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The Islamic strictures against interest taking have been an item of concern for pious Muslim businessmen for centuries as were similar strictures for Jews and Christians. A variety of Islamic lending and borrowing instruments have been found acceptable. Islamic financial forms are typically viewed as a key part in a broader move to a more just Islamic social order. The Indonesian Islamic institutions take funds from depositors on which they pay various sums commensurate with their profits. They lend on various bases - in ways that involve sharing risks. Islamic financial institutions include the Bank Muamalat Indonesia which has been functioning since 1992, several new Islamic branches of regular commercial banks, 80 Bank Perkreditan Rakyat (BPRS - smaller banks), and several thousand Bait Maal Wat Tamwil (BMT -- Islamic Savings and Loan Cooperatives) of which several hundred are registered with the Ministry of Cooperatives. Though Bank Muamalat and the BPRS offer the full range of shariah deposit and credit products, most Islamic finance in Indonesia has been in fixed charge forms. The BMT have mobilized a great deal of savings and provided financial services to a large constituency. Islamic finance should be encouraged by regulation and supervision that accommodate its forms while seeing that their unfamiliarity is not used to defraud clients. Islamic banking should be mainstreamed by maximizing the interaction between Islamic institutions and the rest of the financial sector, subject to the constraints of shariah.

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Islamic Banking in Indonesia

By Thomas A. Timberg, Partnership for Economic Growth, Small Scale Credit Advisor, Bank Indonesia, June 1999[1]

The Islamic Banking Movement

The Islamic strictures against interest taking have been an item of concern for pious Muslim businessmen for centuries, as were similar strictures for Jews and Christians.[2] Some tradition exists of devising religiously acceptable, shariah compliant, forms of sharing funds in business. Many Muslim traders have simply ignored the strictures or argued that they did not apply to commercial as distinguished from personal transactions. Other Muslims have simply refused to engage in transactions involving interest.

Over the last several decades, a variety of Islamic lending and borrowing instruments have been developed which religious authorities have found acceptable. Such forms are compulsory, with minor exceptions, in countries like Iran, Pakistan, Saudi Arabia, and the Sudan, but Islamic banks exist, alongside interest taking banks, in many countries including the United States and Europe, where they compete with interest bearing banks and are subject to roughly similar regulation. The introduction of Islamic financial instruments is recent in Indonesia, but their development has been rapid and they represent a considerable focus of interest for many Indonesians today, especially economists and financial experts. This is partly because they are seen as promoting a more equitable, Islamic, and popular economic order (Ekonomi Rakyat).

The Islamic financial forms are typically viewed as a key part in a broader move to a more just Islamic social order, which would have unique features, not only in the working of financial markets but other aspects of the economy as well. To quote one standard source:

> Islam possesses its own paradigm of economic relations within the context of an entire Islamic system based on injunctions and norms, derived from the Quran and Sunna (the actions and sayings of the Prophet), called the Shari'a. The shari'a specifies, inter alia, rules that relate to the allocation of resources, property rights, production and consumption, the workings of markets, and the distribution of income and wealth. Similarly, rules and requirements have been specified that define the framework within which the monetary and banking system can operate.

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[1] USAID-funded Partnership for Economic Growth (PEG) Project. The views expressed in this report are those of the author and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.

[2] Udovitch, Abraham L., *Partnership and Profit in Medieval Islam*, Princeton, NJ: Princeton University Press, 1970.

> The core of this framework is that as a mechanism for allocating financial resources, the rate of interest is replaced with the rate of return on real activities.[3]

The understanding of this Islamic order and the related financial institutions differs somewhat from country to country, and even within countries. In what follows, I will focus on the actual functioning of Islamic financial institutions in Indonesia.

Islamic Banking in Indonesia – Forms of Lending and Borrowing

The Indonesian Islamic institutions take a variety of funds from depositors on which they pay various sums connected with their profits. They lend on various bases – in ways that involve sharing risks with their clients. The attached following gives the borrowing and lending instruments used by Bank Muamallat, Indonesia's first shariah commercial bank, as summarized in its 1998 *Annual Report*:

Table I - Islamic Financial Instruments

Lending Forms

Advance Purchase Forms

Cost Plus Financing -- Murabaha

A sales contract between the bank and the customer for the sale of goods at a price which includes a profit margin agreed to by both parties. As a financing technique it involves the purchase of goods by the bank as requested by the customer. Repayment is conducted by installments within a specified period.

Purchase with Specification – Istishna

A sales contract between the bank and the customer where the customer specifies goods to be made. After the goods are made or shipped the bank sells them to the customer according to a pre-agreed arrangement.

Purchase with Deferred Delivery – Bai al Salam

A sales contract where the price is paid in advance by the bank and the goods delivered later by the customer to a designee.

Lease and Hire Purchase – Ijarah Mutahia Bittamlik

A contract under which the bank leases equipment to a customer for a rental fee. It is pre-agreed that at the end of the lease period the customer

[3] Zubair Iqbal and Abbas Mirakhor, *Islamic Banking*, Occasional Paper No. 49, Washington, DC: IMF, 1987.

will buy the equipment at an agreed price from the bank, with the rental fees already paid being part of the price.

Profit Sharing Forms

Trust Financing/Trustee Profit Sharing – Mudharabah/Mudharabah Muqayyadah

The bank provides the capital (Shahibul Maal) and the customer manages the project (Mudharib). The profit from the project is split according to a pre-agreed ratio

Partnership/Participation Financing – Musyarakah

A partnership between the bank customer in which profits are shared on a pre-agreed basis, but losses are shared on the basis of equity contribution. Management of the partnership may be done either by the bank, the customer, jointly, or by a third party.

Benevolent Loan – Qardh ul Hasan

An interest free loan, generally with a charitable motivation.

Collateral Agreement -- Rahn

An agreement to provide collateral to the bank, either in the bank's or the customer's custody as appropriate. This is connected with some other form of lending.

Agency/Trust – Wakalah

An agreement to authorize another to be an agent to conduct some business. In this case, an authorization to the bank to conduct some business on the customer's behalf.

Agency – Havalah

An agreement by the bank to undertake some of the liabilities of the customer. When the liabilities mature the customer pays back the bank. The bank is paid a fee for undertaking the liabilities concerned.

Borrowing Forms

Ummat Savings – Tabungan Ummat

A savings account from which money can be withdrawn any time at any Muamalat offfice or ATM. Customers share in the bank's revenue. The

Ummat Savings customers also receive life insurance and the opportunity to win a free Umrah pilgrimage to Mecca.

Trendi Savings -- Tabungan Trendi

A savings account for teenagers and students. Beside accident insurance coverage, it offers special prizes for high ranked students and one year scholarships for 50 students.

Ukhuwah Savings – Tabungan Ukhuwah

A savings account conducted in cooperation with "Dompet Dhuafa Republika" for convenience in making regular and automatic payment of Zakat, Infaq, and Shadaqat in three choice of packages: Rp. 25,000, Rps. 50,000, and Rp. 100,000. This saving can also give the depositor an ATM, shopping discounts at certain shops, and accident insurance coverage.

Arafah Savings – Tabungan Arafah

A savings account specifically designed for the hajj pilgrimage. The saving scheme will help customers in planning their hajj in accordance with their financial capability and intended hajj date. Life insurance is also provided. The depositors are also eligible for various prizes.

Fulinves Deposits – Deposito Fulinves

A time deposit with a revenue sharing package. Available for various terms and with a chance for various prizes. Life insurance is provided to those with longer term deposits.

Wadi'ah Current Account – Giro Wadi'ah

A current account providing checking and allowing some profit sharing.

Muamalat Financial Institution Pension Fund – Dana Pensiun Lembaga Keuangan

A pension fund for those who make regular deposits. The bank soon intends to add a variant which provides life insurance.

Indonesian Islamic Financial Institutions

Islamic financial institutions in Indonesia include: the Bank Muamalat Indonesia which has been functioning since 1992, several new Islamic branches of regular commercial banks and at least one bank just converted from the interest system, 80 Bank Perkreditan Rakyat Shariyah (BPRS – smaller banks limited to borrowing and lending in limited areas), 2470 Bait Maal Wat Tamwil (BMT – Islamic Savings and Loan Cooperatives of which about 200 are reported to be registered with the Ministry of Cooperatives and Small Business). The Islamic commercial banks and BPRS (Bank Perkreditan Rakyat Shariah) file frequent and detailed reports with Bank Indonesia and thus produce reliable and current statistics. This is not yet the case with BMT. I also rely on my visits to a number of the Islamic financial institutions in the field and meetings with a number of the very competent experts who are involved in their development. I should particularly thank Mr. Adivarman Khan and his numerous colleagues at Bank Muamalat (especially Mr. Pallas Athene and Basril), and Prof. Dr. Amin Aziz, Chairman PINBUK (Pusat Inkubasi Usaha Kecil -- Center for Incubating Small Businesses (a project of YINBUK -- Yayasan Inkubasi Usaha Kecil -- Foundation for Incubating Small Businesses) and a director and leader in other financial institutions, such as INKOPSYAH BMT (Induk Koperasi Syariah BMT).

Bank Muamalat

The Bank Muamalat as of Dec. 31, 1998 had Total Assets of 447 Billion Rps, 318 Billion Rps in loans, net of a 140 Billion Rps provision which had to be taken for bad loans. Twenty one billion of the loans were to related parties. By contrast, Bank NISP for 1997 had 20 Billion of a total of 1.8 Trillion made to related parties). The Bank Muamalat had total deposits of 392 Billion Rps. The bank had in addition 172 Billion Rps of Commitments and Contingent obligations, mostly composed of forward sales of foreign exchange (101 Billion Rps) and unused but committed finance facilities (65 Billion Rps.) These latter Commitment and Contingency figures are a normal enough feature of bank business. The forward commitments, of course, represent considerable risks.

The Bank Muamalat's loans are distributed among Islamic financial instruments as follows:

Table II -- BankMuamalat Loans by Type of Shariah Instrument

Syariah Financing Type		
Billion Rps	***1998***	***1997***
Bai Bitsaman Ajil (BBA)	141	179
Murabahah	83	130
Mudharabah	68	29
Musyarakah	13	12
Al Qardhul Hasan	1	1
TOTAL	306	351

In Foreign Currencies, Billion Rps	***1998***	***1997***
Bai Bitsaman Ajil	78	86
Murabahah	71	21
Mudharabah	7	1
TOTAL	156	108
GRAND TOTAL	***462***	***459***

About two thirds of the Rupiah finance and half of the Foreign Currency finance is for less than one year. This is a relatively high level of longer term financing for a commercial bank.

The income statement of the bank is more difficult to deal with because of the 140 Billion Rps provision. The total "margin income and profit sharing income was 67 Billion Rps, but 65 Billion of that was distributed leaving a net on intermediation of 2.5 Billion. Fortunately, the Bank made 76 Billion from its Foreign Exchange operations – obviously reflecting the rapid increase in value of the dollars it held – but this gain should be weighed against the loss against which it is provisioning (and the contingent risks against which it is not provisioning) which are connected with the same increase in the value of the dollar versus the Rupiah. Further, the declining value of the dollar will negatively affect this figure in 1999, with no guarantee of a compensating collectibility of loans. Next, with Administrative and Salary expenses running at 38 Billion Rps. the Bank clearly needs to be running a higher margin on its operations. Some adjustment is being made here and will be reflected in next year's accounts.

The implied return on lending of roughly 14%, ignoring the question of non-repayment, clearly means that debtors were charged somewhat less than in other commercial banks (the comparable figure for Bank Niaga is 23-14%), but also reflects the comparatively long term nature of the Bank's portfolio as well as the profit sharing element in some of the lending. [This implied rate of return is computed by taking the return as percent of the December Outstanding; obviously to the extent that the December Outstanding was higher than average the return is understated.] Nonetheless, the overwhelming bulk of the lending is not in profit level sensitive form. About 26% of the Rps finance and almost none of the Foreign Exchange is in such form.

On the liabilities side, the bank had 68 Billion in demand deposits, 103 in Mudharabah Savings Deposits (Tabungan) and 221 in Mudharabah Time Deposits (Term Deposits). Twenty six Billion of these were from related parties, who thus were in a positive position with the Bank as a whole. The amounts in various types of deposits and approximate returns are indicated in Table III below. [The same issue on calculating returns as with loans is present]

Table III -- Bank Muamalat Deposits by Type of Shariah Instrument

Savings and Returns	1998 Amount	1998 Returns
Mudharabah Time Deposits	221	28
Securities	***	23
Mudharabah Savings Deposits	103	7
Wadiah Demand Deposits	68	3
Others		3
TOTAL		

The Bank reports that despite its relatively low payment of little over 10-12% on deposits, while other banks were paying in the mid 20s, the nominal amount of deposits only declined by 15%. This reflects the strong customer loyalty experienced by all shariah financial institutions. It remains to be seen, as more shariah alternatives emerge whether competition among them will have much effect. To the extent that a shariah financial institution is party of a mosque or pesantren (religious school dormitory) complex and patronizing it is part of affiliation with that complex, this competition may be less intense.

Obviously, the 1998 financial performance was unsatisfactory, even in the context of the Monetary Crisis, and the foreign exchange exposure seems high. It is perhaps in this context that the entire senior management of the Bank has been changed over the last few weeks, and better results will hopefully be achieved next year.

In recent months a number of banks have either announced that they will sift to Islamic principles or open shariah branches, so competition for Bank Muamalat is likely to increase.

Bank Muamalat has a specifically social focus. Its "mission is to become the catalyst for Islamic Financial Institution Development." As part of its strategy to serve the SME sector, "its mission is to enhance its role in small scale industry finance." Fourteen percent of its lending is to SME, vs 6% (May 1999) for commercial banks as a whole.[4] It intends to increase that percentage as well as the money it routes through its network of Islamic Financial Institutions, 29 of the 80 total BPRS, and 100 BMT of a total of more than 2000, and it aspires, as well, to serve the 1400 Kopontren, registered multipurpose cooperatives connected with pesantren, Islamic school dormitories, which often have a savings and credit Unit (Unit Simpan Pinjam). Bank Muamalat had 5.6 Billion Rps. outstanding to BPRS in December 1998, especially the Jakarta BPRS Wakalumi in which it had an equity share. In what follows we will deal with all these categories. Bank Muamalat intends to "selectively [distribute] its financing with emphasis on small businesses by using its syariah financial institution network."

Shariah institutions, with the partial exception of the Kopontren, obviously need Islamic sources of funds which only an Islamic financial institution like Bank Muamalat can provide, though I am told that in Indonesia, institutions as distinguished from individuals are permitted to receive and pay interest. Nonetheless, Bank Indonesia is preparing to launch an Islamic money market and has sent a team to Malaysia to see the type that has been developed there.[5]

Bank Muamalat is also one of three sponsors (along with the Indonesian Council of Muslim Intellectuals and the Nahdat Ulema) of YINBUK (Yayasan Indonesia B.. Usaha Kecil) which conducts extensive training for these Islamic financial institutions.

Bank Perkreditan Rakyat Shariyah

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[4] The procedure to get the overall figure for commercial banks was to take out those KUK loans which were made for agriculture, housing, cooperatives and consumption, and divide the remainder into the figure for total credit to private parties

[5] *Bank of Indonesia Report for the Financial Year 1998-1999***.**

There are 80 shariah BPRS with 80.5 Billion Rps. in total assets. The BPRs (Bank Perkreditan Rakyat) were created as a legal category under the 1988 Banking reforms. They are permitted to borrow and lend money but do not have access to the payments system, have lower capital requirements than for commercial banks and are subject to inspection by a special department of the Bank Indonesia, the Urusan BPR. Under the newest rules they must have initial capital of 500 Million Rps in smaller centers, one billion in district towns, and 2 billion in the JABOTEK area around Jakarta. Some of these BPRs are newly formed and privately owned, sometimes by non-governmental organizations, but also by private parties, and even commercial banks. Other BPRs are formed out of pre-existing LDKP (Lembaga Dana dan Kredit Perdesaan), small savings and credit units promoted by the various provincial governments. Some of the BPRs operate under shariah rules and are known as BPRS. The BPRS have an average NPL reported to be about 35% of lendings, somewhat lower than average for BPRs ***.

BPRS have been growing rapidly. In December 1993 there were only 22 of them with 11 billion in assets. They have increased from 1.29% of all BPRs to 3.45% and from .75 of total BPR assets to 2.93%.[6]

The Bank Indonesia has created parallel rules for the BPRS to those for BPRs in general, and provisions that enable them to participate in the two government credit programs in which BPRs are permitted – PPKM/BPRS (Pembiayan Proyekt Kredit Micro) for microenterprises and PMK/BPRS (Pembiayan Modal Kerja). A number of BPRs have shifted to shariah status, but at least one large one has ceased to be a shariah BPR.

Bait Maal Wat Tamwil – Islamic Savings and Loan Cooperatives

Similarly, a number of Savings and Loan Coops follow shariah procedures. So far only a few of these are registered with the Ministry of Cooperation and Small Enterprise and are subject to its rules, as with BPRS more or less modelled on the general rules for savings and loan coops. Most function informally with minimal regulation or supervision.

The BMT are generally associated with INKOPSYAH BMT (Induk Koperasi Syariah BMT) which was established by 18 registered Islamic BMT and 2200 unregistered "pre-coops."[7] Since its foundation a number more have registered, it is estimated perhaps 200 altogether.[8] The registered cooperatives are either freestanding Savings and Loan Cooperatives (Koperasi Simpan Pinjam –KSP) or Units in broader cooperatives (unit Simpan Pinjam – USP). Two Islamic USP I visited included one that was in a

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[6] Urusan BPR, Bank Indonesia.

[7] Dr. Amin Aziz, "The Development of Micro Enterprise Institutions in Indonesia: The Case of National Board of Revenue Sharing Micro Enterprise Cooperatives (INDUK KOPERASI SYARIAH BMT, BAITUL MAAL WAT TAMWIL), Presented at the Symposium of the APEC Center for Entrepreneurship, Jakarta, August 10, 1999.

[8] Interview with Dr. Amin Aziz, PINBUK, July 2, 1999.

multipurpose cooperative that operated a store and garment factory as well as the USP; the other was part of a Kopontren, a registered cooperative connected with an Islamic boarding house or Pesantren. More generally BMT, even free standing ones, are typically closely associated with other Islamic institutions. The Mohamadiya Polyteknik in Karaganyar told us they had 5 BMT associated with them.

The "pre-cooperatives" receive an "operation eligibility statement" from PINBUK (Pusat Inkubas Usaha Kecil). This procedure is based on a MOU which PINBUK has signed with Bank Indonesia.

As of June 1998, there were 330,000 members in 2470 BMT with 187 Billion Rps in outstanding loans. The number of BMT has risen from 300 at the end of 1995, to 700 at the end of 1996, and 1501 at the end of 1997. The BMT currently have 8253 paid staff, mostly university graduates, who have been trained by PINBUK. As of June 1998, of the 187 Billion of outstanding loans of BMT the overwhelming number were short term, under 1 million Rps, and to microenterprises, defined as those with less than 50 Million Rps of capitalization. About half of the borrowers are reported to be "microenterprise groups." (Some of these are possibly guarantee groups of individual microentrepreneurs, but most are presumably classic NGO group enterprises.}[9] The borrowers are predominantly small traders.

This 187 Billion of small lending was 83% funded by the savings of members, and 14% from the capital of the cooperatives. Apparently, no funds came from BPRS, or other Islamic financial institutions. What is interesting is that the BMT appear to be 100% lent up, with no liquid funds in bank accounts or cash. So far, overdues are negligible, less than 1/3% are more than a month overdue.

The shariah BPRS and Coops have been growing in number and size despite the Monetary Crisis.[10]

[9] Group enterprises frequently arise in NGO contexts. The ambiguity about their ownership and control disturbs lawyers, economists, and bankers and clearly poses some danger. Usually they belong to the NGO itself and are controlled by the officers of the NGO, and are a species of fiduciary public but not state enterprise. But their rationale is nominally that they are run for the benefit of their employees or perhaps the broader community, and subject to ultimate democratic control by the NGO membership, and proximate inputs from employees and customers. The ambiguity of the rights and the interests of all the stakeholders makes such group enterprises unstable, but some like the Mondragon cooperatives, the Israeli kibbutzes, or the Hutterite collectives have demonstrated considerable staying power. In these cases, the cement of religion of secular nationalism seems an important ingredient, a cement which may also serve these Islamic enterprises well.

[10] Bank Muamalat, *Annual Report 1998*, Jakarta: Bank Muamalat, 1999 and Aziz, op. cit. See Note 5 Supra.

Findings

Though Bank Muamalat and the BPRS offer the full range of shariah deposit and credit products, most Islamic credit in Indonesia has been in the form of trade finance (Bai al Salaam, Bai Bitsama Ajil, Istishna, or Murabaha), though the proportion is generally declining as the partnership or trust provision of working capital (Musyarakat and Mudharabah) increases. The actual rates charged and paid differ considerably between institutions and from time to time – as they should in order to share risk with their clients, but the average rates on shariah credit often seem to approximate those of other institutions.

Though Bank Muamalat is a Group A Bank, and has not suffered as severely as many large banks, it has been severely affected over the last year or so and needs to start healthy growth again. BPRS and BMT have been growing In nominal terms despite the Monetary Crisis.

The BMT have mobilized a great deal of savings and provided financial services to a large constituency, many of whom have never been served before. They have the advantage of building on the informal network created by the Islamic institutions with which they are associated as well as the moral sanction that comes with that affiliation. On the other hand, as largely unsupervised and unguaranteed institutions, many of which are run by relatively inexperienced personnel using new methodologies they clearly present prudential dangers – though ones not different in principle from those posed by all savings and loan cooperatives in Indonesia.

The 1400 Kopontren Cooperatives connected with Islamic boarding hostels are registered cooperatives most of which have USP, but these generally do not follow the shariah system, though some are beginning to do so. There importance stems from the fact that they have been identified as a prime market segment for Islamic finance and those involved in spreading Islamic financial consciousness and institutions are working vigorously with them.

Recommendations

In form, rather than substance, Islamic finance is quite familiar. Many of its instruments are the same as those used by other financial institutions, leasing, advanced purchase etc. The difference lies in the first instance in the social impulse for sharing – responsibility, risk, and property. Consequently, fixed interest transactions where risk is entirely assigned to the borrower are avoided. More importantly for participants, Islamic finance represents part of a divinely sanctioned economic gestalt with which they wish to fit themselves.

Thus Islamic finance –

enables financial services to an otherwise underserved group furthers a social thrust to assist smaller producers and consumers

but requires some adjustment, mostly formal, of techniques and regulation.

Therefore, as part of a financial sector development strategy Islamic finance ought to be

-----encouraged

-----mainstreamed

-----adjusted to

It should be encouraged by relation and supervision that accommodate its forms while seeing that their unfamiliarity is not exploited to defraud clients. Normal prudential and supervision norms should be adequate. This is the conclusion of a IMF study on the matter, which does, however, suggest that higher Capital Adequacy ratios may be appropriate as well as more detailed disclosure requirements.[11] The paper suggests a modified CAMEL for Islamic Bank supervision. The special risks it deals with are the generally uncollateralized nature of Islamic banking, and the greater risks in the profit sharing forms of lending. To the extent that Islamic banking is collateralized, or does not engage in profit sharing forms the issues are less serious.

As noted the BMT in particular need to be provided some sort of adequate supervision and guarantee to their depositors, though presumably not as elaborate a one as is provided commercial banks and BPRs. This is being done for the registered ones, as part of the new supervision scheme for Savings and Loan Cooperatives.

Islamic banking should be mainstreamed by trying to maximize the interaction between Islamic institutions and the rest of the financial system, subject to the constraints of shariah. The financial system and its regulation should be adjusted as necessary to accommodate the other two thrusts.

[11] Luca Errico ad Mitra Farahbaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision," IMF Working Paper, March 1998.