

CHAPTER I

INTRODUCTION

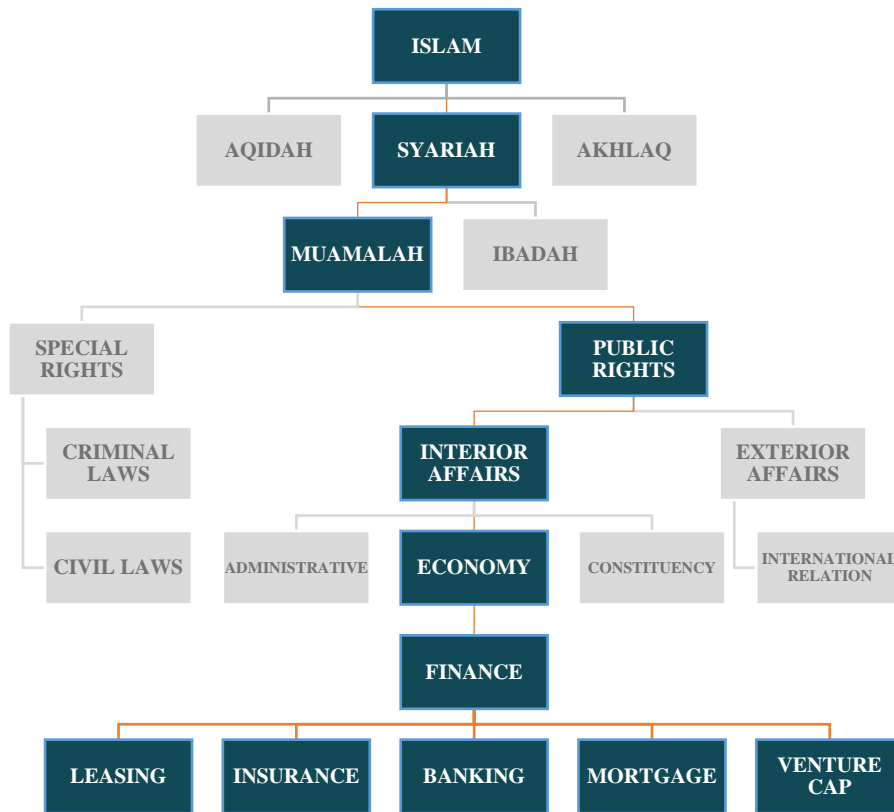
A. Background

Islam has special characteristic as a religion as well as a way of life, while it is not only comprehensive but also universal. Comprehensive means Islamic Shariah summarizes all aspects of life, both ritual (worship) and social (muamalah). Universal Islamic syariah meaning can be applied in any time and place until the end of the day.¹ This universality is particularly evident in the field of muamalah. Besides being broad and flexible, muamalah does not discriminate between Muslims and non-Muslims, where in the field of muamalah, non-Muslims obligations are our obligation as well as Muslims, and non-Muslims right is also our right (Sayyidina Ali, hadith).

The Islamic economic system is a part of Muslim's life in an effort to implement the teachings of Islam in economic activity. Yuliadi (2007) said that this system is an important aspect of an integral and comprehensive Islamic system to create a better human life. Alignment and balance between the horizontal and vertical aspects can guarantee the human's lives of and the universe to walk in harmony and continuous prosperity to the world of the hereafter. By applying the system automatically we can fix unanswerable

¹ Antonio, 2001, Bank Syariah: Dari Teori ke Praktik, pp. 3-5

questions in economy as well as in our life. Schematically Islam as a system can be seen in Figure 1.1.



Sources: Antonio, 2001

FIGURE 1.1

Islam A Comprehensive Way of Life

Scheme 1.1. explains that Islam is a view of life that involves all aspects of life. Economics is part of muamalah problem that concerns in interior affairs which is part of public right. Specific economic issues in the financial sector concerning leasing, insurance, banking, venture capital and so on.

The absence of sharia well-managemnet application in economics system can invite such financial crisis in the late of 1990s, perhaps, it is because suppose basic prohibition interest invited money creation, *gharar*, *maysir* in secondary

market cannot be avoided. It happened as Asian financial crisis of 1997-1998 spent extraordinary cost to countries for bailing out banks as much as 55% of GDP.² This does not include the cost to depositors and borrowers of wider interest rate spreads from bad loan of balance sheets that can push down economic growth of countries involved.

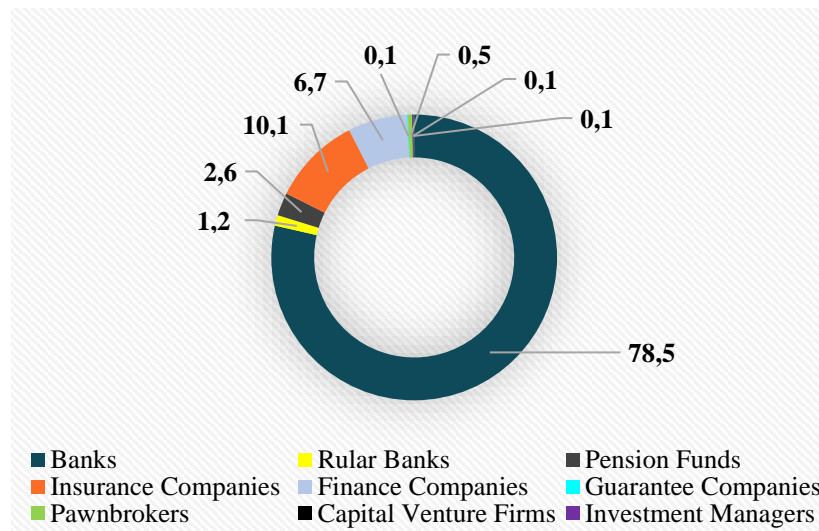
Therefore, financial stability and resilience have been taking place and become interesting phenomena in developing as well as developed countries, which particularly come along with new alternative solution, islamic economics and finance.

Following that issue, several international forums devoted to provide crisis prevention such as World Bank and International Monetary Fund (IMF) by introducing The Financial Sector Assessment Program (FSAP) in 1999, Basel Committee on Banking and Supervision, Islamic Financial Service Board (IFSB), Financial Stability Forum, International Association of Insurance Supervisors, and International Accounting Standard Board. Generally, the aim of those forum is to assess regularly the strength and weaknesses of financial systems to enhance financial stability.

The case study from Indonesia shows that this country is categorized as bank backed asset, because more than 70% of the asset in financial institution dominated by banking (figure 1.2). According to Basurto and Padilla (2006), a strong and good financial system is a key for macroeconomic stability in term of supporting savings and efficiency in allocating resources and investment

² Caprio and Klingebiel 2003 in World Development Indicator, 2009.

opportunities. Hence, it is important to conduct surveillance as prior step to catch up financial system stability. According to Bank Indonesia, the resilience of financial system can be defined through several condition, as follows (i) When financial system is able to allocate resources and to absorb shock occurs, which can prevent surprises in the real sector, (ii) When financial system is still capable of running intermediation function, execute payments and redistribute risk properly if there is interference with the economy and (iii) When price decision, allocation of funds and the risk management in financial system are running well and supporting economic growth.



Source: Islamic Financial Services Authority (OJK), 2016

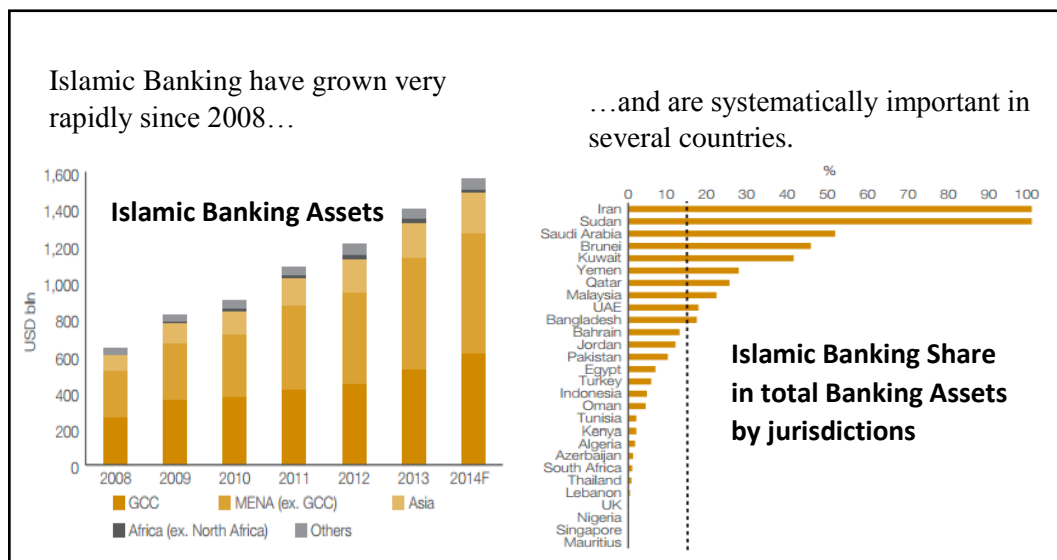
FIGURE 1.2

Asset Composition of Financial Institutions on December, 2016

The stability of the financial system itself cannot be achieved without the depth understanding to any components inside the system. The financial system consists of a number of financial institutions, a set of financial markets, the financial system infrastructure, and a number of procedures and rules that

guarantee the savings and loan running well, where financial system stability cannot be separated from financial institutions soundness and financial market stability. Banking is one important part in supporting financial system stability. A strong banking system and resilience of banking system is the foundation for sustainable economic growth, as banks are at the center of the credit intermediation process between savers and investors (BIS, 2009). The existence of both banks individually and the entire system is a requirement for sustainable economic growth.

Islamic finance, with banking system inside, is one of the fastest growing segments of the global financial industry. In some countries, it has become systematically important, and in many others, it is big to be ignored. Though, Islamic finance encompasses banking, insurance, leasing, investment funds, micro finance, *Sukuk* and equity. Their assets mainly come from banking and



Source: Islamic Financial Service Industry Stability Report, IFSB 2015

FIGURE 1.3

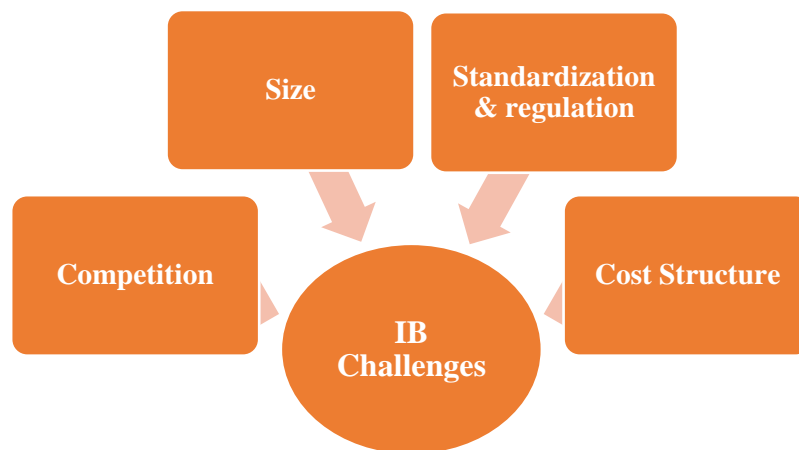
The growing Importance of Islamic Banks

Sukuk represent about 95% of total Islamic finance assets. It is estimated that the sized of Islamic banking industry at global level was closed to \$882 billion at the end of 2014 with average growth rate of 14% per year between 2010-2014.³ This is about two to three times faster than the rate at which conventional bank grew over the same period, due in part to the global financial crisis.

Despite this development of Islamic Banking, it is notable that the literature focusing on micro prudential surveillance apply comprehensive resilience-based supervision is still requires. Generally, Surveillance authorities apply either macro prudential or generic surveillance framework procedure for (Institutions offering islamic financial services) IIFS and Conventional Banks. One of well-known tools is Capital-Management-Earnings-liquidity-Sensitivity (CAMELS) rating system that generally appropriate, but it still less adapted to the specific risks adapted by IB, particularly regarding sharia compliance, capital adequacy, asset quality, and liquidity. Moreover, present literature use partial Islamic Banking (IB) soundness variables, by using (Non Performing Financing) NPF, (Capital Adequacy Ratio) CAR, (Return on Asset) ROA to gain understanding about IB resilience. Gunadi (2013) provided comprehensive understanding about banking resilience even financial system stability by using Financial System Stability Index (FSSI). However, the discussion has been centered toward assessing the banking resilience and stability rather than specific for IIFS and micro prudential perspective.

³ World Islamic Competitiveness Report, EY, 2016

Islamic banking differs from conventional banking in several ways. Conventional Banks (CBs) intermediation is largely debt-based with pre-specified interest rate and allows for risk transfer, while IIFS (IB) intermediation is assets based and centers on risk sharing (Mejía, 2014). In running sale and lease contract, IIFS must have an underlying asset. It makes IIFS more resilient during the global financial crisis compare to its counterpart.



Source: Yazdan, 2012

FIGURE 1.4

IB Challenges in Indonesia

Recent theoretical study (Yazdan Gudarzi Farahani, 2012) found positive and significant relationship between Islamic banking development and economic growth. While the expansion of Islamic bank is expected to support growth, it is still stances challenges in term of competition, size, standardization and regulation, and cost structure. Standardization and regulation of IB is one of potential challenge to be explored, as it can make effective surveillance and give direction for authorities as well as institution itself to promote stability and

resilience that can contribute to economic growth. Moreover, the urge of tool for IB to do supervision and surveillance is categorized as strategic issue in the development of IB in Indonesia.⁴

Recently, composite indicators (CIs) which compare country performance are increasingly recognised as a useful tool in policy analysis and public communication. The number of CIs in existence around the world is growing year after year in academic circles, the media and among policymakers (Bandura, 2006, which cites more than 160 composite indicators). Such composite indicators provide simple illustration of complex and sometimes elusive issues in wide-ranging fields, e.g., environment, economy, society or technological development. This can be used not only in macro level, but also in micro level, such as bank. It is quite rare for IB having tool such as internal composite Index compare to CB.

According to the description above, this study attempts to fill the gap in term of the lack of comprehensive tools for IB to enhance resilience. Analyzing Islamic banking resilience supervision in Indonesia is interesting effort, as this country is the biggest Muslim population in the world and has complete periodical economic situation. This economic situation refers to normal, recession, and crisis in the last two decades.

Hence, this study, entitled “**A Preliminary Study on Constructing Sharia Banking Resilience (SHABAR) Index in Indonesia,**” is going to provide tools as a surveillance the resilience of IB in Indonesia. This study uses

⁴ Roadmap perbankan syariah Indonesia, 2015-2019

a constructed Index to supervise resilience of Islamic banking in Indonesia. The data used is high-frequency data (monthly data) reflect the behavior of the financial institution, particularly IB. This study has adapted the specific characteristics of sharia banking intermediation that is assets based and centers on risk sharing. Methodology used is normalization of indices pre- and post-year by comparing current related variabel of idyosyncratic risk in banking with pre- and post-year. The proportion of every Index forming financial institutions assumed to be equal.

This study will contain several chapters as follows: Chapter 1 provides background and introduction of this study. Chapter 2 covers literature review of Composite Indicators (CI) formation any indicator related to stability of financial institution. Chapter 3 explains the data selected, steps for constructing SHABAR index, and construction model of SHABAR index. Chapter 4 analyses the result of SHABAR index formation, discusses the implications and key issue in building IB resilience sensitivity analysis of each indicator on the Index, and future Index projection. Chapter 5 concludes and offers a way forward for SHABAR Index studies followed by appendix.

B. Research Limitation

There are many factors that may influence Islamic banking resilience in Indonesia. The study limits the analysis problem as follows:

1. Focus on all IBs⁵ listed in website of Bank Indonesia after enactment Act Number 21 of 2008.
2. The data spans from Januari 2010 to December 2016, monthly time series data.
3. Indicators used to build Sharia Banking Resilience (SHABAR) Index based on Trinity of Financial System Stability from Bank Indonesia.
4. Constructing Resilience related to idiosyncratic risk of Sharia Banking (Micro Level)

C. Research Questions

This study has three research questions which are going to be solved, as follows:

1. How to construct an Index for monitoring the resilience of Islamic banking in Indonesia?
2. To what extent does the resilience of Islamic banking in Indonesia?
3. How does each indicator of Index contribute to the resilience of Islamic banking in Indonesia?

D. Research Objectives

Based on research questions above, thus the objectives of this paper are:

1. To know the process of constructing resilience Index as a tool to do initiation surveillance for Islamic Banking in Indonesia.

⁵ Institutions offering Islamic Financial Services, Analog with Islamic Banking

2. To know the resilience of Islamic banking level in Indonesia.
3. To know the contribution of each indicator to the resilience of Islamic banking in Indonesia.

E. Significance of The Research

1. For the community, this research may provide insight about the resilience of Islamic banking in facing a wide variety of inherent risk in Indonesia.
2. For companies, the results of this study are expected to provide input for banking supervision.
3. For academician, this study is expected to contribute to the discourse of science, especially banking resilience and as useful information for academician in developing resilience of financial system particularly Indonesia's IIFS.
4. For policymakers, this study is expected to be a reference material for assessing the resilience of Islamic banking. Moreover, it can become preventive action to identify shocks contribute to fragility and instability of IIFS in Indonesia to decide appropriate policy for stabilization.