TALKING POINTS

ISLAMIC BANKING IN INDONESIA
Growth and Performance Review

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Although the market share of Islamic banking at the end of 2015 is still relatively small at around 5%, the industry registered faster growth rate compared to the conventional banking industry. Total assets of the Indonesian Islamic banking industry grew at a CAGR of 27% between 2009 and 2014, while the total banking industry assets grew at a CAGR of 17% during the same period. In fact between 2011 and 2012, the CAGR of Islamic banking industry reached a high of 30%. But broader slowdown of the banking industry overall growth due to weak economic environment had weighed on the financial performance of Islamic banks in Indonesia.

The year 2015 witnessed a slowdown of the country's Islamic banking industry, with growth slowing sharply to 8.78% in 2015 and 12.4% in 2014 (Table 1). Hence, 2015 marked the lowest growth rate recorded in the last five years. For many years, Islamic banking sector has been growing at a double digit pace, reaching its peak in 2011 after recording a 50% increase in total assets. Since then, the percentage growth rate has started to decline to 34.1%, 24.2%, and 12.4% in 2012, 2013, and 2014 respectively.

This slower asset growth of the Islamic banking industry stems from two major Islamic banks - Bank Syariah Mandiri (BSM) and Bank Muamalat Indonesia (BMI). Assets of these two banks accounted for almost half of the total Islamic banking assets in the country. However, their market shares have been slowly eroding over time, to be taken over by second tier Islamic banks. The market share of these two banks accounted for 55.2% in 2010, but declined to 43% in 2015. In fact, Islamic rural banks seem to have outperformed Islamic banks in 2015 although in absolute value they are much smaller. Islamic rural banks recorded a 17.8% growth in 2015, higher than its growth recorded in 2014 at 12.7%.

A number of macroeconomic headwinds had also attributed to this declining growth rate and in turn significantly impacted the overall growth of the industry. These include increased in electricity and gasoline prices towards the end of 2014, significant depreciation of the Indonesian Rupiah throughout 2015, dropped in Indonesian stock index, and social-political issues related to the seemingly weakening anti-graft body (KPK) under the new administration. For Islamic banking to play a more prominent role in the financial sector and in the bid to increase its market share beyond 5% (it was about 4.8% in December 2015), consistent high growth is a prerequisite.

PLAYERS AFFECTING GROWTH

Major players in the Islamic banking industry include 12 full-fledged Islamic commercial banks and 23 Islamic windows of conventional banks. In addition to this, there are 163 Islamic rural banks whose assets account for only 2.6% of total assets of the Islamic banking industry. Given their small asset size, Islamic rural banks are often left out in discussions related to Islamic banking. Tendency is to refer to full fledge-Islamic commercial banks and Islamic windows of conventional banks only.

The performance of the two largest Islamic banks, BSM and BMI, significantly affects the overall growth of the industry. At the time when both banks recorded the highest growth rate in 2011 (BSM and BMI grew at 49.84% and 51.47% respectively), Islamic banking was also experiencing its fastest growth. In a similar vein, when both banks experienced slowing down growth, the overall growth of the industry was also declining. After several growth years, BSM and BMI found themselves struggling with asset quality legacy of previous management. 2014 and 2015 can be considered as the 'test' years for these two banks.

As shown in Table 2, BSM had the lowest growth rate amongst other large Islamic banks after recording a 5% increase in 2014 and 2015. This was accompanied by a loss of IDR 25.7 billion in 2014 from a profit of IDR 883.8 billion in 2013. Although BSM managed to recover its profit to a high of IDR 374.1 billion in 2015, this was still less than half of its profit in 2013. Its rival on the other hand, BMI, experienced negative growth in 2015 after experiencing a 7.4% decline in assets to IDR 57.8 billion from IDR 62.4 billion in 2014. Worse still, it had to restate its 2013 earnings before tax to IDR 239.4 billion in its 2014 audited accounts from IDR 653.6 billion, so as to avoid a major loss in 2014. By February 2016, total assets of BMI deteriorated further to IDR 53.9 billion.

TABLE 1
ISLAMIC BANKING ASSETS IN INDONESIA (IDR TRILLION)

	2010	2011	2012	2013	2014	2015
Islamic Commercial Bank & Islamic Window	97.62	145.47	195.02	242.28	272.34	296.26
Islamic Rural Bank	2.74	3.52	4.70	5.83	6.57	7.74

Source: Financial Services Authority (OJK).
Notes: USD 1 = IDR 13,788 (Reuters closing rate on 31 Dec. 2015)

TABLE 2
THE TOTAL ASSETS OF SIX LARGEST ISLAMIC BANKS IN INDONESIA (IN BILLION INDONESIAN RUPIAH)

	2010	2011	2012	2013	2014	2015	Feb. 2016*
BSM	32,482	48,672	54,229	63,965	66,955	70,370	71,717
BMI	21,443	32,479	44,206	53,724	62,413	57,803	53,943
BRI Syariah	6,856	11,201	14,089	17,401	20,341	24,230	23,543
BNI Syariah	6,395	8,467	10,645	14,708	19,492	23,018	24,231
Permata Syariah (Islamic Window)	2,274	5,255	10,646	16,259	16,137	15,240	15,981*
CIMB Niaga Syariah (Islamic Window)	3,169	5,263	9,078	9,846	8,462	9,106	N/A

Sources: Figures for Feb. 2016 & BMI's figure in 2015 are un-audited figures from Bank Indonesia (the Central Bank) & other figures from audited Bank's Financial Reports.
*Notes: *As Of March 2016; USD 1 = IDR 13,788 (Reuters closing rate on 31 Dec. 2015).*

TABLE 3
EARNINGS BEFORE TAX OF SIX LARGEST ISLAMIC BANKS IN INDONESIA (IN MILLION INDONESIAN RUPIAH)

	2012	2013	2014	2015
BSM	1,097,133	883,836	(25,679)	374,126
BMI	521,841	239,351*	96,719	125,469**
BRI Syariah	138,052	183,942	10,378	169,069
BNI Syariah	137,744	179,616	220,130	307,768
Permata Syariah (Islamic Window)	256,420	465,421	283,010	184,159
CIMB Niaga Syariah (Islamic Window)	137,675	179,190	104,914	115,034

Sources: BMI's figure in 2015 are un-audited figures from Bank Indonesia (the Central Bank) & other figures from respective audited Bank's Financial Reports.
*Notes: *It is a restatement figure, before restatement it was IDR 653.62 billion.*
*** This figure is unaudited and may change once audited. The un-audited BMI figure in 2014 was IDR 121.346 billion, but it went down 20% once audited to IDR 96.719 billion.*

To some extent and with different magnitude, the growth slowdown was also experienced by second tier Islamic banks and windows (in term of assets) including BRI Syariah, Permata Syariah (an Islamic window of Permata Bank owned almost half by Standard Chartered Bank), and CIMB Niaga Syariah (an Islamic window majority owned Malaysian banking conglomerate CIMB). After a remarkable 100% growth in 2011 and 2012, Permata Syariah registered lower earnings before tax in 2014. This further declined in 2015 to record a 5.6% negative growth. However, in contrast to Permata Syariah; BRI Syariah and BNI Syariah recovered quickly in 2015 and both recorded commendable growth of 19.1% and 18.1%, respectively. CIMB Niaga Syariah also recovered its modest positive growth in 2015. It is interesting to note that the two biggest players are facing serious performance issues as compared to the second tier Islamic banks.

In terms of asset growth, BSM is the slowest growing Islamic bank compared to other Islamic banks in the last five years period, followed by BMI (Table 2). Asset growth of both banks is comparatively lower than the other four second tier Islamic banks. Consequently, their market shares have been shrinking over time. In addition to issues related to asset growth, Islamic banks suffered from lower profitability in 2014 (except for BNI Syariah), as shown in Table 3. BSM went into red whilst BMI recorded the lowest profit but could have potentially met the same fate as BSM if they had not restated their profits in 2013.

Among the second tier Islamic banks, BRI Syariah recorded the steepest drop in profit in 2014, although it increased drastically in 2015. BNI Syariah, on the other hand, is the only Islamic bank that exhibited steady increase in profit levels, implying stability in the bank's performance. In fact, BNI Syariah was the best performing bank in terms of profitability in 2014 and came in second in 2015.

CHALLENGES TO SUSTAINABLE GROWTH

Indonesia, having the world's largest Muslim population and a growing middle class, presents a wide spectrum of unique and untapped opportunities for Islamic banking and finance to play a critical role in supporting the country's economic development. In this context, Indonesia's Financial Services Authority or known in its Indonesian acronym as OJK, issued a wide range of incentives over the course of 2015 to drive the domestic Islamic finance industry. Amongst them was the launched the Shariah Banking Roadmap 2015-2019 in August 2015 aimed at boosting the market share of Islamic banks to 15% by 2023.

With the roadmap, the OJK has formulated several policy directions that when fully implemented will ensure that Islamic banking significantly contribute to sustainable economic growth, equitable development as well as the stability and competitiveness of the financial system. These policy directions include strengthen policy synergy between the government, relevant authorities and other stakeholders; boost Islamic banking capital via improvement in capital requirements of Islamic banks; improve the structure of funds to support the expansion of the financing segment; enhance the quality of products and services; enhance professional development support; and improve public literacy on Islamic banking products.

To spur further growth in the industry, the OJK issued regulation relating to the codification of Islamic banking products and the simplification of requirements to open an Islamic banking network. Under regulation No. 24/POJK.03/2015 titled 'Produk dan Aktivitas Bank Syariah dan Unit Usaha Syariah (Products and Activities of Islamic Banks and Islamic Windows [of a conventional bank])' issued in the November 2015 and made into law the following month, Islamic banks and Islamic windows are allowed to launch new products without a requirement to submit for approval to the OJK. But they will need to report any planned issuance of new products and/or new business activities.

In addition to various incentives and stimulus measures from OJK, Bank Indonesia (BI), the Central Bank of the country, had also facilitated the signing of the MoU for the use of the Mini Master Repo Agreement (MRA) in July 2015. The mini MRA is basically an agreement to repurchase Islamic securities as collateral to secure loans from other banks. With the use of the Mini MRA as a standard agreement, it is expected to provide more options to the industry players in managing their liquidity. In early 2016, BI issued a new rule pertaining to Islamic hedging through its regulation No 18/2/PBI/2016 'Hedging Principles based on Shariah Principles'. Under the new regulation, Islamic banks as well as conventional banks are now allowed to offer deferred sales of foreign exchange through Shari'a-based forward agreement.

While commitment to improve regulatory environment in Indonesia is very important in fostering growth and development of the Islamic banking sector, internal factors or bank-specific factors affecting banks' businesses and performance must not be overlooked. Evidence gleaned from researches showed that internal factors significantly affect bank's performance and profitability. Taking lessons from BSM and BMI, there is a need for a more steady and sustainable approach in fostering growth. One of the critical issues is to strengthen risk management, with greater emphasis now placed on embedding ethics into good corporate governance (GCG) policies.

Rapid asset growth that is not accompanied by proper risk management and ethically-based GCG, could potentially lead to financing risk in the medium and long term, especially for bigger size banks. Hence, in order to foster sustainable growth for the Islamic banking industry, there is a need to improve the quality of growth and strengthen the foundations of the growth itself, which includes greater product innovation, upgrading information technology, and developing talent that are crafted by strong values.

Finally, BI's vision to position Islamic banking as beyond banking needs to be put in place. There has to be realization from all stakeholders of the Islamic banking industry that Islamic banks are in a unique position to contribute to the creation of a more fair, ethical, inclusive and sustainable financial system. Experience somehow has taught us that to have a more robust and sustainable growth, we should not easily get trapped in the number games. We need to look beyond this and have bigger objectives. The numbers will follow suit.

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