

## STRADDLING BETWEEN REGULATION AND INNOVATION: A CASE OF AN ISLAMIC BANK IN INDONESIA

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**Abstrak. Berada di Antara Regulasi dan Inovasi: Studi Kasus Bank Syariah di Indonesia.** Bank syariah, sebagai lembaga keuangan alternatif, kini diterima secara luas dan telah didirikan di pelbagai negara. Di Indonesia, bank syariah pertama kali didirikan pada tahun 1992 bersama dengan kebangkitan Islam di negara itu. Sebelum itu, pendirian bank syariah di Indonesia terhalang bukan karena alasan ekonomis, tetapi karena ada stigma politik yang terkait dengan Islam terutama selama tahun 1970-an. Tujuan dari artikel ini adalah untuk menjelajahi bagaimana bank membuat inovasi untuk meningkatkan kinerjanya yang pada gilirannya membuat legitimasinya tinggi dari mata para pemangku kepentingan. Tulisan ini juga membahas pelbagai peraturan dan peran bank sentral dan pemerintah Indonesia dalam memastikan kontrol dan tata pemerintahan yang baik dan kemudian untuk lebih mengembangkan sistem perbankan Islam dan syariah di Indonesia.

**Kata kunci:** bank syariah, sistem perbankan syariah, regulasi bank sentral, kontrol, tata kelola

**Abstract. Straddling between Regulation and Innovation: A Case Study of an Islamic Bank in Indonesia.** Islamic bank, as an alternative financial institution, is now widely accepted and has been established in various countries. In Indonesia, Islamic bank was first established in 1992 along with the revival of Islam in the country. Previously, the establishment of Islamic bank in Indonesia was hindered not because of economical reason but because of a political stigma associated with Islam especially during the 1970s. The purpose of this article is to explore how the bank makes innovations to increase its performance that makes its legitimacy high on the eyes of its stakeholders. The article also discusses the various regulations and roles of central bank and the Indonesian government in ensuring control and good governance and subsequently into further developing the Islamic and shariah banking system in Indonesia.

**Keywords:** Islamic bank, shariah banking system, central bank regulations, control, governance

### Introduction

Within economy activities, banking sector plays central role for it serves as financial resources distributor. Its intermediary function makes it possible to flow money through saving and lending activity<sup>1</sup>. By collecting funds from customers who deposit their money, bank then provides financing to other customers. Such business activity makes bank always deal with problem of information asymmetry. Other function of bank is as a payment spot that enable business transactions take place that in turn activates economy in a whole. Thus, unlike other industries, banking holds and operates funds that mostly belong to public, to be exactly they belong to depositors. Consequently, the failure of a bank impacts not only on its depositors, but it could

affect the stability of economy of a country<sup>2</sup>.

The nature of bank activities that always deal with some risks lead it to apply good governance in its daily operation. Applying good governance will minimize the risks that are faced by a bank. Banking industry needs different corporate governance than other ones.<sup>3</sup> First, banks are subject to government regulation. Regulatory agencies ensure the safety and soundness of financial institutions and are able to discipline those banks that do not conform to this ideal. Second, banks have little equity in their capital structure compared with firms in other industries. Third, because of the importance of banks for the economy as a whole, bank directors should be held to a higher standard than directors in

Received: 26th January 2015, revised: 16th September 2015, accepted: 18th November 2015.

<sup>1</sup> K. Matthews, & Thompson J., *The Economics of Banking*, (John Wiley & Sons, Ltd, 2005).

<sup>2</sup> K. Spong, *Banking Regulation: Its Purposes, Implementation, and Effects* (5<sup>th</sup> ed.), (Division of Supervision and Risk Management Federal Reserve Bank of Kansas City, 2000).

<sup>3</sup> E. W. Cooper, "Monitoring and Governance of Private Banks." (The Quarterly Review of Economics and Finance 49, 2009)

other industries.<sup>4</sup>

The implementation of good governance has been recognized worldwide. The Basel committee on Banking Supervision (2006) has established the principles of corporate governance for banking organizations. In the introduction, The Basel committee stated that, "The Basel Committee is issuing this paper to supervisory authorities and banking organizations worldwide to help ensure the adoption and implementation of sound corporate governance practices by banking organizations".<sup>5</sup> According to The OECD principles, corporate governance is defined as "a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined". Corporate governance includes setting corporate objectives and a bank's risk profile, aligning corporate activities and behaviors with the expectation that management will operate the bank in a safe and sound manner, running day-to-day operations within an established risk profile and in compliance with applicable laws and regulations, while protecting the interests of depositors and other stakeholders.<sup>6</sup>

In a country level, central bank plays a central role of good governance by establishing, monitoring and then evaluating standards operation for banks in order to they operates accountably. Modern central bank is a government institution and does not compete with banks operating in the private banking sector<sup>7</sup>. Its main functions are monetary control or price stability, which is related to money supply circulation in a country; prudential control, which is related to customers' protection; and government debt placement on the most favorable terms possible.<sup>8</sup>Regulatory intervention is an important control mechanism in publicly traded banks.<sup>9</sup>

### Islamic Banking in Indonesia: A Brief History

In the context of Indonesia, the establishment of Islamic bank is a part of Islamic revival. In the early

90s, the political pendulum swung to Islamic side when Muslim intellectuals from various disciplines established The Indonesian Muslim Intellectual Association (Ikatan Cendekiawan Muslim Indonesia, ICMI) which was endorsed by the Indonesia government at that time. The birth of ICMI was proven to be very influential for the Islamic revival. In 1993, the first chairman of ICMI was elected as a vice president of Indonesia. Furthermore, the majority of the cabinets were held by Muslim Intellectuals who are from the ICMI-base background.

The establishment of Islamic bank in 1992 is another phenomenal evidence of Islamic revival in Indonesia. The Islamic bank was aimed to make available a distribution channel of interest-free of financial transaction for some people that are not so happy, due to religion reason, with conventional banks. This is completely different with the 70s which Islamic bank was hindered to be established, not because of economical reason, but because there was political stigma about Islam<sup>10</sup>. The fully support of the government can be seen from speech of the President of Republic of Indonesia in the launching of the first Islamic bank in Indonesia in 1992, "Take a note that I am as one of founders and shareholders of this bank, in order to my ministers are not reluctant to be shareholder as well...I will also invite entrepreneurs to invest in this bank".<sup>11</sup>

Nowadays, Islamic bank has become alternative financial institution that is increasingly accepted by Indonesian people. As at the end of 2014, the assets of Islamic banks in Indonesia totaled 260.366 trillion rupiahs or 20 billion US dollars.<sup>12</sup> It is equal to 5% of total asset of the entire banks in Indonesia.

This acceptance of Indonesia Islamic banks are interesting to explore considering the level of competitiveness among banks is so tight. Additionally, even though the majority of Indonesia citizen is Moslem, but the economic system is secular-capitalistic.

### Research Methods

This research used case study since it has been acknowledged as a powerful method to gain a better understanding of daily practices within organization. Case studies is one of the appropriate way beside ethnographic and participant observation, in collecting data of research.<sup>13</sup>

<sup>4</sup> E. W.Cooper, "Monitoring and Governance of Private Banks."

<sup>5</sup> Bank for International Settlements, Basel Committee on Banking Supervision, Switzerland: Bank for International Settlements Press & Communications, 2006.

<sup>6</sup> H. V. Greuning, and S. B. Bratanovic. *Analyzing Banking Risk: A Framework for Assessing Corporate Governance and Risk Management*, (The International Bank for Reconstruction and Development/THE WORLD BANK, 2009).

<sup>7</sup> S. Heffernan, *Modern Banking*, (John Wiley & Sons Ltd, 2005).

<sup>8</sup> S. Heffernan, *Modern Banking*, (John Wiley & Sons Ltd, 2005).

<sup>9</sup> Stephen, Prowse, "The Corporate Governance System in Banking: What Do We Know?" Banca Nazionale del Lavoro Quarterly Review, Special Issue (March): 11–40, 1997.

<sup>10</sup> B. Effendy, *Repolitisasi Islam: Pernahkah Islam Berhenti Berpolitik?* (Bandung: Mizan, 2000).

<sup>11</sup> S. Asa Ecip, and Avesina, *Ketika Bagi Hasil Tiba: Perjalanan 10 Tahun Bank Muamalat*, (Jakarta: Bank Muamalat Indonesia, 2002.), p.98

<sup>12</sup> Otoritas Jasa Keuangan, "Siaran Pers: OJK dan Perbankan Syariah Gelar Expo iB Vaganza 2015", in <http://www.ojk.go.id/a/siaran-pers-ojk-dan-perbankan-syariah-gelar-expo-ib-vaganza-2015>, accessed on 2015.

<sup>13</sup> W. F.Chua, "Radical Development in Accounting Thought", (*The Accounting Review*, LXI(4), 1986), p. 615.

Case study as a research strategy which focuses on understanding the dynamic present within single settings.<sup>14</sup> Case study approach is useful for research investigating: 1) Complex and dynamic phenomena where many factors (including factors that are not quantifiable) are involved; 2) Actual practices, including the details of significant activities that may be ordinary, unusual, or infrequent (e.g., changes in accounting regulation); and 3) Phenomena in which the context is crucial because the context affects the phenomena being studied (and where the phenomena may also interact with and influence its context).<sup>15</sup> Case studies can be used for various purposes i.e. to provide description, to test theory, or to generate theory.<sup>16</sup>

### Data Generation

Data collection for case studies will be taken from many sources of evidence such as interviews, questionnaires, documentation, archival records, observations and physical artifacts.<sup>17</sup> The capacity of case studies to capture much information from various data sources create a rich understanding of organizational phenomena than research analysis generated by statistical methods.

### Regulations, Governance and Control of Shariah Banking Industry in Indonesia

Unlike others industry, banking is a kind of industry that is highly regulated. The rationales for regulation of banking industry are that financial systems are prone to periods of stability, more prone to troubles than other firms, and because of the interconnectedness of banks, the failure of one bank can affect others immediately.<sup>18</sup> To overcome such potential risks, some banking regulations are needed. The types of banking regulation i.e.: 1) systemic regulation, which is a regulation concerned with the safety and soundness of the financial system; 2) prudential regulation, which is concerned with consumer protection; and 3) conduct of business regulation, which is concerned with how banks and other financial institutions conduct their business.<sup>19</sup>

In the case of Indonesia, regulations for Islamic

banks are set and issued by central bank of Indonesia, i.e. Bank Indonesia, under an umbrella of law that is signed by the President of Republic of Indonesia, i.e. Act of The Republic of Indonesia Number 21 of 2008 Concerning Shariah (Islamic) Banking. However, in adopting Islamic law into positive regulations, BI works hand in hand with the Shariah National Board (SNB), an institution that is established by Indonesian Ulama Council which its main task is to produce fatwa on Islamic financial institution issues. However, the fatwa doesn't bind Islamic bank until BI adopts and legalizes it to be a positive regulation as the secretary of SNB said:

The Shariah National Board (SNB) is an institution under Indonesian Ulama Council (IUC), established by IUC to serve Islamic Financial Institution. Its main task is as a fatwa maker in term of shariah financial institution... You can see BI regulation no. 11/3 and 11/10. In both regulations it is written that fatwa doesn't bind Islamic bank. Fatwa binds Islamic bank after it has been legalized by BI (my translation).

BI regulation number 11/33/PBI/2009 article 1 verse 5 mentions that the shariah principle is Islamic law principle in the area of shariah banking that applied in the form of the fatwa of SNB.<sup>20</sup> It means that Islamic values principle that is used as a basic to regulate Islamic bank operation by BI is only the ones that have been crystallized by SNB. Islamic banks only obey fatwa from SNB that has been legalized by BI. The collection of SNB's fatwa that had been legalized by BI then issued as Codification of Islamic Banking Products. The codification then becomes a reference for any Islamic banks in launching a new product. Whereas, the complete fatwa which are enclosed with references from Qur'an and Sunnah (the sayings of the Prophet Muhammad) is issued jointly by SNB and BI in a one book (SNB and BI, 2006). Hence, the argumentations of every product that is codified by BI can be traced to the book. Further, next sections explain kinds of BI's control on Islamic banks features in Indonesia. The explanation is accompanied by a case of the implementation of the regulations in a leading Indonesia Islamic bank, just call it "Bank Barakah".

### Control of Ownership of Islamic Bank

The ownership of Indonesia shariah bank is loosely regulated by the central bank as written in the article 6 verse 2 of Bank Indonesia Regulation number 11/3/PBI/2009 concerning Sharia Commercial Bank that states:

<sup>20</sup> Bank Indonesia Regulation Number 11/33/PBI/2009, "Concerning The Implementation of Good Corporate Governance by Islamic Commercial Banks and Islamic Business Units", issued on 7 December 2009.

<sup>14</sup> K. M. Eisenhardt, "Building Theories from Case Study Research", (The Academy of Management Review, 14(4), 1989).

<sup>15</sup> D. J. Cooper, and Morgan, W., "Case Study Research in Accounting", (Accounting Horizons, 22(2), 2008).

<sup>16</sup> K. M. Eisenhardt, "Building Theories from Case Study Research".

<sup>17</sup> R. K. Yin, "Case Study Research: Design and Methods (3rd ed.)", (Sage Publications, 2003). And K. M. Eisenhardt, *Building Theories from Case Study Research*, (The Academy of Management Review, 14(4), 1989).

<sup>18</sup> B. Casu, Girardone, C., and Molyneux, P., "Introduction to Banking", (Prentice Hall Financial Times, 2006).

<sup>19</sup> B. Casu, Girardone, C., and Molyneux, P., "Introduction to Banking".

Ownership by foreign citizens and/or foreign legal entities as referred to in paragraph (1) letter b shall not exceed 99% (ninety nine percent) of Bank's paid-up capital.

BI regulation refers to the higher regulation, i.e. the Government Regulation number 29/1999 concerning Commercial Bank Acquisition article 3 that states:

The maximum amount of bank's shares that can be owned by foreigners or foreign institutions either acquired directly or through stock exchange is 99% (ninety nine per cent) of the total amount of the bank's shares.

Recently, the regulation is viewed as too liberal so that can endanger the banking safety in Indonesia. "In all countries there is a limitation of bank ownership... (therefore we will propose) the maximum ownership of bank by individual or institution will be less than 50%", the Governor of BI said so.<sup>21</sup>

Currently, the total ownership by foreigners of banking industry in Indonesia is about 50.6%.<sup>22</sup> Some realizes that this is a vulnerable situation that can harm Indonesian economy if the investors withdraw their capital. However, others say that the situation can be controlled by a certain regulation and consistent law enforcement. The reason why foreign investors dominate the ownership of banking industry in Indonesia is because there is no one (Indonesian) who are able to supply adequate capital every year...as you know, BI requires the minimum capital adequacy ratio (CAR) is 8%. So if a bank's CAR is less than 8%...then the operation of the bank will be suspended by BI.<sup>23</sup>

Currently the composition of ownership of Bank Barakah is 64.61% foreigner shareholders and 35.39% local shareholders. "...So it could be considered that we are as a foreign bank for 70% of our shares are owned by foreigner...", the Funding and Service Manager of Bank Barakah said so.

### **Control in Organizational Structure and Human Resource Management**

The central bank of Indonesia, i.e.: BI, controls organizational structure of shariah bank by issuing some regulations. The regulations pertain to selection of board of directors, board of commissioners, and shariah supervisory board. The purpose of these regulations is to ensure that the organization operates on the track, as the officer of BI said:

We have fit and proper test mechanism containing many criteria (to assess candidates or existing board

of management). If the candidate is blacklisted by government, has bad debt in a bank or if he has ever been imprisoned, he is prohibited to be one of top management. Of course, his competence is also considered. If he is not competent, then the bank will be damaged. We use interview to test the candidate.

However, the fit and proper test is not only held when a candidate start to enter a bank. If in the middle of his career he commits a fraud, then he must out of the bank. He may enter banking industry again after several periods if his fraud is not so serious. But if he commits a serious fraud, he shouldn't enter banking industry forever anymore.

The more detail requirements above are written in BI regulation no. 11/31/PBI/2009 about fit and proper test on shariah bank and shariah business unit. Article 3 verse 1 of the regulation states that candidates on controlling shareholder, board of commissioner, and candidates of board of directors are obliged to take a fit and proper test which is undertaken by BI (article 4 verse 1). For candidates of controlling shareholders, the purpose of the fit and proper test is to gain an assurance that the candidates have adequate integrity and financial competence (article 5). Whereas, the purpose of the fit and proper test for candidates of board of commissioners and board of directors is to gain an assurance that they have integrity, competence, and good financial reputation (article 13).

The criteria of integrity for controlling shareholder candidates, according to article 6 are:

- a. Have a good moral and ethical sensitivity such as comply to regulation whether it is written or not, including never been imprisoned for any criminal reason.
- b. Have commitment to comply to shariah banking and others related regulation.
- c. Have commitment to endorse board of directors to develop a healthy and sustainable shariah bank.
- d. Not included in a failed of fit and proper test list.

Further criteria are about financial competence for controlling shareholder candidates, i.e.:

- a. Have source of income that can support business development of shariah bank in the midterm and long term period.
- b. Have never been certified bankrupt or ever been shareholder, commissioner, board of directors, or officer of a company which was sentenced guilty by a court within the last past five years.
- c. Have no bad debt, including is not listed in bad debt list.
- d. Commit to doing needed efforts in case the shariah bank facing capital or liquidity problem.

Article 14 stated the criteria for board commissioner and board of directors, i.e.:

- a. Have a good moral and ethical sensitivity such as comply to regulation whether it is written or not,

<sup>21</sup> W. S. A. Wulan, and B. C. M., "Kepemilikan di Bank Maksimal di Bawah 50%", Kontan, 3 June.2011.

<sup>22</sup> \_\_\_\_\_, "Bank Swasta Asing Kuasai 20 Persen", in Kompas, 3 June2011.

<sup>23</sup> Explanation by the Funding & Service Division Head of bank Barakah: "Why the owners of banks in Indonesia now are mostly foreigner?"



including never been imprisoned for any criminal reason.

- b. Have commitment for accountability and high responsibility.
- c. Have commitment to comply to shariah banking and others related regulation.
- d. Especially for board of commissioner, have commitment to monitor board of directors in order to develop a healthy and sustainable shariah bank.
- e. Not listed in a failed of fit and proper test list.

All banks should submit the proposed controlling shareholders, board of commissioners and board of directors to BI for gaining its approval. Further BI checks the completeness of candidates requirements and then held a fit and proper test to them. Candidates who are failed the fit and proper test are obliged to withdraw their candidature at the most of 15 days from the announcement of test result (BI regulation number 11/31/PBI/2009 article 3 verse 1).

Hence, management of Indonesian banks can only submit their candidates of top management to BI but the final decision is on BI as a central bank. Management of Indonesian banks has full authority only on new personnel recruitment or arranges middle level managers' position.

### Control in Launching a New Product

The products of Islamic banks in Indonesia must be based on Islamic tenets (shariah) as regulated in BI regulation number 9/19/PBI/2007 article 2 verse 1 concerning shariah principle application on fund gathering, fund distribution and other service activities:

Bank must fulfill the shariah principles in undertaking fund gathering, fund distribution and other services activities.

BI, along with The Shariah National Board (SNB), controls the application of Indonesian Islamic banks products. Firstly the SNB issued a fatwa about a certain product of Islamic bank. After a fatwa is issued by SNB, then BI legalizes the fatwa into BI regulation. The collection of the legalized fatwa then is codified by BI as a Codification of Islamic Banking Products.

Based on the codification, Islamic bank then can develop its products as was said by the Product Development and Maintenance manager of Bank Barakah:

BI (central bank) regulated the shariah products of Islamic banking. We just follow the regulation. So if we want to develop a new product, we design it, then we submit it to BI to be evaluated. Then if BI needs detail information, they'll call us to make a presentation (about the new product).

In article 2 of BI regulation, the bank is obliged to report its plan to release new product to Bank Indonesia (verse 1). The new product must be a product that

has been determined in the Shariah Banking Product Codification Book (verse 2). In case the new product is not included in the codification book of shariah banking product, it is compulsory for the bank to report its new product to BI obtain the approval from BI (verse 3).

While waiting for approval, BI consults to SNB about the proposed product as a BI officer said, "...If the proposed product is a new scheme and not listed in the book of codification, so it needs a new fatwa then we must talk to SNB about this matter".

Internally, before an Islamic bank proposes a new product to BI, its management has to consult to the Shariah Supervisory Board (SSB) regarding the new product, as one of the SSB member of Bank Barakah said, "If there is a new product, it must be assessed by us. There must be an official opinion (about the new product) from SSB meeting to approve it."

Furthermore, the Product Development and Maintenance Manager of Bank Barakah explained:

BI assesses the risks of a new product such as business risks, operational risks, and for financing products including financing risks, how to mitigate it... further (evaluation) is about transparency of the products feature. How the financing product is communicated to public, is it transparent, and then how the profit sharing of the product...

After the process (of evaluation) is finish, we are allowed to offer the new product to the public. We are given ten days (by BI) after the launching of the new product to make a report that it has been sold at our branches...and has been supported by brochures, by a standard operating procedure, by business process regulation, etc.

The source of the explanation of the manager can be seen in BI regulation number 10/17/PBI/2009 article 2, 3, 4 and 5. In those articles, BI fully controls process of launching of a new product encompassing the shariah bank obligation to report the planning of new product launching to BI (article 2 verse 1), the obligation to refer to Shariah Banking Product Codification Book that has been issued by BI before a shariah bank launches a new product (article 2 verse 2) or else the shariah bank must wait for BI approval if the new product is not included in the codification book (article 2 verse 3).

### Control in Shariah Compliance

BI issued some regulations concerning Islamic bank in Indonesia that ranged from the most general issue of Islamic bank to the specific one that must be complied by all Islamic banks in Indonesia. The most general regulation of Islamic bank in Indonesia that is issued by BI is BI regulation number 11/3/PBI/2009 concerning Shariah Commercial Bank in Indonesia.

The regulation contains basic terms of Islamic bank in Indonesia. Other BI regulations are concerned with more specific issues such as BI regulation number 11/31/PBI/2009 concerning fit and proper test of shariah bank and shariah business unit, number 11/33/PBI/2009 concerning good corporate governance shariah bank and shariah business unit, number 10/17/PBI/2009 concerning product of shariah bank and shariah business unit, etc.

Those BI regulations elaborate the more general legal basic of shariah bank i.e. Act of The Republic of Indonesia number 21 of 2008 concerning shariah (Islamic) banking that was signed by the President of Republic of Indonesia. The implementation of those BI regulations is expected to come to the ultimate objective of shariah bank in Indonesia as written in article 3 of the act:

The objective of Sharia (Islamic) banking is to support the implementation of national development in the framework of improving justice, cooperation, and the people's welfare equitable distribution.

The obedience to BI regulations lead Islamic banks to similar activities one another. The simplest direction of BI to Indonesian Islamic bank is regulation about bank's name, which in it must state clearly the word 'shariah' after the word 'Bank' or after bank's name as it is written in the article 13 verse 1 of BI regulation number 11/3/PBI/2009:

A Bank granted operating license from Bank Indonesia, is obliged to state clearly the word Sharia after the word Bank or after bank's name in the inscription of its name.

Another coercive power is the Islamic banks obligation for obeying Islamic law/shariah in their daily operation. Basically, the compliance to Islamic law or shariah is normative isomorphism because it is between banks with God. However, certain aspects of the shariah that are closely or directly related to banks' products are formally regulated by BI as stated in article 59 of BI regulation number 11/33/PBI/2009 as follow:

Shariah commercial bank is obliged to apply the shariah principles in its operational activities as regulated in BI regulation about shariah principles application in fund gathering as well as fund distributing and service activities of shariah bank.

Whereas, the definition of shariah itself is stated clearly in BI regulation number 11/33/PBI/2009 article 1 verse 5:

Shariah principle is an Islamic law principle in term of shariah banking that is put in the form of fatwa of Shariah National Board-Indonesian Ulema Council.

Any violations of the regulations by Islamic bank make BI gives sanction to them. For example, BI requires every bank submit report timely and any delay

happened make BI gives penalty. This rule impacts on banks to strive to finish their report timely, as a Head of Accounting Division of an Islamic bank said:

If there are some divisions or branches that finish their report late, we admonish them if needed we give penalty to them..... BI gives penalty per day and per item for any late of report. The amount of penalty is fifty thousand rupiahs per item per day. In fact for certain item that is considered significant, the penalty can even reach one million rupiahs per day.

The guidance in determination shariah compliance is fatwas of the National Shariah Board (Dewan Syariah Nasional, DSN). Bank Barakah must ensure that its daily operation is in line with the shariah. As such, Bank Barakah forms Shariah Controller Division. The Head of Shariah Controller Division explained the tasks and responsibilities of that:

We have many tasks. One of them is we monitor daily shariah compliance. We keep in touch with branches so when they have problem with shariah issue, they just call us to consult about it. We also undertake training on shariah issue to Bank Barakah's personnel. In addition, we also undertakes shariah audit, as counterpart of Internal Audit Division. We follow Internal Audit Division schedule in doing audit at branches in Indonesia. Sometimes we audit several times in a month, up to Internal Audit Division.

At the top level, there is Shariah Supervisory Board (SSB) in the highest authority of Bank Barakah and has the task of formulating policy related to shariah. Thus, the Shariah Controller Division is a representative of the Shariah Supervisory Board. Hence, it sends the division report to the SSB, as the Head of Shariah Controller Division said:

Due to we are as a representative of SSB, so the outcomes of our work is approved and signed by the SSB. After the SSB signed the report then it is sent to the Board of Directors and BI.

The report then is followed-up by units or divisions, "So if our report says there is deflection and we make some notes for improvement, then the units or divisions will execute our recommendation. Usually they coordinate with us to do the improvement".

The issues that must be addressed by this division are varied. Issues from branches are usually related to financing, whether they are acceptable or not in shariah view. Mostly issues that arise are in financing, especially in certain region such as eastern Indonesia where the majority of the population are non Muslim (Christian) or in a region wherein trading of alcoholic drink is normal. So the frequently questions from the region are whether or not the branches are in the region allowed to finance such activity, is it allowed to finance Christian or church.

However, there are still many applications that stand on grey area. For such applications, the considerations

that are needed to decide whether or not it is acceptable in Islamic view is deeper and more exhaustively, like Head of Accounting Division explained:

...If a proposal is clear enough that it is about unlawful business in Islamic view such as alcoholic drink company, so it is easy for us to judge it and refuse it. After all, they won't come to us (to apply for financing). However, a discussion is needed for companies that their business is not clear whether or not acceptable in Islamic view. For instance, if there is an advertisement company submits an application, but its most advertising is about cigarette. This is a problem that we must consider, because we don't finance cigarette company. So we discuss such issues from Islamic view.

The Shariah Controller Division also provides trainings about shariah knowledge to Bank Barakah personnel and communicates the shariah knowledge to branches.

### **Innovations to Maximize Profit of Islamic Bank: An Al Barakah Case Study**

As a business entity, Islamic banks are still demanded to create profit as much as possible by their shareholders. However, the description of Indonesia banking regulations above shows that Indonesia Islamic bank have no plenty of room for innovation to create money. The central bank, i.e. BI, regulates almost all aspects of Islamic bank. This actually applies for all banks, either conventional or Islamic bank because, as explained previously, banking industry is a kind of industry that is highly regulated. However, as the competition between banks is so tight, Islamic banks must find new innovations whether in their daily activities or in their products to maintain their existence. In the case of bank Barakah, we analyzed their innovations into activities innovation and products innovation.

### **Innovation in Activity: Distribution of Financing**

Based on article 1 verse 25 of Act of the Republic of Indonesia Number 21 Of 2008 Concerning Sharia (Islamic) Banking, financing in Islamic bank are:

- a. production sharing transaction in the form of mudharabah and musyarakah;
- b. lease transaction in the form of ijarah or lease purchase in the form of ijarah muntahiya bittamlik;
- c. sales and purchase transaction in the form of outstanding murabahah, salam, and istishna';
- d. lending transactions in the form of outstanding qardh; and
- e. Lease service transaction in the form of ijarah for multiple services transactions based on an agreement or convention between the Sharia (Islamic) Bank and/or UUS and other party obligating the parties receiving funds and/or given funding facility to refund such fund after a certain period with ujah compensation, without compensation, or production sharing.

In the case of Bank Barakah, its financing products completely obey the Act number 21 of 2008. Bank Barakah only manages how to maximize, to distribute, to monitor, and to evaluate it effectively and efficiently. Before distributing its financing, Bank Barakah firstly identifies its market target.

In identifying the market target, Bank Barakah only chooses sectors of industry that has good prospect that can make it safer and profitable. The criteria of the good prospect business are: (1) Sunrise industry; (2) Business sectors that is considered free from any potential crisis; (3) Business that is supported by government regulation; (4) Business that has clear market.

In maximizing the distribution of its financing, Bank Barakah divides its branches into three categories, i.e. A for Alliance, B for Business, and C for Corporate. Each category is aimed for certain market segment. A (Alliance) branch category is the small branch which the market segment is small business. The range of lending or financing that is allowed to be managed by A branch is around 50,000,000 rupiahs to 5,000,000,000 rupiahs (5,000 US dollars to 500,000US dollars). For financing that is less than 50,000,000, the branch deliver it to other Islamic Financial Institution (IFI), i.e. Bank Perkreditan Rakyat Syariah (BPRS, the Shariah Rural Bank). BPRS is a shariah bank that focuses to small business. The reason why the minimum value of financing is RP.50.000.000 was explained by the Head of Accounting Division of Bank Barakah:

The minimum value of our financing is 50 million rupiahs. Any proposal containing less than 50 million rupiahs, we suggest to apply it to Bank Perkreditan Rakyat Syariah (BPRS, shariah rural bank). We have built alliance with some BPRS's. That's why we don't finance any application less then 50 million, considering those our brothers (BPRS). So once there is such application, we recommend it to come to BPRS. Then it is up to the BPRS whether it approves the proposal or not.

The next category is B (Business) branch, which the range of financing that it serves is 5 billion rupiahs to 10 billion rupiahs. Hence, B branch is purposed to financing medium business. The last category of Bank Barakah's branch is C (Corporate) branch. C branch targets large company (corporate) as its customer, which the value of financing is more than 10 billion rupiahs.

### **Innovations in Products**

To maximize the selling of its products, Bank Barakah develops some innovations. As compared to other conventional banks, Bank Barakah is considered as a



new bank. So that Bank Barakah must invent innovative products more often in order to exist in the industry. Bank Barakah builds partnership with some companies to spread its financing as well as its funding. For example, as a bank with minimum automatic teller machine (ATM), Bank Barakah joint with other banks so that its customers can easily withdraw their money at any ATM of any banks. Conversely, Bank Barakah cooperates with the post office in gathering fund from customers.

Bank Barakah also built alliance with Islamic micro financing institution such as Baitul Maal Wattamwil (BMT) and Bank Perkreditan Rakyat Syariah (BPRS, syariah rural bank), a micro financing institution. This alliance is to accommodate small value financing that is not covered by financing scheme of Bank Barakah. "... for the very small financing, we ally with BPRS. After all we want to share the potential profit of this financing business with those our brother..." as explained by the Head of Accounting. During 2009, Bank Barakah placed fund at the amount of Rp.999.550.000 that is equal with USD 100.000 as written in its 2009 annual report.

Another example of Bank Barakah's innovation is a joint venture with pawn shop to build an Islamic pawn shop. The difference between Islamic pawn shop and conventional pawn shop is that Islamic pawn shop is interest free. This means that Bank Barakah lends money to customer at zero interest, and the source of profit is from fee of providing or renting certain space for objects that is deposited by customers as collateral.

### Closing Remark

This paper reports the result of a field study of control and governance of Islamic bank in Indonesia. Banking industry is highly regulated because of its very nature that always deals with some risks. In the case of Indonesian Islamic bank, the central bank set some regulations along with the Shariah National Board (SNB), especially for the regulations that are related to the Islamic tenets. The more general regulations that are also applied in conventional banks are set by the central bank alone.

So many regulations that should be obeyed by Islamic banks make them have a little room for innovations. However, as the competition between banks is so tight, Islamic banks must find new innovations to maintain their existence. In the case of Bank Barakah, innovations are emphasized on the service quality enhancement to maintain consumers' convenience. □

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