Paving the Way Forward for Rural Finance
An International Conference on Best Practices

Case Study

Risk Management : Islamic Financial Policies

Islamic Banking and Its Potential Impact

By Thomas A. Timberg
(Nathan Associates, Inc.)

This case study was made possible by support provided in part by the US Agency for International Development (USAID) Agreement No. LAG-A-00-96-90016-00 through Broadening Access and Strengthening Input Market Systems Collaborative Research Support Program (BASIS-CRSP) and the World Council of Credit Unions, Inc. (WOCCU).

All views, interpretations, recommendations, and conclusions expressed in this paper are those of the author (s) and not necessarily those of the supporting or collaborating institutions.

Islamic Banking and Its Potential Impact

This is a little different from other case studies being presented at this conference. Since the representatives of the Shariah Bureau of Bank Indonesia responsible for the supervision and development of Islamic finance will focus on the experience and progress of Islamic banking in Indonesia, I will focus on some questions about the impacts of that banking, particularly in rural areas, and aspects that the Bank Indonesia representatives will not focus on.

Islamic banking is a worldwide phenomenon involving a variety of institutions and instruments, not one "project" or institution. In the past few decades, Islamic institutions and instruments have developed in many countries, including the United States. In certain countries—Iran, Sudan, and Pakistan—all or most financial intermediation conforms to Islamic shariah (religious law) as defined by local authorities. All three of these countries also have banking authorities that govern the general level of charges and returns in the system and these are not usually market-governed systems.

In most other countries, including Indonesia, Islamic transactions and institutions make up a small part of the total and must compete with conventional financial institutions. There is even considerable Islamic banking in the United States.[1] If the terms and conditions of Islamic transactions differ too much from those of conventional institutions they become hard to sustain. The terms and conditions of Islamic institutions therefore tend to converge with conventional ones.[2]

Islamic instruments are simply a narrow group of familiar financing instruments. Any transaction, with any distribution of proceeds, can be conducted as a lease, a sale, a partnership, a fee-generating transaction, or a loan. Islamic instruments generally avoid loans. Though the scheduled distribution of proceeds may be the same as for a conventional loan, the legal risk in case of default is often different in the different forms of financing.

Those who promote Islamic finance often prefer partnership arrangements in which profits or turnover is shared because this conforms more fully to the goals of Islamic banking.[3] One goal of Bank Indonesia in promoting Islamic banking is to increase the

---

[1] See *Financial Times*, March 25, 2003, inter alia.

[2] This fact sometimes disturbs observers who feel that they are being confronted simply with a change of nomenclature. A very articulate answer to this complaint is contained in Mahmoud Amin El-Gamal, A Basic Guide to Contemporary Islamic Banking and Finance, June 2000, at http://www.ruf.rice.edu/~elgamal/files/primer.pdf.

[3] Zamir Iqbal, "Islamic Financial Systems," Finance and Development, June 1997, lists six basic principles: Avoidance of interest, risk sharing, treating of money as potential capital, prohibition of

proportion of financing involving such sharing.[4] Nonetheless, more than 80 percent of Indonesian Islamic financing is in fixed-term forms, mirroring the pattern throughout the world.[5]

Many involved in Islamic banking would like to minimize the differences between Islamic and conventional banking and thus they welcome fixed-term forms. However, because the instruments differ in some degree they typically require some adjustment from their conventional counterparts.[6] For example, in Islamic transactions, the bank often holds the title of the property concerned. U.S. banking authorities have ruled this unobjectionable provided that title holding is only a matter of form to accommodate Islamic strictures.[7]

Although U.S. and other banking supervision authorities have accommodated Islamic banking with few changes in procedures, some countries consider that this is not enough. They have moved to develop national and international Islamic institutions—money markets, bank regulators, deposit protection, bank accounting, and so on. Centers have been developed for all these matters—for bank supervision in Malaysia, for accounting in Bahrain, and several academic centers, including centers at Harvard and Oxford universities.[8]

THE EXAMPLE OF INDONESIA

Indonesia, with the world's largest population of Muslims, has come to Islamic or shariah banking fairly late. Many of Indonesia's Muslim leaders do not believe that commercial interest in its modern form is prohibited, although others do. After some false starts, Islamic financial institutions are developing rapidly and have the enthusiastic support of many young people and intellectuals. The work of the Shariah Bureau of Bank Indonesia demonstrates that Indonesia, especially in particular parts of the country, has considerable unmet demand for Islamic banking.[9]

---

speculation, sanctity of contracts, and avoidance of prohibited activities such as those connected with alcohol and gambling. Others might disagree.

[4] The word *shariah* rather than *Islamic* is usually used in Indonesia.

[5] V. Sunderarajan and Luca Errico, Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead, IMF Working Paper No. WP/02/192, Washington, D.C.: IMF, 2002, at http://www.imf.org/external/pubs/ft/wp/2002/wp02192.pdf. See also Perbankan Shariah: Islamic Banking Statistics, Bank Indonesia, December 2002.

[6] Bank Indonesia, Blueprint of Islamic Banking Development in Indonesia, http://www.bi.go.id/bank_indonesia2/utama/publikasi/upload/syariah%20blue%20print-engl.pdf.

[7] Comptroller of the Currency, Administrator National Banking, Office of the Counsel, NY. Interpretative Letter #867, November 1999, 12 USC 34 (7), 12 USC 29; No. 806, December 1997, 12 USC (7), 12 USC 371. From bibliography at http:/www.failaka.com/Failaka/20Research.html.

[8] Sunderarajan, op. cit., pp. 16–19.

[9] Blueprint, p. 10.

Islamic banking in Indonesia has some unusual characteristics. Like most microfinance institutions in Indonesia, Islamic institutions, micro or otherwise, are generally private, for-profit institutions based on the intermediation of depositor funds secured on a competitive market. In this they are different from microfinance institutions in almost every other country in the world. They typically have no explicit social goal other than profit maximization and conformity with Islam, though in some cases a social element is present, as we will see. Social impacts are thus the result of the market impacts of the Islamic institutions.

Many Islamic institutions in Indonesia, particularly the Bait Maal Wat Tamwil (BMT)—Islamic savings and loan cooperatives—are located in rural areas and provide agricultural financing. Nonetheless, the focus of Indonesian Islamic financial institutions is typically urban and geared toward the financing of trading operations. There has been some discussion of Islamic banking for microcredit, but most documented experience that I know of is in Pakistan, where institutions charge a service fee to cover their costs—something that is not permitted now in many Islamic banking systems.

In terms of agricultural finance, I have encountered only one institution, a BMT in Solo, that provided crop loans. This transaction, which involved a fixed repayment in kind, also might not meet the standards of many Islamic lenders. I am sure other crop loans exist. A couple of Islamic financial instruments are particularly—and according to one source, traditionally—designed for agriculture.

The lending of the various venture capital firms in Indonesia, the Modal Ventura, did support a number of agribusiness ventures on an Islamic, profit-sharing basis. The example is not necessarily an attractive one, however, because although repayment was frequently high, the profit-sharing element, in which low profits were reported, and the devaluation of the Indonesian rupiah led to the decapitalization of these venture capital firms.

Islamic financial institutions in Indonesia include the Bank Muamalat Indonesia, which has been functioning since 1992, several new Islamic branches of regular commercial banks, one other newer commercial bank, 80 Bank Perkreditan Rakyat Shariah (BPRS—smaller banks limited to borrowing and lending in limited areas), and 2,470 BMT (of which a few are reported to be registered with the Ministry of Cooperatives and Small Business). The Islamic commercial banks and BPRS file frequent and detailed reports with Bank Indonesia and thus produce reliable and current statistics. This is not yet the case with BMT.[10]

The amount of funds in Islamic institutions has been growing rapidly, as the paper, "The Blueprint of Islamic Banking in Indonesia," which is also being presented at this

[10] I also rely on my visits to Islamic financial institutions in the field and meetings with experts involved in their development. I thank in particular Mr. Adiwarman Karim and his numerous colleagues at Bank Muamalat (especially Mr. Pallas Athene and Asril), and Prof. Dr. Amin Azis, Chairman of Pusat Inkubasi Bisnis Usaha Kecil (Center for Incubating Small Businesses [PINBUK]), which is a project of Yayasan Inkubasi Bisnis Usaha Kecil (Foundation for Incubating Small Businesses [YINBUK]) and a director and leader in other financial institutions such as Induk Koperasi Syariah BMT.

session, illustrates. Assets in Islamic banks have grown from US$52 million to US$302 million but still account for only 0.26 percent of assets in the banking system. The figure is somewhat higher if we exclude the considerable assets of conventional banks that represent government recapitalization bonds of one sort or another. Bank Indonesia has been moving to ensure that support institutions are developed for Islamic banks.[11]

I will present some data on the largest and oldest Islamic bank, Bank Muamalat, and the BMT because they will not be presented elsewhere at this conference.

Bank Muamalat

Bank Muamalat's position as of December 31, 2002 (from quarterly reports posted on the Bank Indonesia website) can be seen in the following table.[12] Various small approximations were made; precise concepts are specified in Bank Indonesia sources.

Bank	*Assets*	*Credit*	*Deposits*	*Nonperforming Loans (%)*
Bank Muamalat	238	190	190	4.8
Bank Mandiri	28,103	7,101	20,444	6.6
Banking System	123,556	45,556	92,778	8.1

Bank Muamalat's loans, according to its recent annual audited reports, are distributed among Islamic financial instruments as shown in Table 1. (Definitions for these instruments are given in the appendix.)

About two-thirds of the rupiah financing and half of the foreign currency financing are for less than one year. This is a high level of longer-term financing for a commercial bank. There is a trend toward mudharabah. The average return on loans seems to be a little more than 10 percent, which is not high by Indonesian standards.

Bank Muamalat splits gross revenues with borrowers, not net profit as in other Islamic institutions, and almost always insists on collateral. Its "sharing," non-fixed term lending is thus easier for it to manage than it would be in some other countries.

[11] Blueprint, op. cit.

[12] The currency conversion rate used for this paper is 9,000 rupiah (Rp) per U.S. dollar (US$).

Table 1. Bank Muamalat Loans by Type of Shariah Instrument (Rp billion)

Financing Instrument	1998	1997
For Rupiah		
Bai Bitsaman Ajil	141	179
Murabahah	83	130
Mudharabah	68	29
Musyarakah	13	12
Al Qardhul Hasan	1	1
Total	306	351
For Foreign Currencies		
Bai Bitsaman Ajil	78	86
Murabahah	71	21
Mudharabah	7	1
Total	156	108
Grand Total	462	459

The bank made a profit when many Indonesian banks were losing money. It used to have a higher percentage of nonperforming loans, but the situation appears to be improving. The pattern of outside funds deposited in Bank Muamalat by instrument can be seen in the following figures, from a similar source to Table 2.

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

The cost of outside funds seems to be roughly half that charged borrowers—again somewhat low by Indonesian standards. Bank Muamalat reports that despite its relatively low payment of 10–12 percent on deposits, while other banks were paying in the mid-20s, the nominal amount of deposits declined by only 15 percent. This reflects the strong customer loyalty enjoyed by all Islamic financial institutions. In recent months a number of banks have opened or announced that they will shift to Islamic principles or open shariah branches, so competition for Bank Muamalat is likely to increase.

Bank Muamalat has a specifically social focus, as noted in its 1998 annual report. Its mission is “to become the catalyst for Islamic financial institution development,” and “enhance its role in small scale industry finance.” Almost 17 percent of its lending goes to small and medium enterprises, which is above average for commercial banks. Bank Muamalat intends to “selectively [distribute] its financing with emphasis on small businesses by using its shariah financial institution network," 29 of the 78 BPRS, and 100 of the 2,000 BMT, and aspires, as well, to serve the kopontren (registered multipurpose cooperatives connected with pesantren, Islamic school dormitories), which often have a savings and credit unit.

Bank Muamalat is also one of three sponsors that conduct extensive training for BMT. The other training sponsors are the Indonesian Council of Muslim Intellectuals and the Majlis Ulema Indonesia (a group of Islamic scholars) of Yayasan Inkubasi Bisnis Usaha Kecil (Foundation for Incubating Small Businesses [YINBUK]).

Bank Perkreditan Rakyat Shariah

The roughly 80 shariah BPRS have Rp 80.5 billion in total assets. They 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 commercial banks, and are subject to inspection by Bank Indonesia. BPRS have been growing rapidly (as noted in the Bank Indonesia Blueprint) although they still constitute a small portion of the total.

Bait Maal Wat Tamwil—Islamic Savings and Loan Cooperatives

The BMT savings and loan cooperatives follow Islamic procedures as well. So far only a few of these are registered with the Ministry of Cooperation and Small Enterprise and are subject to its rules. The BMT, like the BPRS, more or less follow the general rules for savings and loan co-ops.

Most BMT are associated with Induk Koperasi Syariah BMT (Inkopsyah BMT), which was established by 18 registered Islamic BMT and 2,200 unregistered "pre–co-ops."[13] Other BMT are associated with other organizations, especially the foundation Dompet Dhuafa and some religious organizations, or are independent.

The registered cooperatives are either free-standing savings and loan cooperatives (Koperasi Simpan Pinjam–KSP) or units in broader cooperatives (Unit Simpan Pinjam—USP). I visited one Islamic USP that was part of a multipurpose cooperative that operated a store and garment factory as well as the USP; another was part of a kopontren. BMT, even free-standing ones, typically are closely associated with other Islamic institutions. The Mohamadiya Polyteknik in Karaganyar told us that it has five BMT associated with it.

The legal status of BMT, unless they are registered as cooperatives, is ambiguous, although the Ministry of Cooperatives and local governments often work with them. Pusat Inkubasi Bisnis Usaha Kecil (Center for Incubating Small Businesses [PINBUK]) has helped develop a regulatory system for them, and USAID contributed to a national

---

[13] 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.

seminar on the subject. A strong consensus exists on the need for some regulatory scheme to be developed, but the form that such a scheme would take is still unclear.

As of June 1998, there were 330,000 members in 2,470 BMT with Rp 187 billion in outstanding loans in this network. The number of BMT rose from 300 at the end of 1995 to 700 at the end of 1996 and 1,501 at the end of 1997. The BMT currently have 8,253 paid staff, mostly university graduates, who have been trained by PINBUK. As of June 1998, of the $20 million of outstanding BMT loans, the overwhelming amount was short term, averaged $100 per loan, and went to microenterprises. 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. The borrowers are predominantly small traders.[14]

This $20 million of small lending was 83 percent funded by the savings of members, and 14 percent from the capital of the cooperatives. Apparently, no funds came from BPRS, though some funds have come from Bank Negara Indonesia, a government bank, Bank Maumalat, and some government enterprises, especially Pertamina. The BMT appear to be 100 percent lent up, with no liquid funds in bank accounts or cash. So far, overdue amounts are negligible; less than one-third of amounts due are more than a month overdue.[15]

Kopontren—Cooperatives Connected with Pesantren

The 1,500 kopontren connected with pesantren are registered with the Ministry of Cooperatives. Most of their savings units do not follow the Islamic system, although some are beginning to do so: One hundred to 300 of the kopontren savings units are estimated to have shifted to Islamic banking. The Islamic financial institutions look on them as an important target market segment, but much of the kopontren leadership does not want to identify solely with Islamic financial institutions. Because the pesantren are mostly in rural areas, their cooperatives and credit are frequently connected with agriculture.

FINDINGS AND RECOMMENDATIONS

Though Bank Muamalat and the BPRS offer a full range of Islamic deposit and credit products, most Islamic credit in Indonesia has taken the form of trade finance (bai al salaam, bai bitsama ajil, istishna, or murabaha), though the proportion declines as the partnership or trust provision of working capital (musyarakat and mudharabah) increases. Rates (charged and paid) differ considerably between institutions and from time to time, but the average rates on Islamic credit often approximate those of other institutions.

---

[14] See footnote 13.

[15] See footnote 13.

Although Bank Muamalat did not suffer as severely as many large banks from the financial crisis, it did require some management change and has begun healthy growth again. BPRS and BMT have been growing 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 a large prospective market and 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. However, as largely unsupervised and unguaranteed institutions, many of which are run by relatively inexperienced personnel using new methodologies, they clearly present prudential dangers—though not different in principle from those posed by all savings and loan cooperatives in Indonesia.

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

Thus Islamic finance

- Enables financial services to an otherwise underserved group including small, rural, and agricultural producers;
- Furthers a social thrust to assist smaller producers and consumers and is often given in the context of a movement to assist them; but
- Requires some adjustment, mostly formal, of techniques and regulation to take account of Islamic values.

Islamic finance, as part of a financial sector development strategy, ought to be encouraged, mainstreamed, and adjusted to. An IMF study on the matter concludes that Islamic finance should be encouraged by regulation and supervision that accommodate its forms while ensuring that their unfamiliarity is not exploited to defraud clients. Normal prudential and supervision norms should be adequate. The IMF study does, however, suggest that higher capital adequacy ratios and more detailed disclosure requirements may be appropriate.[16] The paper suggests a modified CAMEL (capital adequacy, asset quality, management, earnings, liquidity) system of banking supervision for Islamic banking. Special risks are the generally uncollateralized nature of Islamic banking and 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.

---

[16] Luca Errico and Mitra Farahbaksh, Islamic Banking: Issues in Prudential Regulations and Supervision, IMF Working Paper, March 1998. Other IMF publications include Nadeem Ul Haque and Abbas Mirakhor, The Design of Instruments for Government Finance in an Islamic Economy, IMF Working Paper, March 1998; and V. Sundarajan, David Marston, and Ghiatt Shabsigh, Monetary Operations and Government Debt Management under Islamic Banking, IMF Working Paper, September 1998. These documents can be accessed at http://www.imf.org/external/pubind.htm.

Nonetheless, the Islamic banks are often more comfortable with specialized regulations and infrastructure that recognize their peculiarities.The BMT in particular need adequate supervision and some guarantee for their depositors, though not as elaborate as those provided commercial banks and BPRs.

Islamic banking should be mainstreamed by maximizing 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.

Donors should ensure that their assistance to financial system development includes Islamic financial institutions. This will help include otherwise excluded groups and avoid regulatory loopholes.

Appendix

ISLAMIC LENDING AND BORROWING INSTRUMENTS IN INDONESIA

These definitions for the borrowing and lending instruments used by Bank Muamalat, Indonesia's first shariah commercial bank, come from its 1998 annual report.[17]

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 that 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 wherein 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 whereby 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. At the end of the lease period the customer buys the equipment at an agreed price from the bank, with the rental fees already paid being part of the price.

[17] This list differs in minor particulars from the lists in other sources such as a recent IMF study, which mentions in addition: mazar'ah—the counterpart of mudharaba for farming in which the bank provides land or funds and the harvest is shared; musaqat—the traditional counterpart of the musharaka in orchard keeping; direct investment; bai'salam or bai'salaf—purchase with deferred delivery; and joalah—service charge. See V. Sundararajan and Luca Errico, op. cit., pp 21–22.

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 gross revenues from the project are 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. This partnership may be managed by the bank or 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 office 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. Besides accident insurance coverage, it offers special prizes for highly 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 packages: Rp 25,000, Rp 50,000, and Rp 100,000. This savings account also gives the depositor an ATM card, shopping discounts at certain shops, and accident insurance coverage.

Arafah Savings—Tabungan Arafah

A savings account designed specifically 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 prizes.

Fulinves Deposits—Deposito Fulinves

A time deposit with a revenue sharing package available for various terms and with a chance to win 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 intends to add a variant that provides life insurance.