

Between Piety and Prudence: State Syariah and the Regulation of Islamic Banking in Indonesia

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Abstract

As in many other Muslim societies, it was chiefly the state that triggered the growth of Islamic banking in Indonesia and the development of Islamic financial products was encouraged as part of efforts by Soeharto's authoritarian New Order regime to co-opt Muslim groups. Local entrepreneurs, however, drew on models from elsewhere in the Islamic world to develop new financial institutions to a level that compelled more sophisticated regulatory responses. Since Soeharto's fall in 1998, the new democratic state has overseen a significant expansion of the Islamic finance sector, but successive governments have been consistent in keeping what is known in Indonesia as the *ekonomi syariah* (*shari'a* economy) firmly under state regulatory authority. Islamic banking is now a flourishing — if still small — part of the finance sector, and a specific-purpose statute has been passed recognising this. The system of regulation governing Islamic finance today nonetheless remains complex, but relies on two lead agencies. Bank Indonesia, the reserve bank, oversees prudential aspects of Islamic banking in a manner very similar to conventional banking. Religious aspects are, however, dealt with by the National Syariah Board of the Ulama Council of Indonesia ('MUI'), and Syariah Supervisory Boards lodged in each financial institution look to it for doctrinal guidance expressed through *fatāwā*. The increasingly conservative MUI is an NGO but it is state-endorsed and state-funded. It is thus the key to state regulation of the sometimes questionable doctrinal 'Islamicity' of Indonesia's Islamic financial institutions, just as Bank Indonesia is the key to state regulation of their commercial activities. There is potential for future tension between these two institutions, but this has not so far weakened state control of Islamic finance in Indonesia. That has, in fact, deepened over the last decade.

I Introduction

In Indonesia, as in many other Muslim societies, 'it has been the government...that has taken the initiative to expand' Islamic banking,¹ that is,

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banking that complies with Islamic principles and, in particular, does not involve interest payments. In fact, the new democratic state that emerged after the fall of Soeharto and his authoritarian New Order regime in 1998 has systematically expanded its regulatory authority over Islamic banking. Successive governments have been consistent in their efforts since then to manage what is known in Indonesia as the *ekonomi syariah* (*shari'a*² economy) and, increasingly, to assert control over it too.

Indonesia was a relative latecomer to Islamic banking. Soeharto's government formally recognised it in 1983, around the same time an Islamic bank was established in Malaysia but several years after Saudi Arabia (1975), Pakistan (1979) and Egypt (which opened the world's first modern Islamic bank in 1971). Bank Muamalat, the first fully-fledged official *bank syariah*³ in Indonesia, only opened in 1991. A legislative basis for Islamic finance had to wait until the following year, when *Undang-Undang Nomor 7 Tahun 1992 tentang Perbankan* [Law No 7 of 1992 on Banking] (Indonesia) ('1992 Banking Law') was passed. Since then Islamic banking has grown steadily in Indonesia to become a small but flourishing part of the finance sector, and a specific-purpose law on Syariah Banking⁴ has been passed. This has all been achieved without major political controversy.

Islamic banking is based on the clear prohibition in verses 2:278 and 3:130 of the Qur'an on taking or receiving what is known in Arabic as *ribā*. It is less clear, however, what *ribā* means. Supporters of Islamic banking interpret it to mean any form of interest payment, but this not universally accepted in Indonesia. Two of Indonesia's major organisations of *'ulamā*,⁵ accept that any transaction involving a return of money on money (including earning or paying interest) is prohibited, but a third does not. On January 2004, the Indonesian Council of Ulama ('MUI')⁶ issued a *fatwā*⁷ (No 1 of that year), restating the Qur'anic

¹ Hanim Hamzah, 'Recent Legal and Regulatory Developments for Islamic Banking and Finance in Indonesia' in Angelo M Venardos (ed), *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System* (World Scientific Publishing, 2010) 99, 101

² There is no standard spelling of Arabic terms in Indonesia. Different spellings are often used interchangeably and variations can be found even within individual documents. *Syariah* is the most common spelling used in Indonesia for the Arabic *sharī'a*, but I use the simplified 'shari'a', allowing variants in names and quotations. Arabic terms are transliterated using a version of the systems used by Brill, Cambridge University Press and the Library of Congress (American Library Association). This system is not applied to local variants of terms derived from Arabic found in names or quotations.

³ The term *bank syariah* was formally recognised by *Undang-Undang Nomor 10 Tahun 1998 tentang Perubahan Atas Undang-Undang Nomor 7 Tahun 1992 tentang Perbankan* [Law No 10 of 1998 on Amendment of Law No 7 of 1992 on Banking] ('1998 Banking Amendment Law') (Indonesia). Indonesia is now one of the few countries in the world to use this term rather than the more commonly-used term 'Islamic Bank' (Ar: *al-bank al-'islāmī; al-mahārīf al-'islāmīya*), but Indonesians commonly use the terms interchangeably: Bank Indonesia, *The Blueprint of Islamic Banking Development in Indonesia*. (Bank Indonesia, 2002) ii, <www.bi.go.id/NR/rdonlyres/9170EE41-7D9A-4376-B520-A6B3A0945153/1331/syariah_bprintengl.pdf>.

⁴ *Undang-Undang Nomor 21 Tahun 2008 tentang Perbankan Syariah Negara* [Law No 21 of 2008 on Islamic Banking] (Indonesia) (the '2008 Islamic Banking Law').

⁵ Ar: *'ulamā*, religious scholars. In Indonesia, the plural *ulama* is commonly also used for the Arabic singular, *'ālim*.

⁶ *Majelis Ulama Indonesia*.

prohibition on *ribā* and defining that term broadly as any ‘additional charges levied on the postponement of agreed payments’. In April 2010, Muhammadiyah, one of Indonesia’s largest mass Muslim organisations, followed MUI’s lead, issuing a similar *fatwā*.⁸ However, Nahdlatul Ulama (‘NU’), the largest *fatwā*-issuing organisation in Indonesia, and reputedly the largest Islamic organisation in the world, sees the matter as *khilāfiyya*, that is, subject to different opinions or unresolved.⁹ In any case, the vast majority of Indonesian Muslims — perhaps more than 90 per cent — continue to use conventional banking services regardless of the debate among the *‘ulamā*,¹⁰ although the tiny Islamic banking sector continues to grow, reaching 6.5 million customers in 2010.

This article offers an account of the development of the regulatory system for Islamic banking in Indonesia, focusing on the expansion of state control. Selected Islamic banking contracts used by a leading Indonesian Islamic bank are also considered to show the extent to which Indonesian Islamic banking has remained largely within the institutional framework for conventional banking.

II Islamic Banking Institutions

Islamic finance sits at the intersection between financial, religious and legal authorities and relates directly to private wealth. Interest groups in Indonesia seeking to influence its regulation are therefore numerous. They include, of course, Islamic banks and conventional banks offering Islamic banking services, as well as Bank Indonesia, the nation’s reserve bank, peak banking authority and leading regulatory institution for Islamic banking. Other regulatory bodies involved in Islamic finance include the Ministry of Finance and the capital market regulatory body, BAPEPAM.¹¹ In addition, MUI and its National Syariah Board (‘DSN-MUI’)¹² have responsibility for overseeing doctrinal compliance by Islamic financial institutions. The Religious Courts¹³ and the National Syariah Arbitration Body¹⁴ deal with Islamic finance disputes. There is also a range of non-bank *shari’*a financial institutions, including *takāful* Islamic insurance agencies, micro-finance institutions,¹⁵ and public (‘BAZ’)¹⁶ and private

⁷ Ar: *fatwā*, legal opinion of religious scholars.

⁸ ‘MUI dan Muhammadiyah Fatwakan Bunga Bank Haram, NU Khilafiyah’, *Voice of Al-Islam* 5 April 2010, <<http://www.voa-islam.com/news/indonesia/2010/04/05/4722/mui-dan-uhammadiah-fatwakan-bunga-bank-haram-nu-khilafiyah>>.

⁹ Ibid.

¹⁰ Umar Juoro, ‘The Development of Islamic Banking in the Post-Crisis Indonesian Economy’ in Greg Fealy and Sally White (eds), *Expressing Islam: Religious Life and Politics in Indonesia*, (ISEAS, 2008) 229, 232–3.

¹¹ *Badan Pengawas Pasar Modal dan Lembaga Keuangan* [Capital Market and Financial Institution Supervisory Agency].

¹² *Dewan Syariah Nasional — MUI*.

¹³ *Pengadilan Agama*.

¹⁴ *Badan Arbitrase Syariah Nasional* (‘BASYARNAS’), formerly the Indonesian Muamalat Arbitration Body, *Badan Arbitrase Muamalat Indonesia* (‘BAMUI’).

¹⁵ *Baitul Mal wat Tamwil* (Ar, *bayt al-māl wa tamwīl*) are increasingly popular in Indonesia. They are essentially savings and loan cooperatives that operate according to ‘*syariah* principles’: see M Shiddiq al-Jawi, ‘Baitul Mal wat Tamwil Dalam Sistem Ekonomi Islam’, *Jurnal Ekonomi Ideologis*, 7 March 2004, <<http://jurnal-ekonomi.org/2004/03/07/baitul-mal-dalam-sistem->

(‘LAZ’)¹⁷ *zakāt*¹⁸ collection agencies. Universities and other educational institutions provide training on Islamic finance and economics. Private organisations are also active in this area: for example, the Syariah Economy Society¹⁹ and the National Association of Syariah Banks, as well as *ṣukūk*²⁰ businesses and other Islamic security enterprises. There is also the Jakarta Stock Exchange, with its Jakarta Islamic Index or JII, and, of course, the general public, as depositors, borrowers and investors, among other capacities.²¹

The chief forms of financial institution that comprise the *shari’*a banking system are categorised by Bank Indonesia as General Syariah Banks, Syariah Business Units and People’s Credit Syariah Banks. The 1992 *Banking Law*²² defines a ‘General Syariah Bank’ (*Bank Umum Syariah*) in art 1(3) as a commercial bank operating under ‘syariah principles’; that is, one that complies with Islamic prohibitions against *ribā*, *gharar*,²³ *qimār*,²⁴ and other *ḥarām* (religiously prohibited) activities.²⁵ As at 2008, there were three General Syariah Banks in Indonesia: PT²⁶ Bank Muamalat Indonesia (since 1992); PT Bank Syariah Mandiri (since 1999); and PT Bank Syariah Mega Indonesia (since 2004). The first of these was established as an Islamic bank, while the other two began as conventional banks²⁷ and later converted.²⁸ By 2010, two more General Syariah Banks had been formed, both converted from conventional non-foreign exchange banks: PT Bank BRISyariah and PT Bank Syariah Bukopin.²⁹ By late 2010, the total number of General Syariah Banks had increased to 10, with the addition of PT Bank BCA Syariah, PT Bank Panin Syariah, PT Bank Victoria Syariah, PT Maybank Syariah Indonesia and PT Bank Jabar Banten Syariah.³⁰

ekonomi-islam/;> and Minako Sakai, ‘Community Development through Islamic Microfinancing: Serving the Financial Needs of the Poor in a Viable Way’ in Greg Fealy and Sally White (eds), *Expressing Islam: Religious Life and Politics in Indonesia*, (ISEAS, 2008), 267–85.

¹⁶ Badan Amil Zakat (‘BAZ’).

¹⁷ Lembaga Amil Zakat (‘LAZ’).

¹⁸ Ar: *zakāt*, charitable contribution required to be made by a Muslim in accordance with Muslim law, Islamic alms-giving.

¹⁹ *Masyarakat Ekonomi Syariah* (‘MES’).

²⁰ Ar: *ṣukūk*, Islamic bond.

²¹ Bank Indonesia, above n 3, 5.

²² As amended by the 1998 *Banking Amendment Law*, and the 2008 *Islamic Banking Law*.

²³ Ar: contractual uncertainty, fraud.

²⁴ Ar: gambling or financial speculation.

²⁵ Juoro, above n 10, 229.

²⁶ PT or *Perseroan Terbatas* is the Indonesian equivalent to a propriety limited corporation in the Australian system.

²⁷ Bank Susulia Bhakti and Bank Umum Tugu respectively

²⁸ Juoro, above n 10, 230. See below for a discussion of the process for conversion, which is controlled by Bank Indonesia.

²⁹ PT Bank BRISyariah was formed from a merger of the Bank Jasa Arta and PT Bank Rakyat Indonesia’s Syariah Business Unit. PT Bank Syariah Bukopin was formerly PT Bank Persyarikatan

³⁰ PT Bank BCA Syariah was previously PT Major International Bank (PT Bank UIB), which was purchased by PT Bank Central Asia and converted to Syariah Bank status. PT Bank Panin Syariah was previously PT Bank Harfa. PT Bank Victoria Syariah was PT Bank Swaguna. PT Maybank Syariah Indonesia was PT Bank Maybank Indocorp. PT Bank Jabar Banten Syariah was formerly the Syariah Business Unit of PT Bank Jabar Banten. ‘Islamic banking business grows 35.6 per year’, *Indonesia Commercial Newsletter*, 2 November 2010 <<http://www.highbeam.com/doc/1G1-250579223.html>>

The 'Syariah Business Unit' (*Unit Usaha Syariah*) is a division of a conventional commercial bank that is operated under 'syariah principles'. This is what is often referred to as an Islamic banking 'counter' or 'window' (art 6(m), 1992 *Banking Law*). The first of these opened in 1999, and by December 2004 there were some 15.³¹ By late 2008, the total had reached 25, falling to 23 by 2010 by reason of the conversion of some to General Syariah Bank status. Since April 2007, Bank Indonesia has permitted these units to operate out of existing branches of their parent bank. This so-called 'office channelling' soon led to a doubling of both numbers of Syariah Business Unit branches and of deposits.³²

'People's Credit Syariah Banks'³³ are rural credit banks operating under syariah principles and chiefly provide funding for agricultural activities (art 1(4), 1992 *Banking Law*, as amended).³⁴ By December 2004, there were 89 of these, increasing to 109 by late 2008 and 149 by 2010.

The following table summarises the growth of these three forms of Islamic banking institutions from 2002 to 2010.³⁵

Table: Number of Islamic banks by type 2002–10

Type of Bank	2002	2003	2004	2005	2006	2007/8	2010
General Syariah Banks	2	2	3	3	3	3	10
Syariah Business Units	6	8	15	19	20	25	23
People's Credit Syariah Banks	83	84	86	92	105	109	149
Total	91	94	104	114	128	137	182

III Islamic Bank Performance

According to government figures, the total profit of Islamic banks in Indonesia as at November 2004 was Rp137 072 000 000 (US\$15 917 000).³⁶ Total assets had grown from around Rp 7.7 trillion (US\$897 144 000) in November 2003 to Rp 14.04 trillion (US\$1 672 166 000) in November 2004.³⁷ By the end of 2006, assets had reached Rp 27 trillion (US\$2 865 189 000), and then Rp 29 trillion in

³¹ PT Bank IFI, PT Bank Negara Indonesia, PT Bank Jabar, PT Bank Rakyat Indonesia, PT Bank Danamon, PT Bank Bukopin, PT Bank Internasional Indonesia, HSBC Ltd, PT Bank DKI, BPD (Bank Pembangunan Daerah) Riau, BPD Klasel, PT Bank Niaga, BPD Sumut, BPD Aceh, and Bank Permata.

³² Juoro, above n 10, 240.

³³ *Bank Perkreditan Rakyat Syariah*, often referred to as 'Islamic rural banks'.

³⁴ Bank Indonesia, above n 3, ii.

³⁵ The table is compiled from the data and sources referred to in the preceding paragraphs.

³⁶ Bank Indonesia (2005) *Statistik Perbankan Syariah 4* <<http://www.bi.go.id/web/id/Riset+Survey+Dan+Publikasi/Publikasi/Statistik+Perbankan+Syariah/sps+0205.htm>>.

³⁷ *Ibid* 5.

2007 and Rp 90.4 trillion in 2010.³⁸ In 2004, Islamic financial institutions held 1.14 per cent of the total assets of all banks in Indonesia; by late 2006, 1.6 per cent;³⁹ and 1.7 per cent in 2007.⁴⁰ By 2008 they were as high as 1.98 per cent⁴¹ and a Deputy Governor of Bank Indonesia, Siti Fadrijah, even claimed they had reached 2.2 per cent.⁴² In 2010, they were at 3.1 per cent and its Syariah Banking Development Programme introduced in 2008, Bank Indonesia claimed that a 5.25 per cent share of national banking assets was achievable by 2015,⁴³ although this is probably optimistic.⁴⁴

In 2004, deposit funds held by Islamic financial institutions constituted 1.13 per cent of total deposits in Indonesia and they had extended 1.91 per cent of total credit in Indonesia. By 2006, however, deposits had climbed to 1.4 per cent and credit to 2.5 per cent of the national total.⁴⁵ According to Bank Indonesia,⁴⁶ the overall value of Islamic finance sector grew by more than 74 per cent per annum from 1998 to 2001, and 60 per cent per annum from 2001 to 2003, before doubling in 2004. Growth fell in 2005 to around 30 per cent but reached 65 per cent in 2006, well beyond the seven per cent average achieved by conventional banks over the same period, before declining again to 35 per cent in 2010. Obviously these high growth rates reflect the fact that Islamic banking in Indonesia has developed from a very small base, but Hamzah also attributes it to a flow of petrodollars from the Muslim Middle East, which he claims reached US\$2.25 billion by 2007.⁴⁷

The Islamic finance sector is significant, not only because it now accounts for over three per cent of overall Indonesian banking activity, but also because of its stability by comparison to conventional banks. Bank Indonesia claims that during the catastrophic economic crisis that began in 1997 and lasted for about five years, Islamic banking suffered less and recovered more quickly than conventional banks. Generally speaking, non-performing loan levels ('NPL') were lower in Islamic banks,⁴⁸ falling from 12.96 per cent to 4.14 per cent by 2002, as opposed to 26.77 per cent to 14.01 per cent for conventional banks over the same period.⁴⁹

³⁸ Juoro, above n 10, 233; and see Indonesia Commercial Newsletter, above n 30.

³⁹ Bank Indonesia above n 36, 13; Bank Indonesia, *Laporan Perkembangan Perbankan Syariah 2006* [Syariah Banking Development Report 2006] (Perbankan dan Stabilitas [Banking and Financial Stability] Publication, Bank Indonesia, 2006) <www.bi.go.id/web/id/Riset+Survey+Dan+Publikasi/Publikasi/Laporan+Perkembangan+Perbankan+Syariah/lpps_06.htm2006: 22>.

⁴⁰ Juoro, above n 10, 230.

⁴¹ Aditya Suharmoko, 'House endorses Islamic bank law', *Jakarta Post* (Jakarta), 18 June 2008; Boediono, 'Keynote Speech' (Speech at the Inaugural Session of the International Centre for Development in Islamic Finance, Jakarta, 25 June 2008) <www.ekonomisyariah.net/index.php?page=Berita:ViewDetailPage&id=154&pp=Berita:ListPage>.

⁴² See, '5 Bank Syariah Lahir Tahun 2009' [5 Bank Syariah [Will be] Born in 2009], *Portal Ekonomi Syariah Indonesia*, 24 November 2008, <<http://www.ekonomisyariah.net/index.php?page=Berita:ViewDetailPage&id=154&pp=Berita:ListPage>>.

⁴³ Hamzah, above n 1, 106; and see also Indonesia Commercial Newsletter, above n 31.

⁴⁴ Juoro, above n 10, 230.

⁴⁵ Bank Indonesia, above n 37.

⁴⁶ Bank Indonesia, above n 3, 5.

⁴⁷ Hamzah, above n 1, 101.

⁴⁸ Bank Indonesia, above n 3, 5.

⁴⁹ Ibid attachment 2(a): 6.

Negative spread in operational activities was largely absent in Islamic banks, while it was widespread in conventional banks.⁵⁰

One explanation for this is that rates of returns paid to depositors by Islamic banks are not determined by market rate fluctuations, as commissions and fees are usually set at the outset. Islamic banks, it is often argued, are thus protected against the high cost of funds caused by excessive fluctuations in market interest rates. Consequently they are able to lend at lower cost. This is reflected in their relatively high loan to deposit ratio. In 2001, conventional banks' ratios in Indonesia generally stayed below 50 per cent, while Islamic banks enjoyed ratios well above 100 per cent. In 2007, conventional banks had reached 63.2 per cent but Islamic banks sat at 104 per cent.⁵¹ This disparity also reflects the fact that, *shukūk* aside, lending is one of the relatively few means by which Islamic banks in Indonesia can earn income.

IV Development of a Regulatory Framework

Forms of Islamic banking operated in Indonesia before the state began legislating for it. By the late 1980s, several non-bank financial institutions offered Islamic profit-share contracts, although they lacked a formal legal regulatory framework for doing so.⁵² When Indonesia's first official Islamic bank, Bank Muamalat Indonesia, was established on 1 November 1991, no banking regulations were in place to support it. Indeed, the banking legislation at that time⁵³ defined 'bank revenue' as 'revenue from interest' — precisely the notion prohibited by conservative interpretations of *ribā*.

Despite lacking a regulatory framework and being a tiny part of the overall banking sector, Islamic banking attracted enough consumer support to survive. During the last years of the New Order, Bank Indonesia accepted the need to recognise and regulate the activities of financial institutions purporting to operate under Islamic principles. It therefore began developing the policies and systems that now form the basis of the current regulatory regime. As mentioned, the first formal step was to enact *1992 Banking Law*, by which the government claimed to have implicitly recognised the Islamic banking system by providing 'the legal foundations for the establishment of 'profit-share banks'.⁵⁴ Although the Law itself was, at best, vague about Islamic finance, one of its implementing regulations,

⁵⁰ Ibid. Juoro disputes the conclusion that Islamic banks were better able to ride out the crisis, pointing to the experience of Bank Muamalat, the only Islamic bank operating at the peak of the crisis in 1997-1998. Bank Muamalat, he says, experienced NPLs as high as 60 per cent and was effectively bailed out by the Jeddah Islamic Development Bank; Juoro, above n 10, 240-1.

⁵¹ Bank Indonesia, above n 36.

⁵² Bank Indonesia, above n 3, 4.

⁵³ *Undang-Undang Nomor 14 Tahun 1967 tentang Perbankan* [Law No 14 of 1967 on Banking] (Indonesia).

⁵⁴ *Bank bagi hasil*. Adiwarnan A Karim, and Sukusah Syahdan, *Islamic Banking: Fiqh and Financial Analysis* (Rajagrafindo Persada, 2005) 1; Hamzah above n 1, 104.

Government Regulation No 72 of 1992 on Banks Applying Profit Sharing Principles,⁵⁵ provided more detail, particularly as regards doctrinal compliance.⁵⁶

A The Syariah Supervisory Board

Article 5 of *Regulation No 72 of 1992* required that banks ‘applying a profit share-based principle’ (that is, Islamic banks) must have a Syariah Supervisory Board or DPS.⁵⁷ This requirement has been adopted in all subsequent Islamic banking and finance regulation in Indonesia and is now an integral part of the system.

The DPS determines whether or not products, services and activities comply with the ‘*syariah*’ requirement. *Regulation No 72 of 1992 on Banks Applying Profit Sharing Principles* provided, for example, that the DPS is to be independent of the bank’s management, and is to be the internally-authoritative body for determining whether the bank’s financial products, services and activities ‘comply with Syariah laws’. Accordingly, DPS membership is limited to ‘people with substantial knowledge of Syariah laws’ and it is required to consult the DSN-MUI for guidance on issues of doctrine.

This effectively ties Islamic banking to the state’s institutional framework for managing Islamic legal traditions, in which the semi-official MUI is central. As a voluntary forum for ‘*ulamā*’ representing wide range of Islamic organisations, MUI is an NGO, not a state agency. In recent years it has certainly been prepared to express views contrary to the government, particularly on issues of public morality. Despite this, it remains endorsed and funded by government as a key source of state policy on Islamic issues. It enjoys a lucrative state monopoly on *halāl* certification and a revenue stream from the DPS system, as well as a significant annual budgetary grant from the Department of Religion. This is because although MUI was, in the past, a largely compliant agent of the New Order’s repressive, statist and developmentalist policies on Islam, it has been able to reinvent itself since Soeharto’s fall as a champion of a populist and often ‘hardline’ (*garis keras*) conservative orthodoxy that sometimes challenges, but more often leads, government policy. While doing so, it has managed to retain and exploit the aura of state endorsement it has enjoyed since the 1970s, allowing it to remain part of the ‘Muslim establishment’ of Indonesia — so much so that many Indonesians assume it is a government agency of some sort. In this way, it has become the most influential public advocate of conservative interpretations of *shari’a* in contemporary Indonesia.

⁵⁵ *Peraturan Pemerintah Nomor 72 Tahun 1992 tentang Bank Berdasarkan Prinsip Bagi Hasil* (Indonesia).

⁵⁶ As discussed below, this Regulation was later repealed by *Peraturan Pemerintah Nomor 30 Tahun 1999 tentang Pencabutan PP 70-1992 tentang Bank Umum Sebagaimana Telah Beberapa Kali Diubah Terakhir Dengan PP 73-1998, PP 71-1992 tentang Bank Perkreditan Rakyat, dan PP 72-1992 tentang Bank Berdasarkan Prinsip Bagi Hasil* [Government Regulation No 30 of 1999 on Revocation of PP 70-1992 on Banks as amended by PP 73-1998, 71-1992 on Rural Banks and PP 72-1992 on Banks Applying Profit Sharing Principles] (Indonesia).

⁵⁷ Dewan Pengawas Syariah (‘DPS’).

Since it was formed in 1999, the DSN-MUI has issued more than 50 *fatāwā*⁵⁸ offering ‘guidance’ relating to ‘Islamic economy and finance’, and cementing its own role. In these *fatāwā* it has, for example, summarised the role of the DPS as being to undertake periodic supervision of the bank; to submit proposals for development of the bank to the bank and to the DSN-MUI; to report on the products and operation of the company to the DSN-MUI at least twice in every financial year; and to refer questions that require resolution to the DSN-MUI.

There is currently some controversy regarding the fees payable to DPS members, and, ultimately, to the DSN-MUI. These are, of course, eventually paid by depositors and borrowers through bank fees. Because the DPS is an additional entity not required in conventional banks and insurers, it is often argued that it increases costs for Islamic financial institutions, although MUI and DPS members do not accept this. They say that compliance with Islamic norms in fact increases profitability such that the DPS fees do not render Islamic products uncompetitive.⁵⁹

B 1998 Banking Amendment Law

Enacted in the same year as Soeharto’s resignation, *Law No 10 of 1998 on Amendment of Law No 7 of 1992 on Banking* (the ‘1998 Banking Amendment Law’), was a watershed. It was the first Law to grant state authority to Islamic financial institutions unequivocally.⁶⁰ It placed them on an equal footing with non-Islamic banks, and opened Islamic finance to the whole banking sector. In this statute, Islamic banking was not treated by the state as a matter of religion but as a technical matter of banking regulation policy. As a result, authority over Islamic banks was placed principally in the hands of Bank Indonesia rather than the MUI or the Ministry of Religion.

Under the amended *1992 Banking Law*, the Reserve Bank was now responsible for the development and supervision of all banks, including Islamic banks (art 29). It was given the sole power to determine the maximum amount allowed for Islamic credit funding (art 11(1)), and banks wishing to engage in Islamic finance were bound by its guidelines for the provision of credits or funds ‘based on syariah principles’: art 8(2). The dominance of Bank Indonesia in Islamic finance in Indonesia was reflected in the law’s revealing treatment of ‘Syariah Principles’ in arts 6(m) and 8(2). These provisions did not refer to the Qur’ān or other sources of Islamic legal tradition, such as the *ḥadīth*⁶¹ or *fiqh*.⁶² Instead they described ‘Syariah Principles’ as being constituted by activities ‘in compliance with regulations fixed by Bank Indonesia’ (art 8(2)).

Although the *1998 Banking Amendment Law* provided general recognition for the Islamic finance industry, it was, like many Indonesian statutes, short on

⁵⁸ Ar: *fatāwā*, plural of *fatwā*, legal opinion of a Muslim religious scholar.

⁵⁹ See, eg, Muhammad Amin Suma, *Asuransi Syariah dan Asuransi Konvensional: Sistem, Konsep, Aplikasi dan Pemasaran* (Ciputat: Kholam Publishing, 2006) 43.

⁶⁰ Bank Indonesia, above n 3, 4.

⁶¹ Ar: traditions, records of the life and sayings of the prophet Muhammad.

⁶² Ar: Islamic jurisprudence.

detail. The following year *Government Regulation No 30 of 1999 on Revocation of PP 70-1992 on Banks as amended by PP 73-1998, 71-1992 on Rural Banks and PP 72-1992 on Banks Applying Profit-Sharing Principles* was issued. It repealed *Regulation No 72 of 1992 on Banks Applying Profit-Sharing Principles*, among others,⁶³ and confirmed that with the enactment of the *1998 Banking Amendment Law*, Bank Indonesia would regulate the operations of conventional banks (*bank umum*), Rural Syariah Banks and General Syariah Banks: art 3. This set the seal on the development of Indonesian Islamic banking as a state-sanctioned financial system, and Bank Indonesia moved quickly to set up its Directorate of Islamic Banking (*Direktorat Perbankan Syariah*). This Directorate now includes an Islamic Bank Supervision Team; an Islamic Banking Research and Regulation Team; and an Islamic Banking Licensing and Administration Team. Regulations produced by this Directorate are considered later in this article.

C *Law No 21 of 2008*

On 16 July 2008, the national legislature⁶⁴ passed a new Law on Syariah Banking that it had been considering since September 2005.⁶⁵ The new statute was based on three draft bills submitted by Bank Indonesia, the Indonesian Syariah Banking Association (*Asosiasi Perbankan Syariah Indonesia*) and the Association of Indonesian Muslim Intellectuals ('ICMI', *Ikatan Cendekiawan Muslim Indonesia*).⁶⁶ These three drafts were similar in content, but that of Bank Indonesia — which sought to centralise supervisory authority around the Bank itself — was the most comprehensive and had the most influence on the final form of the law.

Despite the fanfare that accompanied it,⁶⁷ the *2008 Islamic Banking Law* did not radically alter the existing regulatory framework for Islamic banking. Rather, it was a consolidation of existing laws intended to 'tidy up' inconsistencies,⁶⁸ and it explicitly stated in art 69 that the *1992 Banking Law*, as amended by the *1998 Banking Amendment Law* continued to apply to the extent not inconsistent with the new Law. This meant that Bank Indonesia maintained its pre-eminent role in the administration of Islamic banking. Indeed, if anything, its position was strengthened. The regulations issued by the Bank's Directorate of Islamic Banking therefore remain the best guide to the operation of Islamic banking in Indonesia today.

⁶³ Along with *Peraturan Pemerintah Nomor 70 Tahun 1992 tentang Bank Umum* [Government Regulation No 70 of 1992 on Conventional Banks] (Indonesia) and *Peraturan Pemerintah Nomor 71 Tahun 1992 tentang Bank Perkreditan Rakyat* [Government Regulation No 71 of 1992 on People's Credit Banks] (Indonesia).

⁶⁴ *Dewan Perwakilan Rakyat* ('DPR').

⁶⁵ *Undang Undang Perbankan Syariah Nomor 21 Tahun 2008*.

⁶⁶ See, ICMI website <<http://www.icmi.or.id>>.

⁶⁷ Suharmoko, above n 41.

⁶⁸ Hamzah, above n 1, 104.

D *Bank Indonesia Regulations on Islamic Banking*

By 2006 Bank Indonesia had issued 17 regulations, 14 circular letters and two guidebooks. In 2008 it also released a useful *Code of Islamic Banking Products*⁶⁹ intended to create consistency in the market by defining commonly-used forms of Islamic financial transaction. It identifies MUI *fatāwā*, Bank Indonesia regulations and accounting standards applicable to each transaction, as well as the kind of Islamic banking institution authorised to offer each product.

Regulations issued by the Bank can be loosely grouped in the following four subject matter categories, of which only a few examples are given in each case:

- (1) licensing (for example, Bank Indonesia Regulation [PBI] No 6/24/PBI/2004 on Commercial Banks Conducting Business based on Syariah Principles; PBI No 6/17/PBI/2004 on Rural Banks based on Syariah Principles; and PBI No 11/15/PBI/2009 on the Conversion of Business Activities from Commercial Bank to Syariah Bank);
- (2) inter-bank financial systems (for example, PBI No 2/8/PBI/2000 on Syariah Interbank Money Markets);
- (3) transactions (for example, the Code of Islamic Banking Products; PBI No 6/7/PBI/2004 on Bank Indonesia Wadiah⁷⁰ Certificates; and PBI No 7/46/PBI/2005 on Fund Mobilisation and Financing Agreements for Banks Conducting Business Based on Syariah Principles. This regulation provides definitions of most transaction types, and was formulated by reference to DSN-MUI);⁷¹ and
- (4) prudential regulation of assets and reserves (for example, PBI No 6/18/PBI/2004 on Earning Assets Quality for Syariah Rural Banks; PBI No 6 of 19/PBI/2004 on Allowance for Earning Asset Losses for Syariah Rural Banks; and PBI No 6/21/PBI/2004 on Statutory Reserves in Rupiah and Foreign Currencies for Commercial Banks Conducting Business Based on Syariah Principles).⁷²

PBI No 11/15/PBI/2009 on the Conversion of Business Activities from Commercial Bank to Syariah Bank⁷³ is particularly important for the growth of this sector. It establishes a procedure by which Bank Indonesia will determine when a bank is 'Islamic'. Article 4 provides that a conventional bank that wishes to

⁶⁹ The full Code is available at <www.bi.go.id/NR/rdonlyres/1DFA882B-16DB-44C9-8461-5CA3D8C637A5/16893/CODIFICATIONOFISLAMICBANKINGPRODUCTS.pdf>.

⁷⁰ *Wadiah* (Ar: *wadī'a*, trust or safekeeping) accounts are depositor current accounts on which interest is not paid, although most banks pay some sort of 'bonus'.

⁷¹ Hamzah, above n 1, 1–3.

⁷² See Bank Indonesia Regulation Number: 6/7/PBI/2004 on Bank Indonesia Wadia Certificates, <www.bi.go.id/biweb/utama/peraturan/pbi-6-7-04_engl.pdf>. All other PBI mentioned are available in translation at <www.bi.go.id/web/en/Peraturan> with the exception of PBI No 2/8/PBI/2000

⁷³ This Regulation repealed PBI No 8/3/PBI/2006 of 30 January 2006 on Conversion of Business Activities from Conventional Commercial Bank to Commercial Bank Which Conducts Business Activities Based on Syariah Principles and Opening of Bank Offices Which Conduct Business Activities Based on Syariah Principles by Conventional Commercial Bank; and PBI No 9/7/PBI/2007 of 4 May 2007 on Amendment To PBI No 8/3/PBI/2006.

become an Islamic Bank can do so only with a Bank Indonesia licence for conversion. Under art 14, a request for such a licence must be submitted to Bank Indonesia and must include an overall plan for conversion, as well as:

- (a) a 'mission and vision' statement relating to conversion of business activities to become an Islamic Bank;
- (b) draft amendments for articles of association;
- (c) details of candidate controlling shareholders, candidate members of Board of Commissioners, candidate members of Board of Directors and candidate members of the proposed DPS;
- (d) a business plan;
- (e) a feasibility study on market opportunity and economic potential; and
- (f) a plan for settlement of existing customer rights and obligations.

The Elucidation⁷⁴ to art 14 provides that the candidates referred to in para (c) will be subject to 'fit and proper' testing by Bank Indonesia, and, in the case of DPS Candidates, to interviews by Bank Indonesia. Articles 16 and 17 impose obligations on banks that win approval to convert, including requiring use of the word 'Syariah' in its name (art 16(a)), fixing a timetable for commencement of Islamic banking activities of 60 days from the grant of the licence (art 17(1)), requiring full settlement of all outstanding conventional banking obligations within one year of the licence (art 17 (2)), and prohibiting the conduct of conventional banking (art 17(5)), to prevent mixing of Muslim funds with *haram* interest. Articles 17 and 19 also allow Bank Indonesia to impose punishments for breaches of these obligations, including administrative sanctions under art 58 of the *2008 Islamic Banking Law*, fines of up to Rp 30 000 000, and even revocation of the conversion licence.

The conclusion to be drawn is that Bank Indonesia generally applies a largely conventional banking framework for regulatory and supervisory activities to Indonesia's Islamic banks, rather than creating a separate system. Through this framework it has integrated Islamic banking into the state bureaucratic system for the management of banking.

The result is that *shari'a* banking is often more 'banking for Muslims' than 'Islamic banking', because only limited room is available for doctrinal issues in the overall legal scheme created by the state. The examination of the content of the three Indonesian Islamic banking contracts offered later in this article supports this view. The only significant exception to this pattern is the grant to *ulamā* of a role in doctrinal interpretation through the internal DPS system. This role is to be exercised, however, under the supervision of MUI, which, while, as mentioned, independent and sometimes critical of government policy, was established under state auspices, is endorsed by the state as a source of policy on Islamic issues, and has always been funded by it. It is, in fact, a quango, and often operates in practice as a semi-official (if sometimes fractious) agency of the state.

⁷⁴ The *Penjelasan* or explanatory memorandum that customarily accompanies Indonesian regulations.

E *Accounting Standards*

The Financial Accounting Standards Board⁷⁵ of the Indonesian Accountants Association,⁷⁶ working with Bank Indonesia and Islamic financial institutions, has prepared various Statements of Financial Accounting Standards ('PSAK') for Islamic banking.⁷⁷ PSAK 59 (Accounting for Syariah Banking) was approved by DSN-MUI as *shari'a*-compliant and was updated by ED PSAK 101-106 and revised in 2006,⁷⁸ with PSAK numbers from 100 to 200 allocated for *shari'a* banking standards.⁷⁹

In 2003, Bank Indonesia also issued *Pedoman Akutansi Perbankan Syariah* [Indonesian Syariah Banking Accounting Guidelines] ('PAPSI').⁸⁰ These were criticised as giving rise a 'double tax' on many Islamic finance transactions, thus making them uncompetitive. This is because many Islamic transactions involve the routine purchase of a product by the bank and its marked-up sale to the customer in a way that does not occur in conventional transactions. Value added tax (VAT) may therefore be incurred both when the bank originally purchases the product and again when it is sold to the customer. In this case, PAPSI specifically treated *mudāraba* (profit-sharing joint venture agreements) as 'transactions of sale and purchase between bank and customer, whereby the bank is the seller and the customer is the buyer' and thus imposed VAT on them.⁸¹ This was seen as seriously constraining continued growth of the Islamic finance sector.⁸² After some debate, the government finally amended the *Law on Value Added Tax*⁸³ in October 2009⁸⁴ to remove the 'double tax bind', effective 1 April 2010.⁸⁵

⁷⁵ *Dewan Standar Akuntansi Keuangan* ('DSAK').

⁷⁶ *Ikatan Akuntan Indonesia*.

⁷⁷ For a list of Indonesian Accounting Standards and Interpretations, see Deloitte, *Accounting Standards Updates by Jurisdiction: Indonesia* (September 2009) IAS OLUS <<http://www.iaspl.us.com/country/indonesi.htm>>.

⁷⁸ These comprise ED PSAK 101 (Presentation of Shari'a Financial Statements); ED PSAK 102 (Accounting for Murabahah); ED PSAK 103 (Accounting for Salam); ED PSAK 104 (Accounting for Istishna); ED PSAK 105 (Accounting for Mudharabah); and ED PSAK 106 (Accounting for Musyarakah).

⁷⁹ Karim and Syahdan, above n 54.

⁸⁰ See Hamzah above n 1, 112; Karim and Syadnan, above n 54; and Bank Indonesia, above n 3, 22.

⁸¹ Angelo M Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future* (World Scientific Publishing, 3rd ed, 2012).

⁸² Juoro, above n 10, 244–50; and see Venardos, above n 81, 145.

⁸³ *Undang-Undang Nomor 18 Tahun 2000 tentang Perubahan Kedua Undang-Undang Nomor 8 Tahun 1983 tentang Pajak Pertambahan Nilai Barang Dan Jasa Dan Pajak Penjualan Atas Barang Mewah* [Law No 18 of 2000 on the Second Amendment of Law No 8 of 1983 on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods] (Indonesia).

⁸⁴ *Undang-Undang Nomor 42 Tahun 2009 tentang Perubahan Ketiga Atas Undang-Undang Nomor 8 Tahun 1983 tentang Pajak Pertambahan Nilai Barang Dan Jasa Dan Pajak Penjualan Atas Barang Mewah* [Law No 42 of 2009 on the Third Amendment to Law No 8 of 1983 on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods] (Indonesia).

⁸⁵ Hamzah, above n 1, 112–13.

F *Dispute Resolution*

Legal dispute settlement in relation to *syariah* banking activities has been handled by MUI and by BAMUI, now known as BASYARNAS. This is an independent body that was established by MUI in October 1993 as the specific-purpose arbitration body for Islamic finance, although it can also accept conventional banking disputes. It has not, however, been particularly active. From 1997 to 2001, for example, it decided only 17 cases.⁸⁶

Undang-Undang Nomor 3 Tahun 2006 tentang Perubahan Undang-Undang Nomor 7 Tahun 1989 tentang Peradilan Agama [Law No 3 of 2006 on the amendment of Law No 7 of 1989 on the Religious Courts] (Indonesia) expressly granted those courts jurisdiction over ‘*syariah* economy’ in the amended art 49, and this was confirmed by art 55 of the *2008 Islamic Banking Law*. The Elucidation to art 49 defines ‘*ekonomi syariah*’ very broadly as all conduct or activity carried out ‘in accordance with *syariah* principles’ in a broad sense, including ‘*syariah* banking, *syariah* microfinance institutions, *syariah* insurance, *syariah* reinsurance, *syariah* mutual funds, *syariah* obligations and medium-term notes, *syariah* securities, *syariah* financing, *syariah* pawnbroking, *syariah* financial institution pension funds, and *syariah* business’.

Uncertainty remains, however, as to how Islamic banking disputes will be handled by the courts. Guidance is offered to the Religious Courts by the new *Kompilasi Hukum Ekonomi Syariah* [Compilation of *Syariah* Economic Law] (‘KHES’). Containing 796 articles, this is a detailed ‘benchbook’ selection of *fiqh* on Islamic finance, much of which is drawn from DSN-MUI fatwa. It was issued in the same year as the new *2008 Islamic Banking Law*, but decisions on the issues it covers were not available the time of writing. The judges of the Religious Courts have always dealt almost exclusively with family law and have been slow to explore the technically complex and challenging area of Islamic finance.

G *The Blueprint for Islamic Banking Development in Indonesia*

The current supervisory framework for Islamic banking in Indonesia can be divided into four categories:⁸⁷

- Financial aspects and prudential supervision are in the hands of Bank Indonesia, as is overall policy leadership.
- *Shari’ah* compliance is dealt with by each institution’s *Syariah* Supervisory Board, under the authority of the National *Syariah* Board created by MUI.

⁸⁶ In that period a total of 19 cases were submitted. Two cases were listed as pending in 2010: see Yogie Respati, ‘Basyarnas Sosialisasi Penyelesaian Sengketa Muamalah’ [Basyarnas Socialises Muamalah Dispute Resolution], *Republika*, 28 September 2010, <<http://www.republika.co.id/berita/bisnis-syariah/berita/10/09/27/136724-basyarnas-sosialisasi-penyelesaian-sengketa-muamalah>>.

⁸⁷ For a summary of supervision arrangements, see Bank Indonesia, above n 3, 11.

- Financial market supervision of domestic banks is managed by the Syariah-based Interbank Money Market (PUAS) through the Mudharaba Interbank Investment Certificate system.
- International transactions operate through the International Islamic Financial Market.⁸⁸

The *2008 Islamic Banking Law* confirmed, however, that Bank Indonesia had overriding supervisory authority regarding Islamic banking in all aspects. Bank Indonesia's *Blueprint for Islamic Banking Development in Indonesia* was formulated in 2002 pursuant to the bank's authority to 'establish a sound syariah banking system'.⁸⁹ It is brief, but remains the best guide to state policy in this area.

Broadly speaking, the Blueprint identifies four overarching strategic initiatives for the period to 2015, as follows.⁹⁰

- (1) Compliance with *shari'a* principles in banking operations through:
 - building better understanding of *shari'a* financial concepts;
 - promoting and facilitating the formulation of *shari'a* financial forms and standards;
 - conducting a study on integrated mechanisms and systems for regulation and supervision; and
 - formulating a bank rating system appropriate to the characteristics of *shari'a* banking.
- (2) Improved regulatory and supervisory instruments/prudential practices in banking, with the ultimate objective of creating a self-regulatory banking system.
- (3) Training to build capacity of staff in Syariah Banks and Bank Indonesia, for example, 'murabahah receivables training for rural bank account officers'; basic training in *shari'a* banking for Bank Indonesia staff; upgrading training for bank supervisors; and training for certification of bank supervisors.
- (4) Providing technical and operational assistance to Syariah Economics Communication Centres⁹¹ within the public education system.

Bank Indonesia's priorities include improving the quality of the early warning system for Islamic banking, the CAMEL⁹² rating system; improving regulation of reserve requirements for Islamic banks and earning asset portfolios; and strengthening mechanisms for cooperation between People's Syariah Banks and General Syariah Banks or Syariah Business Units to improve financial services to rural communities. Finally, the Bank seeks the creation of, among others, a formal *shari'a* audit body; a communication board to enable coordination of efforts to improve public awareness and education for *shari'a* banking; an

⁸⁸ See generally, International Islamic Financial Market (IIFM) <www.iifm.net/>.

⁸⁹ Bank Indonesia, above n 3, 2.

⁹⁰ Summarised from Bank Indonesia, above n 3, 27–8.

⁹¹ *Pusat Komunikasi Ekonomi Syariah*.

⁹² An international system of bank rating according to Capital adequacy, Asset quality, Management quality, Earnings and Liquidity.

institute for *shari'a* financing insurance to protect to Syariah Banks from fraudulent practices by customers; and a *shari'a* finance information centre.⁹³

It is obvious from this brief account that the model of Islamic banking development in the Blueprint is based on state institutional development and is little concerned with religious doctrine. According to the Blueprint, Bank Indonesia seeks to support:

[t]he establishment of a competitive efficient syariah banking system that complies with prudential banking principles, and significantly supports real sector activities through [profit] share-based financing with real underlying transactions in the spirit of justice, brotherhood and good deeds to promote the well-being of the nation.⁹⁴

It is significant that this statement does not even mention Islam. Indeed state policy in this area is little concerned with *fiqh*, which is left to the DPS in each Islamic financial institution and MUI's national-level DSN. In fact, the Blueprint even proposes modifying *fatāwā* to match not Islamic tradition but state regulatory policy, calling for 'promoting and facilitating the formulation of syariah financial forms and standards' through 'harmonization of fatwa issued by the National Syariah Board with syariah banking regulations'.⁹⁵

V Three Islamic Banking Contracts⁹⁶

This section examines three Islamic banking contracts produced by Bank Muamalat to determine whether they reflect the overall trend in this sector of favouring established models derived from the conventional finance sector. These contracts were selected as broadly representative of precedents used by banks and lawyers involved in Islamic banking. As mentioned, Bank Muamalat was Indonesia's first Islamic Bank when it was established in 1991, and it was endorsed by the Indonesian government, MUI and ICMI. Its initial capitalisation was only Rp 106 billion (around US\$11 million) but by 2004 it had acquired assets of over Rp 5.2 trillion (US\$546 million), and by 2006, Rp 8.37 trillion (US\$928 million). As Indonesia's leading Islamic financial institution its contracts are thus likely to influence the forms of transaction chosen by other institutions.

The first contract examined has almost no Islamic content. The second is a standard form financial contract with nominal 'Islamic' aspects. The third has a higher level of doctrinal content. This variation is likely to be a commercial response to both differing customer understandings of the *ribā* prohibition and the need to compete with non-Islamic banks. All three contracts are drafted in a similar way to 'conventional' non-Islamic commercial contracts. They predetermine returns for the lender at a level comparable to current conventional interest rates.

⁹³ Bank Indonesia, above n 3, 11.

⁹⁴ Ibid 2.

⁹⁵ Ibid 26.

⁹⁶ Research for this section was contributed by Jeremy Kingsley and Peter Chamberlain, formerly research assistants in the Asian Law Centre at the University of Melbourne. I am grateful to the late Bpk Suryadi, Chief Judge of High Religious Court in Banten, for providing copies of the contracts.

Strictly, predetermined returns are problematic in Islamic finance. A fundamental tenet of Islamic lending is the emphasis on risk being shared, rather than offering guaranteed returns for the lender. Islamic banking transactions such as these are therefore sometimes criticised in Indonesia for masquerading as Islamic.

This ‘engineering’ to fit religious norms into established commercial practice is, of course, certainly not unique to Indonesia. Contracts of this kind are common enough in Islamic banking worldwide, as is dispute as to their religious authenticity and compliance with rules of *shari’a*. Scholars who have investigated Islamic financial contracts in neighbouring Malaysia, for example, have found very similar problems and controversies.⁹⁷

A Contract 1 – Agreement for the Transfer of Title of Export Bills

There is almost nothing expressly ‘Islamic’ about this contract aside from the introduction, which begins with the customary Islamic invocation *Bismillah Hirrahman-Nirraheem* [In the name of God, the Gracious, the Merciful].⁹⁸

This contract does not follow the form of any standard Islamic financial instrument. It does not even claim anywhere to be one, for example, by using an Arabic title or term to describe the transaction it governs. By contrast, the other two contracts expressly identify themselves as one of the three common and well-established Islamic finance structures that together constitute 95 per cent of Islamic finance transactions in Indonesia: *musharabah*, *murabahah* and *mudharabah*.⁹⁹

The recitals and c11 declare the contract to be a loan issued against export bills, that is, rights over payment arising from international sales. Clause 3 deals with repayments, which include amounts in addition to the sum loaned, such that the total received by the bank will exceed the amount loaned:

[t]he client will return to the bank, in the same currency, payment to the same amount that s/he has received ... plus the loan margin set by the bank at the date of payment, which is calculated from the date of transfer of rights of the export bills to the date of repayment.

In cl 5.1 this surplus is identified as a ‘commission’:

[w]ith each transfer of title of export bills, the client shall pay a commission that is calculated from the value of the export bill according to a rate that is determined by the bank.

Although interest rates are usually identified in conventional banking contracts by way of percentage figures connected to repayments rather than a fixed fee, the effect of the commissions is nonetheless essentially the same, at least so far as fixed interest is concerned. This contract is therefore essentially a standard commercial arrangement with a veneer of Islamic content. It is not substantially different to a fixed rate loan agreement offered through conventional banks.

⁹⁷ Matt Richards, ‘Islamic Contracts of Finance in Malaysia’ (2003) 10 (1) *Studia Islamika* 161–200 (Special Issue: *Shari’ah Law in Southeast Asia*).

⁹⁸ Ar: *bismillāh ar-rahmān ar-rahīm*.

⁹⁹ Ar: *musharaba*, *murābaha* and *mudāraba*. See Bank Indonesia above n 40.

B *Contract 2 – Murabahah Funding Agreement*

In both language and substance, this contract is more Islamic in style. Again, it commences with *Bismillah Hirrahman-Nirraheem*, but by contrast to Contract 1, an Arabic term appears in its title. It is labelled a ‘*Murabahah Funding Agreement*’.

In its preamble, this contract specifies that Indonesian law applies to it. *Shari’a* is only mentioned as a ‘tool’ to help interpret the contract. Islamic legal tradition is thus framed as an interpretive device rather than a source of substantive legal rules. This, of course, raises the question of how *shari’a* is to be used in this way. Could *fatāwā*, for instance, be used to affect interpretation? Or *fiqh* textbooks? The contract is silent on this issue.

The preamble to the contract also states that the requirement of a secured level of profit in addition to the cost of setting up the loan is identified as an essential part of the contract. *Murābaha* is essentially a cost-plus or mark-up form of contract,¹⁰⁰ and it provides the framework for 65 per cent of Islamic financial transactions in Indonesia.¹⁰¹ It has been used widely as a financial instrument in Islamic banking elsewhere but the fixed nature of repayment that a *murābaha* contract secures has been controversial. So, for example in ‘The Client’s Considerations’, cl 2.1 states that the lender will purchase goods and the borrower will then purchase these from the lender at a price based on an agreed ‘ratio of profit’ which is effectively fixed:

[t]he Client, on behalf of the Bank, purchases goods from the Supplier for her/his business purposes, with the funds provided by the Bank. Thereafter the Bank will sell the goods to the Client at the same price as the purchase price, plus the percentage ratio of the profit margin agreed upon by both parties, and the cost of setting up the Agreement.

See also cl 6). This is not strictly a fixed return, but rather a proportion of profits that the bank has done its utmost to pre-determine without actually fixing the sum in the way that a conventional bank would. Although the ‘mark-up’ is not a precise equivalent to a fixed price return to Bank Muamalat, it comes very close, as scholars have noted of similar contracts elsewhere.¹⁰²

The return to the lender is also assured through a ‘guarantee’ outlined in cl 8. This guarantee operates through the provision of loan security in the form of assets. In the case of non-payment of instalments, cl 8.1 and cl 8.3 allows the provider of finance to seek further security. Risk is thus still placed largely on the borrower, rather than being equally shared.

¹⁰⁰ Ibid; and Abdullah Saeed, ‘Indonesian Islamic banking in historical and legal context’, in Tim Lindsey (ed) *Indonesia: Law and Society* (Federation Press, 2nd ed, 2008) 318–23.

¹⁰¹ Juoro, above n 10, 235, puts it at 59.2 per cent.

¹⁰² See, eg, the surveys of debate on this issue in Abdullah Saeed, ‘Islamic Banking in Practice: A Critical Look at the Murabaha Financing Mechanism’, (1993) 1(1) *Journal of Arabic, Islamic and Middle Eastern Studies* 59–79; Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (E J Brill, 2nd ed, 1999); Saeed, above n 100; and Muhammad Nejatullah Siddiqi, *Issues in Islamic Banking: Selected Papers* (Islamic Foundation, 1983), among others.

Clause 19.1 provides for contractual disputes to be resolved using an ‘Islamic’ arbitration institution, namely BAMUI (now BASYARNAS). This clause only requires attendance at the tribunal and provides the arbitrators with little guidance as to how Islamic norms would actually be applied or what their content might be.

This *murābaha* contract, therefore, is different to conventional banking arrangements where a specified return would be guaranteed, as in the first contract. These differences are, however, largely nominal and amount to only minor deviation from conventional ‘hire purchase’ arrangements offered by conventional banks.

C *Contract 3 – Mudharabah Agreement*

By contrast to Contracts 1 and 2, this contract has far more ‘Islamic’ content and context. Like the first two examples, the title again uses Arabic terminology, commencing with *Bismillah Hirrahman-Nirraheem*. It is also expressly labelled ‘*mudharabah*’, which is, as mentioned, an Islamic profit-sharing transaction usually seen as the ideal form of Islamic banking instrument, because the risk is, in principle, shared equally.¹⁰³

In the ‘Considerations’ section of the contract, a preamble outlines the nature of finance to be provided. Instead of a standard form of loan arrangement where the lender provides money to the borrower and has no further involvement other than receiving repayments, this contract provides for the ‘Islamic’ concept of a business partnership. To facilitate this, a profit-sharing provision is outlined in cl 2.2.1:

[t]he Bank and the Mudharib [borrower] agree on the sharing of profit based on this Agreement, namely that the income earned by the Mudharib will be shared with the ratio ---% for the Bank and ---% for the Mudharib, before tax and other fees.

See also cl 1. The contract does not lock the borrower into making set repayments. Rather it provides other forms of additional inducement for the lender, including a provision for profit adjustments to be made for later repayments. Clause 1.4:

[i]f at the time of the First Instalment the Mudharib has not met the first repayment in full... or within the agreed time frame, the Mudharib shall admit and agree that the Bank’s profit shall be increased in accordance with Section 2.2, until the amount of repayment is made in full.

See also cl 3.3:

[i]f the Mudharib is late in making a repayment then the repayment shall be carried into the following month, upon which it shall then be paid. As a result of the late repayment, the Mudharib shall agree to and accept that the profit share ratio will be adjusted according to Section 2.2.2.

¹⁰³ Saeed, above n 100, 318–19.

The terms of the profit-sharing arrangements are further outlined in cl 2. Clause 2.4 provides that the possible extent of liability for business losses incurred by the lender is limited strictly to the amount loaned:

[t]he Bank will only bear a loss which totals no more than the full amount of the funds loaned to the Mudharib.

It thus creates a limited business partnership based on risk being shared, rather than risk being carried by the borrower as in conventional loans. In this way, Bank Muamalat accepts more risk than would usually be expected in conventional financial arrangements. Clause 7, however, offers a safeguard measure for the lender, setting breach and termination provisions that will apply where the borrower has administered the business negligently. Given that risks are shared between borrower and lender, this mechanism is essential for protecting the lender's interests.

The only provision that suggests movement away from the application of *shari'a* is the 'applicable law' provision in cl 11, a one-line provision by which the laws of the Republic of Indonesia are applied without any reference to *shari'a*, although, again, dispute resolution must be before BAMUI (now BASYARNAS) in Jakarta (see cl 9). As with the Contract 2, how this clause will operate in light of the recent grant of jurisdiction for 'syariah economy' to the Religious Court is unclear.

Overall, this contract differs significantly from conventional banking contracts by reason of its risk-sharing structure. The question that arises is, however, how often would Bank Muamalat use this form of contract compared to the other two? On any reading other than that from piety, this seems a much less favourable financial instrument for the bank. It is possible that the bank selects from these three types of contract on the basis of customer expectations as to the nature of an Islamic banking transaction, but a more limited use of this third form of contract by comparison to the first two models is likely. Unfortunately, beyond reiterating that *murābaha* is usually said to be the most common form of Islamic banking contract used in Indonesia,¹⁰⁴ data are not available to confirm this.

The impression left from a comparison of these three contracts is of lack of uniformity and even fragmentation. It is not hard to see this as linked to a regulatory framework for the Islamic financial sector in Indonesia that privileges the state and marginalises *fiqh* traditions. The *'ulamā* do have a role to play in Islamic banking through the DPS system and its link at the national level to MUI, and they can influence the Reserve Bank, for example, by approving new financial products more quickly than can the bank.¹⁰⁵ Ultimately, however, authority remains in the hands of Bank Indonesia and it now exercises its powers bureaucratically and often very rigidly, particularly as regards prudential supervision.

¹⁰⁴ Bank Indonesia, above n 37; Juoro, above n 10, 235.

¹⁰⁵ Juoro, above n 10, 248–9.

VI Conclusion

Despite its beginnings as part of the New Order government's efforts to co-opt Muslim groups, Islamic finance developed a trajectory of its own. Drawing on models from elsewhere in the Islamic world, Indonesian entrepreneurs developed new financial institutions to a level where the state was forced to develop a more sophisticated regulatory response to catch up.

This it has done chiefly by bringing Islamic finance under the control of conventional financial regulatory structures, principally Bank Indonesia's prudential banking system. The religious aspects of the Islamic finance industry in Indonesia are dealt with through DSN-MUI, with a DPS lodged in each commercial financial institution, and looking to MUI for guidance. The result is a dual system of regulation. The state-endorsed MUI is the key to the regulation of 'Islamicity' in Indonesia's Islamic financial institutions, just as Bank Indonesia is the key to the close regulation of their commercial activities.

The Indonesian state will naturally always be concerned to exercise control over the administration of any aspect of Islamic legal traditions in Indonesia where wealth is involved. Although MUI has asserted its independence in the post-Soeharto period in many other areas, its approach to Islamic finance has not challenged state policy, and the sector has continued to grow rapidly. Controversy over the commercial benefits of the DPS has, however, been intermittent, and this may suggest an arena for future tension.