, resulting in the extraordinarily low level of Islamic financial deepening and the recent trend of slow-paced growth of Indonesia's Islamic banking. In particular, we use the analytical framework introduced by Suzuki and Uddin (2014) known as "the Islamic bank rent", a new concept that posits that Islamic banks need to earn more profit than conventional banks to maintain their franchise value as prudent *Shari'ah*-compliant lenders.

10.2 Summary of Key Findings

Chapter 2 presented a depth discussion of the birth and initial development of the Indonesia's Islamic banking in the context of social, political and economic dimension of Indonesia. It is worth to note that; in line with the objective of the Islamisation of economics movement, the establishment of Indonesia's Islamic banking has put in place *Shariah* principle as the guidance source in realizing of Islamic economics practices. Accordingly, it is expected that the establishment of Islamic banking will play a crucial role to facilitate the Muslim depositors and investors in their investment and economic activities in accordance with *Shariah* principle. Whereas, the development of Islamic banking in the Western countries can be seen as a form of positive response towards prospective business opportunity in Islamic finance and dynamic demographic change; rather than as a change in political economic constellation between the secular countries and the Islamic world.

On the other hand, we conclude that it is not possible to observe the development of Islamic bank in Indonesia separate to relational pattern between the state and Islam. In this sense, as Hefner's (2008) concludes that Islamic banking development in many Muslim countries have s similar pattern in which the proponents of Islamic finance and banking needed to go through a process of coalition building with three main elements of the society: (1) Islamic scholars (*ulama*), (2) Muslim capital owners and (3) "prominent actors within the state" who see political interest in it. Moreover, from political economy perspective, the development of Islamic banking has been perceived by the proponent of the Islamisation of economics movement as an attempt to create social and economic

justice for the people of Indonesia through wealth creation and wealth transfer in the society (Bakar, 2008).

Chapter 3 presented the facts and findings that revealed a lower profitability performance and a deteriorating trend of the financial performance indicator of Indonesia's Islamic banks in comparison with conventional banks during the period of 2005-2014. Moreover, we acknowledged that the deteriorating financial performance indicators of the Islamic banks are indicating them having experienced insufficient profit earning to develop their business. This makes sense as an adequate profit level is important for the banking business. Thus the worsening performance of the Islamic banks in Indonesia has proven that there is less incentive for Islamic banks to expand their business and accelerate their growth in the banking industry.

In conclusion, the extraordinarily low level of Islamic financial deepening and the slow paced of growth of Indonesia's Islamic banking should be a concern for all stakeholders of the industry. The financial and banking authorities need to be involved to the extent of preparating and supporting the existing regulatory framework, revamping the market structure to provide sufficient incentive mechanisms for market players, improve competitiveness and efficiency, and maintain the sustainability of the future development of the Indonesia's Islamic banks.

In Chapter 4, the theory underpinning the extraordinarily low level of Islamic financial deepening and the recent trend of slow paced growth in Indonesia's Islamic banking were presented as crucial phenomena to be analyzed. This research was needed as Indonesia showed a trend in the midst of arguments that posit global

Islamic finance and banking as having experienced rapid expansion with vigorous performance.

In this context, it is recommended that the Islamic banking industry implement the theoretical framework of "financial sector rent" (bank rent) to justify the creation of "rent (surplus) opportunity" to be captured by banks as the incentive for making them become prudent fund providers (Hellman, Murdock & Stiglitz, 1997; Khan, 2000; Suzuki, 2011; Suzuki & Uddin, 2013).

In Chapter 5 we discussed issues concerning the regulatory framework and the development of Islamic banking in Indonesia and Malaysia. Some important findings in comparison to Malaysia’s Islamic banking industry was advanved for solving the challenges in Indonesia.

Firstly, we recognize that in many cases regulations and policies of Islamic banking development are frequently influenced by the bottom-up approach in which the Muslim community, has a role in initiating or encouraging the Indonesian government to support Islamic banking. This typical Islamic banking development is in contrast to the development of Islamic financial institutions in some countries (such as Iran, Malaysia, and Saudi Arabia), in which the driving factors of Islamic banking development are more due to regulatory support and top-down approaches from the government to the Islamic banking industry. These include initiatives for the preparation of regulation and support for the development of the Islamic banking that predominantly came from government policy, placement of government funds, and state-owned enterprises within Islamic banks.

Secondly, in setting up and preparing the regulatory framework to support the Islamic bank, the Malaysian government implemented a comprehensive approach.

This approach covered aspects for preparing advanced regulatory and supervisory mechanisms, providing adequate and clear incentive provisions, and implementing a pragmatic policy to support the achievement of objectives which have long term development strategy. The Indonesian government did not do well in comprehensively preparing the regulatory framework support. In fact, the regulatory support in the case of Indonesia's Islamic banks were often too late to support the Islamic banking operation. In this context, we perceive that there was a state failure of omission on conditions in the form of a regulatory framework for Islamic banks in Indonesia.

Thirdly, we note that the policies issued by the financial authorities in Indonesia tend to have a conservative stance in providing support for the development of Islamic banking in Indonesia. Accordingly, Indonesia's Islamic banking failed to implement strategic programs for the massive opening of the Islamic banking windows/division (*Unit Usaha Syariah/UUS*) in order to leverage the conventional banking infrastructure. This resulted in the inability for Islamic banking windows/division (Unit Usaha Syariah/UUS) in Indonesia to fully use the conventional banking infrastructure, since the Islamic banking windows/division (Unit Usaha Syariah/UUS) in Indonesia was only allowed to operate at the Islamic bank branches and was separated from the conventional bank branches. This stands in contrast to Malaysia's Islamic banking situation. Malaysia's Islamic banks have successfully developed their Islamic banks' market shares through opening Islamic banking windows, which effectively utilized the conventional bank infrastructure.

Fourthly, it should be emphasized that Indonesia's Islamic banking industry did not provide an adequate incentive mechanism to Islamic banks in the early

stages of their establishment in Indonesia.

In Chapter 6, we analysed the profitability and stability of Indonesia's Islamic banks compared to conventional banks. Accordingly, we drew upon the bank rent approach to make sense of the existing pattern of financing modes in Indonesia's Islamic banks. From the empirical result of cases studies of Islamic banks in Indonesia, Malaysia, and Bangladesh, the financing patterns of Islamic banks still remain a concern, as they are predominantly concentrated on asset-based financing modes rather than purely *Shariah*-based financing modes. It is evident that Islamic banks in Malaysia and Bangladesh rely almost entirely on asset-based *murabaha* financing modes for upholding their continuous stream of bank rent opportunity. In contrast, Islamic banks in Indonesia engage in equity-based *musharaka* financing to a relatively higher extent, even though asset-based financing modes are still prevalent in their asset portfolios. This difference between the financing patterns of Islamic banks in Indonesia, Malaysia, and Bangladesh is reflected in the contrasting results documented by two performance indicators 'Return on Asset' (ROA) and 'Non Performing Loan' (NPL). The ROA of the Islamic banking sector of Bangladesh was higher than the overall banking sector in almost all years during the period under study. On the other hand, the NPL of the Islamic banking sector was lower than that of the overall banking sector during the whole period. However, the scenario is entirely reversed in Indonesia's Islamic banks. In both cases, the overall banking sector was performing better than Islamic banks for almost the entire period by presenting higher ROA and lower NPL. Meanwhile, in Malaysia, ROA and NPL performances of the overall banking sector during the whole period were slightly better than Islamic banks. Interestingly, the nature of the *musharaka*

financing adopted by Islamic banks in Indonesia is not the type of purely "participatory" financing. Rather, it is a unique variant approach of *musharaka* financing mode. Thus, we observe the *murabaha* syndrome in the Islamic banking sector in Bangladesh and Malaysia. Specifically, we highlight findings of the quasi-*murabaha* syndrome as practiced by the Indonesian Islamic banks.

In Chapter 7, an assessment and analysis of the market structure and concentration over the years was done. This was in order to have a better understanding of Indonesia's Islamic banking landscape and its competition configuration.

Using the *k*-Bank Concentration Ratio, we established that in the period of 2006-2014, the concentration ratio flattened with the concentration ratio CR-k3 where total assets was recorded about 36-39% and CR-*k* 5 was about 49-52%. Meanwhile, in terms of total credits, the concentration ratio CR-k3 was recorded at about 28-36% and CR-*k* 5 was at about 49-52%. On the other hand, in terms of total deposits, the concentration ratio CR-k3 was recorded at about 38-41% and CR-*k* 5 was at about 50-55%. In this sense, it also means that during the period 2006-2014, the banking industry in Indonesia showed no significant change on competition circumstances, and the market shares of the bank were predominantly enjoyed by the top five biggest banks. These results also indicate that the banking market in Indonesia was highly dominated by conventional banks and as such the level of competition for the Islamic banks in Indonesia for the particular period increased.

Then, applying the Herfindahl-Hirschman Index (HHI) in measuring the Islamic banking market structure and concentration, this thesis found that during the period between 2004-2008, the market concentration of Islamic banks based on

the total assets, the third party fund/deposit, and total financing had a declining trend. However, we noted that in the period following, from 2008-2012, there was a tendency towards a fluctuating trend.

It was noticeable that during the period between 2012-2014, the concentration pattern according to the HHI index showed a slight declining trend. However, we find that concentration on total financing seemed to increase from 2014. With further scrutiny on this situation it can be argued that the financing activities have been dominated by the main players of the Islamic bank system during the period, and that there was a worse situation within the economy which caused the Islamic banks to face difficulties in channeling their financing.

From this viewpoint, we hypothesize that following the structural approach the level of competition for Islamic banks in Indonesia for these particular periods has increased. In fact, this increased competitive level does not only occur among Islamic bank players but also within a higher competition climate with the services offered by conventional banks. This situation urged Islamic banks in Indonesia to fall into the "quasi-*murabaha*" syndrome practices (Suzuki, 2013; Suzuki and Uddin, 2014). It makes sense, then, to explain the dominant modes of financing in Islamic banking products under the contract asset-based financing such as *murabaha* and its variations.

In addition, from the empirical results we conclude that the occurrence of tight competition level in the consumer banking has driven the Islamic banks to face difficult conditions to achieve promising performance due to a lack of economic scale and a lower efficiency level. In this severely competitive situation the Islamic banks have struggled to acquire depositor funds and fall into a higher cost of

funding in their business. As a consequence, Islamic banks have failed to get the bank rent opportunities to further develop their businesses and have experienced a stagnant growth in the period 2008-2014.

Based on the analysis and empirical results discussed in Chapter 6, following the structural approach, we can conclude that the banking market in Indonesia is highly dominated by the conventional banks and the level of competition for Islamic banks in Indonesia for these particular periods has increased. Under these circumstances, it is worth noting that the implementation of dual banking policy has resulted in Indonesia's Islamic bank being left behind in terms of capability and competency in comparison to conventional banks. Next, along with the remarkable growth of the new Islamic banks in the form of the full-fledged Islamic banks and Islamic banking unit/division establishment, this tough condition has caused the Islamic banking market to become a highly competitive market. As such, it has created a severe level of competition among the Islamic banks. Noticeably, this devastating situation has caused the Islamic banks to struggle at a low level of profitability.

In Chapter 8, we provided empirical results with regards to comparative analyses of the operational efficiency between conventional and Islamic banks in Indonesia using DEA method. Overall, our analysis concludes that during the observation period of 2008-2014, efficiency levels of conventional banks have had a tendency to be higher than Islamic banks in all sizes of overall efficiency, technical efficiency and scale efficiency. It is noticeable that in the overall efficiency and the scale of efficiency measures, the Islamic banks have presented a slightly downwards trend of efficiency between the years of 2008-2014.

These findings explain at least two important conclusions. Firstly, this situation confirms the occurrence of deterioration within Indonesia's Islamic banks' financial and operational performances for the years 2008-2014. Secondly, this situation also proves the occurrence of stiff competition levels between conventional and Islamic banks wherein this situation has driven the Islamic banks to difficult conditions to achieve satisfactory performance due to a lack of economic scale and a lower efficiency level.

From the perspective of the bank rent theory, this chapter derives a crucial conclusion from the empirical data in these particular studies. That is, in measuring the efficiency levels in both Indonesia and Malaysia, we have identified that Indonesia's Islamic banks failed to utilize opportunities for leveraging the conventional infrastructure and networks, whereas Malaysia's Islamic banks have had success in leveraging their condition. Thus, the success of leveraging on conventional infrastructure and networks resulted in significant efficiency, thus Malaysia's Islamic banks experienced relatively higher success in comparison with conventional banks. Malaysia's Islamic banks have successfully optimized this favorable condition to utilize rent effect that created an incentive for further development of Islamic banking in Malaysia.

Furthermore, we borrow the approach used by Khan (2000) to shed light on the process of institutional (state) failure in applying economic policies to the development of Indonesia's Islamic banks. Some important findings have been shown as results of the interaction between financial authorities and market players in responding to the creation of three particular mechanisms of rent seeking in the financial industry, the being monopoly rent, monitoring (financial) rent, and rent

for learning.

Unfortunately, holding “the comparative advantages and monopolistic behavior” in the sense of *Shariah*-compliant product financing modes, which are gripped by the Islamic banks in a relatively long period of the development of Islamic banking in Indonesia. In fact, this situation did not lead to a capability building for Islamic banks to significantly accumulate adequate profit from their business. It also meant that, within the framework of monopoly rent and from the standpoint of benefits received by Islamic bank customers, the actual social benefit of Islamic banks is lower than that of deadweight welfare loss that occurs in the Islamic banking market. In addition, the Indonesian Islamic banks, under monopoly rent circumstances, have seemingly failed to accumulate such large profit in order to induce more investment and innovation in the face of rigorous market competition. In conclusion, it seems that the Indonesian Islamic banks have failed to exploit their comparative advantages in transforming their banking business in order to be able to capture the competitive banking market.

Meanwhile, the empirical results show that there is inadequate incentive to encourage the better monitoring portfolio that is expected of Indonesia’s Islamic banks. Thus, this finding indicates that Indonesia’s Islamic banks have failed in utilizing the monitoring rent in the competitive banking market, and as a consequence, the Islamic banks have no ability to sustain their sustainable growth.

By observing the occurrence of stagnation in development of Indonesia’s Islamic banks and adopting a rent for learning perspective (Khan, 2000), we opine that the stagnation is also caused by unsuccessful determination of regulations and incentives provided by the financial and banking authorities to increase their

capability and capacity to grow and expand their business.

This is caused by the inability of Indonesia's Islamic banks to utilize their accumulated profit in improving product innovation and the financial intermediary know-how. For instance, although Indonesia's Islamic banks have increased their equity based financing (under *mudaraba* and *musharaka* contracts), they have merely been experiencing *murabaha* syndrome. This has involved risk adverse behaviour, more focus on consumer financing, and tendencies to be conservative in implementing risk management in order to monitor financing portfolios.

Conclusively, the discussion in Chapter 9 has shown failures of Indonesia's Islamic banks in utilizing bank rent opportunities under the frameworks of monopoly rent, monitoring rent, and rent for learning in the banking market. Therefore, as a consequence of this, Islamic banks have had less competitive advantages in comparison to conventional banks. In this regard, the institutional failure that occurred began with the occurrence of the structural failure, as market structure shape was characterized by high transaction cost. Moreover, another institutional failure is the existence of transition failure. This transition failure is rooted in the government and in the policy making process, which failed to arrange for well-founded direction and well-developed policies that could perform institutional transformation for the sake of improving net social benefit. If we analyze the regulatory framework and strategic documents as reported in the master plan of Indonesia's Islamic banking development that is used by the financial and banking authorities for the preparation of Islamic banking development, we find that in the process of forming the Islamic banking business, Indonesia's Islamic bank failed to make the process of technology transfer. This is especially evident in

responding to rent for learning mechanisms to increase their capability and competence in facing severe competition in the banking market.

The structural dilemma faced by Indonesia's Islamic banking is an important indication that the regulatory framework and market structure did not manage to provide adequate incentive mechanisms for the Islamic bank industry. In conclusion, due to this particular structural dilemma, Indonesia's Islamic bank responded by being seemingly hesitant in expanding their business, which in turn led to the slow pace of growth and stagnancy.

In conclusion, the governmental (regulatory) failure in preparing the same level playing field between conventional and Islamic banks in Indonesia has caused the Islamic bank to be less competitive and profitable in comparison to the conventional bank. Whereas, in the case of Malaysia, Malaysian government is successful to prepare the same level playing field between conventional banks and Islamic banks through utilizing the conventional bank's infrastructure of the Islamic bank's holding company, tax and fiscal incentive, and increasing public awareness of *Shariah* products.

In order to sum up the empirical result and analysis that we have discussed throughout this research, we refer to the basic question posed in Puzzle 1 of this research (see section 1.2 in Chapter 1), in elaborating and analyzing plausible causes and fundamental constraints behind the extraordinarily low level of Islamic financial deepening and slow pace of growth in Indonesia we can propose a number of important conclusions as follows:

1. It is worth noting that facts and findings have proved the current overall performance of Indonesia's Islamic banks are lower than conventional banks

during the period of 2005-2014. This research finding reveals that Indonesia's Islamic banks have a lower profitability performance and a deteriorating trend of financial performance indicator in comparison with conventional banks. Besides having a gloomy trend for key financial indicators, Indonesia's Islamic banks have faced a structural dilemma in their funding and financing activities. They have had relatively higher costs of funding and have had a limited capacity and capability in their financing activity. These unfavourable conditions have caused them to focus only on the consumption segment of financing and hesitate to take the the more risky corporate financing. Accordingly, since the Islamic banks are experiencing financial deterioration with the performance indicators, it has become evident that Indonesia's Islamic banks have insufficient profit to develop their business. In this regard, Indonesia's Islamic banks could not acquire adequate bank rent opportunity in their business. Therefore, the current deterioration performance of Islamic banks in Indonesia has proven that there is less incentive for them to expand their business and accelerate their growth in the banking industry. Thus, this research's finding is in line with the concept of "Islamic bank rent," a concept introduced by Suzuki and Uddin (2014) in which Islamic banks must earn an extra profit (they call this "Islamic bank rent") to maintain their franchise value as prudent "*Shariah* compliant" lenders and ensure sustainable income in the future.

2. In conducting an analysis of the market structure and competition issues of the contemporary development of Indonesia's Islamic banking, we conclude that the banking market in Indonesia is highly dominated by conventional banks

and the level of competition for Islamic banks has intensified. This increased competitive level does not only occur among Islamic bank players but also in highly competitive climates in the services offered by conventional banks. This condition also explains the dominant of modes of financing in Islamic banking products under the contract asset-based financing such as *murabaha* and its variations. Without the adequate incentives, it will be difficult for Islamic bank managers to improve the profit and loss sharing under *mudaraba* and *musharaka* financing contracts. It is worth noting here that although we acknowledge that the Indonesian Islamic banks have relatively a higher portion of equity based financing under *mudaraba* and *musharaka* financing contracts through the two-steps *mudharaba/musharaka,* in fact this particular financing mode has urged the Islamic banks in Indonesia to fall into practices common to "quasi-*murabaha*" syndrome (Suzuki, 2013; Suzuki & Uddin, 2014; Suzuki, Uddin, Pramono, & Khan, 2017). The discussion on the market structure and concentration related to Indonesia's Islamic banks bring us to the essential findings of the existence of structural dilemma in Islamic banking industry. Under these circumstances, it is to be noted that the implementation of dual banking policy resulted in a situation where Indonesia's Islamic banks lost their capability and competency in comparison to conventional banks. Consequently, this devastating situation has caused Islamic banks to suffer low levels of profitability as supported by the analysis of the performance measurement of Islamic banks, in which we find that the current trend of the Islamic banks ROA and NPF perform relatively low in comparison with the conventional banks.

Furthermore, to answer the main question as exposed in Puzzle 2 in this research (see section 1.2 in Chapter 1), we examined the secrets of successful development of Malaysia's Islamic banking. By comparing the circumstances of Islamic banking of Indonesia and Malaysia, we find the following findings to be important:

1. We highlight the fact that the Indonesian government was late to prepare a regulatory framework to support Islamic banking development optimally. In addition, the financial authorities do not provide adequate tax and fiscal incentives for the development of the Islamic banks to grow and have competitive efficiency so as to compete in the banking industry as a whole. Meanwhile, the Malaysian government developed a series of regulatory frameworks and implemented intervention policy for incubating Islamic banking development since the initial preparation for the establishment of the first Islamic bank in 1983. On top of this, they provided substantial tax and fiscal incentives in supporting the competitiveness level of Malaysia's Islamic banking. Moreover, the Malaysian government apparently applied a pragmatic policy oriented by market driven approach for Islamic banks to achieve their business objectives efficiently and encourage excellent innovation in products and services to grasp potential Islamic customers widely.
2. It is worth noting that the Indonesian government and financial authorities implemented a conservative policy in order to utilize the conventional banks' infrastructure and networks for the development of the Islamic banks. By these regulations, the Islamic banking windows/division (Unit Usaha Syariah/UUS) in Indonesia is not able to use the conventional bank infrastructure completely

since the Islamic banking windows/division (Unit Usaha Syariah/UUS) in Indonesia was only allowed to operate at Islamic bank branches. Meanwhile, the office channeling policy issued by the financial authorities, where the Islamic banks were allowed to have Islamic banks' counters at their conventional holding company, was not effectively implemented as it had no strict policy direction from the management of the banks. Remarkably, the key performance indicator (KPI) measurement for the banks has not encouraged the banks' staff to contribute in full to this policy. This is in contrast with Malaysia's Islamic banking experience, in which they successfully developed the Islamic bank's market share through opening of Islamic banking windows which effectively utilized the conventional banks' infrastructure and network. The regulations of the Malaysian government provided a clear direction and favourable situation for Islamic banking windows in optimizing conventional banks' infrastructure and network utilisation. In addition, the conventional banks that run the Islamic banking windows in Malaysia had the same vision and mission to promote the growth of Islamic banking industry, as they treat the Islamic banking windows as integrated business entities of the organization. Accordingly, the banks' staff did not hesitate to promote Islamic banks' products to their customers. These conducive circumstances have been manifested in the banks' operational procedures, in which it is stated that the staff assigned to perform Islamic bank transactions will also be included in performance evaluations as the key performance indicator (KPI) on their contribution to the company. Thus, this leveraging strategy can be viewed as a very successful breakthrough towards accelerating the growth of the assets of

Islamic banks in Malaysia as well as improving efficiency in infrastructure investment in the initial stages of the Islamic bank, since it costs less and can utilize the network infrastructure already established in the Malaysian conventional banks.

3. Obviously, under the conducive regulatory framework for utilizing the conventional banks' infrastructure and network and the availability of sufficient bank rent opportunity, Malaysia's Islamic banks have improved their technical and scale efficiencies competitively in comparison with conventional banks. It is worth noting that under this advantageous business circumstance, Malaysia's Islamic banks have successfully created positive rent effect. Whereas, the Indonesian government and financial authorities apparently failed to incubate the Indonesian Islamic banks for encouraging further development in the banking industry.
4. It is worth noting that the success of Malaysian government to prepare the same level playing field between conventional banks and Islamic banks has contributed considerably to the development of the Islamic banking industry. In contrast, the governmental (regulatory) failure in preparing the same level playing field in Indonesia is recognized become a root cause of extraordinarily low level of penetration and recent slow down of the Islamic banking development. Hence, 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.

10.3 Policy Implication

Based on the success of the Malaysian government in its strategic planning

implementation to develop Islamic banking and finance industry, we underline that the Malaysian government had been very aggressive in building the institutional infrastructure of the Islamic financial system and creating incentive mechanisms which became essential factors in prompting the market players to expand Islamic banking and finance industry. These incentive packages include tax incentives, fiscal incentives, and innovation incentives (Chang, 2009; Lai 2014).

Accordingly, by preparing support in the form of incentive packages and regulations that create rent opportunity for the Islamic bank, it is expected that the Indonesian government can improve their own market structure, which will encourage the creation of a healthy and competitive climate, and increase the efficiency level of the Islamic banking sector.

For this purpose, as part of policy implications, this research advances these following recommendations:

1. From the perspective of the structure of banking industry in Indonesia, it is proven that Indonesia's Islamic banking faces a structural dilemma. Also, this particular dilemma indicates that the regulatory framework and market structure did not manage to provide adequate incentive mechanisms for the Islamic bank industry. Therefore, in resolving the issue of the slow pace of growth and stagnancy in the Islamic banks, the most important prerequisite is to improve the market structure by maintaining the bank rent opportunity as an incentive mechanism to encourage the market players to expand their banking businesses.
2. The Indonesian government, Bank Indonesia (the Central Bank), and the Financial Services Authority (FSA) should have a common policy and

intensive coordination in order to facilitate an adequate bank rent opportunity to the Islamic banks through tax incentives, capital injection, regulatory support, and public education in campaigning Islamic bank product which in turn will bring benefit for the whole Indonesia's economy.

3. Realizing that the banking business is a capital-intensive and highly regulated industry by nature, the Ministry of State Owned Enterprise (SOEs) in Indonesia can take initiative to implement a strategic partnership and merger with the existing state owned banks in order to set up the state owned Islamic bank with a scale of capital and large networks to be able to operate efficiently and compete with banks on a large scale at the domestic and international level.

4. Another strategy to accelerate the development of Islamic banks is the establishment of a bank that focuses on products and operation. For instance the Islamic bank is intended to serve the Small and Medium Enterprises (SMEs) and the Islamic microfinance, as it has *mudaraba* and *musharaka* financing products which are expected to contribute to rural development and poverty alleviation programs. In this sense, it is expected that the Indonesian government and financial authorities should implement "a directed-market driven strategy" whose strategy is to follow the market demand as service excellence and indirectly guide it to the desired direction for the optimum benefit to the society (Ascarya and Yumanita, 2006).

10.4 Potential Directions for Future Research

Referring to the limitations of the study as described in Chapter 1, there are some potentials that should be proposed as the directions for future research:

1. Conducting the study on effective policies by the financial authorities in Indonesia to implement "a directed-market driven strategy", which is expected to be significant to the Islamic banking's contribution in SMEs development
2. Conducting the study on the strategic role that can be played by the voluntary sector of Islamic finance (i.e. *zakat* and *waqf* funds) in addressing the issue of limited collateral funding and financing of Islamic banks to support SMEs and Islamic micro finance development.

10.5 Summary

This chapter has presented a number of fundamental constraints or the reasons behind the extraordinarily low level of Islamic financial deepening and the slow pace of growth within Indonesia's Islamic banking comprehensively. It worth to highlight that in resolving this issue, it is imperative to improve the market structure by creating sufficient bank rent opportunity as an incentive mechanism to encourage the Islamic banks in expanding their banking business. In addition, this chapter advances a number of recommendations related to policy implications and potential directions for future research.

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APPENDIX

Appendix: List of Interviewees in this Research

Interviewees' Institution and Position	Date
Senior Officer of the Islamic Banking Department at Financial Services Authority (FSA)	15 March 2016
Senior Officer at Ministry of State-Owned Enterprises (SOEs)	15 March 2016
Senior researcher at Bank Indonesia (the Central Bank)	15 March 2016
Senior researcher at Bank Indonesia (the Central Bank)	17 March 2016
Senior researcher at Bank Indonesia (the Central Bank)	17 March 2016
Member and senior researcher of National Shariah Council (Dewan Syariah Nasional/DSN), Indonesia and member of the International *Shari'ah* Research Academy for Islamic Finance (ISRA) Council of Scholar, Malaysia	17 March 2016
Senior banker of the Indonesian Islamic Bank	18 March 2016
Member of the National *Shari'ah* Advisory Council, Bank Negara Malaysia (BNM), Malaysia	8 June 2016
Senior researcher of the International *Shari'ah* Research Academy (ISRA), Malaysia	8 June 2016
Senior banker of the Malaysian Islamic Bank	8 June 2016