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Islamic Finance in Indonesia: Past, Present and Future

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This insight aims to highlight new rules governing the Islamic finance sector in Indonesia and the enhanced role of the National Shariah Board, to set out the current state of the market including opportunities for foreign investment and to trace the roots of the industry in the country with the world's largest Muslim population.

New stress test rules for Islamic financial institutions

On 19 November 2014, the Indonesian Financial Services Authority (OJK) issued new rules regarding the development of Islamic finance in the country. This followed an August 2014 initiative to encourage coordination in Islamic finance among government bodies and the private sector in order to help Islamic banks navigate a range of local and federal regulations.

The new requirements include:

- Indonesian Islamic banks (not Islamic business units of conventional banks) are to hold increasing levels of capital calculated according to a risk assessment process (those banks with the highest risk profile need to comply with a capital adequacy requirement of 14%; the previous highest requirement was 8%). The risk assessment process must be carried out every six months and more often if necessary.
- The types of capital-boosting debt that Islamic banks can issue, which must include a loss absorption feature that allows regulators to convert such debt into equity if a lender faces insolvency.
- Islamic banks are required to include ratios in contracts for common types of Islamic compliant profit-sharing financing (including *mudaraba* and *musharaka*), calculated on a feasibility analysis of a customer's business and cash flows.
- Issues such as the separation of Islamic units from conventional parents and guidance for conventional firms that want to become Shariah compliant ones.

Conventional banks must spin off their Islamic units and list them on the IDX (the Indonesian stock exchange) by 2023. The OJK has said that it expects such listings to spur consolidation among Islamic banks over the next few years.

However, in August 2014, Bank Mandiri decided to skip its plan to launch an initial public offering of its Shariah unit (Bank Syariah Mandiri or BSM) as the unit's growth was lower than expected. The Bank also decided to postpone a capital injection of about US\$41m as BSM's capital ratio of 14%-15% was considered sufficient.

OJK and National Shariah Board cooperation

On 11 November 2014, the OJK signed a Memorandum of Understanding (MOU) with the National Shariah Board of Indonesian Ulama Council (DSN-MUI), laying the groundwork for cooperation in achieving the stable and sustainable development of the Indonesian Shariah financial services sector in accordance with Shariah principles. The role of the DSN-MUI is to issue fatwas and oversee their implementation.

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Specific objectives of the MOU include supporting the strengthening of regulation and supervision of the Islamic financial services industry and enhancing Islamic financial literacy and protecting consumers in the sector. The MOU's scope encompasses preparing regulations, supervising the implementation of fatwas and reciprocal consultation.

The MOU will be followed up by a co-operation agreement.

Unlike the Gulf region, Indonesia appears to be heading towards a centralised model to supervise Islamic finance. Previously, many countries left Shariah boards in individual Islamic banks and financial firms to decide whether their products and activities obeyed religious principles. For example, in October 2014 Oman's central bank set up a five-member Shariah board to help oversee the sultanate's Islamic banking industry, while Pakistan's securities commission established a nine-member Shariah board in May 2013.

As of November 2014, DSN-MUI had already stipulated 95 fatwas relating to the Indonesian Shariah financial services industry. They comprise 67 fatwas that relate to the Shariah banking sector, 14 fatwas in relation to the Shariah capital markets sector, six on Islamic compliant insurance, four on pledges for debts (Rahn), two on Sharia multi-level marketing and two relating to Shariah financial accounting.

Key facts about Islamic finance in Indonesia and its development to date

- Indonesia is the fourth most populous country in the world after China, India and the US. It is home to the world's largest Muslim population of approximately 210 million people (about 85% of the total population).
- Indonesia's entire banking system is only worth about 51% of its 2013 GDP value. That compares with 150% in Malaysia and 350% in China.
- The first Islamic financial institutions arrived somewhat later than they did in other Muslim-majority countries, as any conspicuous Islamic behaviour was linked to radicalism. Only in the early 1990s were Islamic financial institutions permitted to form. The first relevant legislation was enacted in 1992 and amended and extended in 1998.
- Indonesia has less than 2% of global Islamic finance assets and only about 5% of its total domestic banking assets are Shariah compliant. Malaysia, with less than a tenth of Indonesia's population has become one of the global leaders of the Islamic finance industry and Islamic banks in Malaysia hold more than 20% of total banking assets.
- According to statistics published by the OJK, as of September 2014, there were 11 Islamic banks in Indonesia with 2,139 offices. Two leading banks - Bank Syariah Mandiri and Bank Muamalat - together account for at least half of the country's Islamic finance sector. Twenty-three conventional banks have a Shariah "window" comprising 425 offices and there are 163 Islamic rural banks with 433 offices.
- Alongside Malaysia and Bahrain, Indonesia is one of the top three countries in the world that regularly issue sovereign sukuk. As of September 2013, Indonesia had about US\$16.7 billion of sukuk in issuance. The government has issued regular rupiah sukuk issuances (once every two weeks) since 2010. Most of Indonesia's sukuk deal flow is very short term, typically less than a year. This is partly due to the perception that longer-term bonds would not be liquid.

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- Indonesia is already a member of the Islamic Development Bank (IDB), the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM) and the International Islamic Liquidity Management Corporation (IILM) and has adopted the regulations of the IFSB and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

The cultural background

Indonesian retail banking customers have appeared to be pragmatic and to make economic decisions based on non-religious reasoning. Thus Shariah compliant “windows” of conventional banks tend to be more popular than all-Islamic banks.

In 2013, as much as 40% of all loan-type arrangements through Islamic compliant banks were projected to be for the purchase of cars, motorbikes and household goods.

Compliant credit cards are offered, for example by Bank Danamon Syariah.

Real estate mortgage products are increasing but at a slow pace. This may be due to the Indonesian government’s traditionally cautious approach to real estate mortgage loans in general.

The nature of investment opportunities in Indonesia tends to favour infrastructure and project financing. The new Indonesian president, Joko Widodo, took office in October 2014. During his early campaigning days, he said that rapid infrastructure and improvement would be a key pillar of his presidency. Islamic finance also fits in with the activities of the small and medium-sized enterprises which account for more than 98% of Indonesian businesses.

Islamic banking may now be nearing the limits of expansion in its core customer base: people who value Shariah compliance above all other factors.

Foreign investment in the Indonesian Islamic finance industry

Bank Muamalat is jointly owned by the IDB, Boubyan Bank of Kuwait, Atwill Holdings, National Bank of Kuwait and other smaller shareholders.

In June 2014, Dubai Islamic Bank (DIB) acquired a 24.9% stake in Bank Panin Syariah (BPS). The OJK has received a proposal from DIB to increase its stake in BPS to 40%.

Indonesia holds attractions to investors from other countries with much larger Islamic banking systems, especially in those Arab countries that continue to experience political and social unrest. For example, Al Baraka Islamic Bank, headquartered in Bahrain, chose Indonesia as one of 12 countries in which it operates. The Al Baraka representative office in Indonesia was established in 2008. According to its website, the office serves as a base for Al Baraka to conduct research on local banks and their potential for acquisition and for assessing the business potential of Indonesia and also generates leads for the other parts of the Al Baraka group.

In September 2014, Indonesia successfully marketed a US dollar denominated 10-year sovereign sukuk. It was almost seven times oversubscribed despite offering a modest yield on a US\$1.5 billion issuance. Investors in the US and Europe were allocated 35% and another 35% was allocated to those in the Middle East.

The attraction of foreign investor inflows is undoubtedly a driving force behind the latest reforms. Given the current fragmented nature of the Islamic banking offering in the country, consolidation appears inevitable.

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Foreign institutions must seek regulatory approval to raise their stakes in Indonesian banks above a 40% threshold to a maximum of 99%.

Key themes regarding the Indonesian government's approach to Islamic finance to date

- Islamic finance should be a credible alternative to conventional finance and open to all Indonesians.
- Aim to reduce speculative transactions.
- Contribute to the achievement of mid- to long-term price stability.
- Support larger-scale strategic planning and development.
- Branding Islamic finance as “beyond banking”.

Conclusion

Driven by government influence and foreign investor interest, Islamic finance looks set to become a more meaningful part of Indonesia's financial industry. It will help maximise the number of people the government can bring into the financial net. The Islamic finance model that is developed in Indonesia is likely to be a hybrid between the Malaysian and Middle Eastern approaches.

For more information, please contact the author or visit our [Islamic Finance](#) and [Indonesia](#) practice pages on the Web.

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