

THE BLUEPRINT OF ISLAMIC BANKING DEVELOPMENT IN INDONESIA





Foreword

Assalamu'alaikum Wr. Wb.

Realizing the rapid development of sharia banking in Indonesia, particularly after the Act No. 10 of 1998 on the amendment of the Act No. 7 of 1992 on banking and the Act No. 23 of 1999 on Bank Indonesia have come into effect, the need for a Blueprint containing a well-defined vision and objectives of sharia banking development becomes imminent. Based on a number of on-going researches conducted since year 2001, Bank Indonesia, as the banking regulatory authority, has formulated the Blueprint, which also defines strategic initiatives and stages to achieve the objectives for a sustainable development.

The Blueprint contains a vision and mission to develop sharia banking derived from Islamic values captured both at a micro and macro level. Based on the vision and mission and considering the actual condition of the sharia banking that cover influencing factors, development trends, and several key issues, Bank Indonesia has defined strategic objectives to be achieved in the next ten years.

The strategic initiatives basically can be categorized into four major activities, i.e., sharia compliance, regulatory and supervisory instruments quality improvement, operational efficiency support, and systemic stability support. Considering its comprehensiveness, the Blueprint is an invaluable guidance for Bank Indonesia in developing sharia banking in the future. Moreover, the Blueprint will be a critical reference to the institution taking over the role of regulatory and supervisory role from Bank Indonesia enabling it to conduct a sustainable and consistent development. The Blueprint also serves as a general reference for stake holders.

In order to accommodate expectations of sharia banking stake holders, Bank Indonesia has established a consultative forum

comprising of an Expert Committee for Sharia Banking Development, sharia bankers, rural sharia banks and non-bank sharia financial institutions. A special team from SKha Consulting has also contributed in the early stage of development particularly in conducting surveys and refining the Blueprint format. Finally, we would like to express our gratitude to all parties that has contributed in the finalization of the Blueprint.

Much remains to be done to realize a sound and compliant sharia banking system and could deliver benefits to the Indonesian society and economy in general. Its success depends on the support of the sharia banking stakeholders. May Allah always give us rahmat and hidayah so that we would be able to conduct our task well.

Jakarta, September 2002

Deputy Governor of The Central Bank of
The Republic of Indonesia



Maman H. Somantri



Glossary

Mudaraba	A form of business contract between two parties in which one party brings 100% capital and the other (entrepreneur) personal effort	Sharia commercial bank	A commercial bank that operates under sharia principles. This term is used by Bank Indonesia in its Banking Acts. A common international term for sharia bank is Islamic Bank.
Mudarib	In a mudaraba contract, the person or party who acts as an entrepreneur	Sharia business unit	Division of a conventional commercial bank which is operated under sharia principles
Murabaha	A contract of sale in which the seller and buyer agree on the seller's cost and profit	Sharia rural bank	A rural bank that operates under sharia principles.
Musharaka	An agreement between two or more parties for a business purpose under which each party invests capital and the risk and benefit will be shared jointly.	Takaful	Mutual support which is the basis of the concept of insurance or solidarity among Muslims
Riba	Literally means an increase on principal of loan. In banking activity, it is assume to be similar with interest.	Zakat	A religious levy that is prescribed by Islam on all muslims having wealth above an exemption limit at a rate fixed by the Islamic law.
Shahibul maal	In a mudaraba contract the person who invests the capital		
Sharia	Literally means the way of Allah as guided by the Quran and the <i>Sunnah</i> of the Prophet Muhammad SAW. This term is used to refer to the Islamic law.		
Sharia bank	Including sharia commercial bank, sharia rural bank and sharia banking unit of conventional bank.		



Abbreviations

ATM	Automated Teller Machine	IIFM	International Islamic Financial Market
BAMUI	Badan Arbitrase Muamalat Indonesia (Indonesian Muamalat Arbitrage Body)	IMA	Investasi Mudharabah Antar-bank (Mudharabah Interbank Investment)
BAPEPAM	Badan Pengawas Pasar Modal (Capital Market Supervisory Body)	IT	Information Technology
BAZIS	Badan Amil Zakat Infaq Shadaqah (Amil Zakat Infaq Shadaqah Institution)	LDR	Loan to Deposit Ratio
BPRS	Bank Perkreditan Rakyat Syariah (Sharia Rural Bank)	MES	Masyarakat Ekonomi Syariah (The Society for Islamic Economy)
CAR	Capital Adequacy Ratio	NPL	Non Performing Loan
CBO	Conventional Branch Office	OJK	Otoritas Jasa Keuangan (Financial Services Authority)
CCB	Conventional Commercial Bank	PLS	Profit Loss Sharing
CCO	Conventional Cash Office	PUAS	Pasar Uang Antar-bank berdasarkan prinsip Syariah (Sharia-based Interbank Money Market [SIMM])
DPS	Dewan Pengawas Syariah (Sharia Supervisory Board [SSB])	SBO	Sharia Branch Office
DSN	Dewan Syariah Nasional (National Sharia Board)	SBU	Sharia Business Unit
FDR	Financing to Deposit Ratio	SCB	Sharia Commercial Bank
GCG	Good Corporate Governance	SME	Small Medium Enterprise
IAI	Ikatan Akuntan Indonesia (Indonesian Accountant Association)	SU	Sharia Unit
IFSB	Islamic Financial Services Board		



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Executive Summary

Executive Summary

The development of sharia banking in Indonesia is a realization of the needs of the public seeking an alternative banking system that is both capable of delivering sound banking/financial services and compliant with sharia rules. As a matter of fact, the development of sharia financial institution has started well before a formal legal base for sharia banking operation came into force. Therefore, the stipulation of the Act No. 7 of 1992 concerning Banking as amended by the Act No. 10 of 1998 and the Act No. 23 of 1999 concerning Bank Indonesia is the answer to the needs.

After the stipulation, the sharia banking has shown rapid development in terms of total assets (at average 74 percent annual growth). Bank Indonesia, as the banking regulatory authority, is in a position to conduct the task as mandated in the Banking Act to establish a sound sharia banking system. The development of sharia banking should be aligned with the Indonesian Banking Architecture that is currently in the process of development. For those reasons, Bank Indonesia needs formalize its strategic direction in a Blueprint.

The Blueprint defines the position, vision and strategic initiatives in developing sharia banking for the next ten years. The Blueprint serves as a critical reference for the sharia banking stakeholders. The vision of the sharia banking development is defined as follows:

“The establishment of a competitive and efficient sharia banking that complies with prudential banking principles, and significantly support real sector activities through share-base financing with real underlying transactions in the spirit of justice, brotherhood and good deeds to promote the well-being of the nation”.

The initiatives, which are defined in the Blueprint, are derived from the strategic objectives that will be achieved by

Bank Indonesia together with other stakeholders in the next period. The initiatives can be categorized into four major activities, i.e., ensuring a better sharia compliance, improvement on prudential regulations, supporting operational efficiency and competitiveness, and supporting a higher level of systemic stability. The initiatives will be implemented in three stages. The first stage puts strong foundation for sustainable development of the industry. The second stage focuses in strengthening the structure of the industry. The last stage focuses on the adoption of international standards for sharia banking services.



Chapter I

Background



Background

1.1. A Brief History of Sharia Banking Development in Indonesia

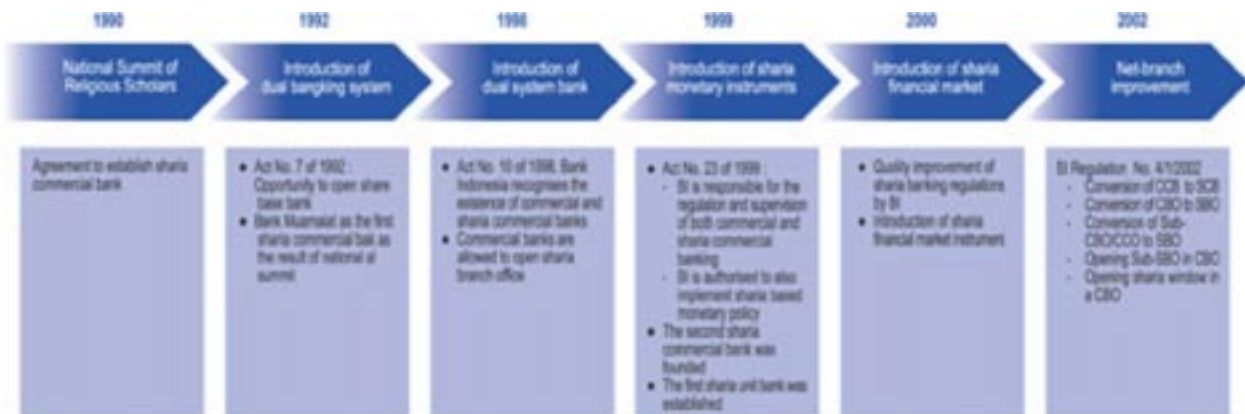
The development of the sharia banking in Indonesia has started well before a formal legal base for sharia banking operation came into force. Before 1992, there have been several non-bank financial institutions that apply share base contract founded. This evidence shows a public need of the existence of financial institutions applying sharia principles in their operations.

In order to accommodate the public needs for the existence of the new banking system, the government has implicitly allowed the sharia banking operations in the Act No. 7 of 1992 concerning Banking which is elucidated in the Government

Decree No. 72 of 1992 concerning Bank Applying Share Base Principles. The set of regulations have served as legal foundations for sharia banking operations in Indonesia (the new era of dual banking system).

During the period between 1992 to 1998, there was only one sharia commercial bank and 78 sharia rural banks came into operation. In 1998, the Act No. 10 of 1998 on the amendment of the Act No. 7 of 1992 concerning banking came into force to give stronger legal foundation for the existence of sharia banking system. The new Act No. 23 of 1999 concerning Bank Indonesia gives an authority to Bank Indonesia to also conduct its task according to sharia principles. Since then, sharia banking industry has been growing more rapidly. In general, the development of sharia banking in Indonesia can be illus-

Exhibit 1 Sharia Banking Development in Indonesia



1.2. Sharia Banking in statistic

The economic and monetary turmoil happening during the period 1997 to 1998 resulted in tremendous impact to the Indonesian economy. During the period of crisis, many financial institutions, including banking

institutions, experienced financial hardship. High interest rate has resulted in a high cost of capital to the entrepreneurs i.e. the real sector and finally caused low productivity. The quality of bank assets has deteriorated significantly while the banking system was burdened by a high cost of funds caused by high market interest rates.

Furthermore, low productivity and high risk investments have prevented the banks from investing their funds in the real sector. As the consequence, the banking system started to lose its intermediary function as indicated by a low LDR ratio.

Contrariwise, during the economic crisis, sharia banking could still perform better than the conventional banking as indicated by a relatively low level of non-performing loans and the absence of negative spread in the operational activities (see **Exhibit 2 (a)**). This could be understood since the rates of returns paid to the depositors are not determined by market interest rates. Therefore, sharia banks are able to channel a relatively lower cost of funds to the entrepreneurs. The evident shows that sharia banks are relatively more able to conduct lending as indicated by a relatively high LDR ratio i.e. between 113 – 117 percent (see **Exhibit 2 (b)**). This experience has brought a hope to the public for the presence of sharia banking as an alternative banking system that is capable of both delivering economic benefits and ensuring compliance with sharia principles.

During the period between 1998 to 2001, sharia banking system has grown quite rapidly at about 74 percent annually (in terms of asset size) from Rp. 479 billion in 1998 to Rp. 2.718 billion in 2001. The third party managed funds has also increased from Rp. 392 billion to Rp. 1.806 billion. The sharia banking system has also developed institutionally. There has been another commercial bank converting its operations into sharia commercial bank, besides there have also been 3 sharia unit banks and 3 sharia rural bank came into operations by the end of 2001. The number of sharia branch offices and sharia unit banks has also increased from 26 to 51 branches.

In spite of its rapid development, sharia banking system still acquires a small portion of market share (approximately 0.26% of the total asset size of the national banking system). Many steps have been taken to improve the operational quality of the sharia banking in order to gain public confidence and customer satisfaction.

1.3. Objectives

The sharia banking development should be conducted in accordance with the actual needs and expectations by the stakeholders of the sharia banking in Indonesia that includes:

- Sharia commercial banks, sharia unit banks and sharia rural banks
- Bank Indonesia as banking regulatory and supervisory authority
- National sharia council (DSN)
- Muamalat arbitration body (BAMUI)
- Other sharia financial institutions: Takaful (sharia insurance), Baitul Mal wat Tamwil, BAZIS, and sharia security companies
- Other regulatory bodies: Ministry of finance and capital market regulatory body (BAPEPAM)
- Universities / educational institutions that concern about training program on sharia finance and economics
- Organisations and companies related to sharia economic and finance such as: sharia economic society (MES), Association of national sharia banks, Jakarta Stock Exchange, vendors and etc.
- Public in general

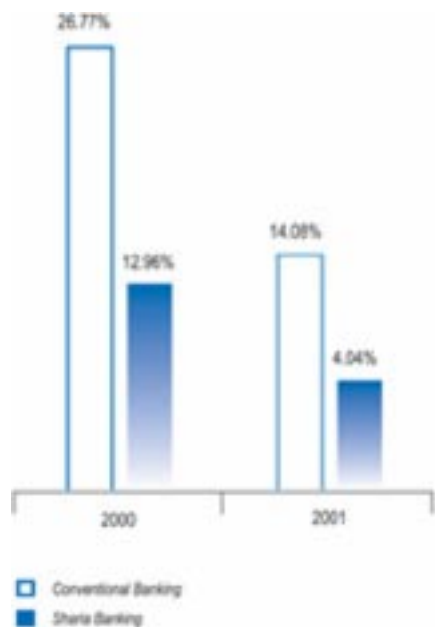
The strategic objective of the sharia banking development includes:

- High level of competitiveness while complying with sharia principles
- Significant roles in sustaining national economy and public welfare
- Global competitiveness through compliance to international operational standards

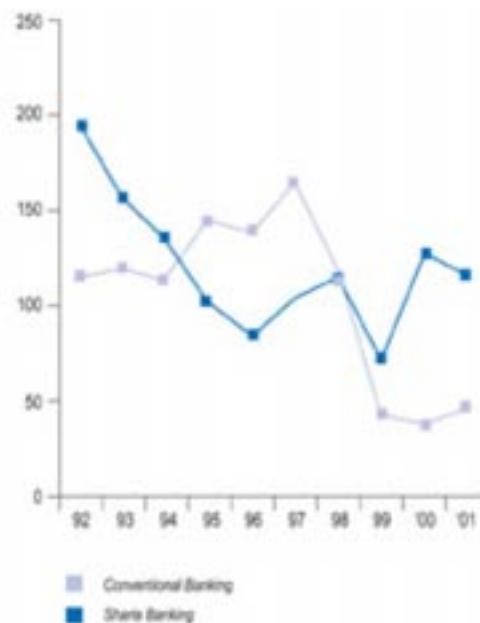
The success of the sharia banking development fully depends upon the stakeholders. Therefore, the same vision and proper coordination are the key success factors supporting a sustainable sharia banking development in the future.

Exhibit 2 Financial performance of sharia banking as compared to the conventional banking in Indonesia

Sharia Banks' NPL level has been lower and improved faster than that of Conventional bank during crisis



Conventional banks' LDR fell and stay below 50% while sharia banks' is already back above 100%



1.4. Indonesian Banking Architecture (API) as a trend for Indonesia banking development

In its effort to establish a sound, efficient and structurally strong banking system leading to systemic stability and economic development, Bank Indonesia is developing API. The objectives of API cover:

- To have a strong banking industrial structure supporting a sustainable economic development.
- To have a robust banking industry that is resilient to financial risks.
- To implement *good corporate governance* in the banking industry
- To have effective and efficient banking regulatory and supervisory system.
- To have infrastructure supporting efficient operational banking activities.
- To provide consumer protection.

Sharia banking development, basically, has the same objectives with the development of API, apart from the sharia

aspects. The Blueprint emphasises the initiatives by Bank Indonesia to achieve the strategic objectives.

1.5. The purpose of the Blueprint

The Blueprint is developed to identify challenges faced by sharia banking industry in the coming years. The Blueprint also defines the Vision, Mision and Objectives of the development so that the stakeholders can use it as a reference in aligning their aspirations. The Blueprint defines strategic initiatives in priorities for the next 10 years.

The Blueprint serves as:

- A guidance for Bank Indonesia to develop sharia banking in Indonesia
- A reference to stakeholders
- A reference to the institution that will take over the role of regulatory and supervision of banking from Bank Indonesia.



Chapter II

*Benefits and
Challenges*

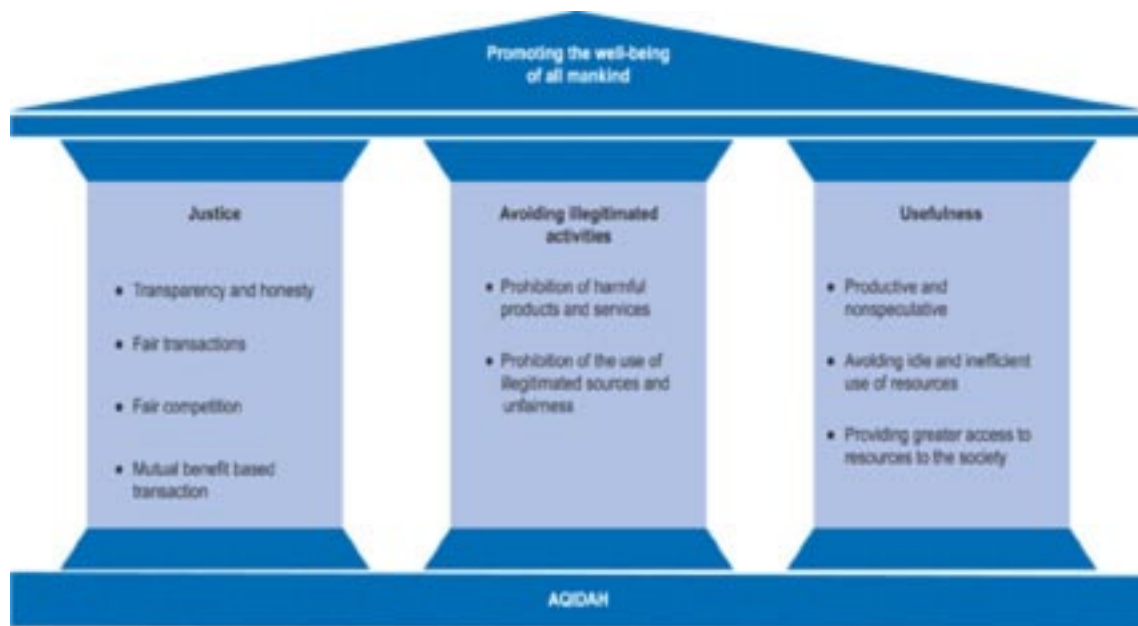
Benefits and Challenges

2.1. Sharia principles in economic and financial activities

The recent theory of the firm emphasised the profit maximation for the shareholders even though it has currently shifted to delivering benefits to wider parties (maximization of stakeholder

value). The sharia base economics offers a wider concept of benefits. The benefits should be gained not only at the end of the economic transaction, but also benefits from the process and the products. Any economic transaction should content more benefits (maslahat) and promote justice.

Exhibit 3 Perspectives of sharia principles on economics



Sharia principles also support the economic players to comply with local law system and codes of conducts in any economic activity. As the realisation of the sharia principles, sharia banking/financial system differs at three areas: principles of justice avoiding prohibited activities and concerning benefits. **Exhibit 3** above illustrates the interpretation of economic principles according to sharia. Sharia banking system, therefore, does not only focus on the prohibition of riba but also on the implementation of sharia principles comprehensively and maintain them in a balance. Therefore, a balance between profit maximation and compliance to the other sharia principles is

essential to the sharia. Sharia economic principles are reflected in the macro and micro perspectives. In the micro perspective, sharia principles emphasise competence/professionalism and trust (amanah). In the macro perspective, sharia principles emphasise distribution, prohibition of riba and activities that do not bring benefits to the system as a whole. In general, the two perspectives are illustrated in **Box 1**. Thus, the benefits of the existence of the sharia banking/financial system, which is not only purposed to the Muslim society but also all human being (*rahmatan lil 'alamin – blessing to the universe*), can be clearly seen.

2.2. Challenges in developing sharia banking system in Indonesia

The evidence shows that in the period of economic turmoil, sharia banking performed relatively better than the conventional banking. Therefore, the sharia banking system is expected to play more significant roles in the Indonesian economic recovery process. However, the sharia banking system is still facing challenges especially in the early stage of development. Some key issues include:

- *Lack of comprehensive and appropriate framework and instruments for regulation and supervision*
- *Limited market coverage*
- *Lack of knowledge and understanding by the public*
- *Lack of efficient institutional structure supporting efficient sharia banking operations*
- *Operational inefficiency*
- *Domination of non-share base financing*
- *Capability to comply with international sharia financial standards*

Box 1. Micro and Macro Perspectives

Sharia values in micro perspectives emphasise integrity and prudence in managing public funds, elaborated in several basic characteristics as follows:

- *Shiddiq*: to ensure high morality in bank management leading to honesty. Financial management should be conducted legitimately (*halal*) and prevent doubtful (*subhat*) and illegitimate (*haram*) activities.
- *Tabligh*: to socialize and to educate the public about sharia principles, products and services and also the benefits to gain.
- *Amanah*, to preserve mutual trust between capital owners (*shahibul maal*) and the trustee (*mudharib*) through honesty and prudence in the banking operations.
- *Fathanah*, to ensure the bank is managed professionally in order to generate profit with manageable risks and to ensure the services is provided in manners (*ri'ayah*) and sincerity (*mas'uliyah*).

Sharia values in macro perspectives emphasise real contribution to social welfare through the implementation of several norms, such as:

- Norms of *zakat*: To stimulate people for investment while providing disincentive to people who do not wish to invest their funds productively, since *zakat* is only levied on the profit of the investment and on the principal of wealth.
- Norms of the prohibition of *riba* : To promote share base financing and to prohibit *riba*. The implementation of this norm is expected to improve brotherhood and sincerity in facing financial uncertainty.
- Norms of the prohibition of unproductive speculation/gambling (*maisir*) : To ensure that economic activities are always attached to real economic activities.

Lack of comprehensive and appropriate framework and instruments for regulation and supervision

To support the operational soundness, sharia banking should be equipped with a proper set of regulatory and supervisory instruments that fit its operational activities, which are different from the conventional ones. At the early stage of development, sharia banking still applies conventional framework for regulatory and supervisory activities although a few set of regulations have been developed, such as: licensing regulation, inter-sharia bank financial instruments, sharia monetary instruments (SWBI) and minimum statutory reserve for sharia banking. The lack of proper regulatory and supervisory framework could potentially reduce its operational capability.

To cope with the challenges, Bank Indonesia as the banking regulatory authority has put foundations for regulatory instruments that cover:

- Establishment of financial instruments that is expected to improve efficiency
- Formulation of early warning system for sharia banking (CAMEL rating system) which is capable of describing its operational risks and maintaining sustainability, and also transparency in the reporting
- Formulation of the rules of conduct for the players to improve the quality of corporate governance
- Developing the concept of regulation that concerns about systemic stability
- Developing the concept of regulation that ensures compliance with sharia principles

Limited market coverage

For the time being, sharia banking system still acquires a limited market share. By the end of 2001 sharia banking services could only be delivered through 51 sharia branches, unit offices and 81 sharia rural banks that represent only 2% of all commercial banking offices in Indonesia. Limited operational coverage could potentially reduce customer comfort significantly.

There are several challenges that should be faced in the effort to expand the operational coverage, such as:

- Creating a conducive environment to attract new comers, especially the conventional banks that already have wide operating network or promoting strategic alliance with other financial institutions to improve efficiency
- Simplifying of the licensing procedures for the new comers without reducing prudentiality
- Providing information about sharia financial services
- Improving the professionalism and the quantity of manpower of the industry.

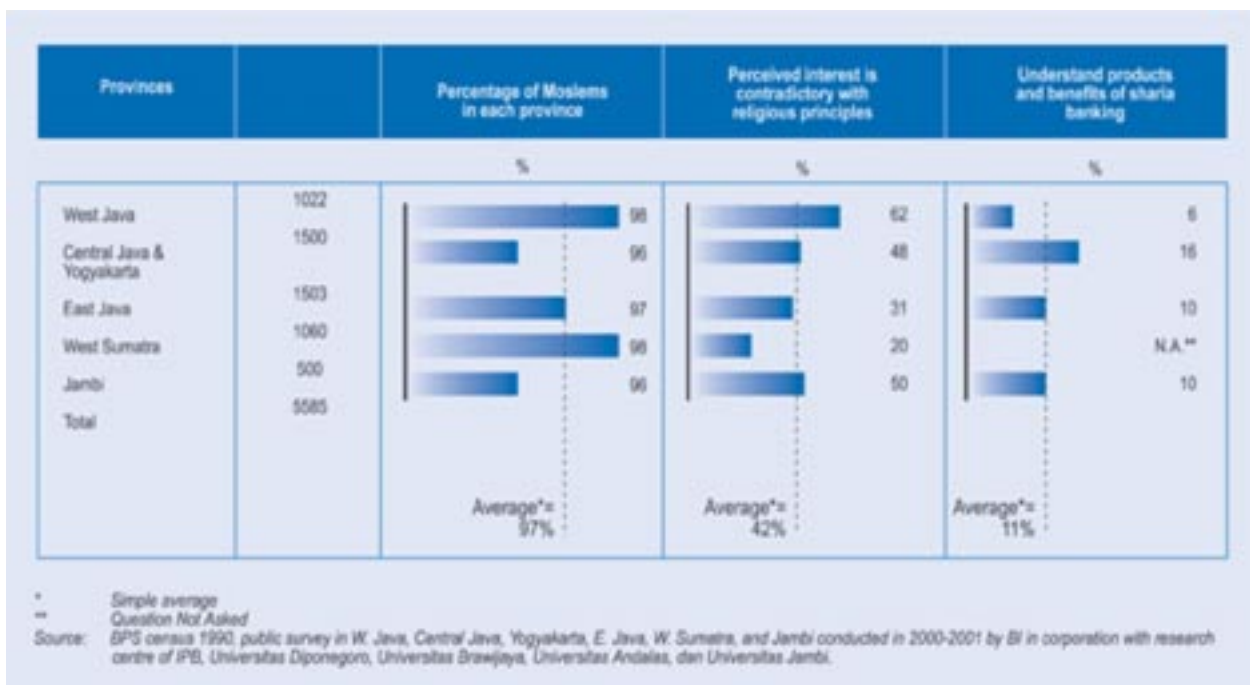
Low awareness and knowledge of sharia financial products and services

Based on surveys conducted in a collaboration with universities within six provinces in Indonesia between 2000 to 2001, it is concluded that there is still a gap between needs and knowledge of sharia financial products and services (see **Box 2**). The gap could delay the success to mobilise potential public funds to investment because of low switching rate from potential demand to real demand. Furthermore, the gap will also make marketing and selling effort for sharia banking products and services more difficult. There are several challenges to face in order to improve the awareness and knowledge among the potential target customers, such as:

- Large numbers of people dispersing in wide diversified background
- Effort to educate the public requires considerable budget and other resources
- Limited promotion budget of the stakeholders in industry due to the small size of the industry

One potential solution to overcome these challenges is to have a concerted and coordinated effort of public education. To enrich

Box 2 The result of surveys on public perception



the perspectives for development strategy, Bank Indonesia could also identify key success factors determining the success of national initiatives in several events such as National Saving Movement (Gerakan Tabungan Nasional) and Family Planning (Keluarga Berencana).

Lack of efficient institutional structure supporting efficient sharia banking operations

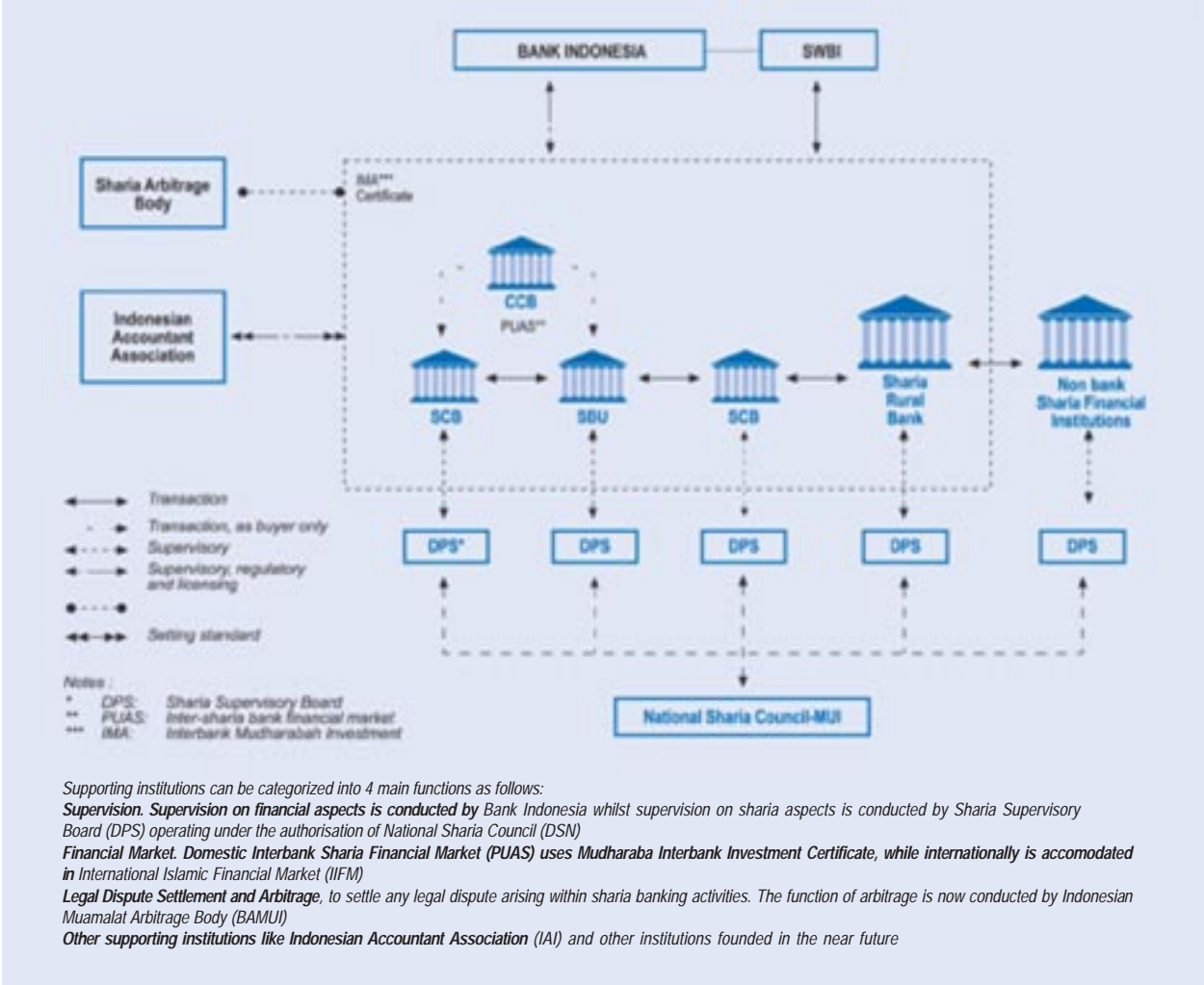
A comprehensive, effective and efficient institutional structure is essential to ensure stability and sustainable development of sharia banking. Currently, there have been supporting institutions founded as parts of sharia banking in Indonesia (see Box 3). However, it still requires substantial effort to make them more

effective in order to sustain an efficient sharia banking operations.

There are several institutions and functions that need to be developed to improve the institutional environment, such as:

- *Sharia auditor*, to ensure the compliance of sharia banks with the sharia principles
- *Communication Board (FKPPS)* to enable an effective coordination of the effort to improve public awareness and education for sharia banking
- *Institution for Sharia Financing Insurance*, to provide financial protection to the sharia banks against fraudulent practices by recommended customers.
- *Sharia finance information center*, serving as a linkage between real sector and sharia finance sector by providing

Box 3. Institutional structure supporting efficient sharia banking operations



- *Special Purpose Company*, to facilitate asset securitization for Islamic banks that want to enhance its liquidity management. It also provides sharia investment opportunities for other domestic banks and investors as well as international investors.

Continual improvement of sharia banks performance

In spite of its performance that is systematically better than the conventional ones, sharia banking still gives a lower rate of return to the investors compared to the rate of return paid by the conventional banks. Improving the operational efficiency leading to a higher rate of return to the customers could motivate investors of the sharia banking to stay loyal with Islamic banks since they expect both the sharia compliance and also the rate of return. This should be noted carefully, particularly when facing an era of free competition in which the competitors come not only from banking industry but also from other companies from different industries that are capable of delivering similar financial services. The scarcity of competent sharia bankers who are skilful, knowledgeable in sharia banking operation and sharia mindset has also been critical for improving the performance of sharia banking. The effort to improve the quality of human resources will also include managerial and operational aspects.

Besides improving internal efficiency, the sharia banking may also apply different strategies for expansion: '*economies of scale*' and or '*economies of scope*'. The first strategy could be conducted through the expanding the operational coverage, such as conducting strategic alliances with either domestic or international companies. The second strategy could be conducted by providing a wider variety of banking products (including the use of technology advantages) so that the public could enjoy the sharia financial services in a more flexible way.

Domination of share base financing in sharia banking transaction

One of the features that could potentially benefit the economic system is the presences of share base financing. However, the share base financing has not been dominating due to some possible reasons that prevent share base financing from the

applications, such as:

- Higher risk involved in the investment due to lack of transparency and inability to monitor the investment
- Principal-agent problem, where the agent (*mudharib*) does not always act in the best interest of the principal (*shahibul maal*)
- Lack of competency of the sharia banks human resources to conduct such investments
- Unavailability of information about business performance of each targeted industrial sector.

There are several alternatives to overcome this challenge, such as:

- Identification of non-claimable source of funds like *zakat*, *infaq* dan *sadaqah* to be channelled through competent institutions
- Reducing factors causing agency-problem in share base transaction such as standardization of contract and establishing industrial indices as benchmarks
- Improving the competence of the human resource in conducting share base financing like project assessment capacity.


Ability to comply with international sharia financial standards

Global sharia financial/banking industry has achieved significant business volume (approximately US\$ 140 billion in 1997). There have been 170 sharia financial institutions established in more than 30 countries. Such business volume offers opportunity to conduct strategic alliances with internationally reputed sharia financial institutions. In order to achieve that vision, national sharia banking system has to be able to operate with international sharia financial standards. With this ability, the national sharia banking system could also participate in the International Islamic Financial Market (IIFM) that will operate in 2003. Indonesian sharia banking system will also be prepared to adopt international sharia banking standard set by Islamic Financial Services Board (IFSB) that will be established in 2002.

Generally, the challenges for sharia banking development that based on the industry structure analysis is illustrated in **Exhibit 4**.

Exhibit 4 Affecting factors in sharia banking industry development





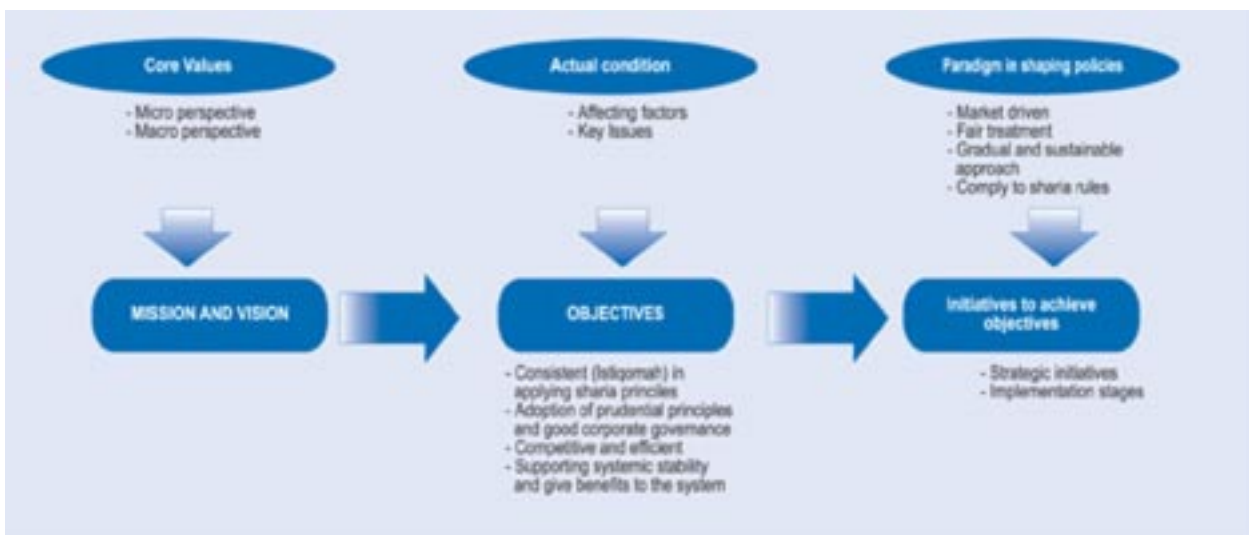
Chapter III
Vision,
Mission and
Objectives

Vision, Mission and Objectives

Vision and mission of sharia banking development are derived from Islamic values and realised into each operational activities. The objectives are defines after accomodating the actual condition within the industry. To pursue the established

objectives, Bank Indonesia has also defined initiatives and paradigm for the policies to be taken. The framework for sharia banking development covering vision, mission, objectives and initiatives, is illustrated in **Exhibit 5**.

Exhibit 5. Development framework covering vision, mission, objectives, and initiatives



3.1. Vision and Mission

Based on sharia values, vision for sharia banking development in Indonesia is stated as follows:

“A sound sharia banking system that is competitive, efficient and compliant with prudential practices, and capable of supporting real economic sector through the implementation of share based financing and trades with real underlying transactions in the spirit of brotherhood and good deeds to promote well-being for all society”

The mission which reflects the roles of Bank Indonesia in fulfilling the vision is:

“Creating a conducive environment for sharia banking development that is compliant to sharia principles and capable of supporting real economic sector, which covers:

- *Conducting continual studies and researches about conditions, opportunities and requirements for sharia banking;*
- *Preparing the concept and conducting risk-based supervision that fit with its characteristics to maintain operational sustainability;*
- *Preparing institutional structure that aimed at improving operational efficiency of the sharia banking;*
- *Designing an appropriate framework for a sound entry and exit policy that is capable of maintaining systemic stability “*

3.2. Objectives

In the pursuit of the realization of the established vision and having taken into consideration of the actual conditions, Bank Indonesia set up realistic objectives that includes the affecting factors shaping the industry in the years to come (see Exhibit 5); benefits and challenges; and strength and weaknesses of the players and the stakeholders of the industry.

The objectives of the sharia banking development until the year of 2011 are:

- ***Compliance to sharia principles in banking operations***, as indicated by:
 - The establishment of standardization of sharia financial norms
 - Efficient sharia supervisory framework (instruments and institutional coordination)
 - Low level of complaints by the public
- ***Implementation of prudential practices in banking operation***, that covers:
 - Implementation of risk based regulatory and supervisory that fit with its characteristics supported by competent human resources
- Implementation of good corporate governance in sharia banking operations
- Implementation of efficient exit and entry policy
- Implementation of real time supervision
- Implementation of self regulatory system
- ***A competitive and efficient sharia banking system***; as indicated by:
 - Globally competitive players
 - Effective strategic alliance
 - Good coordination with supporting institutions
- ***Systemic stability and benefits to society***, as indicated by:
 - Implementation of safety net arrangement as an integrated part of the sound national banking system
 - Fulfilling the demand of sharia banking services by the public with the targeted market share at 5 percent of the total share
 - The implementation of sharia financial system comprehensively that serves all the society
 - The significant use of share base financing



Chapter IV

Initiatives

Initiatives

To achieve the established objectives, Bank Indonesia embarks on strategic initiatives, which need to be undertaken by itself or by cooperative effort with other stakeholders of sharia banking (as illustrated in **Exhibit 5**). Therefore, the success depends upon the contribution by all stakeholders. Bank Indonesia as banking regulatory authority that should always promote compliance with sharia principles and sound banking practices.

Bank Indonesia has also established paradigms in the implementation of the strategic initiatives so that the objectives would be achieved objectively. Those paradigms include:

- *Market driven*, real demand based development
- *Fair treatment*, developing sound and fair competition based of its own characteristics; not by giving special treatment as an infant industry
- *Gradual and sustainable approach*, priority and focus are determined based on situation and condition to adopt gradual and sustainable approach
- *Comply with sharia principles*, sharia based regulatory framework and supporting institutional structure

The initiatives established can be categorized into four areas and will be implemented in three phases based on the level of urgency. The four main areas cover compliance to sharia principles and prudential banking practices, operational efficiency and systemic stability. The initiatives are to be conducted in stages in order to place strong development base that accommodate real public demands. Systematically, strategic initiatives can be illustrated in **Exhibit 6**.

4.1. Stage I (2002 – 2004)

The first stage focuses on the establishment of a strong

base for sharia banking regulatory framework that adopts sound operational banking characteristics.

I. Compliance to sharia principles

Promoting a better understanding about sharia financial concepts

Every player in the sharia banking system should have the same level of understanding about the sharia financial concepts. A balance of knowledge on theory of finance and sharia concepts is essential to a better understanding about sharia financial concepts. Therefore, the establishment of sharia compliance authority would also play important role to improve its operational quality. Any support by Bank Indonesia that is purposed to improve the competence of the sharia compliance authority is considered important.

Supporting and facilitating the formulation of sharia financial norms

As a matter of fact, the standardization of international sharia financial norms has been started by international sharia institutions like AAOIFI. However, to implement those norms locally, it is considered necessary to have a set of sharia financial norms that is fully understood by all the players to avoid different perceptions on international fatwas.

Conducting a studies to develop an integrated regulatory and supervisory mechanism

A sound financial operations and compliance with sharia principles are two different aspect that should be achieved simultaneously. In practice, a clear mechanism should be

Exhibit 6. Stages for implementation and priority of strategic initiatives



	Placing strong base for sustainable development Stage I (2002 – 2004)	Strengthening industrial structure Stage II (2004 – 2008)	Complying with international standards for financial products and services Stage III (2008 – 2011)
Compliance to sharia principles	<ul style="list-style-type: none"> Promoting a better understanding about sharia financial concept Supporting and facilitating the formulation of sharia financial norms Conducting a studies to develop an integrated regulatory and supervisory mechanism 	<ul style="list-style-type: none"> Supporting a more efficient sharia supervisory activities Developing incentive concept to improve compliance with sharia principles 	<ul style="list-style-type: none"> Realising the integrated rating system that accomodates sharia and financial aspects
Prudential set of regulations	<ul style="list-style-type: none"> Improving foundation for prudential regulation and good corporate governance Improving network regulations To study a feedback mechanism in developing banking regulations To study the implementation of real time supervision 	<ul style="list-style-type: none"> Developing risk based regulations and supervision Developing entry and exit policy 	<ul style="list-style-type: none"> Promoting the establishment of self-regulatory system
Operational efficiency and competitiveness	<ul style="list-style-type: none"> Supporting economies of scope and economies of scale Supporting human resource quality development To study about mutual cooperation with related institutions Supporting the effort to signify the role of sharia arbitrage institutions 	<ul style="list-style-type: none"> Supporting strategic alliances Establishing cooperations with related supporting institutions 	<ul style="list-style-type: none"> Supporting the establishment of global and internationally competitive players
Systemic stability and benefits to the economy	<ul style="list-style-type: none"> To advocate the establishment of sharia financial information center Conducting preliminary studies about potential systemic costs Conducting studies for the benefits of the implementation of sharing contracts 	<ul style="list-style-type: none"> Enhancing the roles of the sharia financial information center Supporting the involvement of ranting agencies in sharia banking activities Designing an appropriate concept of depositinsurance Conducting studies about voluntary sector Supporting the use of share base finance 	<ul style="list-style-type: none"> Supporting the realisation of a comprehensive and integrated sharia financial system

II. Prudential set of sharia banking regulations

Improving foundation for prudential regulation and good corporate governance

Regulatory foundations that can adopt its operational characteristics and sharia principles is important to support operational sustainability in the long run. For that reason, Bank Indonesia has been supporting the establishment of several sharia financial standards.

Finalization of Statements for Financial Accounting Standards (PSAK) for sharia banking and Indonesian Sharia Banking Accounting Guidance (PAPSI) prepared by Indonesian Accountant Association (IAI) in cooperation with other sharia financial institutions is important for the development of sharia banking regulations. The two standards are expected to be finalised in 2002.

Set of regulations that are considered as priority includes:

- Improvement of regulations on specific areas, such as:
 - Earning asset quality
 - Allowance for earning asset losses
 - Short term liquidity facility
 - Intra-day liquidity facility
 - Regulation on monthly reporting
 - Capital Adequacy Ratio
 - Legal lending limit
 - Net open position
 - Liquidity measurement
 - Soundness rating system
 - Transparency
- Improving the quality of early warning system for sharia banking (CAMEL rating)
- Improvement on:
 - Regulation concerning *Reserve Requirement* for sharia banks, including: adjustment for minimum statutory reserves, secondary reserves and liquid asset ratio
 - Regulation concerning earning asset portfolio to anticipate the development of sharia financial market

- Developing a cooperation mechanism between sharia rural banks and sharia commercial banks or sharia unit banks in order to improve financial services to the rural society
- Conducting academic research and other activities in an effort to find a possibility of the issuance of sharia banking act

Improving network regulation

In order to attract new comers into sharia banking system, Bank Indonesia in March 2002 has issued a new regulation No. 4/1/PBI/2002 concerning the conversion of a commercial bank to sharia commercial bank and opening sharia branch office by a commercial bank without reducing prudentiality in the operations. The regulation covers:

- The conversion of conventional commercial bank to sharia commercial bank
- The sharia business unit relating to the establishment of sub-branch office or the expansion the network by colocation of sharia sub-branch office in a conventional commercial bank. This can be conducted for the commercial bank that has at least one sharia branch office in a particular working area.

To study a feedback mechanism in process to develop banking regulations

In accordance with a sound banking regulatory concept, the role of stakeholder is very important. Therefore, Bank Indonesia will always support effective feedback mechanism in the design process of banking regulations. The support has, in fact, been realized in terms of cooperation with other parties (including academicians) in designing the banking regulations.

To study the implementation real-time supervision

In order to improve the effectiveness of banking supervision, Bank Indonesia will conduct a study seeking a possibility of conducting information technology base banking supervision. The objectives of the technology

based banking supervision is the Real Time Supervision for sharia banks and sharia unit bank. For sharia rural banks, Bank Indonesia will develop a system that enable the supervisors to observe the financial conditions daily.

III. Operational efficiency and competitiveness

Supporting economies of scope and economies of scale

The entry of the new comers into sharia banking system will operationally improve efficiency (economies of scale). This effort includes attracting global players to participate in the system.

As mentioned earlier, Bank Indonesia has been trying to reduce the obstacles for the establishment of the new sharia commercial banks, conversion of the conventional commercial banks to sharia commercial banks and opening sharia unit banks without ignoring prudential principles and considering the current policy implemented in general.

Besides, Bank Indonesia will continuously conduct research on the market potential that is purposed to identify potential target and to provide information to potential investors. The information provided is expected to ease the potentia investors in decision making process (reducing the budget for feasibility study).

Supporting human resource quality development

Sharia banking is a new industry which characterised by specialised skills and knowledge. Lack of operational skill would endanger its operational sustainability. Bank Indonesia as banking regulatory authority, together with other stakeholders, supports human resources quality development through training programs that are purposed for:

- Staf of commercial banks that are interested in the banking operations according to sharia principles
- Students from universities and other academical institutions, that are expected to be potential players or users of the sharia banking system

- Lecturers from universities and other academical institutions, that are expected to socialize sharia banking in their curriculum

To study about mutual cooperation with related institutions

In accordance with its operational features, the operations of sharia banking should closely attached to real sector. Therefore, support from other governmental institutions and related institutions from locally and internationally could be expected to increase efficiency. Several local institutions include Central Statistic Bureau, Capital Market Authority, rating agencies, institution managing *zakat*, *infaq* and *sadaqah*.

Supporting the effort to signify the role of sharia arbitrage institutions

One of important aspects in developing sharia banking is the availability of sharia arbitrage institutions that is capable of resolving sharia financial disputes efficiently. Inefficient dispute settlements would affect liquidity and could also cause insolvency.

Currently, BAMUI is the only one dispute settlement agency that is established to resolve sharia financial disputes. Bank Indonesia will consistently support BAMUI to signify its roles and functions.

IV. Systemic stability and benefits to the economy

Advocating the establishment of Sharia Financial Information Center (FKPPS/ Communication Board)

Accurate perception and understanding about condition and features of sharia banking by the public could improve syatemic stability. This could be understood since better knowledge about the real market condition of sharia banking could mitigate panic. Information sharing could be initiated by the establishment a forum that is credible to inform the market about actual market condition

effectively. Besides, the establishment of such forum is in accordance with the spirit of *tabligh* (to broadcast good deeds). The target groups that are included in the public education programs includes:

- Religious leaders (Ulama)
- Students, teachers/lecturers of the universities and other academical institutions
- Professionals (in banking and other sectors)
- Companies (corporates and SMEs)
- Mass organizations
- Related institutions
- Public in general especially in high potential areas

Conducting preliminary studies about potential systemic costs

The studies about potential systemic costs caused by banking failure is one of the aspect that is mandatory. The studies will be started by the analysis of contract (level of financial risks) and followed by the studies about deposit insurance (takaful) and optimal stopping rules/exit policy.

Conducting studies for the benefits of the implementation of sharing contract

Share based finance is the major sharia modes of finance. Practically, there are variations in the implementation of sharing contracts depending upon several aspects: level of transparency, the availability of industry indices and level of basic needs. As a matter of fact, the benefits gained from the implementation of share base finance can be observed within certain communities. There is a need to explore further so that the implementation of share base financing could benefit the public more.

4.2. Stage II (2004-2008)

The second stage comprises continual steps undertaken in the first stage. The programs are focused on the realization of what have been started in the first stage.

I. Compliance to sharia principles

Supporting a more efficient sharia supervisory activities

There are two choices to be taken, either simultaneously or independently, to improve efficiency of supervisory activities on sharia compliance, such as:

- To strengthen the position of National Sharia Council and Sharia Supervisory Council by designing the most appropriate remuneration mechanism that ensures their independency in conducting their tasks. This initiative is expected to increase the commitment for time allocation and improvement of professionalism. There is also a need to draw a clear jurisdiction of their task to avoid overlapping.
- To prepare and to support the establishment of independent sharia financial auditors having skill competence in sharia banking and independence like general public accountant.

Developing incentive concept to improve compliance with sharia principles

One of the supporting factors for sharia compliance is the implementation of appropriate incentive (either rewards and punishments). In order to support the implementation of sharia principles, Bank Indonesia with other stakeholders will conduct studies for an integrated incentive mechanism between financial and sharia aspects.

II. Prudential set of sharia banking regulations

Developing risk based regulation and supervision

In accordance with the development of comprehensive regulatory concept, Bank Indonesia will implement risk based regulatory concept. Along with the implementation of the concept, sharia banking is expected to operate within a sound banking regulatory framework.

Developing exit and entry policy

One of the important components to maintain the soundness of the sharia banking operations is an appropriate entry and exit policy. Along with the implementation of such policy, it is expected that the industry will be supported by high skilled and dedicated players. Besides, a clear and appropriate entry and exit policy would help in designing other banking regulations that could give impact more systemically, such as deposit takaful.

Developing the real-time supervision

Real-time banking supervision is important in assessing the real assets quality of the banks. The supervision activities will also be supported by automated data processing so that it could simplify and improve the efficiency of the regulatory and supervisory activities.

III. Operational efficiency and competitiveness

Supporting the strategic alliances

Having adopted international sharia financial standards, national sharia banking institutions will always be promoted to conduct strategic alliances with internationally reputed sharia financial institutions.

Establishing a cooperations with related supporting institutions

Based on the studies conducted, Bank Indonesia will put an effort to realise the cooperation with related institutions in order to improve operational efficiency.

IV. Systemic stability and benefits to the economy

Enhancing the roles of the Sharia Financial Information Center

Bank Indonesia will support the activities promoting

communication channel between the regulator and the regulatees and also the public in general.

Supporting the involvement of rating agencies in sharia banking activities

Bank Indonesia will support the involvement of rating agencies to assess sharia banking condition in micro as well as macro level. At the micro level, the involvement of rating agencies could promote sound development of sharia financial market, such as in the issuance of sharia financial papers.

Designing an appropriate concept of deposit takaful

In order to increase robustness when facing financial uncertainty, Bank Indonesia will develop appropriate safety net scheme (deposit takaful) to mitigate panic since its presence is essential to maintain public confidence.

Conducting studies about alternative sources of funds from the voluntary sectors

Following up the cooperation with related institutions, Bank Indonesia will also conduct a study to more activate the role of voluntary sector in the economic system.

Supporting the use of share base finance

In order to gain more benefit for the economic system, Bank Indonesia will consistently support the use of share base financing. The success of the implementation of share base economy will depend upon the readiness of the system such as industry indexation, transparency and the use of voluntary sector as the source of finance for share base financing. The support also includes the persuasion to the sharia commercial bank to implement share base financing without ignoring prudential banking operations.

4.3. Stage III (2008-2011)

The third stage of implementation is the finalization process in the development program. At this final stage, the system is expected to be capable of adopting international standards for sharia banking operation and services.

I. Compliance to sharia principles

Realising the integrated rating system that accommodate sharia and financial aspects

Following up the effort to integrate financial and sharia aspects in sharia banking activities, Bank Indonesia consistently supports the implementation of the integrated financial and sharia regulatory and supervisory framework.

II. Prudential set of sharia banking regulations

Realising incentive base regulatory framework

In accordance with the modern banking paradigm, Bank Indonesia ultimately will support the implementation of incentive based banking regulatory system. The ultimate objective is to establish self-regulatory banking system.

III. Operational efficiency and competitiveness

Supporting the establishment of globally competitive players of sharia banking industry

Bank Indonesia will consistently support the establishment of globally competitive players of sharia banking industry.

IV. Systemic stability and benefits to the economy

Supporting the establishment of a comprehensive and integrated (kaffah) sharia financial system

Bank Indonesia will consistently support the establishment of a comprehensive and integrated sharia financial system that is capable of optimize the use of all possible financial sources and use it efficiently and professionally for the sake of public welfare.