INDONESIAN ISLAMIC BANKING OUTLOOK 2010

Directorate of Islamic Banking | 2009

BANK INDONESIA

iB Islamic Banking

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FOREWORD

Bismillahirrahmanirrahiim.

We should be grateful to Allah SWT for his Guidance so as towards the end of 2009 we are still able to navigate through all challenges and carry out number of activities in developing a sound Islamic banking to grow and contribute well again to the welfare of the people and economy at large. While the national economy is not completely recovered from the 2008 global financial crisis, Islamic banking was still growing at a higher rate than national banking industry, although the rate is somewhat lower than what estimated at the beginning of the year whilst the quality of financing and investment remained intact.

During 2009, Bank Indonesia together with practitioners and related stakeholders of Islamic banking has labored maximum efforts to maintain growth and quality of Islamic banking industry in the midst of economic uncertainty. Throughout this period, Bank Indonesia at its capacity as regulatory and supervisory authority for Islamic banking, has introduced some measures to improve regulation with the support from reliable research function in an effort to produce effective regulation that will propel development of Islamic banking. On the supervisory side, various activities have been undertaken to develop and ensure a more effective supervisory system by using advanced information technology, developing competency of bank supervisors, and conducting supervision with the risk-based supervision approach.

Having observed the analysis on Islamic banking industry and various other factors that may be influential, and forecast on development and policy direction that may be beneficial to practitioners and stakeholders, as in the previous years, at the end of 2009 Bank Indonesia is publishing Islamic Banking Outlook 2010. This publication is expected to provide useful information to all related parties in anticipating a more challenging condition and tightening business competition in the coming year. In our opinion, we must prepare ourselves for the year 2010 with some optimism and maximum efforts (*ikhtiar*).

Finally, we hope this Islamic Banking Outlook 2010 will be valuable for all. Any criticism and suggestion to improve future undertakings will be appreciated. May Allah SWT bestow us with His guidance and blessing in accomplishing this task (*amanah*), responsibility and dedication to the people and this beloved country.

Billahi taufiq wal hidayah, wassalamu'alaikum warahmatullah wabarakatuh.

Jakarta, November 2009

Directorate of Islamic Banking

Ramzi A. Zuhdi
Director

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CHAPTER 1

Islamic Banking Development Policy 2009

Policy implementation in the area of Islamic banking development is continuously applied to enhance contribution of Islamic banking in real economic development and efficient financial transactions to achieve prosperity of people

Similar to the previous year, the main activities conducted by Bank Indonesia in 2009 cover the area of research, regulation and development, licensing, and supervision of Islamic banks. The activities undertaken serve as part of the effort develop to a sound and prudent Islamic banking system which is compliant with sharia principles.

1.1. Research Activities

The researches conducted in 2009 focused on the areas related to the efforts to improve the comprehensiveness of regulatory setting, product development and institutional building for Islamic banking capable of coping future challanges.

1.1.1. Research on Regulation

A. Research on Legal Lending Limit

Currently the regulation that governs legal lending limit for Islamic banking is Bank Indonesia Regulation (PBI) No.7/3/PBI/2005 issued on 20 January 2005 on Minimum Legal Lending Limit, which was further amended by PBI No. 8/13/PBI/2006 on 5 October 2006. The Islamic Banking Act of 2008 necessitates the regulation on minimum legal lending limit for Islamic banking. Article 37 of the Act explicitly requires Bank Indonesia as a regulatory authority to determine Minimum Legal Lending Limit with some references stipulated, specifically on the lending limit to affiliated and non affiliated parties of the banks. In line with Bank Indonesia's regulatory paradigm where development of regulation should be in stages and continue to adhere to Islamic values and special characteristics of the Islamic banking, it is necessary to conduct rigorous study on this minimum legal lending limit.

With reference to the research finding on the minimum legal lending limit, some recommendations were proposed such as (i) LLM for Islamic Rural Bank is set higher for Non-related Party; it is now 20% for Non-related party as individual and 30% for Non-related party as a group, (ii) suggestion to apply lower lending limit for the Third Party that obtains financing facility using profit sharing method, both for Islamic Commercial Bank and Islamic Rural Bank. This was after considering higher possibility to experience moral hazard on the financing, (iii) formulation on list of related parties that requires redefinition with regard to other definition of "affiliated parties", which has been stipulated under Article 37 Islamic Banking Act No. 21 Year 2008, (iv) exclusion from LLM of inter bank fund placement that serves a purpose as payment system such as ATM.

Besides, it is important to note that further studies on minimum capital adequacy requirement of Islamic banking also takes priority. This is to maximize the role of Islamic banking in public financing and fulfill LLM requirement both seen from prudential and shariah perspectives, as well as to stimulate customers' business in every sector of the economy.

B. Research on Minimum Capital Adequacy Requirement

The research on Minimum Capital Adequacy Requirement or CAR for Islamic banking is basically a revision of the previous research on "Equity Concept for Islamic Banks". The research is referring to Islamic Banking Act No. 21 Year 2008 Article 51 concerning obligation of Islamic banks and Islamic business units to keep their level of prudence whereby capital adequacy factor is paramount. This research also carried out to diagnose minimum CAR of the existing conventional and Islamic commercial banks for the purpose of completing a regulation that is Bank Indonesia Regulation Number 7/13/PBI/2005 concerning standard method for credit risk and market risk on foreign exchange. The regulation did not previously take into consideration operational risk in the calculation of CAR. Bank Indonesia regulation No.10/15/PBI/2008 concerning Minimum Capital Adequacy Requirement for Commercial Bank has been revised to detail out the core capital of at least 5% from ATMR and availability of hybrid capital instrument. Bank Indonesia regulation Number 10/24/PBI/2008 concerning Earning Asset Quality of Islamic Bank asserts one article replacing Article 12 under Bank Indonesia Regulation Number 7/13/PBI/2005, which then allows Islamic bank to invest in suku. In addition, this research was also conducted to accommodate international standards development such as the standards formulated by Islamic Financial Services Board (IFSB), Basel II of the Bank for International Settlement (BIS) and accounting standards related to Minimum Capital Adequacy Requirement, especially from risk management perspective.

From accounting and shariah principle standpoints it can be concluded that type and recognition methods in Islamic banking capital should be associated to core capital and additional (complementary) paid-up capital together with innovative instrument (hybrid capital). Changes in capital components on financial instruments (asset side) are categorized under trading portfolio that is to be minimized with certain criteria. Islamic bank that has implemented trading category on Islamic bond, which is exposed to risks such as price changes in specific and systematic way as the benchmark rate, market risk that can impose risk charge applied in conventional system, and inherent operational risk in Islamic banking, can anticipate all these by using capital charge such as basic indicator.

C. Study on Earning Assets Quality

The study was conducted to review regulation concerning earning assets quality in response to the enactment of Islamic Banking Act No. 21 Year 2008. The current policy set invites the players to provide the regulator with the feedback in improving the quality of regulation. One of the problems voiced out by industry players and shariah advisors is related to earning assets quality of financing using mudharabah and musyarakah contracts. Therefore, the focus of this study is to identify possible methods for the assessment techniques that are relevant to the real practices.

The study reveals that profit-share based financing has various applications, which covers: (i) mudharabah financing with condition to rechanneled specifically for murabahah financing, (ii) project financing, and (iii) non-project financing in the form of working capital and investment. At the implementation stage, mudharabah with specific condition to rechanneled to murabahah has the highest market share of up to 60% from the total of profit sharing based financing. Each of the financing application apparently has its own characteristic, therefore it is necessary to standardize the evaluation on earning assets quality based on its type of financing application.

From the analysis on each charateristics of the financing, combining with Islamic accounting principles regulation, the evaluation of earning asset quality is proposed to be differentiated based on type of financing and source of fund. As for mudharabah with specific condition rechanneling to murabahah, it is suggested that the evaluation adopted is similar to that of earning assets quality evaluation for murabahah. For mudharabah based project financing, it is suggested to adopt revenue realization ratio method/revenue projection. The adoption of this ratio method is to capture two objectives that; i.e. a) to predict realization of profit sharing and b) indication of future payment. At the same time, it is suggested, for the non-project based mudharabah and musyarakah contracts, to adopt the projection method, in which threshold varies with respect to the customers' payment. This is due to the financing that is included in the variable claimed financing using revenue sharing mechanism, in which each business level has different characteristics. As for variable claimed financing using profit loss sharing basis from variable claimed sources of fund using profit loss sharing basis, the evaluation is suggested to adopt net asset value (NAV) method. This can be a possible alternative as the financing and source of fund are using PLS principle where the cost will remain unchanged.

1.1.2. Research on Product Development

Study on Commodity Murabahah

Types of murabahah products can be grouped into 3 (three) category namely: (1) murabahah product - direct financing to customer for purchasing consumer and productive products; (2) commodity murabahah for liquidity purposes - this liquidity instrument is created through trading of commodity (usually metal) by 2 (two) warehouses by deferred; (3) murabahah deposit-it is fixed income saving mode using murabahah contract. From the above three products, (simple) murabahah product serves as the basic transaction. This product has been widely accepted since it reflects the basic trading activities and it facilitates the financing process for consumption and productive sectors, whilst commodity murabahah product is offered to enhance liquidity and to enable possible fixed income deposit purposes.

In practice, transaction of commodity murabahah product for liquidity purposes consists of several contracts whereby each contract is dependent to other contracts (*ta'alluq*). This condition is not permissible to the majority of scholars/*ulama*, as the commodity under transaction is no longer the focus of the contract. Commodity murabahah transaction is basically designed for the purspose of justification on borrowing money in shariah way, although in reality, investors cannot control the use of the funds. Similar to that of commodity murabahah for liquidity purposes, murabahah deposit transaction consists of several transactions in one contract (*mu'allaq*), which is not permissible by shariah and the commodity is no longer the focus, therefore the said product is no longer in compliance with DSN MUI fatwa concerning Commodity Murabahah Trading and Variation of Commodity Murabahah. The aspect of shariah incompliance could eventually ruin the reputation of Islamic banking industry. Economically, such transaction would eliminate the genuine capability of absorbing economic shocks attributed to the Islamic banks.

However, in bridging the interest of banks and their customers for the need of shariah financial transaction using commodity murabahah, the study suggested a product solution called *murabahah commodity*. It is a type of short-term working capital financing that can be exercised through murabahah transaction by purchasing inventory of a firm at certain limit of time. The purchase is required to tranform goods into cash. This product will stimulate business sectors to obtain collateralized working capital and it can become a liquidity instrument to enhance efficiency of other Islamic financial institutions. This product is still in compliance with fatwa of DSN-MUI No.:04/DSN-MUI/IV/2000 concerning Murabahah and Ijma' of ulama that requires halal goods to serve as underlying transaction and prevent credit with riba, gharar and maysir and to reduce the possibility of side streaming in using the bank's fund. However, the bank may be exposed to credit risk and price risk in case of payment failure.

1.1.3. Research on Strengthening Islamic Banking Infrastructure

A. Early Concept on Real Sector Return Index as Reference Index of Islamic Banking Return

As the bank that is closed to real sectors, the operation of Islamic bank should depict the real sectors so that it will be able to contribute to sustainable economic growth. However, in determining the product price both in profit sharing or trading mechanism, the Islamic bank still using benchmarks of conventional interest rate[1]. This is an unavoidable consequence of implementing a dual banking system. Further more, the fact that the Islamic banking share is still 2% compared to national banking has brought consequences of a high correlation on pricing policy of Islamic banks to the interest rate of conventional banks.

1 Based on empirical study carried out by DPbS as in Box 3.1 Islamic Bankingn Outlook 2008, "Response of Islamic Banking Return and Profit Sharing Towards Changes on External Interest Rate".

This fact necessitates for another indicator in real sector return activities as root of Islamic banking operations, which can be used as benchmark to determine Islamic banking pricing. This indication can theoritically mirror the real rate of return for each sector of the economy. Moreover, real sector indication can be adopted by Bank Indonesia to monitor real sector performance and analyze the gap between real sector and financial sector. Further, when benchmark for a real rate of return of the real sector becomes available, the Islamic banking return index can be formulated to describe all performance of Islamic banking as a whole. This index concept is different with that of index defined by Zaman (1993), which was more on adjustment index towards the price hikes of the financial assets.

To obtain the end result in the form of real sector index as Islamic banking return index, it is necessary to conduct several multilayer studies that mutually reinforcing. At the first stage, the study is designed to obtain real sector performance transmission mechanism to the price of Islamic banking product, to determine real sector indicators that could be used to assign reference rate of return as profit expectation, and to form real sector model that can provice alternative reference rate of return for economic sectors and hence a price benchmark for Islamic banking.

Reference rate of return representing the actual real sector return lends benefit at macro level in Islamic financial industry, especially for Islamic banking as; (i) it can be a reference for product pricing, (ii) it is reference for investment feasibility estimate, and (iii) it can minimize unfairness in market interaction among players in the banking sector. Furthermore, it will imply positive implications such as; (i) availability of accurate information for market players as a form of fairness, hence create conducive market, (ii) stimulate the creation of transparent and efficient financial market, (iii) stimulate the optimal capital formation and allocation of resources towards maximum investment actvities that support real sectors, and (iv) stimulate the balance between real sector and financial market, as well as to minimize its gap.

B. Roadmap of Islamic Bank Risk Based Supervision

As one of the supporting components in Indonesia's economic system, Islamic banking has to maintain its operational sustainability. As one of the efforts, Bank Indonesia has prescribed a road map to implement a risk based supervisiory concept. Among its objectives is to improve supervision capability in observing the actual condition of Islamic banks more accurately, in the area of Islamic financial performance and managerial quality, particularly in assessing its strategic management decisions. Technically, it implies that all Islamic banking supervisors must be equipped with adequate information that represents accurate financial performance and decision-making process.

The concept consists of two main parts: first, the methods to determine criteria and ratios used in the assessment; and, second, supervisiory infrastructure that allows information to flow to the banking supervisors timely and accurately allowing prompt corrective action. To that purpose, the development of calculation supporting facility concept in the terms of information technology has become necessary. Risk based supervision system development has to be carried out comprehensively covering risk profile to soundness rating criteria of each Islamic bank.

The infrastructure development is carried out in a continuity which consists of stages of development allowing the supervisors to conduct the tasks smoothly regardless to system up grading process. The development program will also invites the relevant parties, including the banks, to better coordinate and synchronize the IT structures.

The study includes the analysis on the accounting and financial standards, nationally as well as internationally, as the basis to build a solid infrastructural framework.

C. Indonesian Islamic Banking Mapping en route ASEAN 2015

As the part of the Indonesian banking system, the Islamic banking industry needs to be well-prepared to fulfill the national commitments in the AEC framework in 2015. This initiative is to strategize and to get the most of the regional globalization process.

One of the efforts to arrive at that level is to conduct a specific study to identify competitive advantage in ASEAN Islamic banking industry, which includes Indonesia, Malaysia, Singapore and Brunei Darussalam, vis-à-vis External Industry Factors that consists of 1) Development Vision, 2) Human Resources, and 3) Regulation; and Internal Industry Factors such as 4) Financial Condition, 5) Network Coverage, and 6) Variety of Products. The comparison and mapping shows that the condition of the four countries is relatively similar, especially between Indonesia and Malaysia that fall into the same quadrant (of analysis).

In general, Indonesia is positioned in almost similar to the Malaysia whose Islamic banking industry has the highest competitive advantage in ASEAN. Nevertheless, Indonesia must improve several factors to uplift its competitive advantage, particularly in the area of qualified human capital, implementation of information technology, and variety of products that are capable of entertaining the customers and integrating into the global Islamic financial market.

1.2. Industrial Development Activities

Bank Indonesia supports the development of the industry in a Grand strategy for Islamic Banking Market Development program. The program focuses its activities into three areas, i.e.: public education, institutional strategic alliances, and knowledge sharing within the central bank.

1.2.1. Public Education in Islamic Banking

This program is aimed at upgrading the operational competence of the players. The programs conducted cover Basic Training on Islamic Banking

(BEIB) in terms of Service Excellence, iB Workshop, Training of Trainers (TOT), and contributions in various conferences. The BEIB Plus Service Excellence program was designed for Islamic banking frontliner to upgrade their operational skill and service excellence. The programs were also adopted at the manager level through iB Workshop in the area of Leadership and Change Management. This is to further equip the players with paradigm on how to cope the dynamics and future challenges.

In oreder to meet the increasing need and to support the availability of the trainers, Bank Indonesia has also conducted several Training of Trainers (TOT) for lecturers and students. The program was conducted on subsequent basis in cities across the countries. At the same time, Bank Indonesia has also contributed in a number of activities and seminar which were open to all stakeholders of the industry.

Bank Indonesia has also conducted two types of awareness program covering above the line (ATL) and below the line (BTL) programs. The ATL programmes are awareness programs that are conducted using advertisement on Islamic Banking (iB is read as ai-bi) in various information media such as radio, print media, television, indoor media, and outdoor media. Whilst the BTL programs were conducted in trms of Fesitival Ekonomi Syariah 2009, Bank Indonesia Booth at Pekan Raya Jakarta 2009, iB Blogger Competition in Kompasiana.com, and several other events that are on going until the end of 2009. To synergize the program, Bank Indonesia together with Islamic banking industry has formed forum in marketing and communication at the beginning of 2009. The forum was designed as a place for sharing of opinion, exchange of information and in conjunction with the awareness program of Islamic banking.

1.2.2. Institutional Cooperation at Domestic and International Level

Bank Indonesia has initiatied some formal institutional cooperation both at domestic and international levels through business synergy at the area of education and training. At domestic level, the program includes National

Shariah Board – Indonesian Council of Ulama (NSB-ICU), International Center for Development in Islamic Finance (ICDIF) – LPPI, and leading universities as well as prominent training institutions in Indonesia.

Bank Indonesia cooperation with NSB-ICU is aimed at improving upgrade the quality as well as the quantity of Islamic scholars in the field of Islamic banking particularly to the scholars who are also the member of Shariah Supervisory Board taking part in proposing the sharia jurisprudence (fatwa) related to Islamic banking. The cooperation covers Islamic Banking Shariah Supervisory Board Capacity Upgrading and Certification Program, Islamic Banking New Fatwa Discussion Program, Awareness and Training Program for Shariah Supervisory Board Members and NSB-ICU Board in the form of Discussion with the theme Contextualization and Actualization of NSB-ICU Fatwa and Ijtima' Sanawi 1430 H Program.

As for the cooperation with Indonesian Institute of Accountants – Islamic Accounting Commitee, Bank Indonesia is involved in its Islamic accounting standard development program. Meanwhile, Bank Indonesia and ICDIF-LPPI has conducted several trainings such as Basic Training in Islamic Banking, Shariah Plus Service Excellence and Course on Islamic Banking and Finance with support from Department of Foreign Affairs – Republic of Indonesia, attended by participants from Asia Middle East Dialogue (AMED) members. Cooperations with Asbisindo, MES and PKES were also developed to support the awareness programs. One of the programs was M-Life Festival held during the month of Ramadhan 1430H.

At the international level, Bank Indonesia has contributed as a full member at several international financial standards-setting bodies such as Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) since it was established. As a full member, Bank Indonesia has involved in a number of strategic decision-making processes and working groups setting prudential standards, i.e. Capital

Adequacy, Sharia Governance, Bussiness Conduct, dan Prudential Islamic Finance Database.

1.2.3. Internal Competence Development

Bank Indonesia conducted several programs to internally upgrade the competence of Bank Indonesia employees through various trainings and equipping the internal system. One of the efforts was the formation of Islamic Banking Committee (IBC) that assists Bank Indonesia in translating the fatwa issued by DSN (NSB-ICU) into Bank Indonesia regulations. This is to accelerate the process in incorporating the fatwa operationally. IBC consists of 11 members holding variety of expertise in terms of fiqh, economics – finance, legal aspects and marketing.

1.3. Regulatory Activities

Regulatory activities for the year 2009 were a continuation program to refine the existing regulations in response to the enactment of Islamic Banking Act No. 21 of 2008. Several regulations which are related to institutional building such as Islamic Commercial Bank, Islamic Business Unit, Islamic Rural Bank, Conversion from Conventional Bank to Islamic Bank, Fit and Proper Test have been issued. The issuance of these regulations is to accomodate the content of the new Islamic Banking Act, which may be incompatible with existing regulations.

In addition, after the enactment of Act No. 6 of 2009 concerning Government Regulation Replacing Act No. 2 Year 2008 concerning Second Amendment on Act No. 23 of 2009, a new banking regulation has been issued concerning Short Term Facilities for Islamic Commercial Bank and Islamic Rural Bank.

1.3.1. Regulations Responding to Islamic Banking Act No. 21 Year 2008

A. Bank Indonesia Regulation Number 11/3/PBI/2009 dated 29 January 2009 Concerning Islamic Commercial Bank

The regulation was in response to specific clauses stipulated under Islamic Banking Act namely legal status of ICB. Under the new regulation, Bank Indonesia only recognizes banks as limited liability companies (Perseroan Terbatas – PT), and it does not recognize a bank that is incorporated as government owned company or cooperative. In addition, another new regulation in place is regulation for self - liquidition by banks.

Another things under consideration, apart from Islamic Banking Act. No. 21 are harmonization of PBI with other regulations, including terms such as "Cash Activities Outside the Office" replaced by "Cash Services Activities" (CSA), and in the event of discharging and/or resignation of any member of Board of Commisioners, Board of Directors, and Shariah Supervisory Board must be reported to Bank Indonesia.

In lieu of supporting Islamic banking development in the future, several mechanisms on licensing and reporting have been simplified, namely:

(i) The planning of CSA opening shall only be reported in the Bank Business Plan. It includes also the event of the opening, change of address and closing of CSA that are reported to 3-Monthly Realization Report of the bank Business Plan.

(II) The upgrading office status from Sub-Branch to Branch requires only regulation fullfilment for Office Branch opening.

(III) The downgrading of status of Branch to Sub-Branch requires only a report to Bank Indonesia.

(IV) The closing of domestic branch only requires to process at one stage; and

(V) The closing of overseas branch only requires a notification to Bank Indonesia

B. Bank Indonesia Number 11/10/PBI/2009 dated 19 March 2009 Concerning Islamic Business Unit

Relatively recent update of Bank Indonesia Regulation is the obligation of Islamic Business Unit (IBU) to obtain license from Bank Indonesia, as stipulated under Islamic Banking Act No.21 (Article 5). IBU working capital is set out for Rp.100.000.000.000 (one hundred billion) by the new regulation, under which the status of IBU Director is Board of Directors from Conventional Bank that is responsible for IBU. IBU Director has to possess adequate competency and commitment for SBU development and attend interview session with Bank Indonesia.

The PBI requires that IBU must be separated from its holding company (spin off), if the following fulfilled:

1. IBU asset has reached 50% (fifty percents) from the total assets of the holding company (conventional Bank); or
2. Minimum of 15 years after the enactment of Islamic Banking Act No. 21

The separation of IBU from its commercial holding bank can be exercised with the establishment of a new Islamic Commercial Bank entity, and relocating all rights and obligations of IBU to the new existing ICB. The paid up capital of ICB is set out minimum of Rp. 500.000.000.000 (five hundred billions rupiah) and must be upgraded in stages to a minimum of Rp.1.000.000.000.000 (one trillion rupiah) in 10 years after the release of the license. In the case of the Conventional Bank fails to exercise the separation of IBU therefore the IBU license shall be revoked. Thus, IBU in Indonesia will be no longer in existence by the year of 2023.

C. Bank Indonesia Regulation Number 11/15/PBI/2009 dated 29 April 2009 Concerning Changes in Business of Conventional Bank to Islamic Commercial Bank.

With a reference of Islamic Banking Act, conventional bank is allowed to change its business unit to Islamic Commercial Bank; but considering the shariah aspects; Islamic Commercial Bank is not allowed to change its business to Conventional Bank.

Financially, to convert the business line from conventional bank into Islamic Commercial Bank, the bank has to have a minimum CAR of 8%

and minimum paid up capital of Rp. 100.000.000.000 (one hundred billion rupiah).

Conventional Bank that has obtained license to convert its business into Islamic Bank shall resolve its rights and obligations as a conventional bank in a period of 1 (one) year since the date of the approval.

D. Bank Indonesia Regulation Number 11/23/PBI/2009 dated 1 July 2009 Concerning Islamic Rural Bank

Similar to IBU, legal status of Islamic Rural Bank (IRB) is limited to Private Limited as stipulated by Islamic Banking Act No. 21 Year 2008. With regard to its ownership, this regulation states clearly that IRB is not permitted to build and/or owned by non- Indonesian citizen nor non-Indonesian legal status company.

The opening of IRB Branch Office shall be relocated at the same province of the holding. Nevertheless, for equity requirement, IRB planning to have a new branch shall inject minimum additional capital of 75% (seventy five percents) from minimum capital requirement.

E. Bank Indonesia Regulation Number 11/31/PBI/2009 dated 28 August 2009 Concerning Fit and Proper Test on Islamic Bank and Islamic Business Unit

The rationale of the regulation concerning Fit and Proper Test is to further maintain public trust, and to stimulate implementation of good corporate governance of Islamic Commercial Bank and Islamic Business Unit.

The Fit and Proper Test comprises of 2 types based on the nature of the objects:

(i) 1. The Fit and Proper test for Majority Shareholders, Candidates of Majority Shareholders, Candidates for Islamic Commercial Bank Board of Commisioners and Board of Directors and Candidates for IBU Managing Director.

(2) The Fit and Proper test for Majority Shareholders, Board of Commisioners, Board of Directors, Executives of Islamic Commercial Bank, who are in this case indicated to involve in any event of disobedience including fraud in the operation of ICB and IBU.

The Fit and Proper Test is conducted to ensure that human resources of the Islamic banking are filled with integrity, competence, and good reputation. The test consists of administrative fulfillments and interview session/s.

1.3.2. Regulations Responding Act No. 6 Year 2009

A. Bank Indonesia Regulation Number 11/24/PBI/2009 dated 1 July 2009 Concerning Short Term Facilities for Islamic Commercial Bank

As stipulated in the Amendmend of Government Regulation (PERPU) No. 2 of 2008, Bank Indonesia must facilitate Islamic Short Term Funding Facilities (known as FPJPS) for Islamic Commercial Bank for the tenor of 90 (ninety) days and high quality collateral that meet the minimum value of the amount of the facility.

ICB that faces liquidity shortage may obtain FPJPS using Mudharabah contract. FPJPS can be applied if the bank is in solvent position. The FPJPS is guaranteed by the bank with its high quality collateral such as bonds and assets from that have current ratings.

The period of FPJPS is 14 (fourteen) days and the period is extendable to the whole period of FPJPS at maximum of 90 (ninety) days.

B. Bank Indonesia Regulation Number 11/29/PBI/2009 dated 7 July 2009 Concerning Short Term Facilities for Islamic Rural Bank

Islamic Rural Bank (IRB) facing liquidity shortage may apply for Islamic Short Term Funding Facility (known as FPJPS) using mudharabah contract. The criteria of IRB eligible for the facility are: (i) possesing collectible indicator as current level 3 for the last two periods; (ii) possessing management evaluation at the level of minimum C for the last two periods; and (iii) possessing negative cashflow for the last 14 (fourteen) calender days. FPJPS is guaranteed by IRB with high quality collateral that has minimum value to the amount of the facility and/or shareholders' bond.

The period of FPJPS is 30 (thirty) calender days and the period is extendable to the whole period of FPJPS for maximum of 90 (ninety) days.

1.4. Supervisory Activities

Islamic banking supervision is aimed at ensuring Islamic banks develop with measurable soundness and efficiency, adopting good corporate governance, adopting prudence principle, and complience with sharia principles. In order to perform the supervisiory function, Bank Indonesia as a banking authority has conducted on site and off site supervision, which includes observation, assessment, and analysis of bank conditions. Supervision of individual Islamic banks is based on the results of risk assessment focusing on specific areas portraying high risks and problems in the future.

1.4.1. Islamic Banking Issues During 2009

The main problems faced by Islamic banks during 2009 were generally related to liquidity risk and credit risk. This is the impact of the global economic crisis affecting the economy and the national financial sector in general that occurred in the previous year. Related to potential increase in liquidity risk, Bank Indonesia has been implementing anticipatory steps including daily, weekly, and monthly liquidity monitoring, in particular on certain balance sheets accounts, analysis of the sources of funds, including analysis of Inter-bank Islamic Money Market transactions, secondary reserve monitoring to Third Party Funds, fulfillment of Current Account Requirement, Net Reserve position, financing and securities growth, and simulation of the resilience of liquidity and bank capital. In general, the liquidity risk of Islamic banking since the second quarter of 2009 is in a controllable position.

The global economic crisis indirectly affects the performance of Islamic banking. The deteriorating condition in the real sector economy affects costumer ability to meet its obligations to the bank which subsequently increases the credit risk. This is reflected by the increase in portion of Non-Performing Financing (NPF) to 5.72% per September 2009. Financing under special attention (coll-2) during 2009 also increased significantly, thus it led to potential increase of NPF. Despite the increase in credit risk, Islamic banking in general still has sufficient capital to cover the potential loss in the future.

In response to the financing problem, supervisors have conductied proactive anticipatory actions by requesting the particular banks to draw action plans to overcome the situation and contingency steps if necessary. Islamic banks under Intensive Supervision' are demanded to submit more detailed reports allowing the supervisors to detect financial development and other strategic issues.

In case of problems requiring immediate action, Bank Indonesia launched special examinations or and asked commitments on the action plans from the bank management.

1.4.2. The Level of Profitability

Despite its insignificance to affect Islamic banking directly, the global crises it has affected the Islamic banking profitability. This is due to high equivalent rate of margin and profit-sharing ratio imposed by Islamic banks to the customers as the main source of income. Wth a relatively smaller critical mass, islamic banks still have higher fixed costs and at the same time the banks are require to allocate more allowance for earning asset losses that subsequently reduce its profitability. Islamic banks in general, has determined the base lending rate with its main component of the cost of loanable funds (CoLF), overhead costs (OHC), spreads and risk premiums. The OHC covers of labor expense, rental expense, promotion expense, fixed assets depreciation, maintenance and repair expense and tax expense, while the amount of spread is calculated based on the determined risk premium according to the criteria of the prospective customer i.e economic sector and customer ratings.

1.4.3. Islamic Banking Information Technology

Implementation of business strategy and ability to compete with conventional banking requires advancement in information technology (IT). This is necessary for Islamic banking to arrive at a reliable value when adopting the concept of beyond banking promoted by the industry. In order to cope the future business challenges, most of the banks are now procuring new IT infrastructure. The final objectives os to enternain the customers with financial efficiency and ease.

IT Development in IBU may benefit from the current core banking system existing in the conventional counterparts. Thus providing the same reliability as the holding bank, from the aspect of availability, confidentiality, validity, and security as well. Utilizing of the holding bank's IT infrastrucutre may also serve as an alternative solution to overcome technological shortcoming in the IBUs. So far, IT development program in Islamic banking has been successful in generating good fee-based income, i.e fees gained from Internet banking, mobile banking, and ATM.

Eventually, the use of more sophisticated banking information technology requires adequate risk management process capable of overcoming any technological failure. Bank Indonesia through Bank Indonesia Regulation Number 9/15/PBI/2007 Concerning Risk Management in Utilizing Information Technology by the Commercial Banks, has regulated the banks, including Islamic banks, to mitigate the risks of operating IT. During 2009, Bank Indonesia has conducted monitoring and inspection of IT operation in Islamic banking to ensure reliability and security of the system and to make sure that the IT development is pursued in a continual basis.

1.5. Licensing Activities

1.5.1. Institutional Licensing

In 2009, number of Islamic Business Unit (IBU) and Islamic Commercial Bank (ICB) increased after the issuance of the license for IBU of PT Bank OCBC NISP Tbk in September 2009 and IBU of PT Bank Sinarmas in October 2009, and license to convert business activities of PT Bank Harfa to ICB under the name of PT Panin Bank Syariah in October 2009. That made up the ICB to 6 banks and IBU to 25 units. The number of ICB is expected to increase until early 2010 given the fact some new applications are in the the pipeline.

The number of IBU in 2009 decreased as compared to that of 2008 due to the closure two IBU licenses of the conventional banks, namely PT Bank IFI and PT Bank Export Indonesia (Persero), and the spin-off of the IBUs. In 2009, Bank Indonesia has approved two spin-off licenses for PT Bank Rakyat Indonesia (Persero) Tbk and PT Bank Bukopin to become separate entities of ICB, namely PT Bank BRI Syariah and PT Bank Syariah Bukopin. The office network of ICB and IBU up to September 2009 experienced a significant increase to as many as 107 offices. Islamic Office Channelling Services of IBU even increased to 215 units. Further, in the same period, 7 business license of the new Islamic Rural Banks (IRB) have been granted. The number of IRB up to September 2009 is 137 units with additional 8 licences to be issued in the near future.

1.5.2. Product Licensing

Product licensing process for ICB and IBU are classified into two main activities, namely: (i) confirmation on products similar to those existed in the Codification Book of Islamic Banking Products, and (ii) approval/rejection of new products that are not existed in the codification book. During 2009, Bank Indonesia has confirmed 29 ICB and IBU, and has approved 2 new Islamic Banking products. New ICB and IBU products that have been confirmed are products that already exist in Islamic banking with and without additional features such as wadiah/mudaraba iB-saving with free administrative costs facility, *mudaraba* iB savings with insurance coverage, iB *mudaraba savings* in Dollar with Safe Deposit Box facility for customers, iB *mudaraba saving* account for individual customers with additional ATM withdrawals facilities and additional cash transfer service features to cash in Inter Country Transfer products.

New products approved by Bank Indonesia are iB *Musharaka Mutanaqisah* Financing Products and Wa'ad iB Foreign Exchange Product (FX). *Musharaka Mutanaqisah* financing products is in reference with the Fatwa of DSN-MUI No.73/DSN-MUI/XI/2008 dated November 14th, 2008 Concerning *Musharaka Mutanaqisah*. This financing product is a Musharaka financing scheme in which the amount of capital is gradually declining along with the purchase from Musharaka partners. Both banks and the customer act as business partners to jointly provide the funds and/or asset to finance a certain business activities. The banks and the customer bear the loss proportionately according to the portion of their capital.

IB *Wa'ad* FX product is in reference with the Fatwa DSN-MUI No.28/DSN-MUI/III/2002 dated March 28, 2002 on the Sale and Purchase of Foreign Currency (Al-Sharf). This product is a sale and purchase of currency transaction by more than 2 days settlement using *wa'ad* (promise) scheme and will only be offered to customers who already have an Trade Islamic financing facility, which is not used for the purpose of speculation. Both banks and customers make agreement on the general provisions of buying and selling foreign currency. Customer then sends an appointment letter for certain currency to buy other currencies with a currency foreign exchange in the future such as 30, 60, or 90 days. Before the settlement date of the FX transactions, a customer sends an offer letter to execute the transaction. The Bank is not obliged to accept the offer of the customer, but if the bank accepts the bid, then the customer is unable to cancel the transaction and has to pay according to the purchase price or to sell the currency on the settlement date.

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CHAPTER 2

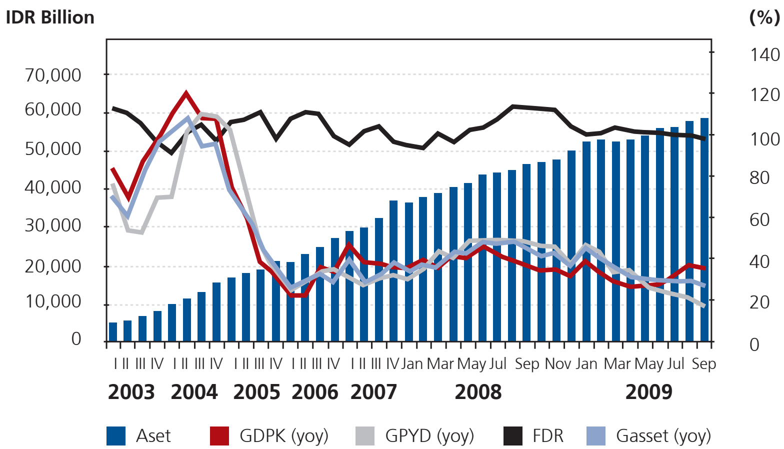
Development of Islamic Banking 2009

2.1. Overview

The strong pressure on national economy in the middle of 2008 due to the global crisis, has caused slowing down of the economic growth in 2009. However, Islamic banking continued to show positive performance, despite competing in an increasingly competitive environment along with decreasing trends of interest rate followed by stronger position of capital market and non-bank financial industry.

As a part of national banking industry, Islamic banking development showed relatively high growth in terms of business volume (26.55% y-o-y). Although the growth was relatively lower than the previous year but it was higher than that of the conventional banks (12.5% y-o-y). In general, Islamic banking still showed good performance marked by effective intermediary function, along with higher funding and financing growth compared to the conventional one. Also, the availability of wider network access that meets increasing demand of the society, thus laid a strong foundation towards the recovery of national economy.

Graph 2.1
Islamic Bankin Performance



The sluggish growth of the national economy left the impact on high financing risk and tight competitiveness in funding distribution. It was similar with the decrease in the conventional banking interest rate that slowed down the growth of financing of Islamic banks. This can be seen from the growth of financing in September 2009, which was only 18.16%, or lower compared to that of the same period in 2008 or 42.9%. However, during the same period, Islamic banks third party fund recorded significant growth at 35.19% (yoy). One of the causes was the competitive profit sharing scheme of third party fund, beside high trustworthiness from society towards Islamic banking services. The increase of third party fund, which was not balanced with the disbursement of financing, caused a decrease in Islamic banks profitability. However, the effectiveness of Islamic banks still maintained the financing to deposit ratio above 90%.

In terms of outreach, Islamic banking services during this reporting period has reached more than 89 districts/cities in all 33 provinces of Indonesia, although the big portion still remained in Jakarta area with the equivalent of 46.12% from the total Islamic banking financing. The expansion of the networks capacity has encouraged the participation of larger segment of the society to become customers/users of banking services, as indicated by an increase of bank accounts/deposits that reached 4.5 million accounts until September 2009.

2.2. Institutional Development

In 2009, the number of Islamic banks increased due to conversion of 2 Islamic Business Units (IBU), which are PT Bank Rakyat Indonesia (Persero) Tbk and PT Bank Bukopin, into Islamic Commercial Banks (ICB). The number of IBU has changed due to the closing of 3 Islamic Business Units as a result of liquidation (PT Bank IFI), and merger of the bank (PT Bank Niaga and PT Bank Lippo into PT Bank CIMB Niaga) as well as conversion of holding/parent bank into non-bank financial institution (PT Bank Export Indonesia). Whilst until the end of September 2009, new license for IBU of PT Bank OCBC NISP Tbk has been released.[2]

2 There were 2 licenses issued for PT. Bank Sinar Mas (Shariah Business Unit) and PT. Bank Panin Syariah (Islamic Commercial Bank) in October 2009.

At the same time, the operational network of Islamic banks showed a significant increase up to September 2009 as compared to the same period in 2008. This condition was due to additional outlets of Islamic banking services that has reached 218 offices, in terms of branch and sub-branch offices of ICB and IBU, and additional of 245 Islamic banking services provided by conventional banks at their branch offices (office channeling). As of September 2009 there were 1,059 Islamic bank offices operated by 5 ICBs and 24 IBUs together with 1,685 Islamic banking services via office channeling. (Table 2.1.)

Table 2.1
Office Networks

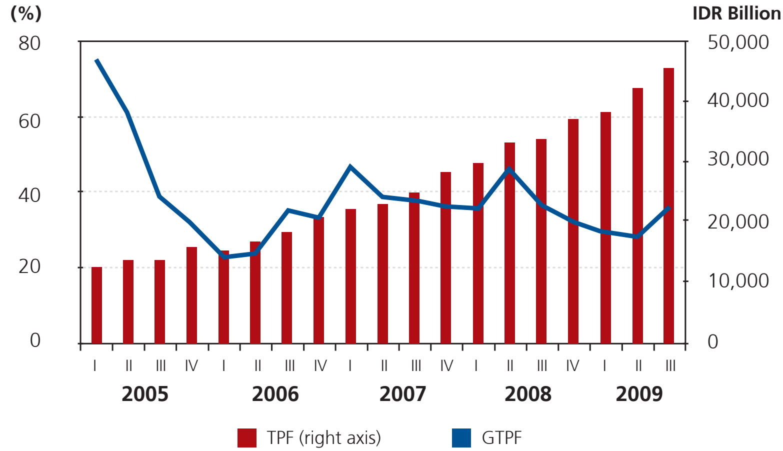
Group of Bank	2007	III-08	IV-08	I-09	II-09	III-09
Islamic Commercial Bank (ICB)	3	3	5	5	5	5
Islamic Bank Unit (IBU)	26	28	27	26	25	24
Number of ICB & IBU	711	841	953	1021	1032	1059
Number of Islamic banking service	1195	1440	1470	1618	1680	1685

2.3. Funding

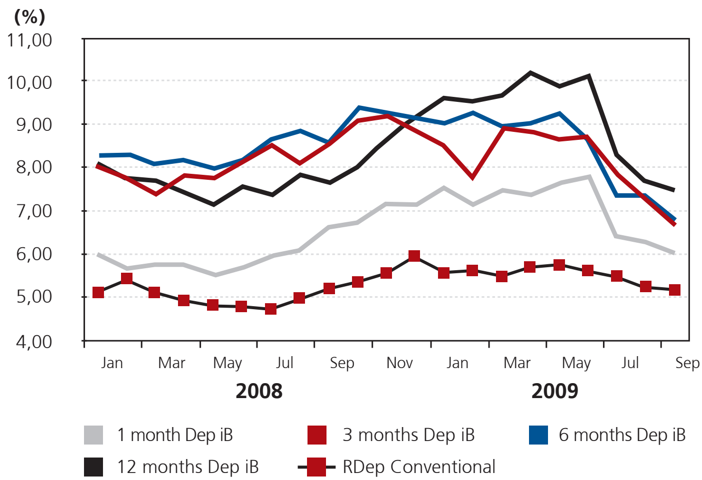
After the global financial crisis, the performance of Islamic banks funding recorded a downturn until mid of 2009, but then it rebounded and showed significant improvement during the third quarter with rapid growth of 35.19% (yoy), although it was still a little bit lower than the same period last year at 36.01% (yoy), as showed by Graph 2.2.

The growth of the third party fund was significantly affected by the competitivenes of the returns offered by Islamic banks, though it was decreasing in the second semester of 2009 (Graph 2.3).

Graph 2.2
Development of Islamic Bank's Third Party Fund



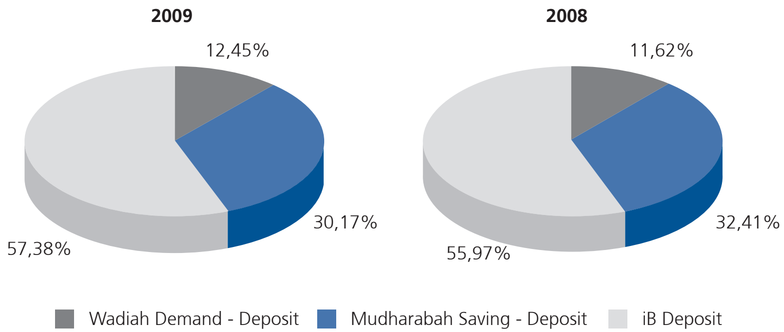
Graph 2.3
Comparison of Average Deposit Interest Rate of Conventional Bank
and Deposit Returns Equivalent of iB Bank



As for September 2009, longer term deposits with higher rate of return acquired higher portion than shorter term savings. iB term-deposits acquired 57.38% of the total funds, or higher than the same period in 2008 where the portion reached

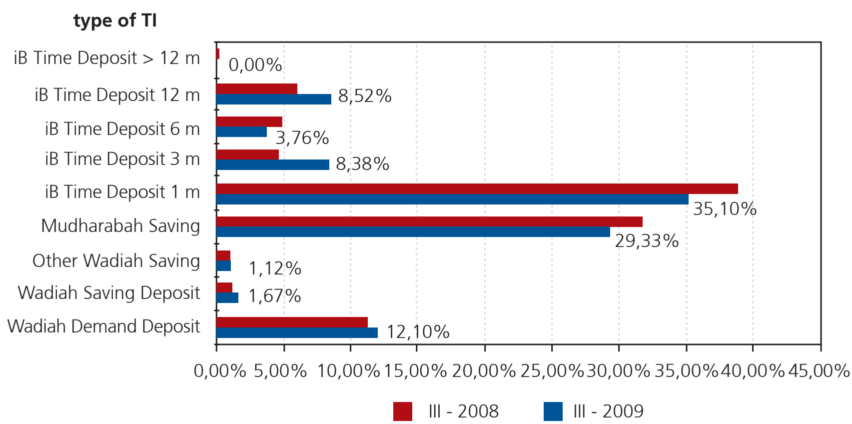
55.94%. The increase also occurred at iB demand-deposits (wadiah) with the share of 12.45%. (see Graph 2.4).

Graph 2.4
Proportion of Islamic Banking Portfolio



From maturity perspectives, public tends to opt the longer time deposits in 2009. This can be seen from Graph 2.5, where 12-months and 3-months time deposit showed an increase from 6.06% and 4.72% in the third quarter of 2008 to 8.52% and 8.38% in September 2009, respectively. Whilst, the player prefered less risky instrument due to an adverse economic situation. If the situation persisted, it could jeoperdize the operational sustainability in the long run.

Graph 2.5
Proportion of Islamic Bank's Third Party Fund (in %)



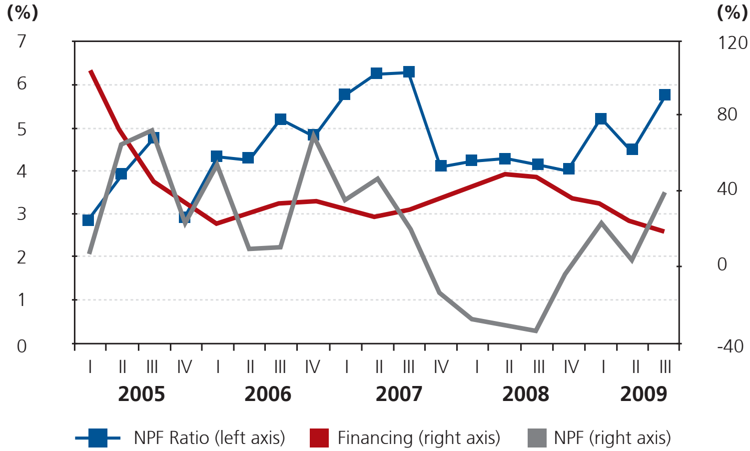
The increase of corporate customers in 2009 is in terms of iB deposit and iB current accounts from 87 thousands to more than 100 thousands accounts. Overall, during 2009 the third party fund's account for Islamic banking increased by 892 thousands accounts to make up the grand total of 4.55 million accounts. (see Graph 2.6)

Graph 2.6
Development of Third Party Funds Account as Group of Customer

2.4. Fund Disbursement

For the reporting period, fund disbursement of the Islamic banking, especially financing experienced a decline by 18.16% (yoy), lower than that of 2008 (47.25% yoy). The slowdown mainly occurred at the beginning of the year, and had started since the end of 2008. Considering that Islamic banking financing is always closely related to the real sector, the slowdown of the economy due to a weak export demand and downward pressure on commodity prices may affect business expansion and decline in consumption. The weak performance was also reflected by the increase of financing default significantly (Graph 2.7).

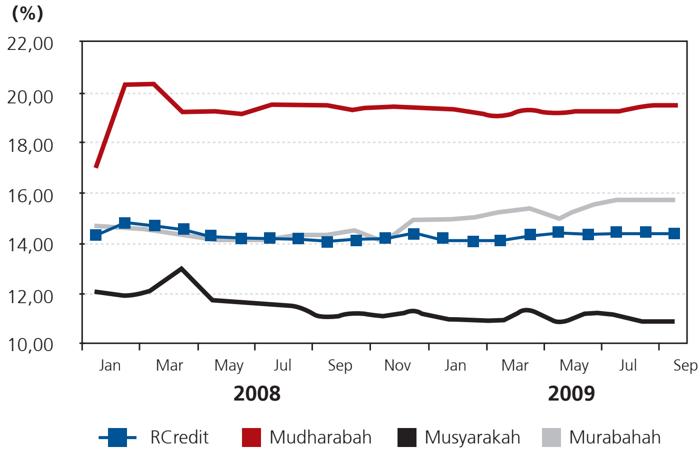
Graph 2.7
Development of Non Performing Financing



The increase of financing default during the reporting period indicated by the non-performing financing (NPF) ratio of 5.72%. The increase of NPF mainly occurred in consumption/consumer financing, especially for home financing, in addition to NPF increase for trade sector, hotel and restaurant, as well as services sector that are considered as the main sector of Islamic financing - thus exposure to risk is higher. With this condition, as the ability of Islamic banks to manage risk is still elementary, therefore apart from other factor such weakening of the real sector, internal factors that have been identified to cause diminishing quality of financing includes imprudent decision making as well as risk and price appraisal that are not sensitive to the decrease of conventional bank's interest rate (Graph 2.8). This caused some customers to shift away their financing from Islamic banks.

Graph 2.8

Equivalence Rate of Financing of Islamic Banks and Banking Credit

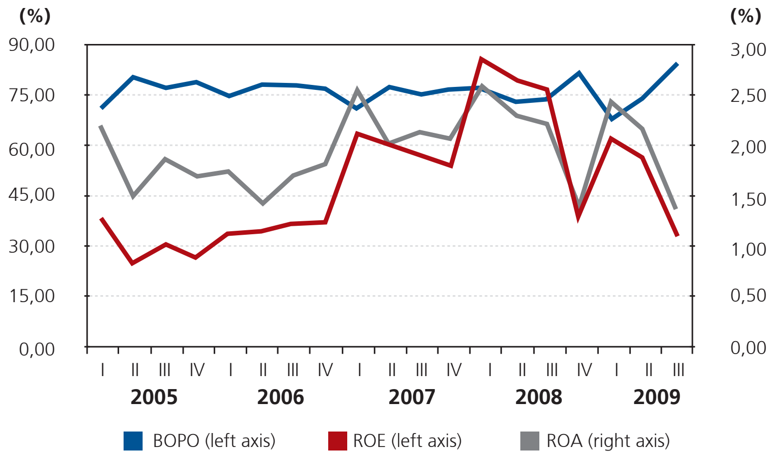


However, in general, the risk that was caused by high financing default is still within the anticipated range of the Islamic banks as reflected by NPF ratio (net) of 2.95%.

2.5. Profitability and Capital

The poor condition of real sector since the end of last year, followed by a decline in financing performance and tightened competition with conventional banks, had caused the decrease in profitability. This is reflected by a decrease in ROA from 2.21% in September 2008 to 1.40% in September 2009. The increase of operational cost by 52.9% (yoy), which in turns resulted in BOPO (operating cost/operating revenue) ratio of Islamic banks to increase and caused ROE to drop as shown by Graph 2.9. The drop in profitability was majorly contributed by write-off.

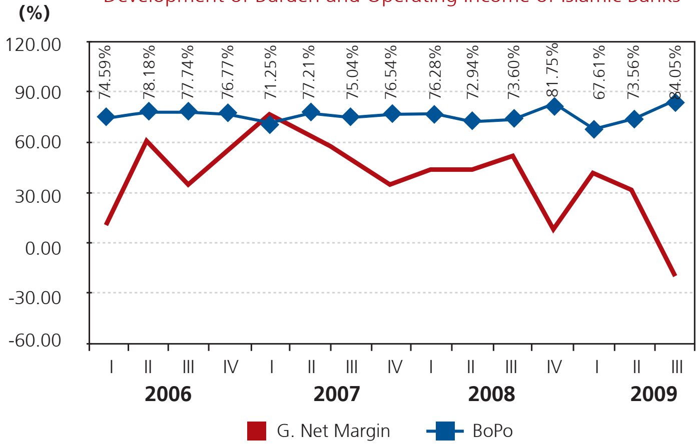
Graph 2.9
Development of Islamic Banking Profitability



On the revenue side, the efforts of Islamic banks to maintain profitability can be seen from increases in relatively high operating income from Rp.4.06 trillion in September 2008 to Rp.5.65 trillion in September 2009, or it grew by 39.4% (yoy). The revenue from fund disbursement, especially in the form of murabahah financing was still the main contributor. However, some revenue diversification measures have been intensively implemented, as reflected by significant growth of the fee-based income by 100.22% (yoy). Nevertheless, in an attempt to maintain attractiveness of fund mobilization, Islamic banks increased allocation of returns to their fund owners (depositors), which caused net revenue of Islamic banks, grew only by 33.99%.

The growth of cost that was match by revenue growth had caused declining efficiency of Islamic banking operation where the ratio of operating cost to operating income reached 84.05%, much higher than that of 2008 (73.60%). This should cause concerns as decreasing efficiency may possibly be followed by a rise in financing default; where if it is persistent may cause a decrease in capital adequacy. For a reference, the average CAR of Islamic banks for the reporting period is still sufficient, at 11.6%.

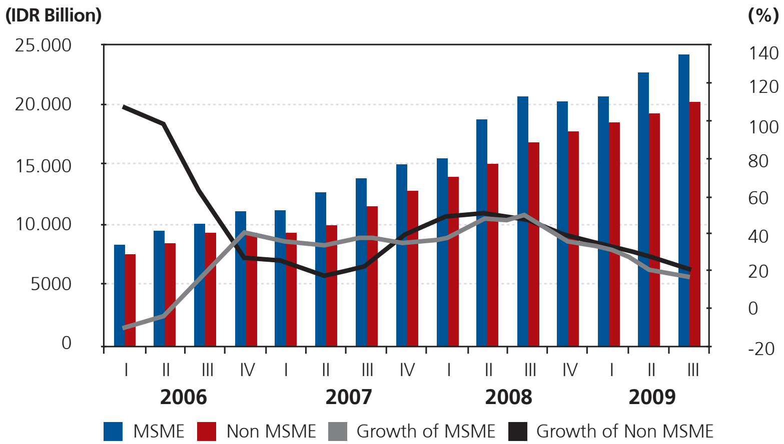
Graph 2.10
Development of Burden and Operating Income of Islamic Banks



2.6. Financing of Micro Small Medium Enterprises (MSME) and IRB

Financing to MSME sector still acquired a significant portion in the portfolio in terms of working capital or investment to the sector that reached Rp. 24.19 trillion or constitutes 54.32% of the total financing by ICB and IBU. High number of financing towards MSME sector is in line with its high market potential and its extensive coverage throughout the country.

Graph 2.11
MSME Financing by Islamic Banks



However, in line with the slowing growth of financing, the growth of financing (working capital and investment) to MSME sector also experienced a slowdown from 48.23% (yoy) at the third quarter 2008 to 16.90% in September 2009. The sluggish growth of financing to MSME sector is probably caused by decreasing demand in business financing and strong competition from conventional banks, in addition to an increase of Islamic banking prudential stance.

Apart from direct financing to MSME customers, the financing of ICB and IBU to MSME sector is also conducted by way of linkage financing program through Islamic Rural Banks (IRB). With this program, it is expected that financing by commercial banks to MSME can be carried out more efficiently and effectively, mainly by utilizing the role of IRB as community/local banks that knows best the characteristic of MSME customer in its area.

Other significant and encouraging development is the increase in business volume of IRB by 24.24% and the combined total asset as of September 2009 is Rp 1.96 trillion. IRB also demonstrated a good intermediary function as reflected by Financing to Deposit Ratio (FDR) of 131,62% until September 2009. Also, the quality financing of IRB during the same period tend to improve where the ratio of NPF was 8.12%, or lower compared to the ratio of NPF in 2008, or 8.38% gross and net NPF of 6.65%.

Table 2.2

Profile of IRB Finance

Description	2006	2007	2008	I-2009	II-2009	III-2009
Number of Office	105	114	131	133	133	136
Total Asset	906,325	1,207,198	1,693,363	1,747,780	1,820,576	1,957,971
Total Financing	636,287	879,744	1,256,610	1,332,419	1,409,900	1,520,771
Total Third Party Funds	529,821	717,858	975,815	1,034,228	1,082,786	1,155,428
FDR	120.02%	123.69%	128.78%	128.83%	130.21%	131.62%
NPF (Gross)	8.29%	7.99%	8.38%	8.41%	7.91%	8.12%
NPF (Netto)	7.09%	6.62%	6.19%	6.51%	6.20%	6.65%

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CHAPTER 3

Prospect and Policy Direction

As has been previously discussed, Islamic banking condition in 2009 showed decreasing trend in business volume growth and level of profitability. Nonetheless, there are certain upcoming opportunities in the year 2010 such as: conducive tax regulation (Act No. 42 year 2009 on Value Added Tax), higher credit rating for Indonesia, relatively high growth for Indonesian economy at global level, new establishment of Islamic banking, and awareness program, Islamic banks and other concerned parties. Meanwhile, new challenges have to be taken into consideration either from internal Islamic banking business or its external factor. Internal factors are matters related to increasing in competitive advantage, upgrading in service quality, efficiency as well as improvement in non-performing financing. On the other side, external factors are related to global crisis recovery that can influence national macro economy condition and Islamic banking business activity and also the volatility risk on fuel price.

3.1. The Prospect of Macroeconomic Condition

In general, the global economy is in contraction throughout 2009 indicated by a decrease in economic growth rate. However, most regions are slowly recovering from the crisis that first occurred in the second semester of 2008. This recovery has been largely led by satisfactory economic performance in some Asian countries. The recovery is also evident from a sluggish economic contraction of the developed countries, compared to near distress in the past year. Overall, the process of economic recovery in 2009 will have its effect to the global economy in 2010. The IMF projected this bullish sentiment in the World Economic Outlook published in October 2009, so does Consensus Economics Inc. (November 2009), a survey that estimated the global economy would recover in all regions (Table 3.1).

As one of the emerging markets in Asia, Indonesian economy was able to maintain a relatively stable growth rate during the crisis. As previously estimated, the Indonesia's economic growth was effectively driven by domestic demand and stable consumption in agriculture, communication, construction, trade as well as transportation sectors. In 2010, this pattern is expected to continue. Hence, expected economic recovery in the developed countries as the main trading partners of Indonesia, coupled with positive outlook of external trade would expectedly be able to ensure sustained economic growth for the country in 2010.

Tabel 3.1
The Projection of World GDP

		Consensus [1]		WEO [2]	
	2008	2009	2010	2009	2010
World output	2.0	-2.2	2.8	-1.1	3.1
Advanced economies					
United States	0.4	-2.4	2.7	-2.7	1.5
Euro zone	0.6	-3.8	1.2	-4.2	0.3
Japan	-0.7	-5.7	1.4	-5.4	1.7
Developing economies					
Eastern Europe	4.2	-5.7	2.3	-5.0	1.8
South East Asia	4.3	0.7	4.8	0.7	4.0
Asia Pacific	3.7	1.1	5.1		
China	9.0	8.5	9.6	8.5	9.0
India	6.7	6.1	7.5	5.4	6.4
Indonesia	6.1	4.4	5.4	4.0	4.8
Latin America	4.2	-2.2	3.4	-2.5	2.9

1) November Survey 2009, Consensus Economics Inc.
2) World Economic Outlook October 2009, IMF

In 2010 the national economy is expected to perform better that the previous year. This projection is supported mainly by growth of private consumption; higher export and existing fiscal stimulus. The strong performance of private consumption is mainly due to high consumers' confidence to the economy, given the facts that inflation is manageable, more conducive business environment, as well as the effect of high returns on exports. Government fiscal stimulus package, which has translated into encouraging consumption growth and high government investment spending, is expected to fully support performance of the domestic economy.

At the supply side perspective, the growth of some sectors is estimated to increase. This is in line with the domestic as well as strong external demand in the second semester of 2009. With this figure, Bank Indonesia could expect that in 2010 the economic growth could reach 5.0 – 5.5%. However, there are certain issues that should be taken into consideration in light of global economy recovery, especially indicators related to the advance economies, as they are Indonesia's major trading counterparts. The issues include domestic demand in most countries is driven by fiscal stimulus policy, high unemployment rate in the developed countries, and the rising tendency of protectionism among countries. Likewise, the volatility of oil price caused by speculative activities and unstable economy should cause some concerns and requires careful analysis.

From the consumer price data, stable inflationary outlook and expectation, appreciation of Rupiah, and low prices of global commodity had cause low inflation rate in 2009. While in 2010, Consumer Price Index (CPI) is estimated to return to its normal pattern of 5±1% rate, or in line with the increase of domestic economic activities, the increase of imported inflation due to an increase of commodity prices in the global markets, as well as the increase in expected inflation.

Further, an upgrade of the Indonesia's sovereign credit rating from Ba3 to Ba2 by Moody's is projected to have positive effect to the capital inflows and external finance premium. In fact, this condition would affect performance of the financial sector to generate economic stability, including exchange rate stability to achieve growth targets.

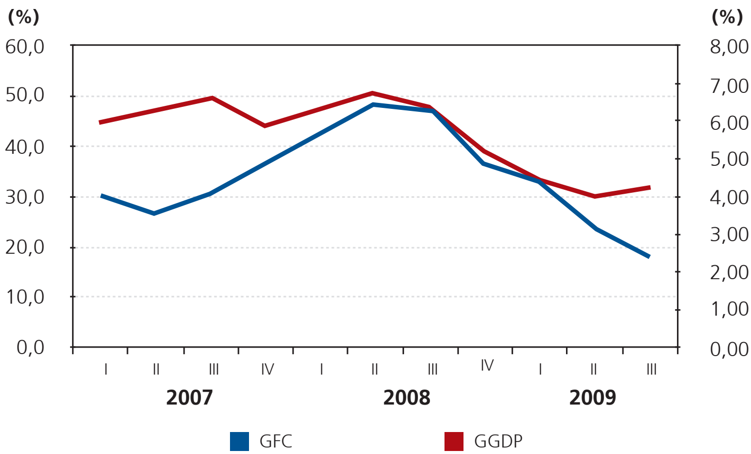
In an effort to strengthen the real sector, as stipulated in the past year economic policy and implemented in the previous year, the government is expected to continue to apply similar policies; for instance, the optimization of strategic sectors and industries to stimulate production and increase exports. In the case of supports to the Islamic financial sector, the endorsement of Act No.42/2009 concerning Value Added Tax that gives tax neutrality for Islamic financial transactions is operationally encouraging. The law is expected to improve efficiency and boost the growth of financial industry, especially Islamic banking sector. This VAT law has possibly addressed the main obstacles of Islamic banking development, mainly the issue of double taxation imposed on trading-based (murabahah and the like) transactions, which dominates the Islamic banking portfolio.

3.2. Macroeconomic Impact on Islamic Banking and 2010 Projection

3.2.1. Macro Impact and 2010 Projection Based on Generic Development

The impact of global financial crisis that had caused a decline in the world and national economic output, also affected the local banking sector. One of the impediments to the poor performance of national banking was general slowdown in the economy. This situation is somewhat different from other countries, especially developed ones, whereby the collapse of their banking industry was directly caused by the global financial crisis. The Indonesian Islamic banking is still at the early level of development and relatively not integrated to the global financial system, the growth of Islamic banking, which in this case proxied by the growth of financing, is not directly affected by financial performance, but rather by general economic condition (Graph 3.1.).

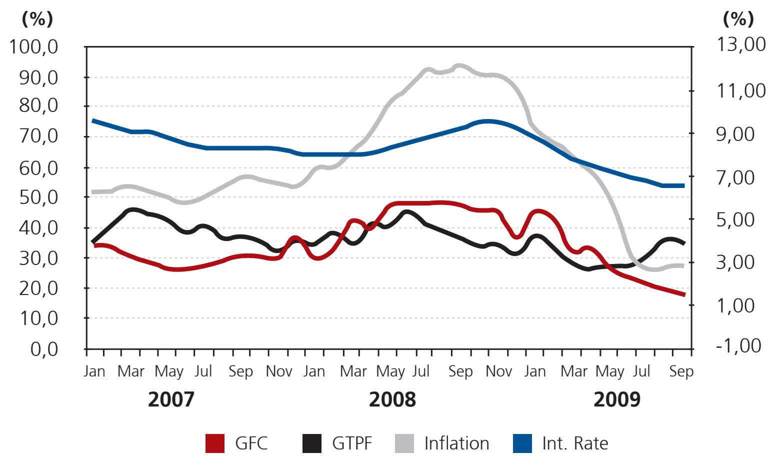
Graph 3.1
Growth of Islamic Banking Financing



Therefore, organic growth of the national Islamic banking industry (existing industry) will be affected by macro condition of the Indonesian economy and changes in banking sector environment. Some factors that have been identified to influence the growth of national Islamic banking industry, namely: (i) Act No. 42 Year 2009 concerning Value Added Tax (VAT), which will put into effect on 1 April 2010; (ii) an increase of Indonesian credit rating which reflects the decrease of investment risk in Indonesia; (iii) Indonesian economic performance which is able to grow positively during the crisis with higher growth compared to other countries in the region; (iv) the recovery of global economic performance.

The growth of the industry will also depends on its capability to mobilize more third party fund (TPF). The development of TPF in year 2009 shows negative correlation between the fluctuations of banking interest rate and the fluctuation of its TPF (Graph 3.2). This indicates a tendency of a decrease in interest rate along the year 2009, which is expected to augment the growth of Islamic banking TPF. Subsequently, the recovery of global economy that has been estimated to increase the economic volume of trading partner countries in all regions by 2010, will also stimulate national economic

Graph 3.2
Growth of TPF IB, Financing IB, interest rate and inflation

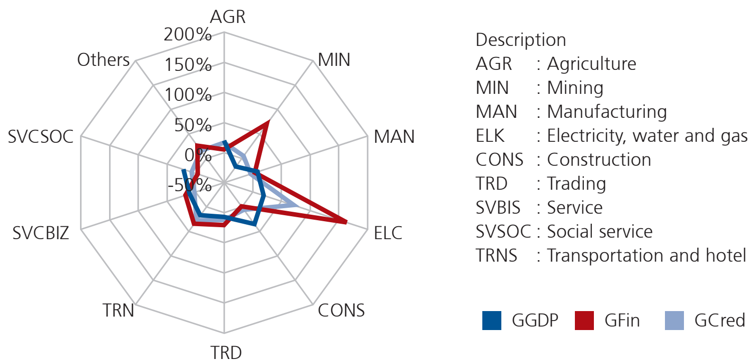


performance. Such condition may lead to the rise of inflation rate, which could be followed by relatively tight monetary policy with subsequent increase in interest rate. This condition is estimated to have an effect on Islamic banking performance, specifically in the funding side, where an increase in the interest rate is projected to slowdown competitiveness of Islamic banking in terms of return on deposits. If depositors of Islamic banking, especially the floating customers that are mainly corporations, shift their fund to the conventional ones that offer higher return, it will consequently put a pressure to the Islamic banking liquidity. Nevertheless, it is also subject to the government's effort to maintain the inflation rate.

The financing portfolio of Islamic banking grows significantly in the area of electricity, mining, and transportation sectors. Whilst on contrary, portfolio in construction and social services sectors are decreasing (Graph 3.3a). This condition is in line with the development of national banking credit, where both of the electricity and transportation sectors are dominant.

Graph 3.3a

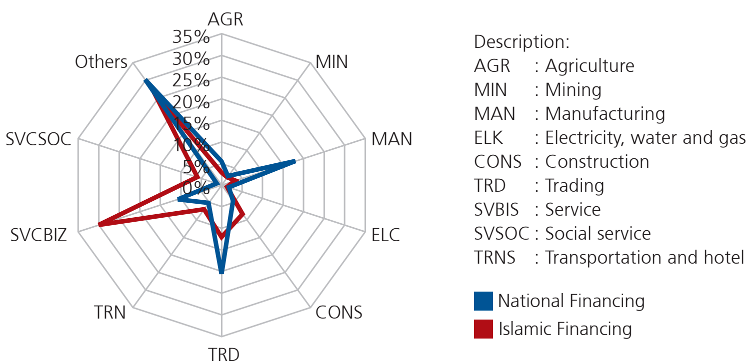
GDP sector and the shifting portfolio



As of the GDP growth, apparently all sectors are showing positive trends except for mining sector with, trading and agriculture experienced the lowest growth. Graph 3.3a also shows the pattern of banking financing growth, either national or Islamic banking are relatively different from the pattern of national economic growth. It shows how financing to sectors by banks are distributed more equally; despite the similar portion as of Islamic banks which relied on electricity and transportation. Based on the projection of sectoral growth, which has been carried out by Bank Indonesia, electricity and transportation sectors will again experience the highest growth in 2010 followed by construction sector. Other than that, the growth of manufacturing and trading sector in 2010 will be better than that of 2009[3].

As for the comparison of financing portfolio composition between national banking industry and that of Islamic banking, it is shown that Islamic financing is dominated by trading based contracts with relatively low risk, disbursed mainly in services, others (consumption) and trading sectors (Graph 3.3b).

Graph 3.3b
Comparison of portfolio composition



This pattern is similar to that of national banking. Besides, the sluggish performance of national economy during 2009, which is shown by slowdown in economic growth, has affected the financing allocation policy in domestic market-based economic sectors. It is estimated that by the year 2010, the

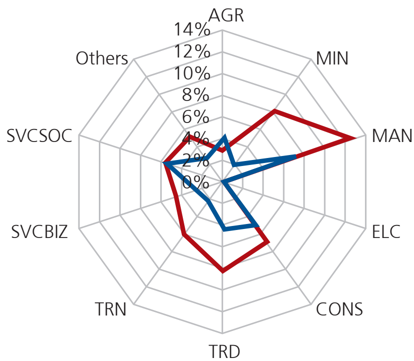
3 Directorate of Economic Research and Monetary Policy Bank Indonesia, October 2009

recovery of global economy where economic volume in all domestic and external sectors will increase, will affect the financing allocation policy in the banking sector. Islamic banking must seize this opportunity accordingly, since the pattern of financing allocation in year 2009 is the same with that of the last year's pattern. Also, it is expected that Islamic banking industry could further explore and diversify their financing to the sectors that has positive growth potential, hitherto received a very low portion of the total Islamic banking financing portfolio.

Non-performance financing in each economic sub-sector, financing of Islamic banking industry shows lower quality compared to the national banking financing in each sub sector (Graph 3.3c). However, the determination in asset quality was somehow affected by large exposures related to particlar industries. Therefore, this figure does not reflect the industry as a whole.

Graph 3.3c

Comparison of NPF Per sector



Description:
AGR : Agriculture
MIN : Mining
MAN : Manufacturing
ELK : Electricity, water and gas
CONS : Construction
TRD : Trading
SVBIS : Service
SVSOC : Social service
TRNS : Transportation and hotel

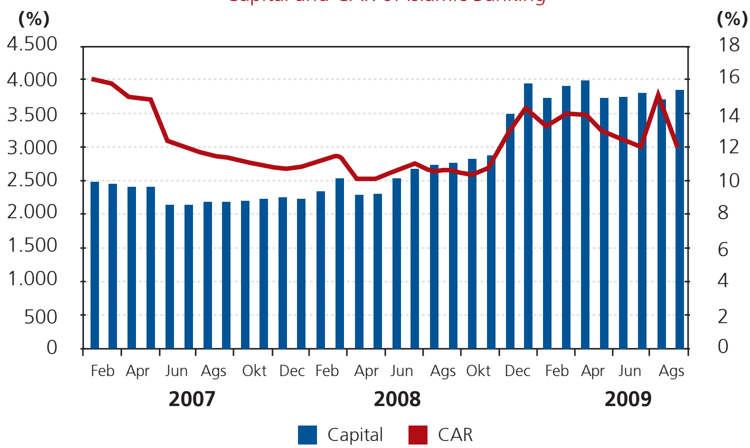
3.2.2. Macro Impact and Institutional Growth-Based 2010 Projection

The development of Islamic banking at its growing phase is influenced by internal growth and the role of new players in Indonesian Islamic banking industry. Tax neutrality which has been endorsed in the new VAT law, as well as improvement of the country risk and macro economy is expected to attract more new investors to take part in in the Islamic banking industry.

With this improvement in business climate for Islamic banking, the growth of Islamic banking in 2010 is expected to further increase, not only because of organic growth factor (existing industry) but also due to an increase in number of banks or new players in the industry.

The prospect of new players is also expected to encourage the existing Islamic banks to increase their efforts and capacity by injecting additional capital along with expanding their office networks. Hence, the increase of capital will then support the Islamic banking to satisfy their capital adequacy requirement (CAR). Further, the office network expansion would show positive correlation to the increase of TPF, therefore would need adequate capital accordingly (Graph 3.4). This effort is nonetheless for the purpose to maintain prudential level of Islamic banking operations, competitiveness and market share growth. The additional paid-up capital and office networks eventually would increase the volume of national Islamic banking industry. It must be acknowledged that an increase in projection of Islamic banking industry volume would very much depend on some assumptions as determinant factors. Nevertheless, the growth of Islamic banking industry in 2010 would be higher than the previous year and even higher compared to that of the national banking.

Graph 3.4
Capital and CAR of Islamic Banking



3.3. Policy Direction

Optimization of VAT Law Implementation

The enactment of Act No.42 Year 2009 concerning Value Added Tax has become second milestone after the issuance of Islamic banking Act last year. This has become as a new fuel for growth of the national Islamic banking in 2010. The issue of double tax as the main obstacle for growth of the Islamic banking industry has now been resolved. The said Act will surely promote more conducive business environment for the new players and increase level of competitiveness of the industry. Therefore, adjustment on the new regulation is required with regards to the opening of new Islamic banks. The adjustment process will surely consider the interest of national banking industry as well as the interest of domestic economy. The initiatives is open to further research on the tax incentives leading to a stronger ground for development.

Higher Quality in Supervisory Process and Human Capital

The Economic recovery in 2010 and the implementation of new tax regime are expected to raise the volume of industry and boost number of Islamic banks in the country. The projection of an increase in industry volume as well as total number of Islamic banks would surely demand more competence human resources at the level of players/practitioners or supervisors.

In the short term, there will be an improvement in training programs for the existing Islamic banking human capital, especially for their service excellence competency and business evaluation of real sector enterprises as well as micro, small and medium enterprises (SMEs). At the same time, this set of skills is also required at the supervisor level. Beside quality improvement of supervisor in term of their understanding on banking operational and business sectors, the effort must be taken to increase number of supervisors to anticipate the growth of Islamic banks either in numbers or network coverage.

Bank Indonesia would consequently make an adjustment to such industry development through organizational structure mechanism and its human capital.

Beside that, the improvement of supervision quality can also be carried out through the initiation of information exchange among related sectors. While in the long term, the enhancement of human capital is still in the program through cooperation with educational institution. Educational institution is believed would provide huge number of human capital with sound competence in the long run. The form of cooperation with educational institution could be in term of Islamic economic/finance/banking training for lecturer, curriculum recommendation, and supplying literatures such as Islamic economic/finance/banking textbooks. In order to develop awareness of the academician, Bank Indonesia will consistently play an active role to persuade and encourage educational and research institution to get involved in knowledge exploration and enhance their ability in Islamic banking and finance.

Higher Quality of Supervisory Framework

The challenges faced in operational prudence aspect would be encountered in two main programs, such as: improvement in both supervision quality and supervisiory infrastructure. Supervision quality improvement can be continuously executed by keeping abreast with the latest technical development from IFSB, BIS or other international commitment from countries under G-20 Forum. Islamic banking industry would be then expected to contribute positively towards prudent and coherent national financial system development. In the aspect of supervisiory infrastructure improvement, direction for development is addressed to the effort to complement the existing system with reference on quality risk management and governance.

Stronger Capital Structure

The projection of Islamic banking industry volume in 2010, including its third party fund, must be followed with an increase in capital so that Islamic banking still has high financial buffer. Internally, an attempt to strengthen this capital can be carried out through dividend policy and new capital injection by the owners or new investors. Therefore, Bank Indonesia would play an active role to facilitate the growth of capital through such approaches.

Higher Efficiency through Financial Deepening

For maintaining Islamic banking industry competitiveness and performance, it is imperative to have efficiency upgrading which can be realized through financial deepening with enrichment variety of product and services, which consistently upholds shariah compliance. Beside the improvement of banking product variety, the efficiency improvement can also be carried out through financing activity (cross sector) with other Islamic finance sub system like collaboration with zakat system. Collaboration between banking system and other Islamic finance sub-system is translated throughout efforts to establish appropriate regulatory framework and information exchange to ascertain the initiation of financing process with a cross-sector base within the prudential framework. The framework for cross-sectors financial system will be outlined in the Indonesia Islamic Finance Architecture (AKSI) that would become an initiative for all components of Indonesian Islamic financial system.

3.4. Islamic Banking Prospect for 2010

Referring to the analysis on fundamental macroeconomic condition within the recovery of world economy coupled with a dynamic process occurred in the internal Islamic banking industry, it is estimated that Islamic banking industry in 2010 would experience a better growth than the previous year.

Meanwhile, taking into consideration that Islamic banking industry development up to the end of 2009 would be in between two scenarios such as pessimistic and moderate (Table 3.2), coupled with the current dynamic macro-economy and Islamic banking industry development, therefore the projection for the year 2010 would be parallel with that have been formulated in the program of Grand Strategy of Islamic Banking Market Development 2008 (Table 3.3).

Table 3.2
Growth projection of National Islamic Banking 2009

Pessimist Scenario	Moderate Scenario	Optimist Scenario
Projected Growth 25% Total Asset IDR 57 trillion	Projected Growth 37% Total Asset IDR 68 trillion	Projected Growth 75% Total Asset IDR 87 trillion

Table 3.3
Growth projection of National Islamic Banking 2010

Pessimist Scenario	Moderate Scenario	Optimist Scenario
Projected Growth 26% Total Asset IDR 72 trillion	Projected Growth 43% Total Asset IDR 97 trillion	Projected Growth 81% Total Asset IDR 124 trillion

The assumption employed in this scenario, either projection of pessimistic, moderate or optimistic, depends upon the availability of assumed supporting factors that have dominant and significant effect, directly or indirectly, to the growth of Islamic banking industry. These assumptions are as follows:

Pessimistic Projection Scenarios

- Generic growth
- Domestic and global economic recovery.
- The success of public education and banking promotion.
- Act No.42 Year 2009 on Value Added Tax is able to encourage industry to enhance their performance.

Moderate Projection Scenario

- New number of Islamic banks and the spin-off of Islamic Business Unit (IBU) to Islamic Commercial Bank (ICB).
- Domestic and global economic recovery.
- The success of public education and banking promotion.
- Act No.42 Year 2009 on Value Added Tax is able to encourage industry to enhance their performance.
- The entry of new investors in the national Islamic banking industry through the establishment of new Islamic bank, or new capital injection in the existing Islamic banks.
- Upgrade human capital requirement for both quantity and quality wise.

Optimistic Projection Scenario

- New number of Islamic banks and the spin-off of Islamic Business Unit (IBU) to Islamic Commercial Bank (ICB).
- Domestic and global economic recovery.
- The success of public education and banking promotion.
- Act No. 42 Year 2009 on Value Added Tax is able to encourage industry to enhance their performance.
- The entry of new investors in the national Islamic banking industry through the establishment of new Islamic bank, or new capital injection in the existing Islamic banks.
- Upgrade human capital requirement for both quantity and quality wise.
- Policy and regulation incentives on monetary and fiscal by Bank Indonesia and Government institutions related to Islamic banking industry.
- Development of Islamic finance and banking into an integrated government programs which are formulated in the policies such as; pilgrimage fund management by Islamic banks, regional-owned banks Islamic holding and the conversion of state-owned banks

Box 1

Act No. 42 Year 2009 on the Amendment of VAT and Sales tax of Luxury Goods Law : Tax Neutrality for Islamic Finance Stimulates Growth

Legal certainty is a significant requirement to encourage industrial development. This has been the case with Islamic banking, which hitherto encountered uncertainty over taxation treatment on its trading-based transactions such as murabahah financing.[1] Among the impacts to such legal uncertainty are different treatment from tax offices throughout the country to Islamic banking transaction, constraint in product development, different shariah rulings implementation as an attenpt of the Islamic banks to avoid double tax,[2] cost incurred by Islamic banks from the claim of unpaid tax,[3] and unfavorable investors' response on their investment in Indonesian Islamic banks.

The effort to solve the problem of legal uncertainty over tax treatment on murabahah has been going on for many years with the involvement of various parties. One of the important achievement related to this matter is on 15th October 2009, when the House of Representative (DPR) of Republic of Indonesia, together with the government, agreed upon the legitimization of the third amendment on the VAT and Sales tax of Luxury Goods Law where a new article is inserted that explicitly regulate/clarify this problem.

In the Act No. 42 Year 2009, the article that regulates transaction related to Islamic finance is as follows:

1. Article I, Section 2, Clause 1 stipulates on the understanding on delivery of Taxable Goods, including (regulated under Letter h) "the delivery of Taxable Goods by Taxable Person in conjunction with financing contract conducted based on shariah principles, where its delivery is assumed to be directly from Taxable Person to party who demands the Taxable Goods"[4]

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1 Financing with murabahah contract placed biggest portion in the total of Islamic bank portfolio (per September 2009, 56.2% total portfolio of Islamic bank is in the form of murabaha contract)

2 This can cause the reputation risk over compliance to sharia principles.

3 In the previous VAT regulation, in the event of VAT default payment, the bank must pay 10% VAT plus fine 48% and fine 2% from the principle of VAT expense.

4 "In Murabahah contract, Islamic banks act as fund provider for example to purchase a vehicle from Taxable Person 'A' over the order of Islamic banks's customer (Mr B). Although based on sharia principles, Islamic banks must purchase first that vehicle and then sell it to Mr. B, according to this act, the delivery of the vehicle is considered to be conducted directly by Taxable Person 'A' to Mr. B" (the elaboration of Article I, Section 2, Clause 1 Letter h Act No. 42 Year 2009).

2. Article I, Section 5, Clause 3 regulates the classification of non-taxable services such as a group of banking services (regulated under Letter f). In the elaboration of this article, it is ascertained that one form of banking services that is excluded or non-taxable is: financing services including financing based on shariah principles in the form of leasing with the right for option, factoring, credit card business, and/or consumer financing; and loan using pawn contract, including shariah pawn and fiduciary.

The new rule that provides neutrality views in regulating taxation (tax neutrality) for shariah financial transaction requires socialization, either among domestic industry players or related parties abroad. Indonesia with largest Muslim population and relatively high demand on development financing has been a lucrative destination for international investor to expand their business. However, the existence of foreign investor in national Islamic banking industry must be clearly stated. It has to contribute positive benefits for the national interest, that is to meet the goal of developing Islamic banking services and serve the increasing demand of the society towards more efficient Islamic banking and excellent in quality services.

Clear tax regulation and tax neutrality for Islamic banking transaction, which will be put into effect on 1 April 2010, is another achievement in Indonesian legal system that definitely supports Islamic banking. It is expected to have positive impact in the development of Islamic banking in the future. In line with the spirit to develop national Islamic banking, the next important step in the context of regulating taxation is to create appropriate tax incentives and ability to optimize some potential development of Islamic banks for the benefits of the economy.

Box 2

The Challenges of Indonesian Membership in Forum G-20

Indonesia membership in G-20 is another self pride since it is an international recognition for Indonesia to participate in regulating the global finance system. The establishment of G-20 to join the Financial Stability Board (FSB) is a continuation of Washington Action Plan (WAP)which is to enhance membership of new countries in managing the stability of global financial system. FSB forum possesses a mandate to keep the stability of global financial system, determine the standard for financial sector and collaborate with IMF to implement Early Warning Exercise. The FSB issues fundamentally cover the following: *strengthening global capital framework, robust global liquidity market, reducing moral hazard by systemically important institutions, strengthening accounting standard, improving compensation practices, expanding oversight of financial system, strengthening the robustness of the OTC derivatives, relaunching securitization on a sound basis, supervisory college and cross border crisis management*. As a country member, Indonesia is expected to contribute positively and play an active role in international cooperation in the field of economy, finance and banking. However, the urgency to create financial system and national banking with operational quality equal to other countries in G-20 including developed countries will be much stronger.

The issue of international regulation for standardization concept in relation to regulatory framework development for Islamic banking industry should be perceived positively. As a member of G-20, Indonesia should effectively show the regulatory framework of Islamic banks in developing one goal of international financial stability system. The existence of cross-membership between IFSB, BIS and IMF where Indonesia is a member country of the three institutions would give more opportunity for Indonesia to play role at international level.

Box 3

Challenges for Human Capital Needs

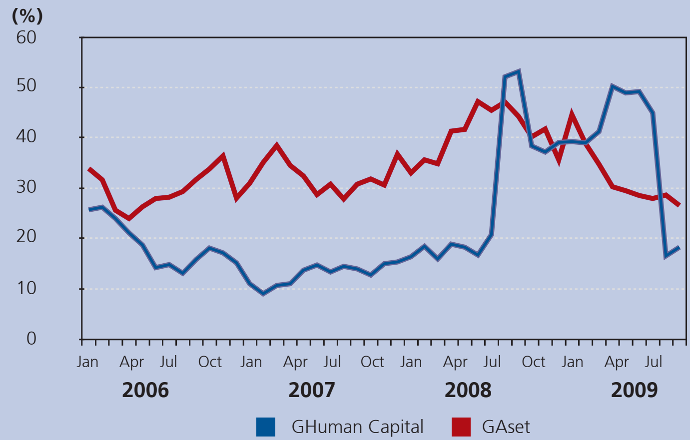
Capable human capital who are professional and competent in banking and fiqh muamalah, especially in Islamic finance, are an important factor in the development of Islamic banking industry. Formalization of Islamic economics and finance is a relatively new undertaking, which caused scarcity in number of available resources that are proficient in Islamic finance and economics to support the needs of Islamic banking industry. However, the emergence of formal and non-formal institutions that offer Islamic economics and finance courses has expanded potential availability of human capital in this industry.

In addition, the capability to understand real sector and banking practices are also required. Therefore, apart from emphasis on number of formal or non-formal institutions offering Islamic finance, it is also important to look after the construction of its curriculum to ensure the outputs of such institutions are capable and well equipped.

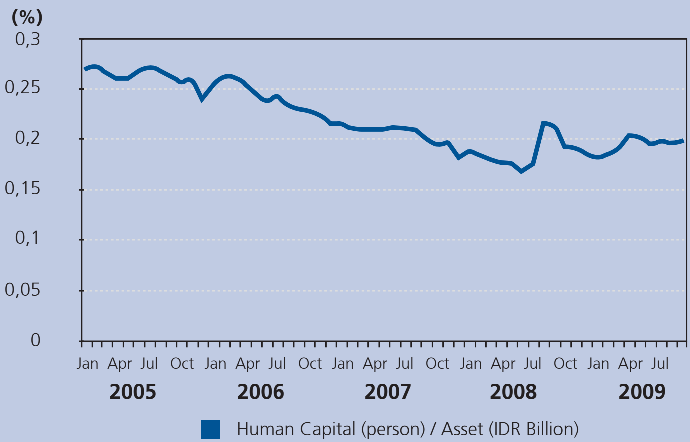
On the other hand, the fast growth of Islamic banking as an infant industry has made the issue of human capital becoming even more important. Based on the available data of asset growth and human capital development plan of Islamic banks, it is shown that the acceleration of asset growth, as business volume proxy, exceeded the availability of additional human capital except during August - September 2008 and March - July 2009 (Graph B. 1). From the ratio of human capital per billion Rupiah of asset, it indicates a decreasing trend although it started to increase again slowly in the mid of 2008 (Graph B. 2). This condition indicates an imbalance of the input factor in the industry. If this issue were not being handled seriously, it would cause inefficiency in the operations of Islamic banking industry.

Thus, there should be a serious effort to solve the problem of human capital shortage as follows: (i) revision of curriculum in formal or non formal institutions, especially in the context of applied finance and real sector; (ii) variety of teaching topics of formal and non formal institution to enhance quality and readiness; and iii) establishment of institutional networking between educational institutions and Islamic banking industry in the forms of internship and research program to enrich the theory and practice of Islamic finance.

Graph B.1



Graph B.2



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Appendix 1a

List of Bank Indonesia Regulation 2007

1. Bank Indonesia Regulation Number 9/1/PBI/2007 dated 24 January 2007 concerning the Rating System for Commercial Banks Based on Sharia Principles

2. Bank Indonesia Regulation No.9/2/PBI/2007 dated 5 March 2007 concerning Daily Report of Commercial Banks.

3. Bank Indonesia Regulation No.9/4/PBI/2007 dated 26 March 2007 Concerning Revocation of several decree letter of Bank Indonesia directors and circulated letter of Bank Indonesia concerning Prudential Banking Principle

4. Bank Indonesia Regulation No.9/6/PBI/2007 dated 30 March 2007 concerning Second Amendment on Bank Indonesia Regulation No.7/2/PBI/2005 concerning Asset Valuation of Commercial Banks

5. Bank Indonesia Regulation No. 9/7/PBI/2007 dated 4 May 2007 concerning Amendment on Bank Indonesia Regulation No. 8/3/PBI/2006 concerning Conversion Of Business Of Conventional Commercial Banks To Commercial Banks Conducting Business Based On Sharia Principles And Establishment Of Bank Offices Conducting Business Based On Sharia Principles By Conventional Commercial Banks

6. Bank Indonesia Regulation No.9/8/PBI/2007 dated 13 June 2007 concerning the Recruitment of Foreign Expert and Knowledge Transfer Program in Banking Sector.

7. Bank Indonesia Regulation No.9/9/PBI/2007 dated 18 June 2007 concerning the Amendment on Bank Indonesia Regulation No. 8/21/PBI/2006 concerning Quality Rating Of Assets Of Commercial Banks Conducting Business Based On Sharia Principles.

8. Bank Indonesia Regulation No.9/12/PBI/2007 dated 21 September 2007 concerning to Amendment on Bank Indonesia Regulation No. 8/17/PBI/2006 concerning Incentives In The Framework Of Bank Consolidation.

9. Bank Indonesia Regulation No.9/13/PBI/2007 dated 1 November 2007 concerning Minimum Capital Requirement of Commercial Banks with Market Risk Consideration.

10. Bank Indonesia Regulation No.9/15/PBI/2007 dated 30 November 2007 concerning to the Implementation of Risk Management in the use of Information Technology by Commercial Banks.

11. Bank Indonesia Regulation No.9/16/PBI/2007 dated 3 November 2007 concerning Amendment on Bank Indonesia Regulation Number 7/15/PBI/2005 concerning Minimum Core Capital Requirements for Commercial Banks.

12. Bank Indonesia Regulation No.9/17/PBI/2007 dated 4 December 2007 concerning Quality Rating System of Rural Banks Conducting Business Based on Sharia Principles.

13. Bank Indonesia Regulation No.9/18/PBI/2007 dated 17 December 2007 concerning Revocation of Decree Letter of Bank Indonesia Directors no. 31/153/KEP/DIR dated 20 November 1998 concerning liquidity credit for Public Pawn Company through PT. Bank Ekspor Impor Indonesia (PERSERO). Decree letter of Bank Indonesia Directors No 31/154/KEP/DIR/ dated 20 November 1998 concerning liquidity credit to Public Pawn Company through PT. Bank Bumi Daya (PERSERO), and decree letter of Bank Indonesia directors No 31/155/KEP/DIR dated 20 November 1998 on liquidity credit to Public Pawn Company through PT. Bank Umum Koperasi Indonesia.

14. Bank Indonesia Regulation No.9/19/PBI/2007 dated 17 December 2007 concerning Implementation of Sharia Principle for Funding and Financing Activities as well as Islamic Banking Services.

Appendix 1b

List of Bank Indonesia Regulation 2008

1. Bank Indonesia Regulation No.10/1/PBI/2008 dated 30 January 2008 concerning Amendment on Bank Indonesia Regulation Number 8/5/PBI/2006 concerning Banking Intermediary.

2. Bank Indonesia Regulation No.10/9/PBI/2008 dated 22 February 2008 concerning Amendment on License for Commercial Banking Business to Become Business License of Rural Bank for The Purpose of Consolidation.

3. Bank Indonesia Regulation No.10/10/PBI/2008 dated 28 February 2008 concerning Amendment on Bank Indonesia Regulation No. 7/7/PBI/2005 concerning Customer Complaint Settlement.

4. Bank Indonesia Regulation No.10/16/PBI/2008 dated 25 September 2008 concerning Amendment on Bank Indonesia Regulation No. 9/19/PBI/2007 Implementation of Sharia Principle for Funding and Financing Activities as well as Islamic Banking Services

5. Bank Indonesia Regulation No.10/17/PBI/2008 dated 25 September 2008 concerning Islamic Banking Product and Islamic Business Unit.

6. Bank Indonesia Regulation No.10/18/PBI/2008 dated 25 September 2008 concerning Restructuring of Islamic Banking Financing and Islamic Business Unit.

7. Bank Indonesia Regulation No.10/23/PBI/2008 dated 16 October 2008 concerning Second Amendment on Bank Indonesia Regulation No. 6/21/PBI/2004 concerning Minimum Current Account Requirement in Rupiah and Foreign Currency for Commercial Bank Conducting Business based on Sharia Principles.

8. Bank Indonesia Regulation No.10/24/PBI/2008 dated 16 October 2008 concerning Second Amendment on Bank Indonesia Regulation No. 8/21/PBI/2008 concerning Asset Valuation of Commercial Banks Conducting Business based on Sharia Principles.

9. Bank Indonesia Regulation No.10/32/PBI/2008 dated 20 November 2008 concerning Islamic Banking Committee.

10. Bank Indonesia Regulation No.10/36/PBI/2008 dated 10 Desember 2008 concerning Islamic Monetary Operation.

Appendix 1c

List of Bank Indonesia Regulation 2009

1. Bank Indonesia Regulation No.11/3/PBI/2009 dated 29 January 2009 concerning Islamic Commercial Bank

2. Bank Indonesia Regulation No.11/10/PBI/2009 dated 19 March 2009 concerning Islamic Business Unit

3. Bank Indonesia Regulation No.11/11/PBI/2009 dated 13 April 2009 concerning Implementation of Card as Payment Tools

4. Bank Indonesia Regulation No.11/12/PBI/2009 dated 13 April 2009 concerning Electronic Money

5. Bank Indonesia Regulation No.11/15/PBI/2009 dated 29 April 2009 concerning Changes on Business Activities of Commercial Bank to Islamic Bank

6. Bank Indonesia Regulation No.11/19/PBI/2009 dated 4 June 2009 concerning Certification on Risk Management for Commercial Bank

7. Bank Indonesia Regulation No.11/23/PBI/2009 dated 1 July 2009 concerning Islamic Rural Bank

8. Bank Indonesia Regulation No. 11/24/PBI/2009 dated 1 July 2009 concerning Islamic Short Term Funding Facility for Islamic Commercial Bank

9. Bank Indonesia Regulation No. 11/29/PBI/2009 dated 7 July 2009 concerning Islamic Short Term Funding Facility for Islamic Rural Bank

10. Bank Indonesia Regulation No. 11/30/PBI/2009 dated 7 July 2009 concerning Intraday Liquidity Facility based on Sharia Principle

11. Bank Indonesia Regulation No. 11/31/PBI/2009 dated 28 August 2009 concerning Fit and Proper Test for Islamic Commercial Bank and Islamic Business Unit.

Appendix 2

Product and Services of Islamic Banking

PRODUCT NAME	CONTRACT
FUNDING	
iB CURRENT ACCOUNT	
iB USD Current Account	Wadiah
iB Current Account	Wadiah
iB Saving	Wadiah
Haji iB Saving	Wadiah
Hajj iB Saving	Mudharabah
iB Gold Saving	Mudharabah
iB Planned Saving	Mudharabah
iB education Saving	Mudharabah
iB Planned Saving	Mudharabah
iB Islamic Saving of Scheduled Collected Fund	Mudharabah
iB Umrah Saving	Mudharabah
iB Saving	Mudharabah
iB Education Saving (Tapenas)	Mudharabah
iB Children Saving	Mudharabah
iB Multipurpose Saving	Mudharabah
iB Deposit	Mudharabah
iB USD Deposit	Mudharabah
iB Deposit	Mudharabah Muqayyadah
Deposit Special Investment Deposit iB	Mudharabah Muqayyadah
iB Money Transfer Services Across Countries	Ijarah
iB Bank Guaranty Services	Kafalah
iB SKBDN Services	Kafalah, Wakalah bil Ujroh
iB Sharia Card Services	Kafalah, Qard, Ijarah
iB Gold Deposit Box Services	Qard and Ijarah
iB Transfer of Debt Services	Gard, bai, murabahah

PRODUCT NAME	CONTRACT
FUNDING	
iB SERVICES	
iB Money Exchange Services	Sharf
iB Money Transfer Services	Wakalah
iB Money Transfer of Foreign Exchange	Wakalah
iB Bancassurance Services	Wakalah bil ujrah
iB L/C Export Services	Wakalah bil ujrah, bai and kafalah
iB L/C Import Services	Wakalah kafalah
iB Pawn	Qard and Ijarah
iB Gold Pawn	Qard, Rahn and Ijarah
SALE PURCHASE	
iB Financing	Ijarah
iB Multi Services Financing	Ijarah
iB Educational Multi Services Financing	Ijarah
iB Medium and Cooperative Financing	Ijarah
iB Micro and Small Financing	Ijarah
iB Working Capital Financing	Ijarah
iB Multi Function Services	Ijarah
iB House Financing	Ijarah
iB Education, Family, Health Multi Service Financing	Ijarah
iB Umrah Multi Service Financing	Ijarah
iB Need of Goods Financing	Ijarah Wal Wakalah
iB Financing	IMBT
iB Leasing Equipment of Financing	IMBT
iB Channeling Financing	IMBT
iB Financing	Istishna
iB House Financing	Istishna
iB Financing	Istishna Paralel

PRODUCT NAME	CONTRACT
iB FINANCING	
SALE PURCHASE	
iB House Credit Ownership Financing	Istishna Paralel
iB House Building Financing	Istishna Paralel
iB Financing	Salam
iB Financing	Murabahah
iB of Lot Ready Built Financing	Murabahah
iB Need of Goods Financing	Murabahah
iB Consumtive Financing	Murabahah
iB Middle and Cooperative Financing	Murabahah
iB Micro and Small Financing	Murabahah
iB Working Capital Financing	Murabahah
iB Channeling Financing	Murabahah
iB Consumer Financing	Murabahah
iB Vehicle Ownership Financing	Murabahah
iB House Renovation Financing	Murabahah
iB House Financing	Murabahah
iB Multi Function Financing	Murabahah
iB Islamic Card	Kafalah, Qard, Ijarah and Wadiah
iB Gold Investment	Wakalah
iB Financing	Musyarakah
iB Circled Fund Financing	Musyarakah
iB Medium and Cooperative Financing	Musyarakah
iB Micro and Small Financing	Musyarakah
iB PRK Financing	Musyarakah
iB Syndication Financing	Musyarakah
iB Financing	Mudharabah
iB Medium and Cooperative Financing	Mudharabah
iB Micro and Small Financing	Mudharabah

PRODUCT NAME	CONTRACT
iB FINANCING	
iB INVESTMENT	
iB Working Capital Financing	Mudharabah
iB MTN BSMI Financing	Mudharabah
iB Channeling Financing	Mudharabah Muqayyadah
iB Executing Financing	Mudharabah Muqayyadah
iB Musyarakah Mutanaqisah Financing	Musyarakah Mutanaqisah
iB Many to One Financing	Mudharabah Muqayyadah
iB Musyarakah USD Financing	Musyarakah
iB Pension Financing	Murabahah, Ijarah
iB Financing	Qard

Appendix 3

Development Indicator of Islamic Banks

in million IDR

Information	2000	2001	2002	2003	2004	2005	2006	2007	2008	Mar - 09	Juny - 09	Aug - 09	Sept - 09
Number of Bank													
Islamic Commercial Bank	2	2	2	2	3	3	3	3	5	5	5	5	5
Islamic Banking Unit	3	3	6	8	15	19	20	26	27	26	25	24	24
Islamic Rural Banks	79	81	83	84	88	92	105	114	131	133	133	135	137
Office Network	146	182	229	337	443	550	636	711	953	1021	1032	1048	1061
Islamic Commercial Bank	57	86	115	197	266	304	349	401	581	635	643	654	660
Islamic Banking Unit	10	15	31	56	89	154	182	196	241	253	256	259	264
Islamic Rural Banks	79	81	83	84	88	92	105	114	131	133	133	135	137
Office Channeling (LS)													
Number of Bank	-	-	-	-	-	-	10	17	21	21	22	19	19
Number Of Officer	-	-	-	-	-	-	456	1,195	1,470	1,618	1,680	1,646	1,694
Detail of Office Network													
Head Office	5	5	8	10	18	22	23	29	32	31	30	29	29
Branch Offce	28	48	68	116	148	189	209	224	273	305	307	308	311
Sub Branch Office	8	5	11	26	58	105	116	123	283	305	311	317	319
Cash Office	26	43	59	101	131	142	183	221	234	247	251	259	265
Islamic Commercial Bank and Islamic Banking Unit													
Total Asset	1,790,168	2,718,770	4,045,235	7,858,918	15,325,997	20,879,874	26,722,030	36,537,637	49,555,122	51,667,804	55,238,065	57,011,948	58,034,387
Share with Total Banks	**0.17%**	**0.25%**	**0.36%**	**0.74%**	**1.20%**	**1.42%**	**1.58%**	**1.84%**	**2.14%**	**2.20%**	**2.21%**	**2.39%**	
Financing	1,271,162	2,049,793	3,276,650	5,530,167	11,489,933	15,231,942	20,444,907	279,443,111	38,194,974	39,307,689	42,194,896	43,889,680	44,522,796
Share with Total Banks	**0.40%**	**0.57%**	**0.80%**	**1.16%**	**1.93%**	**2.19%**	**2.58%**	**1.68%**	**2.92%**	**3.01%**	**3.16%**	**3.21%**	
Musyaraka	31,739	53,593	60,191	305,997	1,270,868	1,898,389	2,334,751	4,406,360	7,410,833	8,108,032	9,141,713	9,931,523	10,007,431
Mudharaba	378,604	402,623	498,681	794,244	2,062,202	3,123,759	4,062,200	5,577,912	6,205,284	5,890,411	6,134,245	6,315,730	6,459,391
Murabaha	775,721	1,420,401	2,324,222	3,955,815	7,640,299	9,487,318	12,624,241	16,552,689	22,486,186	22,732,110	24,245,367	24,632,479	25,045,544
Salam	0	427	51	0	0	0	0	0	0	0	0	0	0
Istishna'	74,583	167,893	220,720	295,960	312,962	281,676	336,970	350,995	368,758	404,345	412,442	431,903	414,954
Qardh	0	0	0	0	98,928	124,862	250,446	539,945	958,515	1,210,570	1,201,884	1,377,837	1,400,317
Others	10,515	4,856	172,785	178,151	104,674	315,938	836,299	516,230	765,398	962,221	1,059,245	1,200,208	1,195,159

Development Indicator of Islamic Banks

in million IDR

Information	2000	2001	2002	2003	2004	2005	2006	2007	2008	Mar - 09	Juny - 09	Aug - 09	Sept - 09
Depositor Fund	1,028,923	1,806,366	2,917,726	5,724,909	11,862,117	15,582,329	20,672,181	28,011,670	36,852,148	38,040,322	42,102,848	44,018,960	45,381,017
Share with Total Banks	**0.15%**	**0.23%**	**0.35%**	**0.64%**	**1.23%**	**1.38%**	**1.61%**	**1.85%**	**2.10%**	**2.13%**	**2.31%**	**2.38%**	
Wadia Demand Deposit	221,139	299,982	358,964	637,478	1,620,115	2,045,333	3,415,747	3,750,376	4,238,337	4,208,595	5,198,901	5,499,938	5,491,895
Mudharaba Saving Deposit	336,611	590,872	815,308	1,610,616	3,263,759	4,370,568	6,430,355	9,454,060	12,470,952	13,045,251	14,148,787	13,858,961	14,577,940
Mudharaba Time Deposit	471,173	915,512	1,743,454	3,476,815	6,978,243	9,166,428	10,826,079	14,807,234	20,142,859	20,786,476	22,755,160	24,660,061	25,311,182
Capital													
Paid in Capital	523,703	523,703	523,703	625,528	731,039	951,224	991,224	1,017,224	1,752,465	1,852,465	1,801,465	1,801,465	1,801,465
Reserves	7,941	21,508	32,779	34,381	98,735	230,128	268,040	275,308	334,841	334,846	448,623	448,617	448,617
Previous Year Net Income	25,139	83,027	54,050	42,663	162,366	238,285	355,047	540,141	432,496	289,497	516,878	668,703	468,553
Financing to Deposit Ratio (FDR)	123.54%	113.48%	112.30%	96.60%	96.86%	97.75%	98.90%	99.76%	103.64%	103.33%	100.22%	99.71%	98.11%
Commercial Bank Loan to Deposit Ratio	12.96%	4.01%	4.12%	2.34%	58.09%	61.67%	61.56%	4.05%	3.95%	5.14%	4.39%	5.61%	5.72%
Islamic Bank Non Performing Financing (Gross)	12.96%	4.01%	4.12%	2.34%	2.35%	2.82%	4.75%	2.46%	2.18%	3.22%	2.30%	3.40%	2.95%
Commercial Bank Non Performing Loan		18.76%	12.10%	8.09%	8.20%	5.80%	7.60%	6.07%	4.07%	3.20%	3.93%	3.94%	3.98%
Return On Asset (yearly)		3.7%	1.6%	0.7%	1.41%	1.35%	1.55%	1.78%	1.42%	2.44%	2.16%	2.08%	1.38%
Return On Equity (yearly)		15.9%	10.3%	7.0%	24.80%	26.71%	36.94%	53.91%	37.94%	62.51%	56.06%	54.71%	34.14%
Islamic Rural Bank													
Total Asset				292,959	471,454	604,971	906,325	1,207,198	1,693,363	1,747,780	1,820,576	1,909,892	1,957,971
Share with Total of Rural Banks				**2.32%**	**2.82%**	**2.88%**	**3.78%**	**4.17%**	**4.95%**	**5.08%**	**5.12%**	**5.21%**	
Financing				192,969	328,102	435,912	636,287	879,744	1,256,610	1,332,419	1,409,900	1,501,553	1,520,771
Share with Total Rural Bank				**2.15%**	**2.70%**	**2.89%**	**3.61%**	**4.11%**	**4.70%**	**5.00%**	**5.07%**	**5.22%**	
Total Depositor Fund				184,925	267,062	353,565	530,150	711,250	975,815	1,034,228	1,082,786	1,139,960	1,155,428
Share with Total of Rural Banks				**1.84%**	**2.08%**	**2.23%**	**3.25%**	**3.66%**	**4.37%**	**4.53%**	**4.55%**	**4.61%**	
Islamic Rural Bank Financing to Deposit Ratio				104.35%	122.86%	123.29%	120.02%	123.69%	128.78%	128.83%	130.21%	131.72%	131.62%
Commercial Rural Bank Loan to Deposit Ratio				**89.32%**	**94.80%**	**96.12%**	**107.87%**	**110.24%**	**119.78%**	**116.84%**	**116.83%**	**116.43%**	
Islamic Rural Bank Non Performing Financing						10.64%	8.29%	7.99%	8.38%	8.41%	7.91%	7.80%	8.12%
Commercial Rural Bank Non Performing Loan				**7.96%**	**7.59%**	**7.97%**	**9.98%**	**7.98%**	**9.88%**	**10.33%**	**7.47%**	**7.23%**	

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