CONTROL, REGULATIONS AND LEGITIMACY OF AN ISLAMIC BANK: AN INDONESIAN CASE STUDY

NOVAL ADIB

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CONTROL, REGULATIONS AND LEGITIMACY OF AN ISLAMIC BANK: AN INDONESIAN CASE STUDY

By

NOVAL ADIB

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LIST OF ABBREVIATIONS

BI: Bank Indonesia

CAR: Capital Adequacy Ratio

ICMI: Ikatan Cendekiawan Muslim Indonesia

IDB: Islamic Development Bank

IUC: Indonesia Ulema Council

MUI: Majelis Ulama Indonesia

NIS: New Institutional Sociology

NPF: Non-Performing Financing

SNB: Shariah National Board

SSB: Shariah Supervisory Board

KAWALAN, PERATURAN DAN KESAHIHAN BANK ISLAM: SATU KAJIAN KES DI INDONESIA

ABSTRAK

Penyelidikan ini adalah tentang bank Islam di Indonesia yang telah berjaya mengekalkan kewujudan dan perkembangannya sejak dua dekad pengoperasiannya di Indonesia. Tujuan penyelidikan ini adalah untuk memahami bagaimana pihak bank memperolehi dan mengekalkan kesahihan daripada pelbagai pihak yang berkepentingan, khususnya dari segi cara bank dikawal dan bagaimana mekanisme kawalan luaran mempengaruhi amalan dalaman bank. Kajian ini juga mengulas tentang sejarah perbankan. khususnya perbankan Islam di Indonesia untuk mendapatkan pemahaman yang kontekstual.

Pendekatan kajian kes yang dimaklumkan oleh teori institusi sosiologi baru (New Institutional Sociology, NIS) dan teori legitimasi digunakan dalam penyelidikan ini. Teori NIS digunakan untuk menganalisis bagaimana bank Islam memberi maklum balas terhadap tekanan dan pengaruh daripada pihak yang berkepentingan. Teori legitimasi digunakan untuk menganalisis bagaimana bank Islam mendapatkan dan mengekalkan kesahihan daripada pihak-pihak yang berkepentingan. Data telah dijana daripada 24 temu bual deengan pihak pengurusan bank dan pengawal selia termasuklah daripada bukti dokumentari dan pemerhatian.

Kajian ini mendapati bank menghadapi pelbagai tekanan dan pengaruh tekanan yang paling kritikal adalah daripada pengawal selia iaitu melalui pelaksanaan kawalan dan peraturan. Walau bagaimanapun, tekanan tersebut kadangkala bercanggah dengan

pelabur yang menuntut keuntungan yang tinggi manakala orang ramai mengharapkan pihak bank untuk memainkan peranan sosialnya. Pihak bank mendapati cara-cara inovatif untuk bertindak balas terhadap tekanan bercanggah tersebut, dan hasilnya memperoleh kesahihan daripada pihak-pihak berkepentingan tersebut.

Kajian ini menyumbang kepada teori dan amalan. Penggunaan NIS dengan teori kesahihan tersebut menghasilkan pemahaman yang lebih baik tentang proses institusionalisasi di dalam sesebuah organisasi. Sekiranya teori NIS hanya menerangkan tentang proses institusionalisasi di dalam sesebuah organisasi, maka teori legitimasi pula menerangkan dengan lebih terperinci tentang kesahihan yang diperolehi dari hasil proses institusionlaisasi. Kajian ini juga menyumbang kepada peningkatan pemahanan tentang amalan bank Islam. Pematuhan terhadap nilai-nilai Islam serta peraturan-peraturannya tidak menghalang bank Islam daripada mencapai objektif ekonomi. Malah, bank-bank Islam masih kekal wujud semasa krisis ekonomi sedangkan kebanyakan bank-bank konvensional yang lain telah gagal beroperasi.

CONTROL, REGULATIONS AND LEGITIMACY OF AN ISLAMIC BANK: AN INDONESIAN CASE STUDY

ABSTRACT

This is a research about an Islamic bank in Indonesia that has managed to maintain its existence and grown over the two decades of its operation in Indonesia. The purpose of this research is to understand how the bank gains and maintains its legitimacy from its diverse stakeholders, specifically in terms of the way the bank is regulated/controlled and how the external control mechanism influences the bank's internal practices of the bank. This research also reviews the history of banking, in general, as well as of Islamic banking in Indonesia to obtain a contextual understanding of the issues

This research uses a case study approach informed by the new institutional sociology (NIS) and legitimacy theory. The NIS theory is used to analyse how the Islamic bank responds to pressure and influence from the stakeholders. The legitimacy theory is used to analyse how the Islamic bank gains and maintains its legitimacy from the stakeholders. Data were generated from 24 interviews with the management of the bank and as the regulators as well as from documentary evidence and observations.

This research found that the bank faced various pressures and influences with the most critical pressure coming from the regulator through control and regulations. However, the pressures are sometimes conflicting; with investors demanding high profit while the public expect the bank to play a social role. The bank finds innovative ways to respond to such conflicting pressures, and, as a result, gains legitimacy from its stakeholders.

This research makes contributions to theory and practice. The use of NIS along with the legitimacy theory provides a better understanding about the institutionalization process in an organization. If the NIS theory only explains about the process of institutionalization in an organization, then the legitimacy theory explains in more detail about the legitimacy gained by an organisation as a result of the institutionalisation process. This research also contributes to improving the understanding about the practice of Islamic banks. The conformance to Islamic values as well as to the regulations does not prevent Islamic banks from pursuing economic objectives. In fact, Islamic banks have survived during economic crises while many other conventional banks collapsed.

CHAPTER 1

INTRODUCTION TO THE STUDY

1.1. Introduction

This chapter explains the reasons why the topic needs to be researched. The background of the research is described to clarify the underlying research problem. The approach that is utilized in this research is also briefly explained. Finally, the contributions of this research are described to depict the usefulness of this research.

1.2. Background of the Study

Islam, a religion dealing with the life of human beings, encourages business and provides detailed laws covering business activities, as illustrated from a verse of the Qur'an, "Allah has made business lawful for you" (Al Baqarah: 275). The early Muslims engaged not only in domestic trade, but they also went to distant lands for commercial trade. Consequently, Islam reached Africa and East Asia through business activity. Thus, business activities have played an important role in disseminating Islam worldwide.

Currently, shariah business is growing rapidly, especially in the area of banking. A shariah business organization is a business institution that uses the Islamic Legal system (shariah) as the fundamental aspect of its operation. These fundamental aspects are, among others, prohibition against riba (usury), not using or selling something that is unlawful (haram), no cheating or engaging in fraud, such as hiding product defects in marketing, etc. Currently the total asset of the Islamic finance industry are around $1.14 trillion worldwide and is growing 10% yearly (BMB-Islamic, 2012).

In Indonesia, shariah banking has grown rapidly, from just one bank that used shariah as its operational basis in 1992, it has since been followed by many other banks. Some banks entirely reformed their operational basis before emerging with a new name and identity. As at the end of 2011, the assets of Islamic banks in Indonesia totalled 149 trillion rupiahs or 16.5 billion US dollars (Rachman and Nuraini, 2012). This means an increase of around 49% compared to the same period in the previous year.

The existence of Islamic banks is considered more significant considering that no single Islamic bank collapsed due to the economic crisis (Boumediene and Caby, 2010; Khan and Crowne-Mohammed, 2009-2010). In the case of Indonesia, even though seven banks were closed down by the government because of their bad condition during the economic crisis in 1997, none of these were Islamic bank.

In general, an economic crisis always begins with the banking sector. In Indonesia, the banking crisis happened in 1997. According to the World Bank (1998), one of factors triggering the crisis was the weakness of the banking system in Indonesia. The weakness of the Indonesian banking system was used by bank owners by lending public funds to their own groups and to build real estate as well as an excessive number of condominiums, which, in turn, increased the insolvency of the banks (Tarmidi, 1999).

The recent 2008 crisis in the US also started from the failure of one banking product, i.e. subprime mortgage (Gorton, 2008). Subprime mortgage is a financial innovation designed to provide home ownership opportunities for those who actually are not bankable or riskier borrowers in the US (Gorton, 2008). Hence, not only those who are eligible (prime), but also those who are less eligible (subprime) can be financed to own a home.

Further consequences can be predicted. The demand for housing increased rapidly in the US. Thus, the price of a house as well as the interest rate also increased. However, most of the demanders were less eligible or risky borrowers. Consequently, there was massive insolvency of the subprime mortgage just in this last decade. Such a situation led to the banking crisis in the US in 2007.

On the other hand, Islamic bank managed to weather the crises due to its basic natures of avoiding interest-based and gharar (high speculation) business. By avoiding interest-based business, Islamic banks are safeguarded from the negative-spread risk; the risk when the interest should be paid to customers is higher than the interest taken by bank from the debtors. The avoidance of high speculation business also protects Islamic bank from the crises. All businesses conducted by Islamic bank should be based on real asset (asset-based business). High speculation business such as derivative can multiply market risk exposure relative to capital due to the pursuit of higher yield (Dodd, 2000). Thus, Islamic banks are protected during the crises since they do not face the same types of risk as compared to their conventional counterpart.

The examples above show the need and importance of proper banking regulation as well as good corporate governance for banks. As an industry that is more prone to trouble than others, the banking industry needs to be highly regulated and controlled.

Unlike other industries, banks hold assets that are mostly owned by the public. Hence, banks need to be regulated for the protection of depositors, to ensure monetary and financial stability, and also an efficient and competitive financial system (Spong, 2000).

In addition to external regulation, banks also need to implement good corporate governance. The need for good corporate governance is acknowledged by the Basel committee, which issued a directive on Banking Supervision (2006) stating 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”.

The proneness of banks to crisis makes their legitimacy vulnerable. Scott and Meyer (1991) viewed commercial banks as facing strong institutional forces. Scott (2003) argued that organizations, such as utilities and banks, are subject to strong institutional as well as strong technical pressure. Hence, it is interesting to explore how banks respond to control and regulation from the institutional perspective, to be exact, from the legitimacy perspective. Moreover, Deephouse (1996) found that regulators can confer legitimacy on banks. According to Stigler (1971), as quoted by Joskow et al. (1993), the regulatory process “automatically admits powerful outsiders to industry's councils”.

The research on the response by Islamic banks to control and regulation is more interesting because, unlike conventional banks, which only need obey the central bank, Islamic banks have two sources of regulation that should be complied with, i.e. the central bank and the Shariah National Board. The central bank regulates the economic and management/technical aspects of the bank, while the Shariah National Board generates regulations that are based on Islamic principles.

1.3. Problem Statement

As an industry that is the backbone of any economy, banking should maintain its continuous existence. The important role of the banking industry ensures that banks need to be controlled and regulated. However, the regulation and controlling of banks does not make them safe from the economic crisis. Indeed, based on the 1997 and 2008 experience, the banking industry is the first sector that is harmed during an economic crisis.

The experiences of the economic crises show that Islamic banks have managed to maintain their existence during the crises. Islamic banks are still able to operate their business under such a capitalistic atmosphere, even under the ‘capitalistic crises’. As a bank, Islamic banks have the same basic nature as their conventional counterparts, that is, as a highly regulated industry. Such strict regulation of banks is to protect customers’ assets, to stabilize the monetary and financial system and to make the financial system efficient and competitive (Spong, 2000).

In addition to the similarities between Islamic and conventional banks, there are substantive differences between them. The existence of Islamic banks is based on Islamic principles while that of conventional banks is based on capitalistic principles. At the operational level, the most significant difference between them is that Islamic banks strictly avoid interest-based schemes in their business while conventional banks utilise interest as their main source of profit.

To a certain extent, the different values adopted lead to different regulations being imposed on the respective banks. Conventional banks are only regulated by the central bank whereas Islamic banks are regulated by the central bank in conjunction with the Shariah National Board, especially for regulations pertaining to Islamic principles.

However, even though Islamic banks operate based on Islamic principles, they exist under the same atmosphere as conventional banks, that is, a capitalistic and secular atmosphere. Hence, Islamic banks compete with conventional banks in the same arena. In order to win the competition as well as to maintain their existence, Islamic banks should accommodate their stakeholders' will to gain legitimacy from them.

Hence, it is imperative to investigate the ways in which Islamic banks comply with the regulations imposed by the regulator as well as the demands from other stakeholders and to understand how Islamic banks maintain their existence by keeping their legitimacy high in the eyes of the stakeholders.

1.4. The Objectives of the Study and its Approach

The focus of this research is to understand and explain how an Islamic bank maintains its legitimacy in its institutional environment. As such, this study seeks to understand the way that Islamic banks comply with the procedures or regulations or adhere to the values, and, as such, obtain their legitimacy from the stakeholders. A case study of a large and prominent Islamic bank in Indonesia is used in this research.

The central research question of the research is: How does Bank La Riba maintain its legitimacy in the eyes of its stakeholders?

The specific research questions are as follows:

1. How and why are Islamic banks regulated/controlled in Indonesia?
2. How does the external control mechanism influence the internal practices of the bank?
3. How does the bank maintain its legitimacy from the institutional environment specifically from its stakeholders?

1.5. Contributions of the Study

This study seeks to provide a new insight into the way Islamic banks gain legitimacy. As such, this study is expected to contribute insights concerning how Islamic banks respond to the regulations controlling them. As a bank that operates based on Islamic principles, it has a certain mechanism for controlling and governing itself that, to some extent, is different from its conventional counterpart. It is hoped that the findings will provide new insights concerning the control and governance of Islamic banks.

The use of institutional theory in capturing the process of control and regulation in Islamic banks is another contribution of this study. Rather than a process that seeks to attain 'the 3 Es', i.e. economy, efficiency and effectiveness, the institutional perspective views the obedience to regulations as well as the implementation of good governance as being aimed to gain legitimacy from the institutional environment.

From a practical view, it is hoped this research will provide new insights to management about the relationship between companies with their environment or their stakeholders, so that they can better manage their environment as well as their stakeholders. In terms of controlling and governance, a better understanding of the environment and the stakeholders will lead management to have good corporate governance that covers all stakeholders' interests and is acceptable to their environment.

1.6. The Outline of the Thesis

The thesis consists of eight chapters as follows:

Chapter two crystallizes the research idea by reviewing the literature concerning Islamic banking. Firstly, the chapter describes the banking concept in general, which is then followed by the explanation of the regulation and control in the banking industry. Further the chapter explains the development of banking regulation in Indonesia. The nature of Islamic business in general, and, more specifically, in Islamic banking, is discussed further. Lastly, the chapter discusses the relationship between Islamic banks, control and regulation.

Chapter three discusses the theoretical framework that is employed to explain the phenomena regarding Islamic bank legitimacy in this research, i.e. the new institutional theory (NIS). The NIS is used because it is able to explain the interaction of an organization with its environment. The origin of the NIS and the environmental management are discussed in the second and third sections of the chapter. After the NIS is clearly explained, the following section discusses the control and regulation of Islamic banks from the institutional perspective. The theoretical legitimacy of an organization and the legitimacy of Islamic banks are explained in the last two chapters.

Chapter four discusses the research methodology that is used in this research. The position of accounting within the knowledge area is clarified in the second section before discussing the ontological and epistemological basis of the research in the third section. The following sections discuss the research method used in this research. The rest of the chapter describes the research process consisting of a preliminary visit, data collection and data analysis.

Chapter five of the research describes the historical context and regulation of Islamic banks in Indonesia. The historical and the environmental context during the establishment process of Indonesia Islamic bank are explored. The next section in this chapter discusses the general legal basics underlying the operation of Islamic banks in Indonesia. In addition to the general legal basics, the operation of Islamic banks in Indonesia is also guided by more detailed regulations issued by the central bank. Such regulations are described in the next section of the chapter.

Chapter six describes the organizational case findings during the fieldwork. The chapter starts from a description of the development of Bank La Riba over the two decades of its operation. Further, the chapter discusses the key processes of the daily operation of Bank La Riba. The description of the key processes aims to depict the overall picture of the day-to-day operation of Bank La Riba.

The findings are then analysed theoretically in chapter seven using the new institutional theory (NIS) as well as the legitimacy theory. Firstly, the chapter analyses the institutional environment of the bank. The next section of the chapter discusses the isomorphism processes that take place in Bank La Riba. Along with the explanation of the isomorphism processes, the legitimacies gained by Bank La Riba are also discussed. The final section of the chapter explains the process of maintaining the legitimacy of Bank La Riba.

Chapter eight discusses the contributions of the research, which consist of theoretical and practical contributions. Further, the chapter discusses the limitations faced during the research. Lastly, the chapter provides several recommendations for future research concerning the Islamic banking industry and for the regulators.

CHAPTER 2

LITERATURE REVIEW

2.1. Introduction

This chapter explains the literature supporting the idea of the research. Firstly, the chapter discusses the nature of the banking industry. The reason behind the establishment of banks and their role in economic activities is explained in this section. Further, as an industry that is highly regulated, the regulators of banks and the regulations are discussed. The viability of Islamic banks is discussed further including the historical context of Islamic banks and their development.

2.2. Nature of Banking Industry

Within economic activities, the banking sector plays a central role. Almost all kinds of business involve the banking industry in this modern era due to its main role as a distributor of financial resources. Its intermediary function makes it possible to flow money through savings and lending activities. By collecting funds from customers who deposit their money, banks then provide financing/lending to other customers. Thus, the deposits of customers are considered as liabilities for the bank, and, similarly, the lending to customers are assets of the bank. Hence, by pooling assets and liabilities, banks are considered to be engaging in asset transformation, which is transforming the value of assets and liabilities (Heffernan, 2005).

Matthews and Thompson (2005) explained in more detail the reasons why banks exist. Financial intermediation is the basic reason for the existence of banks. Financial intermediation is the process of borrowing by deficit units from financial institutions rather than directly from the surplus units themselves. Hence, financial intermediation involves the surplus units depositing their funds with financial institutions, which, in turn, are loaned to deficit units. Figure 2.1 illustrates the process of financial intermediation.

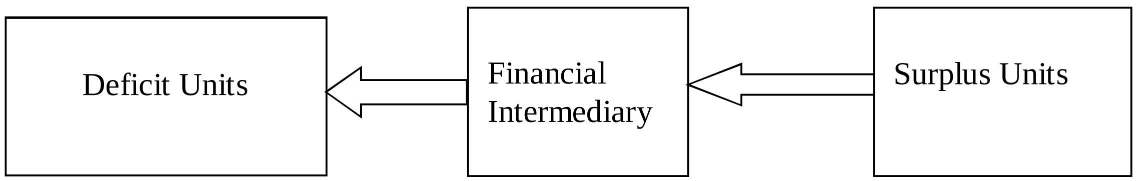

Figure 2.1: Process of Financial Intermediation

The nature of lenders and borrowers are different in a number of ways. Borrowers often desire to be lent large amounts of funds, whereas lenders usually have only small amounts of surplus funds. For example, an application to a bank to purchase a house needs more funds than can be provided by any individual lender. Thus, a bank acts as a mediator collecting funds from any individual depositor and then lending them in a larger sum to debtors. This is called ‘size transformation’ (Matthews and Thompson 2005).

Further, lenders usually have a short horizon for lending their funds. They want to have full access to their money so that they can withdraw whenever they want. Borrowers usually wish to secure their funds over the life of the project or investment. Banks can overcome this gap by offering short-term deposits for lenders and long-term loans for borrowers. This is called ‘maturity transformation’ (Matthews and Thompson 2005).

Finally, lenders usually prefer to deposit their funds at low risk, whereas borrowers usually tend to invest the borrowed funds in high risk projects. Banks offer low risk to lenders and bear the high risk of borrowers' projects. As compensation, banks charge the borrower higher than the amount that has to be remunerated to the lenders. This type of transformation is called 'risk transformation' (Matthews and Thompson, 2005).

Banks also play the role as the point of payment that enables business transactions between the seller and buyer to take place. Although cash payment is still the main method in paying transactions through banks, other methods of payment also take place. Before the 1990s, cheques were the most popular alternative tool for conducting payments through a bank. However, since the mid-1990s, credit cards and automatic teller machines (ATM) have gained popularity in settling transactions through the bank. Hence, in this context, banks are involved in ownership transformation. In addition to their intermediary functions, banks also expand their function into non-banking financial services, such as mortgages, asset management, insurance, sales of foreign exchange, and operating deposit boxes.

Greuning and Bratanovic (2009) argued that the expansion of the functions of banks resulted from the development of technology and the environment that began in the 1980s. Such technological progress, as well as some deregulation, led banks into new challenges with increasing competitive pressure among banks. Banks were presented with opportunities to design new products and provide more services.

Thus, whatever the kind of services offered by the banking industry, it holds and operates funds or assets that mostly belong to the public. Consequently, the failure of a bank not only impacts its depositors, but could affect the stability of the economy as a whole. Greuning and Bratanovic (2009) classified the risks faced by banks into three categories, i.e. financial, operational and environmental risks. Financial risk consists of two types of risk, i.e. traditional banking risk and treasury risk. Traditional risks encompass balance sheet, income structure, credit and solvency risks that can result in loss to the bank if they are not properly managed. Treasury risks are the ones that are based on financial arbitrage. They can result in a profit if the arbitrage is correct or a loss if it is not correct. The main categories of treasury risk are liquidity, interest rate, currency, and market (including counterparty) risks.

Operational risks encompass overall business processes including strategic planning, governance and organizational structure, management of staff careers and internal resources, product and knowledge development and customer acquisition approach. Environmental risks relate to the bank's business environment, including macroeconomic and policy concerns, legal and regulatory factors, and the overall financial sector infrastructure and payment systems of the jurisdictions in which it operates (Greuning and Bratanovic, 2009).

2.3. Regulation and Control in the Banking Industry

The nature of bank activities, which always deals with some risks, is the reason why – unlike other types of industry – banks need to be highly regulated and controlled. Banking is a fragile business because it depends on the confidence of its depositors. Spong (2000) explained the purposes of bank regulation as follows: protection of depositors, monetary and financial stability, efficient and competitive financial system and consumer protection. Matthews and Thompson (2005) argued that the main reasons for banking regulation are threefold. First, consumers lack market power and are prone to exploitation from the monopolistic behaviour of banks. Second, depositors are uninformed and unable to monitor banks, and, therefore, require protection. Finally, banking regulation is needed to ensure the safety and stability of the banking system.

The protection of depositors is the most basic reason for banking regulation because they hold a significant portion of their money in banks. Bank depositors have more difficulty than customers of other types of business in protecting their interest. Spong (2000) explained in more detail how bank regulators produce regulations for banks. Bank regulators put their self in the depositors'/creditors' shoes when they set regulations. In other words, a bank regulator has much the same concerns as creditors and takes much the same steps. For example, creditors try to limit a borrower's risk or charge more for higher risks. Creditors also try to limit their own exposure and increase a borrower's stake in the transaction by securing collateral for the loans they make and by limiting a borrower's indebtedness relative to his or her income and resources. A creditor may also want to impose restrictions on a borrower's activities and use of assets and undertake periodic investigations of the borrower's operations.

Bank regulators take many similar steps in an effort to control banking risks and thereby protect depositors and ensure financial stability. Banks, for instance, are restricted to certain activities and must maintain adequate capital relative to assets and operational risks. They are also expected to maintain enough low-risk liquid securities to cover normal fluctuations in deposits. They are regularly examined, and bank supervisors will impose tighter restrictions on banks if their condition declines (Spong, 2000).

The purpose of bank regulation concerning monetary and financial stability is related to the vast number of transactions conducted by people and business through banks. A safe and acceptable means of payment is needed or else serious disruptions will occur if the vast number of transactions via banks cannot be accomplished with a high degree of certainty and safety. Hence, bank regulation should ideally prevent such fluctuation in business activity and problems at individual banks from interrupting the flow of transactions across the economy and threatening public confidence in the banking system.

According to Spong (2000), a good banking system is one that can provide good services to customers with competitive prices. Therefore, bank regulation should create a regulatory framework that supports efficiency and competition and ensures an adequate level of banking services throughout the economy.

Finally, the interests of customers should be protected during their business relationship with banks, because consumer protection is a key part of banking regulation (Spong 2000). Spong (2000) then classified consumer protection into three general categories or objectives. Two can be classified broadly as disclosure laws and civil rights laws. The third category consists of laws designed to protect a consumer's privacy and provide safeguards against specific abuses in the extension, collection, and reporting of consumer credit.

Regulations for the banking industry are set and issued by a central bank. The modern central bank is a government institution and does not compete with banks operating in the private banking sector (Heffernan, 2005). Its main functions are monetary control and 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 favourable terms possible (Heffernan, 2005).

2.4. Good Corporate Governance of Banking

The nature of bank activities that always deal with some risks require banks to apply good governance in their daily operation. Applying good governance will minimize the risks faced by a bank. Gruining and Bratanovic (2009) defined corporate governance as including setting corporate objectives with the bank’s risk profile, aligning corporate activities and behaviour 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.

Cooper (2009) explained why the banking industry needs different corporate governance than other industries. First, banks are subject to government regulations. 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 other industries (Cooper, 2009).

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”. According to The OECD principles, corporate governance is defined as:

> "Corporate governance involves 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. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders, and should facilitate effective monitoring".

At a country level, the central bank plays the central role of ensuring good governance by establishing, monitoring and then evaluating the standards of operation for banks in order for them to operate accountably. Joskow et al. (1993) argued that regulators have different interests to shareholders in terms of the form of good governance. Regulators focus on safety and soundness while the focus of shareholders is on wealth maximization (see also Booth et al., 2002). However, the implementation of good governance is costly (Shleifer and Vishny, 1997; Baker and Gompers, 2003). Therefore it is not feasible for regulators to monitor all firms' activities because it is costly to monitor a firm's actions as they cannot control the daily operations (Stigler and Friedland (1962), as quoted by Becher and Frye, 2011).

The relationship between regulation and governance raises the issue of whether they are a substitute or complementary. Previous studies show conflicting results. Using a sample of 2000 CEOs employed by more than 1000 firms, Joskow et al. (1993) found that CEOs of regulated firms are paid less than CEOs of unregulated firms. The use of CEO as a proxy for corporate governance implementation is based on John and Senbet's (1998) study. John and Senbet (1998) argued that the board of directors are presumed to carry out the monitoring function on behalf of shareholders because the shareholders will face difficulty in controlling the company by themselves because of the wide dispersion of ownership of common stock. Bryan and Hwang (1997) argued that regulation can affect CEO compensation through limitations on the scope of the CEO's job, reduction in the investment opportunity set, increased monitoring, and increased political pressure. By using CEO compensation data for a regulated industry, i.e. electric utility companies, Bryan and Hwang (1997) found that in a less rigid regulatory environment, incentive-based compensation of the CEOs is higher than for those who exist in a more rigid regulatory environment.

Booth et al. (2002) also found there is negative relationship between regulation and internal control mechanism. They gathered data for firm value, assets, common stock owned by insiders and the percentage of independent outside directors from 300 samples of firms consisting of the 100 largest banks, 100 utility firms and 100 firms other than bank or utilities industries. The result is that the monitoring by independent outside directors acts as substitute for officer and director ownership. For firms in which officer and director stock ownership is high, the percentage of independent outside directors on the board is smaller.

However, there are other findings that are contradictory to the substitute argument. Wang et al. (2010) argued that regulators play an important role even in the presence of monitoring. Adams and Ferreira (2008) contended that board oversight is a complement to regulation. Becher and Frye (2011) found that the relationship between regulation and governance is complementary. They contended that the presence of regulators can pressure firms to adopt effective corporate governance. Roengpitya (2007) stated that external governance mechanisms do not replace the internal mechanisms in banks. Roengpitya (2007) used the board composition of banks, especially the proportion of the outside board directors (OBD), to implicate bank governance. He studied whether and how deregulation affects the structure of the bank board of directors, from which some implications of governance can be drawn. Adams and Mehran (2003) argued that the board of directors of a banking firm plays a crucial role in its governance structure because the nature of a banking firm is that it has a number of parties with a stake that may complicate its governance.

Prowse (1997) stated that regulatory intervention is an important control mechanism in publicly traded banks. McLaughlin and Safieddine (2008) found that regulation can lessen information asymmetry in a regulated firm. They compared pre and post-issue operating performance between industrial and regulated firms. The results show that industrial firms experience a statistically significant difference in abnormal operating performance, wherein there is a significant decrease of abnormal operating performance of industrial firms from the pre-issue to the post-issue period. Whereas, regulated firms show an insignificant difference for abnormal operating performance between the pre-issue and post-issue period (McLaughlin and Safieddine, 2008).

2.5. The Development of Banking Regulation in Indonesia

Until 1982, the banking industry in Indonesia was based on Act no. 13/1968 concerning the central bank and some articles in Act no. 14/1967. Both acts were the first systematic regulation concerning the banking industry in Indonesia. Previously, the regulation of banking in Indonesia was Act no. 24/1951, which was an adoption of Dutch law – the colonizer of Indonesia – De Javashe Bank Wet (Law of the Bank of Java).

However, those regulations (the Acts of 1967 and 1968) were seen as over-regulating considering the development of global economic and business (Bank Indonesia, undated-c). In the 1980s, the economy of Indonesia was threatened due to the global decrease of oil and gas prices. This situation eroded most of the national revenue of Indonesia since the value of oil and gas export was 79.11% of the total exports of Indonesia and about 64.16% of Indonesia's tax revenue was from oil and gas tax. This was a vulnerable economic condition since the economic structure of Indonesia mostly depended on external sources, i.e. oil and gas exports.

The hard economic condition led the government to optimize the involvement of the private sector in financing the development in Indonesia. For that reason, the role of the banking sector was optimized to maximize its intermediary function. Consequently, the Indonesian central bank, i.e. Bank Indonesia (BI) issued a package of regulation called 'Paket Juni 1983' (June package 1983) containing some deregulation of the banking industry, such as the elimination of the lending limit and banks were free to set their interest rate (floating rate) for lending and depositing (Bank Indonesia, undated-a).

The deregulation succeeded in increasing the competitive environment among banks. Many banks, primarily private banks, took the initiative to determine the direction of their business. BI strengthened the bank monitoring system, particularly by identifying and listing 'bad persons' (Daftar Orang-Orang Tercela), i.e. those who have committed fraud or crime in the banking industry. Hence, those who were on the black list should not be involved in the banking industry.

In 1988, the government of Indonesia, in conjunction with BI, continued to issue further deregulation of the banking industry through 'Paket Oktober 1988 (October Package 1988), which was a return point of the banking restriction policy that had been applied since 1971. Through the October Package 1988, the restriction of the establishment of a new bank as well as its branches was eased by the government. The restriction of the establishment of rural banks was also eased. By having only 10 billion rupiahs (equal to 4 million US dollars at that time) anyone could establish a commercial bank or 50 million rupiahs (equal to 40 thousand US dollars at that time) for a rural bank. Such easiness to establish bank had never been enjoyed by the industry before. This resulted in the rapid growth of the banking sector. Foreign loans also flowed through the banking or non-banking financial institutions to finance the consumptive sector.

However, the October Package 1988 also had negative side effects, such as the abuse of power by the management of some banks. This condition led to the regulator issuing another regulation obliging banks to operate their business prudently and cautiously. The regulation was called Paket Februari 1991 (The February Package 1991). The main feature of this regulation was the requirement that a bank's capital adequacy ratio (CAR) should be at least 8%. Thus, banks should strengthen their own capital to at least 8% of their total assets.

In 1992, the government issued the Banking Act thereby replacing Act number 14/1967. This Act was part of the deregulation of the banking industry in Indonesia. Some aspects that were regulated in the Act were about banking structure, scope of activities, requirements of establishing a new bank, professionalism enhancement of bank's management and protection of the public funds by applying prudential principles and fulfilment of the bank's healthiness requirement. Since then, there was a change in bank classification, i.e. commercial bank and rural bank. The new Act also gave an opportunity for the establishment of Islamic banks by allowing financing based on the profit-loss sharing principle.

Between 1992 and 1993, Indonesian banks faced the problem of an increase in bad debt. The problem brought losses to banks. Thus, they were reluctant to expand their lending. In addition, banks were hesitant to distribute their lending due to the tight rules of banking management. To overcome such problems, the BI issued Paket Mei 1993 (The May Package 1993), which loosened the prudential principles of banks. The result was very significant. In 1994, Indonesia experienced economic growth primarily in the property sector. The May Package 1993 brought high growth in bank lending in a very short time. Even though the BI sought to limit the lending of banks, the large amount of lending was distributed to many sectors, especially to the property sector. Consequently, the economy overheated and the inflation rate increased rapidly.

In 1996, the BI sought to overcome the overheated economy by using moral suasion to banks to decrease their lending expansion. The result was that the amount of lending decreased some months later. However, the situation was too complicated to control. The expansion of banking was very hard to control. This situation led the government to liquidate seven banks that nearly collapsed in 1997 (Bank Indonesia, undated-b). The very high cost of the banking failure had to be paid for by the Indonesian government. The Economist (2003), as quoted by Noy (2004), estimated that about US 75 billion was paid to bail out the banking failure and called it “the most expensive bail-out in world history”.

2.6. Islamic Business

There is much evidence that Islamic business works well in the real world like other businesses. The Islamic capital market, Islamic Insurance or Takaful, Islamic Banking, Islamic Investing, are some testament to its success and continued growth. These Islamic businesses significantly shaped the discourse of Islamic economics. Vogel and Hayes (1998, p. 2) captured the essence of growth in Islamic understanding in their statement:

> In the last three decades it has emerged as one of the most significant and successful modern implementations of the Islamic legal system, and a test case for future Islamic legal innovation and development.

According to Vogel and Hayes (1998), Islamic finance (and Islamic economics and business) is not an invention of this century's Islamic extremist political movements but stems from injunctions found in the Qur'an and the sayings of Prophet Muhammad. These are inspired central tenets in the religious law of Islam concerning commercial dealings. The centuries-old practice of finance in Islamic form was largely eclipsed during the period of the European colonial empires, when almost the entire Islamic world came under the rule of Western powers (Vogel and Hayes, 1998).

Chapra (2003) classified the development of economics in five stages. The first stage is the early form of economics when Adam Smith published his book, The Wealth of Nations. At this stage there is no role of any institution except markets in distributing and allocating resources. The term of laissez faire (free from any intervention) was applied at this stage. Therefore, the role of the family, the society, the state, and moral value was totally ignored.

The second stage is economics with an aggressive role played by the state. The reason underlying the active role of government was due to some newly independent countries after the Second World War, which faced difficulty in accelerating development solely through the market forces. Since the state did not generally have adequate resources for playing the role, there were large budgetary deficits. These were financed by means of monetary expansion, and, subsequently, led to inflation and a