

Miranda S Goeltom: Opportunities for Indonesian investment through sharia financing – experiences and challenges

Keynote speech by Prof Dr Miranda S Goeltom, Acting Governor of Bank Indonesia, at the International Seminar on Islamic Finance and Banking “Opportunities for Indonesian Investment through Sharia Financing – Experiences and Challenges”, New York, 17 July 2009.

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Distinguished speakers and participants,

Ladies and Gentlemen,

May I ask you to join me in thanking God the Beneficent and Merciful for His unbounded grace that has enabled us to gather here today on such an important occasion, the International Seminar on Islamic Finance and Banking, entitled “Opportunities for Indonesian Investment through Sharia Financing: Experiences and Challenges”. I am thrilled to see so many distinguished speakers and participants, all prepared to contribute with their insightful experience and expertise.

In my opinion, this seminar is of paramount importance in the midst of our efforts to discuss alternative solutions to avoid a repeat of the current economic and global financial crises. In such a deep global crisis we must seek ways to survive and, subsequently, return to our previously hard-earned growth and stability. This is precisely the time when collective action is required most, in order for us all to survive this global financial tsunami and emerge the other side stronger and wiser. Given the depth and systemic nature of the crisis, a wait-and-see approach or simply hoping that recovery will take place on its own is utterly unacceptable.

The crisis and the current global financial system

Ladies and Gentlemen,

A number of analyses argue that the ongoing global financial crisis is inseparable from the effects of the global financial system. In the past decade, financial products have become more diverse, advanced and complex. This is attributable to the effect of innovative development in terms of information and technology, deregulation of supporting financial systems and a favorable global macroeconomic environment, including a low real interest rate.

BIS data shows that global financial assets stock increased sharply from about 100% of global GDP in 1980 to over 300% in 2005. This development was further accompanied by expansive growth in the amount and scope of derivatives and financial instruments. The position of interest rate swap and other derivatives reached USD600 trillion at the end of 2007 (11 times annual global GDP) compared to USD75 trillion in 1997 (2.5 times global GDP). The position of Credit Default Swap (CDS) also reached five times that of global corporate bonds in 2007, which is a very different picture when compared to conditions in 2004, where the share of CDS was just 85% of corporate bonds.

On the other hand, however, such developments also carried fatal side effects. Financial instruments have become more independent from their underlying transactions that should serve as the foundation. Risk assessment on the types of asset owned has also become more difficult and complex. We have further witnessed that the phenomenon of escalating activity in the global financial market turned out *not* to be permanent.

As we have noticed, bubbles have burst and brought terrible impacts on the global economy since mid 2007. The most commonly used adjective to describe the current financial crisis is “unprecedented”. It is unprecedented in terms of the speed at which events unfolded and triggered a series of domino effects; the scale of the impact that has become global; and it is truly unprecedented in terms of the panoply of unconventional measures taken by authorities around the world. This is clear for all to see in the policy responses taken to overcome the crisis, which is incredibly complex and certainly costly. The IMF projected that global economic growth would contract from 3.2% in 2008 to -1.3% in 2009, whereas economic growth in developed countries is expected to be even worse, shrinking by -3.8%. IMF also predicted that total losses due to the current global financial crisis will top US\$4 trillion, two-thirds of which stem from the banking sector.

The crisis and the sharia financial system

Ladies and Gentlemen,

The lesson we can glean from this crisis is that a sound and resilient economy is not based on speculative activity. Furthermore, financial sector activity must be founded on business activities that produce real benefits to the public. This condition, in my opinion, implies that the behavior of the current financial system needs to be reset; going back to basics (*khittah*) as intermediary institutions that distribute funds from surplus units to deficit units.

One alternative that has the potential to bolster back-to-basics principles would be to expand the role of the sharia financial system. This relates to the structural advantage of the sharia economic system, which does not permit speculative transactions or products without a real underlying transactions. A traditional sharia financial system focuses on conservative products and avoids exposure to high-risk financial instruments. Consequently, the dependence on financial instruments is comparatively low because investment in each financial instrument must be identified clearly and accurately.

The key characteristics of the sharia financing system also aligns the role of banks to be consistent with their primary function, namely to collect funds from their owners and distribute it to borrowers. To be more precise, the main function of banks is to facilitate and finance activities associated with the supply of goods and services to the people; more specifically “real” activities. Therefore, financing activities through sharia banking are closely linked to real sector development. Moreover, speculation and gambling, the main culprits behind the on-going crisis, are not tolerated. Thus, by design, the Islamic financial system can instill greater stability in an economy. And, if implemented correctly, the Islamic financial system can provide an optimal risk management system.

Sharia financial system performance

Ladies and Gentlemen,

The potential role of sharia financial institutions in the economy has been discussed on numerous occasions. According to The Banker magazine in 2007, sharia-compliant assets worldwide have grown by almost 30% per annum in recent years. Such growth outstrips most other business segments in financial services. In 2008, sharia financial assets worldwide reached \$643 billion and are expected to exceed \$1 trillion by 2010. In fact, there are currently more than 400 financial institutions offering sharia compliant products globally, including *Sukuk*, which has created significant demand in the market over the last five years. Countries like United Arab Emirates, Saudi Arabia and Malaysia are competing to become centers of Islamic finance.

In such a competitive environment, Indonesia also has a great opportunity to advance itself as the center of Islamic finance. As the most populace Muslim country on the planet, with a population of more than 237 million, Indonesia is undoubtedly a promising market.

Since the establishment of its first Islamic bank in 1992, the sharia industry in Indonesia has exhibited relatively robust growth. Sharia banking is in its infancy since the establishment of the first Islamic bank in 1992, however, has demonstrated strong and steady growth. Business volume has grown expansively, exceeding the growth rate of the banking industry as a whole. Currently in Indonesia there are three full Islamic banks (FIBs), 19 Islamic Banking Units at Conventional Banks (IBUs), and 92 Islamic Rural Banks. As a whole, the industry is supported by 531 Islamic bank offices currently operating throughout Indonesia (288 FIBs, 121 IBUs and 92 rural banks).

The sharia banking industry has amassed total assets amounting to Rp50 trillion (USD 4.2 billion), or 2.1% of all bank assets in Indonesia. This share has increased steadily from previous years: 1.4% in 2005, 1.6% in 2006, 1.8% in 2007 and 2.14% in 2008. With 1,470 branch offices spread over the country, the amount of financing provided by the industry has grown from a mere Rp 5.5 trillion (USD 458 million) in 2003 to Rp 28 trillion (USD 2.3 billion) in 2007 and Rp 38 trillion (USD 3.2 billion) in 2008. The industry has also shown its commitment to support micro and small-scale businesses with microcredit financing (KUR). By the end of 2008, total microcredit extended by sharia banks reached Rp 326 billion (USD 27 million). As a whole, the Islamic banking sector has grown at a compounded annual growth rate (CAGR) of over 46% in the last five years. Notwithstanding, the Industry is expected to acquire a 15% market share of the total national banking system by 2015.

With reference to the capital market, the first corporate *sukuk* was issued in early 2002, followed by tens of corporate *sukuk* issued over the subsequent years. Islamic capital market development was marked by its inclusion in the National Master Plan in 2005. As of December 2008, there were 22 corporate Islamic bonds issued under *mudharabah* and *ijarah* contracts totaling Rp 4.78 trillion (equivalent to USD 434.5 million), or approximately 2.7% of total bonds issued. Furthermore, there are currently 36 issuers of Islamic Mutual Funds, consisting of equity funds, fixed income funds and balanced funds. Net Asset Value (NAV) totals Rp1.8 trillion (USD163.64 million), approximately 3.5% of total NAV for mutual funds.

Those promising sharia financial institutions are inextricably tied to strong political will from the stakeholders. In June 2008, the Islamic banking industry in Indonesia gained new momentum as Parliament passed a new Islamic Banking Act. In April of the same year, Parliament also enacted a new bill concerning Islamic Bonds. The promulgation of these two laws has provided a firm legal foundation for Islamic banking in the country, thus promoting the advancement of Islamic banking and finance. In August last year the Government successfully issued state *sukuk* and then in February of this year retail state *sukuk* were issued. Surely, this has contributed significantly to further catalyze the development of a wide-based retail secondary market for investment products that adhere to Islamic rules. Meanwhile, a bill to tax sharia transactions is being drafted, which we expect will be passed shortly. We hope that it will provide fairer tax treatment for sharia financial activities, thus making sharia products more competitive.

Concerning the current global financial crisis, Indonesia's sharia banking industry has remained relatively stable and insignificant affected. This fact is positively contributed by low exposure to international investment and foreign exchange transactions in Indonesia's sharia banks. It is approximately just 5% of total assets and liabilities. Annual growth in assets, deposits and sharia banking financing remains high, at 29.5%, 27.1% and 26.08% respectively in May 2009. Stable sharia bank performance is also clearly evidenced by low industry-wide Non-Performing Financing (NPF) at just 6.19% in May 2009, despite a slight increase in March and April 2009. NPF has remained relatively steady compared to NPF in 2007 and 2008 at 6.62% and 5.75% respectively. With regards to capital, Tier-1 capital position also increased to Rp2.48 trillion, compared to its 2008 position of Rp2.19 trillion.

However, we are aware that a lot of homework and groundwork still remains to be done. There are issues regarding the basic structure of sharia products, both for asset finance and

fund raising or liability products. These products require further clarification and clearer guidance not only from the banks but also from the authorities. Another set of challenges that lie ahead in terms of further nurturing sharia finance is how to effectively introduce and sell related products to this potentially huge market.

Sharia financing and Indonesia's economic outlook

Ladies and Gentlemen,

We believe that the potential of sharia financing in Indonesia will continue to grow in the future. In a country with such a large Muslim population the potential for sharia product expansion is great. Currently, the number of sharia users is relatively still limited, namely 3.3 million fund account holders and 525 thousand financing account holders.

The outlook for sharia financing in Indonesia is keep promising thanks to robust economic outlook. Indonesia's economy, in fact, has outperformed many other countries in the region and peer group. Economic activities have been sustained by relatively strong domestic demand, capable of absorbing domestic production and preventing the market from falling deeper off the precipice of recession. In the first quarter, the economy recorded 4.4% growth, which far exceeds international economic growth. Whereas, economic growth in Quarter II-2009 is projected at between 3.7% and 4.0%, buoyed by consumption, which is projected to exceed 5%. Holistically, Bank Indonesia expects the economy to grow between 3.5% and 4.0% in 2009.

Inflation in 2009 is projected to be lower than our initial forecast, possibly below 5%. This is affected by, among others, improving inflation expectations and sustainable food supply and distribution. However, Bank Indonesia continues to monitor potential inflationary pressures expected in 2010, including rising global commodity prices. In this context, future monetary policy is designed to strike an optimal balance between stimulating the domestic economy and maintaining macroeconomic and financial system stability in the mid term.

We also believe that Indonesia's growth prospects are supported by sustainable financial system stability. In the financial sector, CAR remains high at 17.3% and NPL is still in the safe zone; below 5%. Meanwhile, bank liquidity, including liquidity in the interbank money market, is improving and deposits have increased. Despite the limited response by bank interest rates and credit disbursements that are far slower than expected, the bank credit extension plan has shown indications of quicker expansion in the near future.

Ladies and Gentlemen,

Let me conclude my brief remarks by expressing that, from the point of view of a central bank in an emerging economy, the winds of change are indeed blowing. Dealing with the global financial crisis is paramount. Many of our working assumptions are constantly being challenged by this new reality, which requires creative and sound policy on our part and, more importantly, courage to implement bold, often unprecedented, measures. In this respect, we at Bank Indonesia believe that sharia financial institutions show great promise as one of cornerstone of future sustainable economic activity.

Finally, I am sure that this Seminar will generate valuable insight and new ideas in terms of dealing with the global financial crisis. Bank Indonesia, as the monetary and banking authority in Indonesia, is ready to fully support the continued development of sharia finance in the country. We invite and warmly welcome all of you who wish to join with us and develop sharia finance.

May God bless all of us with His mercy.