# CHAPTER ONE
# INTRODUCTION

## 1.1 Background of The Problem

MitGhamr was the first Islamic bank established in 1963 as a pilot project to serve rural area in a small town in Egypt. Gradually, its operational feasibility triggered further development such as the set up of Islamic Development Bank in Jeddah (1975), Dubai Islamic Bank in Dubai (1975) and other Islamic national banks elsewhere. Indonesia made its first attempt to establish Bank Muamalat Indonesia in 1992, which was initiated by a group of Muslim intellectuals and supported by President Soeharto. The main reason for this development, in Indonesia and other parts of the world, is because Muslims believe that the Islamic law prohibits interest-based transaction since it is categorized as *riba*. This prohibition has been written in the Al-Qur'an, Al-Baqarah Verse 275:"…*Allah has permitted trading and forbidden interest*…" This has brought back the idea of profit-loss sharing mechanism, which was practiced by Prophet Muhammad S.A.W.

The Islamic banks in Indonesia had informally started before the issuance of legal foundation for Islamic banking in the form of Banking Law in 1992. Prior to this, only few of non-banking financial institutions had implemented profit sharing mechanism in their operational activities. The need of the people for such institutions eventually has expedited a recommendation to the government to authorize operations. To accommodate public calls for the presence of Islamic-based banking system, the government passed a Banking Act No.7 in 1992, which implicitly opened opportunities for Islamic banks business, although it still used a term of 'profit sharing banking' instead of Islamic banking. The operational foundation for this banking system further elaborated in details under Government Decree No.72 Year 1992, concerning Banking with Profit Sharing Principles. These set of regulations have served as legal foundations for Islamic banking operations in Indonesia and initiated an era of dual banking system. In 1998, Banking Act No.10/1998 was enacted to replace Banking Act No.7 year 1992 with the purpose to extend horizon of the legal foundation for Islamic banking system. According to the new Banking Act 1998, conventional bank is permitted to conduct banking business based on *shariah* principles by opening Islamic business unit. Hence, it marked the launch of dual banking system in Indonesia. Further, with the Act No. 23/1999, and its subsequent amendment Act No. 3/ 2004, provided authority for Bank Indonesia to conduct its banking regulatory authority roles and functions based on *shariah* principles. After that, Bank Indonesia formed a special unit called Islamic Banking Bureau during this period, which later in late 2003 expanded its authority to Directorate level. This Directorate and ex ante Bureau, focuses and has full authority on Islamic banking industry development. To stimulate continuous growth both in quantity and quality, Bank Indonesia formulated a strategy for Islamic banking development under the Blueprint of Islamic banking Development that was formerly launched in 2002 with further revision in 2007. To date, Islamic bank in Indonesia has marked its position in national banking industry. Table 1.1 below explains banking development in Indonesia in term of number of legal entities, number of offices and number of service outlets.

**Table 1.1 Number of Islamic Banks in Indonesia**

| Year | BUS | UUS | Offices | No. of OC | BPRS |
|---|---|---|---|---|---|
| 2003 | 2 | 11 | 337 | 0 | 84 |
| 2004 | 3 | 15 | 443 | 0 | 88 |
| 2005 | 3 | 19 | 550 | 0 | 92 |
| 2006 | 3 | 20 | 636 | 456 | 105 |
| 2007 | 3 | 26 | 711 | 1,195 | 114 |
| 2008 | 5 | 27 | 953 | 1,470 | 131 |
| 2009 | 6 | 25 | 1139 | 1,803 | 138 |

*Source: Islamic Banking Statistics, Bank Indonesia*

Note:
BUS :*Bank Umum Syariah*/Islamic Commercial Bank
UUS: *Unit Usaha Syariah*/Islamic Business Unit
OC: Office Channelling
BPRS: *Bank Pembiayaan Rakyat Syariah*/Islamic Rural Bank

During the period of January 2003 to December 2009, Islamic bank has shown some progress in other three major areas such as financing, funding and total assets that can be seen from the following Table 1.2.

**Table. 1.2 Comparison of Islamic and Conventional Banks**
**Total of Financing/Credit (in billion rupiah)**

| Year | National Banking | Islamic Banking | Market Share | Conventional Banking | Market Share |
|---|---|---|---|---|---|
| 2003 | 345,877 | 5,530 | 1.6% | 340,347 | 98.4% |
| 2004 | 450,135 | 11,490 | 2.6% | 438,645 | 97.4% |
| 2005 | 581,078 | 15,232 | 2.6% | 565,846 | 97.4% |
| 2006 | 658,945 | 20,445 | 3.1% | 638,500 | 96.9% |
| 2007 | 819,549 | 27,944 | 3.4% | 791,605 | 96.6% |
| 2008 | 1,092,488 | 38,199 | 3.5% | 1,054,289 | 96.5% |
| 2009 | 1,275,542 | 46,886 | 3.7% | 1,228,656 | 96.3% |

*Source: Islamic Banking Statistics, Bank Indonesia*

From the financing side, Islamic banks have shown increasing trend from 1.6% market share at the end of year 2003 to 3.7% at the end of year 2009, except year 2004 to 2005 whereby its total financing increased but its market share remained the same. As a result, the conventional banks showed its decreasing trend parallel with the increasing trend of the Islamic banks.

As for the funding side, Table 1.2 and 1.3 explain that customer deposits were properly channelled to the financing in the earlier table. Hence, Islamic banks managed its intermediary function very well.

**Table 1.3 Comparison of Islamic and Conventional Banking**
**Total of Funding (in billion rupiah)**

| Year | National Banking | Islamic Banking | Market Share | Conventional Banking | Market Share |
|---|---|---|---|---|---|
| 2003 | 748,344 | 5,725 | 0.8% | 742,619 | 99.2% |
| 2004 | 830,070 | 11,862 | 1.4% | 818,208 | 98.6% |
| 2005 | 945,742 | 15,582 | 1.6% | 930,160 | 98.4% |
| 2006 | 1,114,117 | 20,672 | 1.9% | 1,093,445 | 98.1% |
| 2007 | 1,312,809 | 28,012 | 2.1% | 1,284,797 | 97.9% |
| 2008 | 1,497,295 | 36,852 | 2.5% | 1,460,443 | 97.5% |
| 2009 | 1,694,820 | 38,195 | 2.3% | 1,656,625 | 97.7% |

*Source: Islamic Banking Statistics, Bank Indonesia*

Table 1.3 above shows the increasing trend of funding throughout the years starting from 0.8% in 2003 to 3.1% in 2009. Likewise, the conventional banks recorded a declining share to the overall national banks although its funding growth showed positive trend.

Lastly, Table 1.4 below explains share of Islamic banks' asset in national banking versus portion of conventional banks' asset in national banking.

**Table 1.4 Comparison of Islamic and Conventional Banks
Total of Assets (in billion rupiah)**

| Year | National Banking | Islamic Banking | Market Share | Conventional Banking | Market Share |
|---|---|---|---|---|---|
| 2003 | 1,221,377 | 7,859 | 0.6% | 1,213,518 | 99.4% |
| 2004 | 1,287,407 | 15,326 | 1.2% | 1,272,081 | 98.8% |
| 2005 | 1,490,707 | 20,880 | 1.4% | 1,469,827 | 98.6% |
| 2006 | 1,720,572 | 26,722 | 1.6% | 1,693,850 | 98.4% |
| 2007 | 2,023,039 | 36,538 | 1.8% | 1,986,501 | 98.2% |
| 2008 | 2,360,112 | 49,555 | 2.1% | 2,310,557 | 97.9% |
| 2009 | 2,600,196 | 66,090 | 2.5% | 2,534,106 | 97.5% |

*Source: Islamic Banking Statistics, Bank Indonesia*

The asset market share showed its positive development from 0.6% to 2.5% during the seven-years period but this has not attained the expected growth level. According to the Blueprint of Islamic Banking Development 2002 page 22, Bank Indonesia targeted 5% market share of Islamic banks' asset versus national banking in 2011. However, Islamic Banking Development Report 2006 page 80 stated that Islamic banks' market share towards the national banking share can be targeted at 5% using acceleration scenario by the end of 2008.

With all target statements as above, all Islamic banks agreed that they should have achieved 5% by the end of 2008. Pohan (2007) suggested that Bank Indonesia must exercise all available options to achieve the 5% targeted market share. In relation to the agenda, Bank Indonesia has released Bank Indonesia Regulation No. 8/3/PBI/2006 concerning *shariah* service or known as "office channelling", or Islamic banking services at conventional offices. Pohan added that the regulation must be well enforced or to become a compulsory policy for banking head offices to make their outlets as office channels or Islamic banks' services outlets. The policy was proven effective, at least to increase deposits of Islamic banks' customers due to wider service areas.

However, by the end of 2008 and 2009, Islamic banks failed to achieve its 5% market share target. It was recorded that Islamic banks achieved its total assets of Rp.49 trillions or only 2.1% market share at the end of 2008 and Rp.66 trillions or only 2.5% market share at the end of 2009. This failure has caught attention of many parties because the increase in asset is of paramount importance. Kahf (2004) supported that increase in assets is strongly indicative of the bank's ability to grow and succeed. More importantly, it indicates the bank's ability to generate earnings because growth in asset does not merely raise the amount of money the bank can invest, but it also increases the bank's ability to invest in projects with higher returns. In other words, the bank is able to improve the quality of its investment to a higher level of investment quality.

Using acceleration scenario, Islamic banks failed to achieve its target for 5% market share, but it doesn't mean their asset does not grow. Table 1.5 below shows the two scenarios of market share target of Islamic banks i.e. baseline and acceleration.

**Table 1.5 Baseline and Acceleration Target Scenarios of Islamic Banks' Assets (in billion rupiah)**

| Particular | Targeted | Targeted | Achieved |
|---|---|---|---|
| **2007** | **Baseline** | **Acceleration** | |
| Asset | Rp34,800 | Rp47,940 | **Rp36,538** |
| Market Share | 1.97% | 2.84% | **1.80%** |
| **2008** | | | |
| Asset | Rp48,400 | Rp91,570 | **Rp49,555** |
| Market Share | 2.51% | 5.25% | **2.10%** |

*Source: Islamic Banking Development Report 2006*

Under baseline scenario or under condition of *running the business as usual*, Islamic banks managed to achieve its total assets of Rp. 36,538 million in 2008 slightly higher than targeted Rp. 34,800 million. However, in terms of market share, Islamic banks only achieved 1.8% instead of 1.97%. Likewise, by the end of 2009, Islamic banks achieved Rp. 49,555 million, higher than the targeted Rp.48,400 million but only captured 2.1% market share instead of 2.51%. Comparatively, from acceleration scenario point of view, it shows achievement of Islamic banks in growth of asset and market share are far below the target, and that is the reference point for this study on why 5% market share target was not achieved. This happened because conventional banks also developed and surpassed the Islamic banks' growth in term of assets.

Islamic Banking Development Report 2006 page 66 elaborated that the acceleration projection can be realized with several conditions to be fulfilled, such as increase in capable human capital, increase in office branches, strong product and services development, and more conducive external environment such as more government support.

To earn better understanding on the background of the problem, the following table is presented. Table 1.6 shows real asset growth of both Islamic and conventional banks.

**Table 1.6 Comparison of Islamic and Conventional Banks' Asset Growth (in billion rupiah)**

| Year | Islamic Bank (Rp.) | Growth (%) | Conventional Bank (Rp.) | Growth (%) |
|---|---|---|---|---|
| 2003 | 7,859 | na | 1,213,518 | na |
| 2004 | 15,326 | 95.0% | 1,272,081 | 4.8% |
| 2005 | 20,880 | 36.2% | 1,469,827 | 15.5% |
| 2006 | 26,722 | 28.0% | 1,693,850 | 15.2% |
| 2007 | 36,538 | 36.7% | 1,986,501 | 17.3% |
| 2008 | 49,555 | 35.6% | 2,310,557 | 16.3% |
| 2009 | 66,090 | 33.4% | 2,534,106 | 9.7% |

*Source: Islamic Banking Statistics, Bank Indonesia*

Table 1.6 above shows growth of Islamic banks' assets decreased sharply after 2004 and the rest of the years experienced fluctuating growth. As for conventional banks, year 2004 was the worst asset growth rate compared to the succeeding years. However, after experiencing steady growth of asset, it failed to continue its higher growth at the end of 2009. There are several factors influenced the fluctuating growth of both banks that will be further discussed on Chapter Four.

Table 1.6 also explains Table 1.5 on why 5% targeted market share of Islamic bank was not achieved. It has been mentioned that it was due to the fast speed conventional asset growth that can be seen from year 2007 and 2008 data above. The Islamic banks enjoyed higher growth at 36.7% and 35.6% respectively, or increased from 28% in 2006. Likewise, conventional banks also enjoyed higher growth at 17.3% and 16.3% during the same years of observation, or increased from 15.2% in 2006. Percentage-wise, Islamic banks seem to have higher growth than of conventional banks but in essence, it grew only Rp.9.8 billion and Rp.13 billion in 2007 and 2008 respectively. Meanwhile, during the same years of observation, the asset of conventional banks grew at 17.3% and 16.3% but in essence it grew by Rp.292 and Rp.324 billion respectively. This indicates that Islamic and conventional banks grew at the same time but with different speed, causing the Islamic banks' asset share to national asset being outperformed by the conventional banks.

The question is what happens to Islamic banks' asset growth? There must be a reason why its growth speed cannot be faster therefore it failed to achieve its 5% market share target. This research is trying to analyse what factors influence the asset growth and that relates to Islamic banks' policy directions either internal or external factors. The internal factors identified in LPPS (2006) are increase in number of office branches, increase in number of human capital, strong product and services development and encouraging government support.

## 1.2 Problem Statement and Research Questions

Islamic banks' in Indonesia has failed to achieve 5% market share of the total national banking asset and that was due to its slower growth than the conventional banks. In the year 2007 and 2008, both banks grew but in different speed of growth. As shown on Table 1.6 above, the Islamic banks' asset growth was surpassed by the conventional banks' asset growth.

Thus, this research aims to analyse internal and external factors that have influenced the slow growth of asset in Islamic banks, which caused the acceleration growth scenario was not achieved.

Islamic Banking Directorate researchers (LPPS 2006, Bank Indonesia) mentioned the three factors are important determinants of the asset growth under acceleration projection scenario. Mishkin (2009:431-432) argues that more loan alternatives (strong product and service development) would contribute better asset management. Also different types of customers (spread in different office branches) and capability of bank's loan officers (human capital) are two other important parameters in banking asset management. Hence these factors are contributing factors to the asset growth.

Likewise, the main macroeconomic variables chosen for this research are interest rate, inflation and GDP. Berardi (2001) in Lindiawatie (2007) stated that the main variables in macroeconomics such as interest rate, inflation and GDP have become the main consideration in formulating economic and financial policies for investment. Therefore, financing as the biggest portion in Islamic banks' asset is determined by these variables. In addition, Islamic Banking Directorate researchers (LPPS, 2006) added that due to different industry characteristic, government support is included as determinant of the asset growth. It is suggested monthly industrial production index as mechanism of GDP measurement can be employed as the focus of this research as argued by Ilias and Lankanathan (2009) in their research that presents positive relationship between industrial production index and GDP of Malaysia and their impact on Maybank financial performance and growth.

Several internal factors have been identified such as number of office branches and channelling and number of human capital. As for the external factors, the variables that may affect the asset growth are interest rate, inflation and industrial production index (as proxy of GDP). Therefore, the problem statement for this research is that the market share of Islamic banks in Indonesia is less than 5% and there is a need to analyse factors that influence Islamic banks' asset growth. The factors identified are number of office branches and channelling, number of human capital, interest rate, inflation, and industrial production index.

Referring to the above problem, the research questions are formulated as follows:

1. Does bi-directional causality exist between industrial production index and asset growth in Indonesia?
2. Does number of office branches and channelling give impact on the asset growth of Islamic banks in Indonesia?
3. Does number of human capital give impact on the asset growth of Islamic banks in Indonesia?
4. Does interest rate give impact on the asset growth of Islamic banks in Indonesia?
5. Does inflation give impact on the asset growth of Islamic banks in Indonesia?
6. Does industrial production index give impact on the asset growth of Islamic banks in Indonesia?

## 1.3 Research Objectives

The purpose of this research are explained as follows:

1. To investigate whether bi-directional causality exists between industrial production index and asset growth in Indonesia.
2. To investigate whether number of office branches and channelling gives impact on the asset growth of Islamic banks in Indonesia.
3. To investigate whether number of human capital gives impact on the asset growth of Islamic banks in Indonesia.
4. To investigate whether interest rate gives impact on the asset growth of Islamic banks in Indonesia.
5. To investigate whether inflation gives impact on the asset growth of Islamic banks in Indonesia.
6. To investigate whether industrial production index gives impact on the asset growth of Islamic banks in Indonesia.

## 1.4 Limitations of Research

Other general limitations that may be necessary to be disclosed are as follows:

1. This research is only limited to the discussion of the asset growth of Islamic banks and may not represent a fair assessment of overall performance of Islamic banks during the period of the research.
2. This is an aggregate research between March 2004 to December 2009 of Islamic banks which is looking at the whole performance employing the bird's eye view thus individual Islamic bank may behave differently than this research may recommend.
3. Total Islamic and conventional banks referred in this research exclude BPR and BPRS (Rural Bank/Islamic Rural Bank) due to their different nature that may misrepresent the whole performance of the banks. This is also to follow standard of Information Department of Bank Indonesia on their statistical information of the banks in Indonesia. In addition, this also applies to BRPS number of human capital and number of office branches that are excluded from the statistics.

4. This research only focuses on internal and external factors consist of number of human capital, number of office branches and channelling, interest rate, inflation and industrial production index that give impact on the asset growth of Islamic banks that are limited to only several variables mentioned earlier. Certainly, there are other factors that are excluded and this research output may not represent overall judgement. Other factors such as strong product and service development and government support are excluded due to short period impact that may not be useful to be considered in this research.

## 1.5 Benefits of Research

It is expected that the following benefits from this research are achieved:

1. This research will contribute more structured research that can widen spectrum of knowledge and enrich references in Islamic banking research. With accounting background employed, it is expected that the research finding will provide more perspective to the development of accounting standards particularly on the issues of asset. Some variables used in the research are macro indicators therefore it is appropriate to relate the nature of Islamic accounting standard i.e. asset to the issues of IFRS convergence in lieu of globalization of accounting.
2. As for Islamic banks' managers, they may find alternative in managing its asset growth and identify as well as respond to the determining factors that influence it both internal and external factors.
3. As for Directorate of Islamic Banking, Bank Indonesia, it can impose strategic policies for Islamic banks to develop their assets and financial performance hence strengthen their asset growth and improve national economy.
4. As for public at large, it is to inform public about investment and financing alternative in Islamic banks in which indirectly they will also contribute to the national economy in general.

## 1.6 Research Method

Data used in this research is secondary data in form of monthly time series from Indonesian Statistic on Economics and Finance of Bank Indonesia (SEKI-BI), Islamic Banking Statistics (SPS), Indonesia Banking Statistics (SPI), Statistics Indonesia (BPS) and annual report of full-fledged Islamic banks. This research also refers to library books and previous studies.

The population for this study is all Islamic banks in Indonesia (aggregate total of Islamic commercial banks and Islamic business units) that existed between the periods of the research. This research uses only quantitative data with independent variables in the internal factors are number of office branch and channelling and number of human capital and independent variables in the external factors are interest rate, inflation, and industrial production index. Meanwhile, the dependent variable of this research is asset growth.

The research model is quantitative descriptive statistical model. First, Granger Causality test is conducted to examine whether bi-directional causality exists between variables. After that Impulse Response Function (IRF) and Forecast Error Variance Decomposition (FEVD) analysis are conducted to confirm the finding from Granger causality test. The analysis is conducted under Vector Auto Regression (VAR) framework. VAR simply illustrates the intervariable causative relation in the system by adding intercept. This method developed by Sims in 1980 (Ascarya, 2008), which considered all variables in the system is endogenous (defined in system) so this method is known as atheoretically model (non-theory base). If data employed is stationary at first difference and not at level, VAR model will be combined with correction on fault model and becomes Vector Error Correction Model (VECM). Impulse response function analysis is illustrated to see the response of endogenistic variable on other variable shocks in model. Variance decomposition analysis is also presented to find relative contribution of variable in explaining variability of endogenous variable.

## 1.7 Theoretical Framework

Theoretical framework is a model to create logics of relationship between factors that have been identified with the main subject of the research. Basically the theoretical framework is to discuss relationship between variables that are related one another or in the situation that is under investigation. After that, hypothesis is tested to examine if the formulation of theory is valid.

For this research, the factors identified are internal (number of human capital ad number of office branch and channelling) and external factors (interest rate, inflation and industrial production index) that will be further developed and tested whether they give impact on the asset growth of Islamic banks.

## 1.8 Systematic of Writing

**Chapter One: Background of the Problem.** This chapter elaborates brief history of Islamic bank and its yearly development from 2003 to 2009. Several financial performance indicators are presented to show comparison between Islamic bank and conventional bank in general. That includes identification of internal and external factors that may give impact to the asset growth of Islamic banks in Indonesia.

**Chapter Two: Literature Review.** This chapter explains and discusses definition, overview and theories related to Islamic banks with focus on its asset growth and factors that influence it. This also narrates previous studies that support research model.

**Chapter Three: Data and Research Methodology.** This chapter explains the research methodology, operational definition from each research variables and population (as objects of the research), gathering of data and data analysis technique. Variables identified are internal and external factors such as: number of office branch and channelling, number of human capital, interest rate, inflation, and industrial production index. Data used in this research is secondary data in form of monthly time series from Indonesia Statistic on Indonesian Statistics on Economics and Finance, Bank Indonesia (SEKI-BI), Islamic Banking Statistics (SPS), Indonesian Banking Statistics (SPI), Indonesian

Statistics (BPS) and annual report of full-fledged Islamic banks. This research also refers to library books and previous studies.

**Chapter Four: Analysis and Discussion.** This chapter is presenting analysis on model testing. At first, bi-directional causality is traced using Granger Causality test. After that the output is analysed by Vector Auto Regression (VAR). VAR model of this research is combined with correction on fault model and becomes Vector Error Correction Model (VECM). Impulse Response Function (IRF) analysis is illustrated to see the response of endogenous variable on other variable shocks in model. Forecast Error Variance Decomposition (FEVD) analysis is also presented to find relative contribution of variable in explaining variability of endogenous variable.

**Chapter Five: Conclusion and Recommendation.** This chapter presents conclusion of the testing of hypothesis, recommendation that may benefit some parties, limitation of research and suggestion for future research.