Chapter 3

Islamic Banking in Indonesia: Emergence, Growth, and Prospects

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ABSTRACT

The Indonesian banking sector has been stable and generally sound over the past decade, partly through efforts by the Bank of Indonesia as Indonesia’s central bank and Otoritas Jasa Keuangan as its financial services regulator. This chapter identifies important issues that remain for both conventional and Islamic banking in Indonesia. Authors suggest the government continue its efforts to reform what remains a geographically concentrated industry, to increase the role of bank credit in the economy, and to widen the provision of banking services through technology. Authors highlight the vulnerability of smaller banks in Indonesia to ongoing competitive market pressures and the necessity of creating larger banks through merger or capital raising and improving credit allocation to small and medium-sized businesses. Islamic banking has an important role to play in these developments, and those relating to Islamic social banking.

INTRODUCTION

During the past three decades, Indonesia’s banking sector has experienced two major financial crises. In 1997, the Asian financial crisis severely affected the sector and a number of banks collapsed. By early 1999, Bank Indonesia (BI), the Indonesian central bank, had closed 61 banks, and nationalized another 54 (Caprio & Klingebiel, 2002). With a second crisis emanating from the global financial crisis in 2007–08, Indonesian banking was again adversely affected, although not as majorly as countries with more direct links to the US subprime mortgage market. However, among the outcomes, the Lembaga Penjamin Simpanan (Deposit Insurance Corporation) bailed out the failed Bank Century, while the Indo-
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The Indonesian rupiah (IDR) exchange rate weakened to USD/IDR 12,650, its lowest level since the 1997/98 crisis (Bank Indonesia, 2009) (as of 11 March 2019 USD/IDR 14,298, AUD/IDR 10,064 and GBP/IDR 18,552).

It was after this second crisis that BI intensified its efforts at transforming what had hitherto been a very risky banking system, including its Islamic banks, into a stronger and more resilient industry able to provide the foundation for sustainable financial development and economic growth. However, these developments are largely unknown outside the country. Accordingly, this chapter has three purposes. First, to review the status of Indonesian banking. Second, to highlight some relevant ongoing challenges to both conventional and Islamic banking in Indonesia. Third, to describe how Islamic banking may be able to address some of the banking challenges present in Indonesia.

The structure of the remainder of the chapter is as follows. The first section examines the profile of the banking sector in Indonesia. The second section discusses its regulation and the third section its supervision. The fourth section considers the performance of the sector and the fifth section entails a critical discussion of current and future challenges and possible remedies. The chapter ends with a brief conclusion in the final section.

PROFILE AND INDUSTRY STRUCTURE

Conventional Banks

Banking entities in Indonesia—as per Act No. 10 of 1998 concerning Banking, Chapter III Article 5—are categorised as either commercial or rural banks. Commercial banks are those “…banks that conduct business activities in a conventional manner and/or based on Islamic principles, which within its business activities offer services related to payment flows” (Indonesia Financial Services Authority, 2017, p. 14). In contrast, rural banks provide no payment transaction services. As shown in Table 1, from 2013 to 2018, Indonesia’s commercial and rural banks exhibited a significant improvement in almost all growth indicators, except for the number of banks and bank offices.

Since 2013, the total assets of Indonesia’s commercial banks have steadily increased from IDR 4,954 trillion to IDR 7,768 trillion, an increase of about 56.8%. Similarly, the total assets of rural banks in the same period increased from IDR 77.4 trillion to IDR 131.5 trillion or by about 67%. The largest bank in

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<th>Indicators</th>
<th>2013</th>
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<td>Total Assets</td>
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<td>Commercial Banks</td>
<td>4,954,467</td>
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<td>77,376</td>
<td>89,878</td>
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<td>113,501</td>
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<td>Commercial Banks</td>
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<td>Rural Banks</td>
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<td>No. of Offices</td>
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<td>Commercial Banks</td>
<td>31,847</td>
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<td>32,730</td>
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<tr>
<td>Rural Banks</td>
<td>4,678</td>
<td>4,895</td>
<td>5,982</td>
<td>6,075</td>
<td>6,157</td>
<td>6,242</td>
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Source: Otoritas Jasa Keuangan (2018a)
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