

**FACTORS AFFECTING GROWTH IN INDONESIAN
ISLAMIC BANKING INDUSTRY**

BY

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ABSTRACT

Indonesia is becoming one of the powerhouses of Islamic banking and finance globally. Currently, there are 34 Islamic banks in Indonesia. The number of Islamic banks grew gradually, with 12 full-fledged and 22 *Islamic Bank Windows*. However, the development of Islamic banks is not growing enough compared to conventional banks' growth in Indonesia. The phenomenon of Indonesian Islamic banking growth continues to be an exciting topic in this study. It is worthy of further discussion and study due to its dominance within the Islamic finance market. Accordingly, this study investigates Indonesian Islamic banks' growth based on the phenomenon and lack of literature from an organisational growth perspective. Therefore, the need to investigate Islamic banking growth was triggered by a lack of research to examine the declining growth of Islamic banking in Indonesia over the last 30 years. The study's objective is to expose the root causes of Indonesian Islamic banking's stagnancy from accounting and governance perspectives. This study examines relevant contingent factors of organisational growth in Indonesian Islamic banks, including organisational climate, service orientation, corporate governance, intellectual capital, and regulation. This study combines primary and secondary data analysis to create a comprehensive Indonesian Islamic bank model. It attempts to develop a model for analysing Indonesian Islamic banks' growth based on an organisational perspective. For secondary data, this study uses Islamic banks' annual reports from 2016 to 2018 drawn from the Financial Service Authority database and the websites of each Islamic bank. Furthermore, the research instrument for primary data is a questionnaire survey, with the target respondents being managers of Islamic banks in Indonesia. The managers are respondents as they are best positioned to provide evidence regarding Islamic banks' growth factors. According to the first model's result, only board independence and intellectual capital were accepted to determine an Indonesian Islamic bank's growth. The result of path analysis shows that service orientation has a significant indirect effect on mediating organisational climate and Islamic banks' growth. Service orientation became a mediator between Islamic banks' growth and organisational climate. The analysis result of the second model captured the joint meetings among the *Sharia* Supervisory Board (SSB), Board of Commissioners (BOC), and Board of Directors (BOD) have positive significance in determining the growth of Islamic banks in Indonesia. All board members' meetings will enhance Islamic banks' quality, strengthening their supervision. Structural capital (SCE) and relational capital (RCE) have significant value for intellectual capital traits, negatively affecting profit growth. Human capital has a significant impact only on Islamic banks' revenue growth in Indonesia. This study contributes to the Islamic banking literature on organisational growth and its contingent factors for Indonesian Islamic banks. It also provides significant insight and suggestions to the regulators and policymakers of Islamic banks, such as the Financial Service Authority (Otoritas Jasa Keuangan) and Bank Indonesia. This study contributes to the new discussion regarding Indonesian Islamic banks' organisational growth. It provides significant insight and suggestions to the regulators and policymakers of Islamic banks, such as the Financial Service Authority (Otoritas Jasa Keuangan) and Bank Indonesia. In addition, the results of this study impact the area of organisational growth for further research by academicians, researchers and practitioners.

خلاصة البحث

أصبحت إندونيسيا واحدة من مراكز القوة في الصيرفة والتمويل الإسلامي على مستوى العالم، حيث يوجد حالياً 34 بنكاً إسلامياً في إندونيسيا. ازداد عدد البنوك الإسلامية تدريجياً، مع 12 مصرفاً إسلامياً مكتملاً و 22 بنكاً إسلامياً. ومع ذلك، فإن تطور البنوك الإسلامية لا ينمو بدرجة كافية مقارنة بنمو البنوك التقليدية في إندونيسيا. ولا تزال ظاهرة نمو الخدمات المصرفية الإسلامية الإندونيسية موضوعاً مثيراً في هذه الدراسة، حيث تستحق المزيد من المناقشة والدراسة بسبب هيمنتها في سوق التمويل الإسلامي. وبناءً عليه، تبحث هذه الدراسة في نمو البنوك الإسلامية الإندونيسية بناءً على الظاهرة ونقص الأدبيات من منظور النمو التنظيمي. لذلك، نشأت الحاجة إلى التحقيق في نمو الخدمات المصرفية الإسلامية بسبب نقص الأبحاث لفحص النمو المتراجع للصيرفة الإسلامية في إندونيسيا على مدى الثلاثين عامًا الماضية. الهدف من الدراسة هو الكشف عن الأسباب الجذرية لركود الخدمات المصرفية الإسلامية الإندونيسية من منظور المحاسبة والحوكمة. كما تبحث هذه الدراسة في العوامل العرضية ذات الصلة للنمو التنظيمي في البنوك الإسلامية الإندونيسية، بما في ذلك المناخ التنظيمي، وتوجيه الخدمة، وحوكمة الشركات، ورأس المال الفكري، والتنظيم. تجمع هذه الدراسة بين تحليل البيانات الأولية والثانوية لإنشاء نموذج شامل للبنوك الإسلامية الإندونيسية. يحاول تطوير نموذج لتحليل نمو البنوك الإسلامية الإندونيسية على أساس منظور تنظيمي. بالنسبة للبيانات الثانوية، تستخدم

هذه الدراسة التقارير السنوية للبنوك الإسلامية من 2016 إلى 2018 المستمدة من قاعدة بيانات هيئة الخدمات المالية والموقع الإلكتروني لكل بنك إسلامي. علاوة على ذلك، فإن أداة البحث للبيانات الأولية هي استبانة استقصائية مع المستجيبين المستهدفين وهم مديرو البنوك الإسلامية في إندونيسيا. كان المديرون هم المحييون لأنهم في وضع أفضل لتقديم أدلة بشأن عوامل نمو البنوك الإسلامية. وفقًا لنتيجة النموذج الأول، تم قبول استقلالية مجلس الإدارة ورأس المال الفكري فقط لتحديد نمو البنك الإسلامي الإندونيسي. تظهر نتيجة تحليل المسار أن التوجه الخدمي له تأثير كبير غير مباشر على المناخ التنظيمي ونمو البنوك الإسلامية. أصبح توجيه الخدمة وسيطًا مثاليًا للعلاقة بين نمو البنوك الإسلامية والمناخ التنظيمي. أظهرت نتيجة تحليل النموذج الثاني أن الاجتماعات المشتركة بين هيئة الرقابة الشرعية (SSB) ومجلس المفوضين (BOC) ومجلس الإدارة (BOD) لها أهمية إيجابية في تحديد نمو البنوك الإسلامية في إندونيسيا. ستعمل اجتماعات جميع أعضاء مجلس الإدارة على تحسين جودة البنوك الإسلامية وتقوية الرقابة عليها. بالنسبة لسعات رأس المال الفكري، فإن رأس المال الهيكلي (SCE) ورأس المال العلائقي (RCE) لهما قيمة كبيرة مع تأثير سلبي فقط على نمو الأرباح. ورأس المال البشري له تأثير كبير فقط على نمو إيرادات البنوك الإسلامية في إندونيسيا. تساهم هذه الدراسة في الأدبيات المصرفية الإسلامية حول النمو التنظيمي وعوامله العرضية للبنوك الإسلامية الإندونيسية. كما أنه يوفر رؤى واقتراحات مهمة للجهات التنظيمية وواضعي السياسات في البنوك الإسلامية، مثل هيئة الخدمات المالية (Otoritas Jasa Keuangan) وبنك إندونيسيا.

تساهم هذه الدراسة في المناقشة الجديدة المتعلقة بالنمو التنظيمي للبنوك الإسلامية الإندونيسية. كما أنه يوفر رؤى واقتراحات مهمة للجهة التنظيمية وواضعي السياسات في البنوك الإسلامية مثل هيئة الخدمات المالية (Otoritas Jasa Keuangan) وبنك إندونيسيا. بالإضافة إلى ذلك، تؤثر نتيجة هذه الدراسة على مجال النمو التنظيمي لمزيد من البحث من قبل الأكاديميين والباحثين والممارسين.



APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Muhammad Bahrul Ilmi

Signature



Date, 20 July 2022



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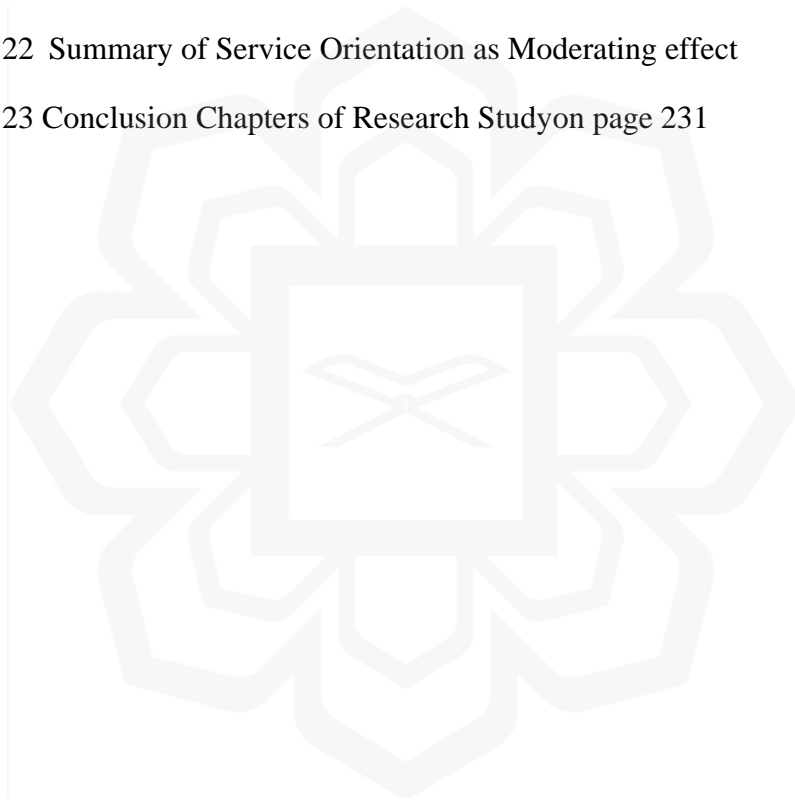
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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Islamic banks were established to serve customers to conduct business transactions more transparent, prudent, and fair. Islamic banking provides an alternative concept to complete business transactions such as *Sharia* compatible investment, financing, and trading opportunities. One of the main functions of Islamic banking is to manage financial transactions. In other words, Islamic banking attempts to create *Sharia* compliance concepts to protect business transactions from *maysir*, *gharar*, and *riba*.

According to the Global Islamic Finance Report (2019), Islamic banking has registered exponential growth throughout the world, with an annual growth rate of 21.8 per cent globally. Moreover, based on the Global Islamic Finance Market Report (2019), Islamic Banking is the largest sector contributing 71 per cent or USD 1.72 trillion to the Islamic finance industry. Furthermore, Islamic banks' development has not been restricted to Islamic countries but is progressing in minority Muslim communities. Therefore, Islamic banking has become a financial intermediary for activities in the economic sector. The financial sector's turnover can impact economic growth and is closely related to the country's development.

Nevertheless, consistent evidence shows that the Islamic banking system is still lagging behind the conventional banking system regarding product offerings and size. In the Indonesian case, preliminary evidence shows that the Islamic banking industry's growth has been significantly inferior to conventional banks' growth for the past 15 years. A similar issue coming from Malaysia, the Islamic banking industry also experienced a similar decline in growth with its annual growth rate from a double-digit in 2011 (24.2%) to 8.2% in 2016. It signals that the Islamic financial industry needs to explore further new opportunities for sustained growth (BNM, 2018). Despite the

growing popularity and acceptance of Islamic banking globally, its lagging in growth in the biggest Muslim countries justifies further investigations.

With the development of Islamic finance influencing the economic sector, on the other hand, managing an organisation will also have an indirect effect on the growth of Islamic financial development to withstand environmental change (Weinzimmer, 2000). Numerous studies on organisational growth have asserted their limitations in determining growth. Previous studies have suggested that despite some organisational growth determinants within strategy and organisation theory, the studies have not reached the factors that lead to organisational growth (Davidsson, 1991; Kazanjian, 1988; Whetten, 1987). Hence, the need to study further determines organisational growth elements to contribute to Islamic banking development literature.

This study will focus on the organisational growth of Islamic banks. In contrast, most studies on Islamic banks' performance are limited to study on determinants of Islamic bank's profitability and efficiency. Hassan & Bashir (2003) found that Islamic banks' profitability measures respond positively to the increase in capital and negatively to load ratios. Furthermore, Yudistra (2003) noted that Islamic banks suffered slight inefficiencies during the global crisis 1998-1999 within the Middle East region. Additionally, the enormous Islamic market power, common in the Middle East, does not significantly impact efficiency. This is because Islamic banks from outside the Middle East region are relatively new and supported by their regulators. Studies by Haron (2004) documented a positive association between growth and profitability in Islamic banks. There was no significant variation in earnings between Islamic banks in a competitive and monopolistic market.

In Indonesia, Islamic banking growth is determined significantly by the dynamics of the actual rate of return and real interest rate (Kasri, 2010). A study by Mukhlisin (2010) on the growth of Islamic banks' assets in Indonesia concluded that industrial production does not have a causal relationship with asset growth. This is due to the size of the industrial output that is too big to cause asset growth the size of Islamic banks' assets is too small to provide significant support for the industrial production in the country. Therefore, there are many pieces of evidence and reasons leading to the