The Interest Prohibition and Financial Performance of

Islamic Banks: Indonesian Evidence

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Abstract

In the beginning 2004, Majelis Ulama Indonesia (Indonesia Ulema Council) released *fatwa* that definitely mentioned the proscribing of interest. In the period after fatwa, the main indicators of Islamic banks indicated a significant growth. Thus, the objective of this study is to investigate whether the financial performance of Islamic banks in the period before fatwa is different from that in the period after fatwa. Furthermore, this study intends to examine the comparative financial performance of Islamic banks and conventional banks in the period both before fatwa and after fatwa. In evaluating banks' performance, this study used various financial ratios categorized as profitability, liquidity, risk and solvency, and efficiency.   To determine the difference, this study used t-test. The result of this study indicates that, in general, comparison of financial performance of Islamic banks in the period before fatwa and after fatwa does not show statistically difference. Likewise, the result of inter-bank analysis also indicates that there is no major difference in performance between Islamic banks and conventional banks in the period both before fatwa and after fatwa,

Keywords: Islamic bank, *Fatwa*, Interest prohibition, Financial performance

1. Introduction

Islamic banks have several characteristics that are different from conventional banks. Interest-free is main characteristic of Islamic banks. As explicitly appear in the Holy Qur'an (2:278-279), interest is prohibited in Islam. The conventional banking system is organized on the basis of a fixed payment called interest.   That is why the practices of the modern banking system are in conflict with the principles of Islam which strictly prohibit interest on any type transaction.   Islam is opposed to exploitation in every form and stands for fair and equitable dealings among all men. To charge interest from someone who is constrained to borrow to meet his essential consumption requirement is considered an exploitative practice in Islam. Moreover, charging of interest on loans taken for productive purposes is also prohibited because it is not an equitable form of transaction. Besides interest-free, other distinguishing feature of Islamic banks are profit and loss sharing, *zakat* (the compulsory Islamic tax) implementation, avoiding *gharar* (speculation in doing transaction or activities), and not involve in the production or consumption of goods and services that are illegal from the point view of Islam (Samad, 2004, p. 3). In short, Islamic banks is emphasized on fulfill the teaching of the Holy Qur'an rather than maximum returns (Kader, *et al.*2007, p. 38)

Fatwa (religious instruction) that definitely mentioned the proscribing of interest was issued by Majelis Ulama Indonesia (Indonesia Ulema Council, hereinafter MUI). MUI was an independent non governmental organization established on July 26, 1975, at Jakarta. The members of MUI consisted of ulama and other Muslim scholars from various Muslim organizations in Indonesia, including two largest, Nahdlatul Ulama (NU) and Muhammadiyah. On December 16, 2003, *fatwa* commission, special commission under MUI, based on *ijtima*, agreed that interest was forbidden (*haram*). Afterward, on January 24, 2004, MUI issued *fatwa* number 1/2004 that was valid since on that date. This *fatwa* stated that interest charged by conventional banks and other financial institutions for loan was categorized as *riba al nasi'ah* and forbidden (*haram*). In the end of this *fatwa*, Muslims in Indonesia were urged to use Islamic financial institution service. In addition, if there was no Islamic financial institution in their area, based on emergency

principle, Muslims could get service from the conventional financial institution (MUI, 2004). Like other MUI's *fatwa*, this fatwa was not legally binding society; however, it provided a clear guidance for Indonesian Muslim in dealing with conventional banks services.

The issuance of this *fatwa* leaded pro and contra in Muslim society in Indonesia (BNI Syariah, 2005). This *fatwa* was gladly accepted particularly by Muslims that wanted a formal statement from MUI with regard to the prohibition of interest in the transaction for borrowing money *(al-qardh)* or lending money *(al-dayn)*. For Islamic banks, this *fatwa* was additional power that provided moral advantage. On the other hand, other party questioned the effectiveness of this *fatwa*. This *fatwa* was issued without any coordination with Indonesia Central Bank. Moreover, they were worried that this *fatwa* would make a rush in conventional banks. People would take out their money from conventional banks and saved it in Islamic banks. The deposit fund of Islamic banks would increase, whereas Islamic banks might not have capability to distribute its fund to the real sector. As result, according this party, the increasing of deposit fund was likely to influence the liquidity of Islamic banks.

Regardless the debate of the fatwa, in fact, the growth of Islamic banks indicated significant growth in year 2004, a year after *fatwa*. As can be seen in the Table 1, in the end of 2004, main indicators of Islamic banks, such as assets, financing, and deposit of fund, are higher than those in year 2003. More over, in the end 2004, Non Performing Loan (NPL) also shows value below than 5 percent that indicate high quality of financing of Islamic banks.

The objectives of this paper are to investigate whether the financial performance of Islamic banks in the period before *fatwa* is different from that in the period after *fatwa* and to examine the comparative financial performance of Islamic banks and conventional banks in the period both before *fatwa* and after *fatwa*. The financial performance of banks is measured based on criteria such as profitability, liquidity, risk and solvency, and efficiency. This study is useful in providing valuable information to relevant parties: Muslim society, Islamic bank management, regulators, and MUI as well.

This paper is organized into six sections. Following introduction in this section, Section 2 describes briefly Islamic banking development in Indonesia along with view of Muslim in Indonesia toward interest and factors considered important to select Islamic bank. Section 3 provides a literature review. Section 4 provides research method that includes financial performance measures, data used in this study, and data analysis. Next section is Section 5 that presents empirical results and discussion. Conclusion, including limitation of the study, is presented in Section 6.

2. Islamic Banking Development in Indonesia

2.1 The growth of Islamic banks 1992-2005

The development of Islamic institution in Indonesia during 1992-2005 achieved remarkable growth. The history of Islamic banking was started in 1992 with the establishment of Act No. 1/1992 that gave a chance for opening a profit sharing bank. In 1992, MUI held workshop on Islamic economic followed by establishment of the first Islamic bank, namely Bank Muamalat Indonesia (BMI). In period 1992-1998, there were 1 Islamic bank and 78 Islamic rural banks. In 1998, Indonesia government issued Act No. 10/1998, as replacement of old Act (No. 7/1992), affirmed that Indonesia started entering era of dual banking system in which Islamic banks operated side by side with conventional banks. This Act provided legal basis for development of Islamic bank. Moreover, Act No. 23/1999 about Central Bank stated that Indonesia Central Bank, as monetary authority in Indonesia, must provide regulation and facilities for the operation of Islamic banks. After implementation of these Acts, formation of Islamic banks increased significantly. Bank Syariah Mandiri (BSM), as a second Islamic bank, was opened in 1999 followed by some conventional banks that opened Islamic banking units. The next significant event, in 2002, Indonesia Central Bank issued "Blueprint of Islamic Banking Development in Indonesia". The objective of this blueprint was to identify major challenges of development Islamic bank in the future. In addition, this blueprint also provided vision, mission, and goal for development of Islamic bank, so that Islamic bank stakeholders had clear guidance to synchronize their vision and aspiration (Indonesia Central Bank, 2002). Moreover, on January 24, 2004, MUI issued *fatwa* that clearly mentioned about prohibition of interest and *riba*. Hopefully, this *fatwa* could provide additional stimulation to the growth of Islamic institutions in Indonesia. The complete figure of Islamic financial institution development during period 1992-2005 can be seen in the Table 2.

2.2 A View toward Interest and Factors Affecting to Select Islamic Bank

In year 2000, Indonesia Central Bank conducted a study about potency, preference, and attitude of people in Java Island toward Islamic bank. The objectives of that study were to provide a map of development Islamic bank potency and to study characteristic and view of potential consumers toward Islamic banking services (Indonesia Central Bank, 2000, p. 1). Indonesia Central Bank carried out this study in partnership with three established universities in Java, namely Bogor Agriculture Institute, Diponegoro University, and Brawijaya University. This study covered provinces in Java Island such as West Java Province, Central Java Province, Yogyakarta Province, and East Java Province. With regard to view toward Islamic bank, in general, most people argued that Islamic bank was an identical to profit sharing bank and a bank that followed Islamic law (shari'ah). More interesting result was their view toward interest. The percentage of

people that viewed interest was forbidden by Islam was slightly lower than percentage of those who had opposite view. As shown in Table 3, the percentage of people who viewed interest was prohibited by Islam reached 45 percent, whereas percentage of people who thought that interest was not prohibited by Islam and did not have a clear understanding was 55 percent. Furthermore, factors considered important in selecting Islamic bank indicated mixed result. For people living in West Java Province and East Java Province, the dominant factors were quality of services and location of Islamic bank.   In those provinces, religion motive was not an important factor in selecting Islamic bank. On the other hand, people in Central Java Province considered that   religion was dominant factor.

In conclusion, this study provided initial data about level of understanding people toward interest. Therefore, by issuance of the *fatwa*, this paper argues that Muslims in Indonesia would clearly understand legal status of interest from point view of Islam. As result, they would fully support the Islamic banks development in Indonesia.

3. Literature Review

In general, method analysis of prior studies on examining of financial performance of Islamic banks with ratios analysis can be categorized into two categories.   First, studies examine the performance of Islamic banks during certain period (e.g. Sarker, 1999; Arief, 1989; Wibowo and Saptutyningsih, 2004). Studies under this category generally examine performance Islamic banks during several years and make inter-temporal comparison.   Second, studies examine the performance of Islamic Banks and compare that with conventional banks' performance (e.g. Samad, 1999; Samad and Hassan, 2000; Rosly and Bakar, 2003).

In terms of studies that examine the financial performance of Islamic banks during certain period, Sarker (1999) analyzed efficiency of Islamic banks under conventional banking framework in Bangladesh.   The result revealed that Islamic banks could not operate with its full efficiency level if it operated under a conventional banking framework. He argued further that Islamic product had different risk characteristic, so that different prudential regulation should be established. In Malaysia situation, Arief (1989) examined the financial performance of Bank Islam Malaysia Berhad (BIMB). He found that, during the first six years of its establishment, BIMB indicated imposing progress.   In Indonesia environment, Wibowo and Saptutyningsih (2004) examined the financial performance of two main Islamic banks: BMI and BSM, during period 2000-2003 with tool called CAMEL-modified. The result revealed that performance of BMI was superior to performance of BSM. In more recent study, Utami, *et al.* (2006) tried to define profile of Baitul Maal Wat Tamwil (BMT) in Banyumas Regency based on its financial performance. The result showed that, in most BMTs being surveyed, the level of financial ratio, which included liquidity, solvability, business risk, and productivity of the employee's ratio, increased from the year 2000 until 2002. In global level, Zaman and Movassaghi (2001) reviewed the growth of the Islamic banks on a global basis and assessed its financial performance. This study covered Islamic banks located in some regions such as South Asia, Africa, Southeast Asia, Middle Asia, Europe and America. They ranked performance of Islamic banks around these regions based on some figures extracted from financial statement ended in year 1996. The result showed that Islamic banks located in Middle East and South Asia dominated the rank.

In the context of comparative financial performance of Islamic Banks and conventional banks, some studies have been done in Malaysia (Samad, 1999; Samad and Hassan, 2000; Rosly and Bakar, 2003). Samad (1999) evaluated efficiency of BIMB during 1992-1996 and compared to that of conventional banks. The result indicated that BIMB had relatively higher managerial efficiency than conventional banks.   In further study, Samad and Hassan (2000) examined the financial performance of BIMB over the period 1984-1997 and compared that with performance of conventional banks. They employed inter-temporal and inter-bank approach.   The finding revealed that financial performance of BIMB was different from conventional banks with respect to liquidity and risk management.   In recent study, Rosly and Bakar (2003) examined the financial performance of Islamic banking scheme and made comparative analysis with their mainstream banks' performance. The result showed that mainstream banks were more efficient than Islamic banking scheme. In Bangladesh environment, Hassan (1999) examined performance of Islamic Bank Bangladesh Limited and compared that with other private banks in Bangladesh. The result revealed that, in terms of deposit growth and investment growth, performance of Islamic Bank Bangladesh Limited was better than performance of private banks during period 1993-1994.   However, due to the lack of statistical technique, this study is unsatisfactory (Samad and Hassan, 2000). With using banks in Pakistan as case study, Mahmood (2005) compared the financial performance of Islamic bank with that of conventional bank. He found that, almost in all ratios, Islamic bank was superior to conventional bank during 2000-2004.   In Bahrain situation, Samad (2004) examined comparative financial performance of Islamic banks and the conventional banks during 1991-2001. The result indicated that there was no significant difference between Islamic banks and conventional banks with respect profitability and liquidity. Similar study in other Middle East country, Kader, *et al.* (2007) also examined comparative financial performance of Islamic banks and conventional banks in UAE. The finding indicated that there was no major difference between Islamic banks and conventional banks   with respect to profitability and liquidity.

4. Research Method

4.1 Financial Performance Measures

In evaluating banks' performance, this study used accounting ratios. The use of accounting ratios is common in the literature (Samad and Hassan, 2000; Samad, 2004). Furthermore, accounting ratios could minimize disparity of bank's size and make them at average (Samad, 2004, p.6). In this study, to measure financial performance of bank, this study employed 13 financial ratios.   These ratios could be grouped under four broad categories as follows.

4.1.1 Profitability Ratios

The profitability ratios are used to asses the capability of company to generate earnings as compared to its expenses and other relevant costs incurred during certain period of time. This study used following ratios for measuring profitability of bank.

a. Return on Asset (ROA) = profit after tax/total asset. It shows how a bank can convert its asset into net earnings. The higher value of this ratio indicates higher capability of firm. This ratio provides indicator for evaluating the managerial efficiency (Samad, 1999; Samad and Hassan, 2000; Samad, 2004; Kader, *et al*., 2007)

b. Return on Equity (ROE) = profit after tax/equity capital. This ratio indicates how bank can generate profit with the money shareholders have invested. The higher value of this ratio shows higher financial performance. Like ROA, this ratio is also indicator for managerial efficiency.

c. Profit to Total Expenses (PER) = profit after tax/total expense. This ratio indicates profitability of the firm with regard to its total expenses.   A high value of this ratio indicates that bank could make high profit with a given expenses.

d. Return on Deposit (ROD) = profit after tax/total deposit. This ratio shows percentage return on each dollar of customers' deposit. In the other words, it indicates the effectiveness of bank in converting deposit into net earnings (Rosly and Bakar, 2003, p. 1257).

4.1.2 Liquidity Ratios

The liquidity ratios measure the capability of bank to meet its short-term obligations. Generally, the higher value of this ratio indicates that firm has larger margin safety to cover its short-term obligations. Among the various liquidity measures, this study used ratios as follows.

a. Cash deposit ratio (CDR) = cash/deposit. The higher value of this ratio shows that a firm is more liquid.

b. Loan deposit ratio (LDR) = loan/deposit.   The low value of this ratio indicates that bank has excess liquidity. This ratio also indicates effectiveness of mediation function of bank. In the Islamic bank context, this ratio is well known also as Financing Deposit Ratio (FDR).

c. Current ratio (CR) = current asset/current liability. This ratio indicates the capability of firm to meet the current liability with the current asset. The high value of this ratio indicates that firm is more liquid.

d. Current asset ratio (CAR) = current asset/total asset. This ratio shows composition of firm's asset. The high value of this ratio indicates that firm has more liquid asset than long term asset.

4.1.3 Risk and Solvency Ratios.

The following ratios measure for risk and solvency.

a. Debt equity ratio (DER) = debt/equity capital. This ratio shows how firm finances its operation with debt relative to the use of equity.

b. Debt to total assets ratio (DTAR) = debt/total asset. This ratio indicates the proportion of assets financed with debt.   A high value of this ratio provides indication that firm involves in more risky business.

c. Equity multiplier ratio (EM) = total asset/share capital. This ratio shows how many dollars of assets must be supported by each dollars of equity capital. The higher value of this ratio indicates signal for risk failure.

d. Loan to deposit ratio (LDR) = loan/deposit. Besides measuring liquidity, this ratio also indicates credit risk for a firm. High value of this ratio indicates possibility insolvency.

4.1.4 Efficiency Ratios

Two ratios were used for measuring efficiency of a bank.

a. Asset utilization ratio (AU) = total operating income/total asset. This ratio measures capability of firm to generate revenue with its asset. The high value of this ratio indicates the high productivity of firm's asset.

b. Operating efficiency ratio (OE) = total operating expense/total operating income. This ratio indicates how efficiently firm uses its assets, revenues and minimizing the expenses. In other words, it shows how well firm

could reduce the expenses and improves productivity.

4.2 Data and Sample

This study used BMI and BSM as a representative of Islamic banks with the reason that these banks have been operating more than 5 years and served as pioneer in Islamic banking in Indonesia. With regard to conventional bank, sample consisted of eight mainstream private banks with the following criteria.

a.   The private banks do not have any loss during 2000-2005.

b.   Like BSM and BMI, based on Indonesia Central Bank directory, these private banks are categorized as foreign exchange bank.

The complete list of banks could be seen in Table 4. Furthermore, this study used a micro bank level panel data on financial statements of both conventional banks and Islamic banks during period 2002-2005. The financial statements of banks were collected from its website and also Indonesia Central bank database. The various ratios were calculated based on these financial statements.

4.3 Data Analysis

To examine the difference of   banks' performance, this study employed inter-temporal comparison and inter-bank approach. The used of these methods is quite common in literature (Samad, 2004; Samad and Hassan, 2005).   In addition, a statistical technique was performed in this study in order to determine the difference. The following sections are discussion of these methods.

4.3.1 Inter-Temporal Comparison

In order to examine difference of Islamic banks' performance in the period before *fatwa* and after *fatwa*, this study employed inter-temporal analysis.   It means that this study made comparison of performance of Islamic banks between two periods: before *fatwa* and after *fatwa*. The window period of this study was two years before fatwa and after *fatwa*. Because the *fatwa* was issued on January 24, 2004, this study assumed that it would not affect the financial statements ended year 2003. Thus, period before *fatwa* included 2002 and 2003, whereas period after *fatwa* included 2004 and 2005. Thus, Islamic banks' performance in the period 2002-2003 was compared to that in the period 2004-2005. Statistic technique performed in this stage was equality of mean test. The equality of mean test was used to compare means from two samples. Samad (2004, p. 6-7) stated that performance studies widely used this test.   To determine whether the difference in means were significant, ρ-value must be less than the 0.05. If the ρ-value is less than 0.05 the null hypothesis would be rejected, or it is no difference among the groups mean.

4.3.2 Inter-Bank Comparison

By this method, financial performance of Islamic banks was compared with financial performance of conventional banks in the period before *fatwa*. Similar comparison method was done for the period after *fatwa*.   Statistic technique performed in this stage was also equality of mean test (independent t-test).

5. Empirical Results and Discussion

This section presents the finding based on the objectives identified earlier in this study. The findings of the study are also presented in figures and tables. The significant results are further discussed and analyzed in detail in this section.

5.1 Profitability Analysis

In terms of inter-temporal analysis of profitability, all measures of profitability of Islamic banks other than ROD show that there is no significant difference in financial performance between period before *fatwa* and after *fatwa*. As shown in Table 5, ROD is only ratio that indicates statistically difference.   The average ROD of Islamic Banks before *fatwa* is 0.01050 compared to 0.01800 in the period after *fatwa*. It indicates that, in the period after *fatwa*, the growth of profit of Islamic banks is relatively higher than deposit fund growth. The growth of this profit in year 2004 and 2005 are 289.41 percent and 92.93 percent respectively, whereas growth of deposit fund of Islamic banks are 117.8 percent and 14.26 percent respectively. Nevertheless, the significant increase of profit does not make other profitability ratios, such as ROA and ROE, showing significant differences between two periods. The reason for this might be that increasing of profit is also followed by increasing of other accounts, such as asset, and equity. It can bee seen in Table 2, total assets Islamic banks in year 2004 and 2005 dramatically increased. This fact might indicate that Islamic banks are in expansion stage during 2004-2005.

In terms of inter- bank analysis, as shown in Table 6 and Table 7, all measures of profitability do not show any statistically difference between Islamic banks and conventional banks in the period both before fatwa and after fatwa. This result is consistent with finding of the other studies that found no significant difference in profitability between Islamic banks and conventional banks (Samad, 2004; Kader, *et al.* 2007). This result might be explained by the fact that revenues of Islamic banks were mainly obtained from financing activities that steadily increased during period 2000-2005. The increasing of financing activities in this period was supported by the low of Non Performing Loan

(NPL) (see Figure 2). As result, profitability of Islamic banks did not lag behind the profitability conventional banks that also increased steadily in that period due to, particularly, the increasing interest rate.

5.2 Liquidity Analysis

In terms of inter-temporal analysis of liquidity, as shown in Table 5, all ratios of Islamic banks, except CAR of Islamic Banks, indicate that there is no significant   difference between period before *fatwa* and after *fatwa*.   However, with regard to CAR of Islamic banks, the difference is statistically significant.   The mean CAR in the period before *fatwa* is 0.252 compared to 0.438 in the period after *fatwa*. In the period after *fatwa*, it seems that Islamic banks are more liquid and exposed to less liquidity risk than conventional banks. A macro economy condition Indonesia, particularly in year 2005, could be used for explanation this result. In year 2005, the macro Indonesian economic undertook a rapid downturn triggered mainly by increasing of domestic fuel prices and depreciation of Indonesia currency. The fuel prices increased around of 126.6 percent in average, whereas rupiah, Indonesian currency, experienced significant depreciation around 8.6 percent.   In turn, inflation rate soared, causing downward pressure on public consumption levels.   In that time, inflation reached 17.11percent that was much higher than target (Indonesia Central Bank, 2006, p. 19). Then, for stabilization of economy condition, Indonesia Central Bank implemented some policies, such as increasing gradually interest rate, open market operation, and increasing minimum reserve requirement. In January 2005, interest rate was 7.42 percent and increased to level of 12.7 percent in November, 2005. In this condition, conventional banks might offer higher return than Islamic banks. In that year, conventional banks promised annual return around 13-15 percent, whereas monthly profit sharing of Islamic banks was around 7-9 percent. Meanwhile, sources of Islamic bank fund are dominated by *mudharabah* investment that is long term account. For example, based on the position in December, 2005, source of fund Islamic banks consisted of 13 percent of *wadiah* current account, 28 percent of *mudharabah* saving account, 58 percent of *mudharabah* investment account, and 1 percent of received financing (Indonesia Central Bank, 2005, p. 8). This fact implies that profit oriented is dominant motives of Islamic banks' consumer. Consequently, if conventional banks offer high return, Islamic banks will experience displacement risk. This risk means that consumers take out their money from Islamic banks and save it in the conventional banks   (Indonesia Central Bank, 2006, p. 21). To anticipate this risk, therefore, Islamic banks seem maintaining higher liquidity in the period after *fat*wa than before fatwa. Islamic bank should provide the guarantee of depositors' deposits and trust because Islamic banks are not only a firm, but also moral trustee of the depositors where deposits are trust given to the banking system (Samad and Hassan, 2000, p. 11).

In terms of inter bank comparison as shown in Table 6 and Table 7, some ratios indicate significant difference between Islamic banks and conventional banks. In the period before *fatwa*, CR ratio shows statistically difference. The mean average of Islamic banks is 2.68800, compared to 1.00812 of conventional banks. It seems that capability of Islamic banks to meet current liability with the current asset is better to that of conventional banks. The reason for this might be related to dominant form of Islamic banks financing that is short term nature.   Like other countries,   financing of Islamic banks in Indonesia have been dominated by *Murabahah* receivables (Indonesia Central Bank, 2006, p. 19). By this form of financing, the Islamic bank purchases for a customer certain product based on his request. The customer will buy the good from the bank on pre-agreed profit basis that does not seem significantly different from interest charged by conventional banks (Brown, 1994).   This type of financing is more popular because it is a short term and low risk investment for bank (Samad, 2004, p. 12). Thus, Islamic banks seems need to maintain high liquidity to cover their short term financing.

In the period after *fatwa*, LDR ratio indicates significant difference.   As shown in Table 7, means average of LDR of Islamic bank is 0.87700, whereas means average for conventional banks is 0.60063.   As shown in Table 2, in terms of financing, comparing to all banks, share of Islamic banks steadily increase since 2003. The percentages of that share in year 2003 until 2005 are 0.16 percent, 1.93 percent, and 2.19 percent respectively (Indonesia Central Bank, 2006).   In addition, the high of LDR is supported also by the low of NPL of Islamic banks.   During period 2002-2005, NPL of Islamic banks was constantly below than 5 percent that indicated outstanding performance of Islamic Banks (see Figure 2). Thus, those facts indicate that Islamic banks serve intermediation function relatively better than conventional banks. Islamic banks might allocate their funds to real sector such as small medium enterprises (Indonesia Central Bank, 2006, p. 20).   It seems that, in the era of post East Asian financial crisis, Islamic banks could recover quicker than conventional banks.

5.3 Risk and Solvency Analysis

The comparison of ratios of Islamic banks in the period before *fatwa* with period after *fatwa* does not indicate statistically difference. Based on data in Table 5, in the period after *fatwa*, means average of all risk and solvency ratios (DER, DTAR, EM, and LDR) are higher than that in the period before *fatwa*. It indicates that Islamic banks involve in more risky business. However, it seems that Islamic banks could manage their business properly, while business risk increases. It could be seen from the low of   NPL of Islamic banks (see Figure 2).

In terms of inter-bank analysis, based on data in Table 6 and Table 7, it can be seen that all measures of risk and

solvency also show that there is not significant difference in performance between Islamic banks and conventional banks in period both before *fatwa* and after *fatwa*.   This present finding does not support the prior study (Samad and Hassan, 2000) that reveal risk and solvency difference between Islamic banks and conventional banks.

5.4 Efficiency Analysis

In terms of inter-temporal analysis, all efficiency ratios show no significant difference. As shown in Table 5, mean average of ratios are relatively equal between two periods. Likewise, inter-bank comparison also indicates that all efficiency measures indicate no significant differences between Islamic banks and conventional banks (see Table. 6 and Table. 7).

6. Conclusion

This study examined the financial performance of Islamic banks in Indonesia. Financial performance measures were expressed in terms of various financial ratios categorized as profitability, liquidity, risk and solvency, and efficiency. As mentioned earlier in the introduction, this study attempted to examine whether financial performance of Islamic banks in the period before *fatwa* was different from that in the period after *fatwa*. Furthermore, comparative financial performance of Islamic banks and conventional banks during period before *fatwa* and after *fatwa* was also examined.

The result of this study has shown that, in general, financial performance comparison of Islamic banks in the period before fatwa and after fatwa was not statistically different. Likewise, inter-bank analysis, in the period both before fatwa and after fatwa, have indicated that there was no major difference in performance between Islamic banks and conventional banks.

The result of this study implies that financial performance of Islamic banks in Indonesia might not associate with *fatwa* issued by MUI. It seems that macro economy indicator, such as interest rate, might affect the performance of Islamic banks in Indonesia. It is supported by finding of previous studies (Gerard and Cunningham, 1997; Metawa and Almossawi, 1998; Haron and Ahmad, 2000; Ghafur, 2003) that indicate motivation of depositors of Islamic banks is the return of the money (welfare maximization premise).

This present study has limitations that should be considered carefully when interpreting the results. In this study, sample of conventional banks included a conventional bank that opened Islamic banking units in year 2005.   This Islamic banking unit might affect the performance of conventional bank as parent company. For further study, it is needed   to exclude this bank from sample of conventional bank. Another limitation, sample of Islamic banks in study was represented by BMI and BSM. Meanwhile, prior study (Rachmawati and Syamsulhakim, 2004) indicated that number of branch office might also affect the performance of Islamic bank in Indonesia. Thus, sample of further study needs to include other type of Islamic bank institutions, for example Islamic rural banks that have grown significantly

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Table 1. Main Indicators of Islamic Banking 2003-2004

(In billion IDRs)

Items	3rd Quarter 2003	4th Quarter 2003	3rd Quarter 2004	4th Quarter 2004
Assets	6,559.3	7,858.9	12,719.6	15,352
Deposit Fund	4,646.1	5,724.9	9,675.7	11.862
Financing	4.832.3	5.530.2	10,131.1	11.489
FDR	112.44%	96.6%	104.7%	96.86%
NPL	3.67%	2.3%	2.8%	2.8%

Source: Indonesia Central Bank (2005)

Table 2. The Development of Islamic Financial Institution in Indonesia 1999-2005

Bank Type	1992	1999	2000	2001	2002	2003	2004	2005
Islamic bank	1	2	2	2	2	2	3	3
Islamic Banking Unit	-	1	3	3	6	8	15	19
Branch Offices	1	40	62	96	127	299	401	504
Islamic Rural Bank	9	78	78	81	83	84	86	92
Total Assets*	NA	NA	1 790 168	2 718 770	4 045 235	7 858 918	15 325 997	20 879 874
Share of Total Banking	NA	NA	0.17%	0.25%	0.36%	0.74%	1.20%	1.42%
Financing *	NA	NA	1 271 162	2 049 793	3 276 650	5 530 167	11 489 933	15 231 942
Share of Total Banking	NA	NA	0.40%	0.57%	0.80%	0.16%	1.93%	2.19%
Deposit*	NA	NA	1 028 923	1 806 366	2 917 726	5 724 909	11 862 117	15 582 329
Share of Total Banking	NA	NA	0.15%	0.23%	0.35%	0.64%	1.23%	1.38%

Source: Indonesia Central bank (2006)

* In million IDRs   NA = Not Available Data

Table 3. View of Muslim in Indonesia toward Interest

	Prohibited by Islam	Not prohibited by Islam	Not Understand/ Not Sure
West Java Province	62%	22%	16%
Central Java Province, and Yogyakarta Province	48%	21%	31%
East Java Province.	31%	69%	
Total	45%	55%	

Source: Indonesia Central Bank (2000)

Table 4. List of Selected Banks

Type of Bank	Bank Name
Islamic Bank	1. Bank Muamalat Indonesia
	2. Bank Syariah Mandiri
Conventional Bank	1. Bank Bumi Putra
	2. Bank Buana
	3. Bank Central Asia
	4. Bank Internasional Indonesia
	5. Bank Lippo
	6. Bank Niaga
	7. Bank NISP
	8. Bank Pan Indonesia

Table 5. Financial Performance of Islamic Banks Before and After Issuing of *Fatwa*

No	Ratios	Before Fatwa (2002-2003)		After Fatwa (2004-2005)		Sign. 2 Tailed ρ-value
		Mean	Std. Deviation	Mean	Std. Deviation	
1	ROA	0.19500	0.00495	0.02250	0.00071	0.500
2	ROE	0.09100	0.05091	0.17500	0.01273	0.313
3	PER	0.13900	0.02970	0.08950	0.03606	0.480
4	ROD	0.01050	0.00212	0.01800	0.00141	0.042
5	CDR	0.26000	0.01414	0.20450	0.02192	0.274
6	LDR	0.75400	0.07213	0.87700	0.00141	0.255
7	CR	2.04800	0.76933	1.71550	0.80540	0.815
8	CAR	0.25200	0.06364	0.43800	0.06930	0.014
9	DER	7.49600	4.02061	11.67200	0.17819	0.393
10	DTAR	0.85950	0.08556	0.91900	0.00425	0.521
11	EM	9.79700	3.90182	19.16050	2.78105	0.298
12	AU	0.01500	0.00141	0.01850	0.00071	0.090
13	OE	0.87850	0.00636	0.80650	0.04455	0.295

Table 6. Financial Performance Comparison before *Fatwa* (2002-2003)

No.	Ratios	Islamic Bank		Conventional Bank		t-value	Sig. 2 Tailed
		Mean	Std. Deviation	Mean	Std. Deviation		
1	ROA	0.01950	0.004950	0.01358	0.012809	-0.619	0.553
2	ROE	0.09100	0.050912	0.08814	0.224722	-0.017	0.987
3	PER	0.13900	0.029698	0.08590	0.131828	-0.543	0.602
4	ROD	0.01050	0.002121	0.01121	0.014612	0.066	0.949
5	CDR	0.26000	0.014142	0.22249	0.166820	-0.627	0.550
6	LDR	0.75400	0.072125	0.52700	0.285893	-2.005	0.082
7	CR	2.68800	0.500632	1.00812	0.624952	-3.479	0.008
8	CAR	0.25200	0.063640	0.31782	0.150793	0.583	0.576
9	DER	7.49600	4.020609	10.25879	3.159859	1.066	0.318
10	DTAR	0.85950	0.085560	0.90928	0.052893	1.086	0.309
11	EM	9.79700	3.901815	26.40441	24.730288	0.906	0.391
12	AU	0.01500	0.001414	0.01265	0.010690	-0.297	0.774
13	OE	0.87850	0.006364	0.90335	0.090141	0.373	0.719

Table 7. Financial Performance Comparison after *Fatwa* (2004-2005)

| No.	Ratios	Islamic Bank		Conventional Bank		t-value	Sig. 2 Tailed
		Mean	Std. Deviation	Mean	Std. Deviation		
1	ROA	0.02250	0.000707	0.02025	0.009161	-0.332	0.748
2	ROE	0.17500	0.012728	0.25288	0.190618	0.552	0.596
3	PER	0.08950	0.036062	0.25313	0.114554	1.918	0.091
4	ROD	0.01800	0.001414	0.02200	0.011988	0.451	0.664
5	CDR	0.20450	0.021920	0.21588	0.091381	0.317	0.759
6	LDR	0.87700	0.001414	0.60063	0.216542	-3.610	0.009
7	CR	1.7155	0.8053	1.0815	0.67039	-1.164	0.278
8	CAR	0.43800	0.069296	0.25200	0.098785	-2.461	0.039
9	DER	11.67200	0.178191	8.24463	2.953099	-1.569	0.155
10	DTAR	0.91900	0.004243	0.79138	0.190851	-.904	0.392
11	EM	19.16050	2.781051	33.91500	27.753091	0.718	0.493
12	AU	19.16050	0.000707	0.02100	0.011735	0.288	0.781
13	OE	0.80650	0.044548	0.80463	0.105503	-0.024	0.982
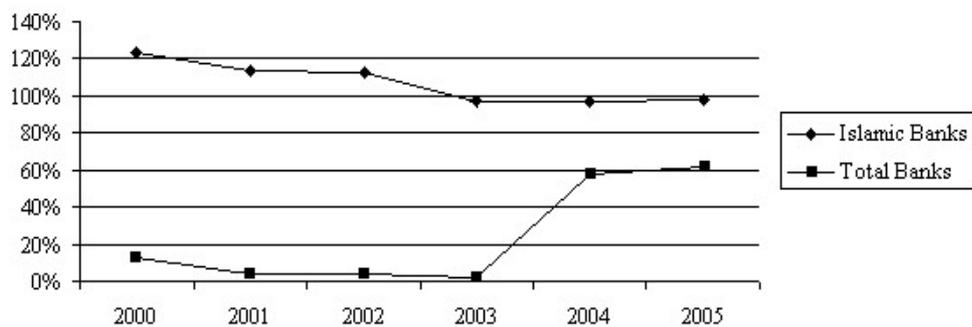
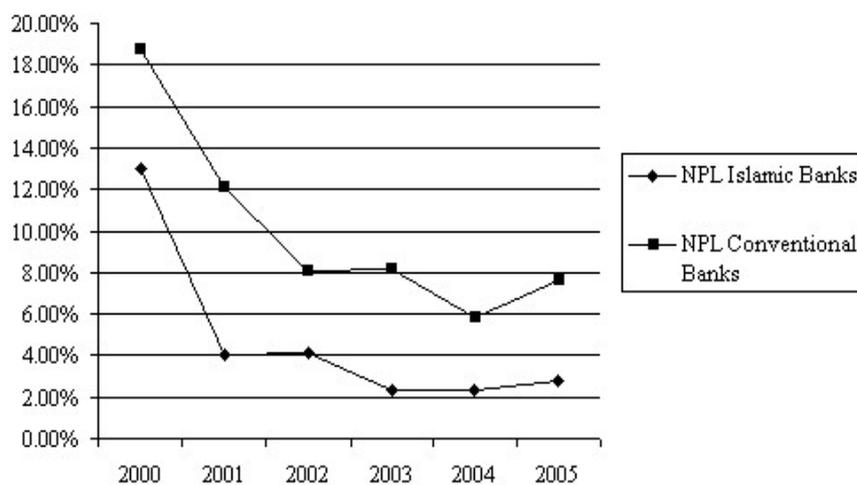Figure 1. The Growth of LDR 2000-2005
Source: Indonesia Central Bank (2006)

Figure 2. NPL 2000-2005
Source: Indonesia Central Bank (2006)