CHAPTER 14

Product development in Indonesia

14.1 Introduction

Product innovation within a Shari'a framework is important for Islamic banks to survive in the long run. The level of product innovation gauges the competitiveness of Islamic banks in the industry, and also the distinctiveness from their conventional banking counterparts. A key factor in determining the extent of innovation and outreach of Islamic finance products will be the approach adopted by financial regulators in the country. Regulators in one country may prove to be detrimental to the level of diversification and innovation of the products sold in the market.

This chapter focuses on the regulatory aspects of product development within Indonesia. Indonesia has adopted a conservative approach to Islamic finance, and according to many industry analysts, this poses challenges for Islamic banks (iB) in Indonesia in developing innovative Shari'a compliant products. This chapter will scrutinise the unique characteristics of the regulatory framework for Islamic banks in Indonesia, and its impact on the product suite. Before a thorough discussion regarding the regulatory challenges of product development in Indonesia can take place, it is pertinent to first know the product development processes in Indonesian Islamic banks.

14.2 Product development processes in Indonesian Islamic banks

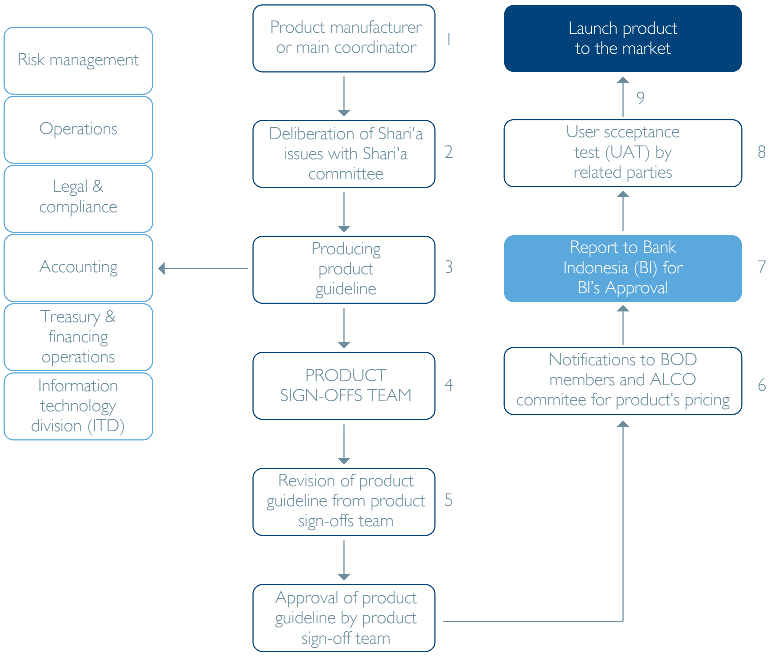
The process of product development in Islamic banks is generally similar across most, if not all Islamic banks around the world. The main differences concern the regulatory framework of the country, which comprises of both internal and external factors, which shape the general regulatory culture. Internal regulation includes legislation and central banks regulations, whilst the latter would include international accounting standards and Shari'a standards. Each country's unique regulatory framework can either smoothen or retard the product development process, depending on the rigidity of the regulatory framework is.

Exhibit 1 explains the 9 stages of product development processes with an Islamic bank.

14.3 Regulatory framework for product development in Indonesia

The regulatory framework for Islamic banks in Indonesia is evolving although the government's commitment to develop Islamic banking remains limited. Islamic banking in Indonesia along with their products and services are regulated by the central bank, Bank Indonesia, under the supervision of Dewan Perbankan Syariah (DPbS), and is underpinned by banking and finance legislation and the compilation of fatwa by the National Shari'a Council. Regulators have generally adopted a conservative approach to Islamic finance, the argument being that by being more rigid, authenticity is maintained. Moreover, banks are incentivised to work in the real sector and not concentrate on producing complex, opaque monetary products, which have only a tentative link to the real sector.

Islamic banking operations in Indonesia are governed by Indonesian law UU No. 21, 2008. The purview of



Stage 1
After doing market research, the Product Development Team (PDT) proposes to launch the new product with specified features and target market segments. PDT appoints the Main Coordinator who will be manufacturing the products and liaise with the respective departments in the bank.

Stage 2
PDT liaises with the Shari'a committee to deliberate Shari'a issues arising from the product structure, and ensure it meets Shari'a requirements.

Stage 3
The Main Coordinator finalises the template of the product guideline to be circulated internally to the Product Sign-Off Team, which consists of a bank's respective departments, in order to determine whether or not the manufactured product meets the internal bank's requirements.

Stage 4
The bank's respective departments give comments on the product guideline if the product does not meet the bank's internal requirements. Any comments will be reviewed and rectified accordingly by the Main Coordinator.

Stage 5
The Product Sign-Off Team approves the product guideline after the internal Bank's requirements has been met and incorporated.

Stage 6
The proposed product along with the approved product guideline will be notified to the Board of Directors (BOD) for their deliberations of internal issues (if any), and the Asset Liability Committee (ALCO) for determining the product's pricing.

Stage 7
PDT will report and present the approved products to Dewan Perbankan Syariah (DPbS) of Bank Indonesia (BI). BI usually will comment if the product does not meet BI requirements and regulations. PDT has to then adjust the product features and product guidelines according to BI comments in order to obtain BI's approval.

Stage 8
The product undergoes a User Acceptance Test (UAT) conducted by the PDT, Information Technology Division, and any related party who will use and sell the product. UAT is aimed at ensuring the bank's core banking system is able to cater to the product's business requirements.

Stage 9
After the UAT is completed, the product can successfully be launched to the market.

Exhibit 1: Product development process

this piece of legislation covers "Badan Usaha Syariah" (BUS)/Islamic banking subsidiary and "Unit Usaha Syariah" (UUS)/Islamic banking window. The functions of Islamic banking are also governed by this legislation whereby apart of collecting and distributing of third party funds, Islamic banking has to perform social functions, which are: (1) accepting zakat, infaq funds, and channelling them to zakat institutions, and (2) accepting waqf funds and channelling them to waqf management institutions.

For developing new products and activities, Islamic banks are governed by Bank Indonesia Regulation No. 10/17/PBI/2008 whereby Islamic banks are obliged to report new products and activities to DPbS Bank Indonesia. In reference to provision 2(3) of the regulation, if the proposed new product or activity is not codified in the Shari'a Banking Product's Codification Book, then the Islamic bank has to present the new product or activity to DPbS in order to get an approval and rubber stamp from Bank Indonesia. In line with provision 3 the Islamic bank must report the plan for launching the new product or activity to Bank Indonesia within a maximum of 15 days before the launch of the new product or activity and before selling it to the market. Failure to do so will result in a penalty.

Apart from Bank Indonesia regulations, Islamic banks have to comply with the National Shari'a Council in developing a new product or activity. Specifically, attention has to be given to the national fatwa compilation issued by the Council. There are, at the time of publishing, 83 fatwas issued by the National Shari'a Council pertaining to Islamic financial transactions.

14.4 Indonesia's Islamic banking product portfolio outlook

As the regulatory framework for product development is conservative, the level of product innovation is minimal. Hence, the nature of Shari'a banking in Indonesia is more focused towards retail-based banking. The offered products are mainly plain vanilla Shari'a compliant products.

Looking into an Islamic bank's product portfolio- according to Bank Indonesia's Report (2011)- on the asset side of the balance sheet, financing products are dominated by murabaha products (56.95%), followed by musharaka products (20.45%). Murabaha based financing is the most popular product in Indonesia as it is user friendly and also faces very few Shari'a impediments in an Islamic bank's operations. For the treasury, the products are limited to the Islamic money market, the so called Pasar Uang Antarbank Syariah (PUAS), FOREX on a spot basis, retail government sukuk, Bank Indonesia placement, and the interbank's Shari'a placements.

Structured products for financing and treasury products have yet to sufficiently enter the Indonesian market, as domestic regulations do not allow for structured products to be offered in Indonesian Islamic financial institutions. However, there has recently been a shift in thinking and it is anticipated that there will be an introduction of new groundbreaking products in the Indonesian market, particularly commodity murabahah iB. The National Shari'a Council has issued the fatwa for this product, and Jakarta Future Exchanges (JFX) has provided the platform for trading. Nevertheless, unlike Malaysia and Middle Eastern countries, this commodity murabahah iB can only be used for liquidity management purposes by Islamic banks, as part of their treasury product's portfolio.

On the liability side, and similar to global Islamic finance practices, products include saving accounts based on wadi'a and mudaraba, current accounts based on wadi'a and time deposits based on mudarabah mutlaqa or muqayyada, with the only exception of deposits based on tawarruq.

14.5 Products in Indonesian Islamic banking industry

Exhibit 2 highlights some of the products offered by Indonesian Islamic banks. As the nature of the Islamic banking industry in Indonesia is focused upon real-sector development and Islamic micro financing, the most saleable products in Indonesia are micro and SME financing as well as cooperative financing. The interest of many Islamic banking stakeholders is on Gold Pawning Syariah as this product is currently worth IDR 7 trillion and set to achieve IDR 8 trillion by the end of 2011.

14.6 Regulatory Challenges for Product development in Indonesia

Two major challenges faced by Indonesian Islamic banks in developing innovative Shari'a compliant products are as follows:

1. As the Bank Indonesia and the National Shari'a Council are independent bodies, there are differences between the two as to what constitutes Shari'a compliant. When the National Shari'a Council approves the product, it does not necessarily mean that Bank Indonesia will concur, and vice versa. As a result, this leads to a lengthy process for Islamic banks in launching their products and services to the market.

2. Indonesia may have the most fatwa issuances among the countries operating Islamic banks, but the fatwas do not discuss the detailed business operation models that are allowed by the National Shari'a Council. The fatwa merely utilises the Islamic sources (Qur'an & Sunnah) to legalise, authenticate and provide the general guiding principles for the products' Shari'a permissibility. The absence of a detailed business operation mode in the fatwa issuance process creates uncertainty for Islamic banks in structuring and executing the products within the Shari'a parameters stipulated by the National Shari'a Council.

No.	Name of The Products	Name of Banks That Offer The Products
		Financing Products
1	Micro and Small Medium Enterprise (SME) Financing iB (Murabaha & Ijara)	Bank Syariah Mandiri, BNI Syariah, Permata Syariah, Bank Mega Syariah, Bank DKI Syariah, BRI Syariah Bank Syariah Mandiri, Bank Muamalat, Bank Danamon Syariah, BRI Syariah
2	Cooperative Financing iB (mudaraba, murabaha)	Bank Syariah Mandiri, Bank Muamalat, BRI Syariah, BNI Syariah, Bank Mega Syariah
3	Pilgrimage Financing iB (Al-Qard)	Bank Syariah Mandiri, Bank Muamalat, BRI Syariah, BNI Syariah, Bank Mega Syariah
		Funding and Consumer Products
1	Omrah and Hajj savings (mudaraba mutlaqa)	Bank Syariah Mandiri, Bank Muamalat, BRI Syariah, BNI Syariah, Bank Mega Syariah
2	Gold Pawning Syariah (Ar-Rahnu)	BNI Syariah, BRI Syariah, CIMB Niaga Syariah, Bank Syariah Mandiri

Exhibit 2: Product offering by Islamic bank in Indonesia

14.7 The way forward

In order to build coordinated Shari'a linkages between Bank Indonesia and the National Shari'a Council, it is expedient to incorporate a Shari'a committee in to the DPbS of Bank Indonesia, that represents the views of the National Shari'a Council. This Shari'a Council incorporation can specifically deal with Shari'a framework development, Shari'a issues related to Bank Indonesia's regulations, and of course product approval for new products proposed by Islamic banks. An in-house Shari'a Council within a central bank has been successfully implemented in Malaysia whereby the Shari'a Advisory Council (SAC) was incorporated under Bank Negara Malaysia's (BNM) governance and has been given the highest authority to deal with Shari'a matters and activities for Islamic banking finance and takaful development. Hence, incorporation of a Shari'a Committee under Bank Indonesia's governance could smoothen the process of product approval for Islamic banks and assist them in launching their new products into the market since only a single product approval, will be required rather than two product approvals.

The Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) Shari'a standards is a great example of how Shari'a standards can be derived by considering all aspects of the product development process, from fatwa issuance to bank execution. Hence, AAOIFI Shari'a standards can be used as a benchmark for the National Shari'a Council to develop the 'best practices standard' for Islamic banks in conducting their Shari'a business in Indonesia. It is recommended also that there should be a working committee or a task force in the National Shari'a Council, which includes Islamic banking practitioners and economists to fuse banking practices and objectives with Shari'a prescriptions. This will assist in the improvement of the fatwa issuance process and align it with the Shari'a business model so that the fatwa is developed in a more holistic manner.