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UNDERSTANDING THE HISTORICAL EMERGENCE OF ISLAMIC FINANCE IN INDONESIA: AN INSTITUTIONAL AND SOCIAL MOVEMENT PERSPETIVE

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Abstract

Despite the rapid growth of Islamic finance globally, studies have not yet attempted to rationalise how it emerged and developed. Therefore, drawing on a dialogue between institutional and social movement theories, this study aims to understand the process that led to the emergence and development of Islamic finance in Indonesia. Based on primary data collected from 32 Indonesian Islamic finance activists and other relevant sources, the study suggests that the emergence and development of the Islamic financial institution in Indonesia was an outcome of the changing approach of the Islamic economic movement

in realising its goals, shifting from an experimental outsider initiative to an internally generated one that attempts to effect change from within. Furthermore, the dynamic development of Islamic finance in Indonesia can be framed and categorised into several periods: an introduction period (1983–1992), a recognition period (1993–2004), a crystallisation period (2005–2014), and a centralisation period (2014–present). These results are expected to enrich the literature on the emergence of Islamic finance and provide insights to develop and 'reform' the Islamic financial institution to realise its idealism.

Keywords: Islamic Finance, Social Movement, Institutional Emergence, Convergence-divergence, Re-orientation Movement

A. Introduction

Islamic finance has experienced significant growth since its inception in Egypt in the early 1960s and has a current value of over USD 2.5 trillion covering 80 countries globally (Global Finance, 2022). Looking back, the emergence of Islamic finance globally has commonly been associated with the rise of the Islamic economic movement, driven by developmental failure in the Muslim world from the 1950s to the 1960s (Chapra, 1992). However, other perspectives have highlighted the issue of a search for identity among Muslim countries with oil surpluses as the reason for its emergence (Kuran, 2004). Therefore, there remains a lack of global consensus on the emergence of Islamic finance. Consequently, it is often perceived as an institution with a poor foundation in need of greater congruency and market legitimisation.

Recently, social studies have begun to discern institutional emergence from the perspective of a social movement journey through a negotiation process involving

society's aspiration for the distribution of opportunity and resources (see, among others, Haveman & Rao, 1997; Ruef & Scott, 1998; Lounsbury, 2002; Arjelies, 2010). In the social movement literature, researchers have focused on collective social attempts to transform social structures and society's incentive mechanism (Gamson, 1975; McCarthy & Zald, 1977). However, the recent view on the intersection between the social movement and institutional analysts has highlighted that the movement can emerge from within a field and consist of multiple stakeholders (Fligstein, 1996). This characteristic can be identified in the emergence of recycling activists in the US (Lounsbury *et al.,* 2003), the civil society movement in the Scandinavian region (Sjostorm, 2007) and socially responsible investment (SRI) activists in France (Arjaliès, 2010). Such studies confirm the new trend in social movements, characterised by a shift away from the traditional understanding of the social movement as a protest-based endeavour to one based on seeking opportunities to reform economic institutions.

At the same time, contemporary institutional analysis has embraced the notion of the field to comprehend individual and institutional actions within a given social structure dynamic that consists of purpose and resource (Dimaggio & Powell, 1983; Lounsbury, 2002). This emerging challenge has led to a reforming of the analysis by considering the movement not only as a producer of other logic but also as a differentiating force capable of shaping different modes within the same field (Morrill, 2006; Stryker & Burke, 2000). It has also transformed the disruptive image of the social movement's effect on institutions into a more positive

endorsement through which the movement conventionally reconstructs, rearranges and expands an institution and its field in a constructive manner (Clemens & Cook, 1999; Schneiberg *et al.,* 2008). Consequently, the new approach to the impact of social movements on institutions emphasises the emergence of a different social movement phase.

Furthermore, through the lens of the social movement approach, previous studies initially highlighted two potential products of the attempts by social movements to frame, namely the transformation of institutional logic or the creation of alternative institutional logic (Arjaliès, 2010; Lounsbury *et al.,* 2003; Rao *et al.,* 2000). The difference between the two sources lies in the movement's primary goal: to change an existing structure or generate a new field. This dualism can originate from the significant determining purpose within the economy derived from its institutional logic (Déjean *et al.,* 2013) and the movement's prime motives (Arjaliès, 2010).

With these perspectives, this study offers an alternative view of the process that led to the emergence and development of Islamic finance. It also aims to identify the different periods and phases within its development. It adopts a social movement perspective of the institution to understand the rise of Islamic finance due to the alignment of the issue with the recently emerged discourse linking institutional theorists with social movement observers (see Arjaliès, 2010, 2014; Rao *et al.,* 2000). This approach is believed to provide more insights into understanding the rise of Islamic finance.

In terms of methodology, as its case study, this research employs an Indonesian narrative on the emergence of Islamic finance as this narrative meets the criteria for the new social

movement standard suggested by Zald and Berger (1978), particularly regarding resource mobilisation. As far as we can ascertain, very few studies have sought to scrutinise the development of Islamic financial institutions in Indonesia. In one such study, Choiruzzad (2013) explained the development stages and the stakeholders involved in mainstreaming the Islamic economy in Indonesia from 1980 to 2012. He argued that the emergence of Islamic finance in Indonesia was primarily due to the limited capacity of financial institutions to distribute resources. However, he did not explore the dynamic between the stakeholders or the movements that led to the drive by Islamic finance to achieve its idealism. These aspects therefore justify the choice of Indonesia as a case study for adopting a social movement perspective on institutions.

Drawing on the previous literature and the background of the emergence of Islamic finance in Indonesia, this study argues that the emergence and development of the Islamic financial institution in Indonesia was strongly influenced by the changing approach of the Islamic economic movement in realising its goals. It is also argued that such a pivot of the movement was connected to its inability to deliver or influence structural change.

This study contributes to the literature that seeks to understand the emergence and development of Islamic finance institutions in Muslim countries, particularly in Indonesia, by utilising the intersection of interest between social movement observers and institutional theorists. It also hopes to provide insights to develop further and 'reform' the institution to achieve its idealism.

B. Research Setting, Design and Method

This study adopts a social movement perspective on the institution to understand the rise of Islamic finance, primarily due to its alignment with the recently emerged discourse linking institutional theorists with social movement observers (see Arjaliès, 2010, 2014; Rao *et al.,* 2000). Furthermore, it employs a field analytic approach to trace the sequential change of the institution of shared meaning that governs resource transfer and movement, which is understood as the 'frame' (Scott *et al.,* 2000). The framing enables the study to connect important events related to the organisational life cycle within the ecology, related acts and legislation, information derived from country reports, a series of regulations from the financial sector regulator, a set of *fatwas* supporting the presence and operationalisation of Islamic financial institutions, social movement-linked intra-organisation communication, media exposure and other related supporting data that aid in understanding the initial framing process.

In the context of Indonesia, it is notable that Islamic finance is commonly understood and framed as an alternative mode and structure of financing based on the teaching of Islamic values that prohibit interest (*riba*), excessive uncertainty (*gharar*) and involvement in prohibited activities (*haram*) (Ahmad, 1947). These led to the denouncement of interest-based financial practices (Ahmad, 1947), the development of alternative financing products such as a profit-and-loss sharing scheme (Siddiqi, 1981) and a strong bond with the real economy (Usmani, 2007). These constructive meanings and characteristics of Islamic finance are often

translated within a different frame, including 'lawful', 'ethical' practice, 'real economy' orientation, and 'de-financialisaton'.

The operationalisation of the research is outlined as follows. Initially, the literature and theoretical exploration were combined with secondary data archiving to establish the initial frame that reflected the perception of Islamic finance in an interpretative form. Following this, a set of interviews was designed to target the sample selected to provide insight into the dynamism of the Islamic finance social movement. The frame established at the outset was then revisited and revised to capture the different understandings of Islamic finance. Finally, as the research is also interested in the evolution of the frame over time, it examines its dynamism from the initial inception of Islamic finance through to its most recent form.

To achieve its objectives, this study conducted 32 in-depth semi-structured interviews with Islamic economic (financial) movement elites and supporters from the first to the most recent generation combined with an analysis based on primary and secondary data. The interview design sought to unveil (i) the process that led to the current situation concerning the form and practices of Islamic financial institutions and (ii) where it should be directed to reach a stable form, as in the case of the recycling activists (Schwartzman, 1993). As such, the interview questions cover a comprehensive discussion. The process began by eliciting the activists' opinions on Islamic finance before exploring their encounters with Islamic economics, their knowledge of early Islamic economic development in Indonesia and their contribution to the Islamic economy field. Furthermore, it investigated the story of the emergence of Islamic finance

based on the activists' understanding. Finally, it asked their opinion on the issues of the hybridity and authenticity of Islamic finance from the outset to the present day.

Moreover, the supporting data were analysed using content analysis to identify relevant and material documents. Content analysis is a research method used to systematically analyse and interpret the content of various forms of communication, such as written text, audio, video or images. It involves identifying and categorising specific words, phrases, themes or symbols within the content to gain insights into patterns, trends or underlying meanings. Content analysis is routinely employed in social sciences, marketing, media studies and other fields to examine the nature, structure and impact of communication. By quantifying and interpreting the content, researchers can conclude and make inferences about the subject matter (Krippendorff, 2018). As such, content analysis is considered appropriate to analyse qualitative data.

Specifically, in this study, the qualitative data used include discussion material from the drafting period of the act related to Islamic economic (financial) institutions and practices, Islamic finance country and industry reports, coverage of the industry's progress within the business-related media, and releases and reports by non-governmental organisations and associations. Meanwhile, the main primary data sources were documents from the legislature, the Masyarakat Ekonomi Syariah (MES) association, Bank Indonesia (BI) and the Indonesian Financial Services Authority (OJK).

In adopting a field analytic approach, this study may have various limitations. Hence, it relied on an analysis of secondary data and the confirmation/narratives of early-period elites

and activists on the process that enabled the rise of the Islamic financial institution. Therefore, the study's results must be interpreted within the boundary of the data obtained.

C. Results

Based on the data analysis, this section details the process of the emergence of Islamic financial institutions, from the introduction, recognition and crystallisation periods up to the current trend for the centralisation of Islamic finance in Indonesia. Important organisational rises, events, legislation and social institutions that are key to the framing and categorising of the emergence of Islamic finance in Indonesia are summarised in Appendix 1.

1. Introduction Period (1983–1992)

The bottom-up characteristic of Indonesian Islamic finance can be traced back to the various types of grassroots ingenuity within the process of the institution's founding. These grassroots efforts included the experimental actions of the proponents of Islamic finance in establishing *Baitul Tamwil* and its perfected model, *Baitul Maal Wat Tamwil*, as the Indonesian version of the Islamic financial institution. Hence, the initiative combined the Islamic social distribution model with a modern financial model for commercial purposes, the seeds of which can be traced back to the 1980s. This phase was followed by a later initiative involving the emergence of a new coalition that pursued and shifted the attitude of the Suharto regime and enabled the foundation of Bank

Muamalat Indonesia, the first Islamic commercial bank in Indonesia, within an unfriendly environmental context.

a. Experimenting Phase

The early 1980s witnessed several events that are regarded as important stepping stones in the emergence of Islamic finance in Indonesia. The first of these was the National Conference of Islamic Economy held at the Islamic University of Bandung (UNISBA) in Bandung in 1983. This conference was the first of its kind in Indonesia. It attracted the participation of many leading figures, including those who had attended the first Islamic economic conference in Saudi Arabia in 1975. It discussed ideas of formally introducing the profit–loss sharing mechanism and establishing an Islamic version of the financial institution. Although it took place within an unfavourable environment and against a lack of any supporting legislation (Indrastomo, 2016), the proponents decided to experiment with the ideas by establishing the *Baitul Tamwil Teknosa* in Bandung in 1984. This became the first institutional experiment to apply a partnership-based financing model as opposed to an interest-based mechanism. It heralded the start of the institutional presence of Islamic finance in Indonesia.

The initial emergence of Islamic finance in Indonesia in the form of the *Baitul Tamwil*, a modified version of the traditional cooperative

with the added function of collecting and disbursing funds from non-members, demonstrated a clear link between Islamic finance and community aspiration. In particular, it was hoped that this type of Islamic microfinance institution would facilitate households' access to financing and prevent the practice of borrowing funds from money lenders that charged exorbitant rates. Hence, the new institution helped to solve the real issue at the periphery. However, despite its commitment, *Teknosa* did not last long; its high volume of non-performing financing exhausted its capital and forced the institution into liquidation (Antonio, 2004).

A similar experimental attempt to build an Islamic microfinance institution to empower low-income people and avoid loan-shark money lenders was recorded in 1988, when several figures or Islamic finance activists agreed to establish *Koperasi Ridho Gusti* in Jakarta. Nevertheless, despite benefitting from a linkage programme that helped to strengthen its capital, the new institution proved unsustainable after its funding was terminated (Nazirwan, 2015). However, their failure aside, the emergence of these two entities helped shed light on the further development of the Islamic finance institution.

b. Initiation Phase

The failure of the two early Islamic finance institutions did not stop the proponents of Islamic finance in their quest to move forward. Instead, their aspirations grew and reached a greater audience. The Islamic finance concept was seen as offering a framework to channel financing to rural people and those under the pressure of money lenders. This vision was subsequently accommodated by the coalition between *Ikatan Cendekiawan Muslim Indonesia* (ICMI), representing intellectual Muslims, and *Majelis Ulama Indonesia* (MUI) as the national board of religious leaders and scholars.

This coalition took the lead in shifting the initiative from the periphery onto the national agenda. MUI hosted a workshop on banking and interest in 1990 that became an avenue for establishing communication between various stakeholders who would later benefit from the rise of Islamic finance. MUI's National Summit subsequently extended the concerns raised in the workshop. As a result, it generated a mandate inspiring the formation of the MUI working group that sought to establish an Islamic bank in Indonesia (Antonio, 2001). Meanwhile, ICMI served as a vehicle for the movement to change the attitude of the Suharto regime. Habibie, the chairman of ICMI, who was also a close aide of President Suharto, enabled the organisation to gain the regime's blessing for many of its agendas

and programmes (Hefner, 2000). Moreover, the special connection between Suharto and Habibie enabled the proponents of Islamic finance to secure their interest in obtaining the consent of the highest authority. In this respect, Amin Aziz, who was a prominent figure in ICMI and MUI, assumed the task of approaching Habibie and successfully persuaded him. Habibie then led the project by lobbying for the establishment of an Islamic bank and directed the formation of two teams responsible for safeguarding against any institutional issues that could arise due to its establishment and collection of capital (Uchrowi & Usman, 2000).

The lobbying process by ICMI, supported by the MUI working group, achieved its objective when Suharto blessed the formation of Bank Muamalat as the first Islamic bank in Indonesia. The president even donated Rp 3 billion towards its initial capital and led the fundraising in *Istana Bogor* on 3 November 1991. It is worth noting that, in persuading the Javanese-born president, the elites highlighted the similarity between the profit–loss sharing practices and the *pardon* system in Javanese mythology. This characterised the successful ‘framing strategy’ implemented by the activists.

c. Formal Institutionalisation Phase

The structural hindrance surrounding the formation of the Islamic bank in Indonesia raised questions about the umbrella under which it existed and operated. In terms of legality, the presence of the Islamic bank was not recognised in the Indonesian Banking Act of 1967, which had become the foundation for the establishment and operationalisation of a bank (Perwataatmadja, 1996). Similarly, BI, as the banking regulator in the country at that time, had no regulatory umbrella, knowledge or experience in establishing and supervising Islamic banks (Harian Jurnal Nasional, 2011).

However, this did not deter the movement from seeking an entrance channel. A former secretary to the Directorate General of Treasury in the Ministry of Finance and executive director of the Islamic Development Bank (IDB) saw an opportunity in the Indonesian 1983 banking deregulation and the Indonesian government economic package (*Paket Oktober*) 1988. He further argued that such practices already existed within the business culture in the society and could be institutionalised within the Islamic banking model.

> *'Since the deregulation was effected, the bank had the autonomy to set its own deposit and lending rate, opening the opportunity to set the rate up to a zero interest rate. In exchange, a profit-loss*

sharing agreement could be established between the bank and its customers for sustaining this business.' (KPA)

He proceeded to share his view with various figures and received firm support for the idea, including from K. H. Hasan Basri, the chairman of MUI during the 1990s, who led MUI in pushing the agenda. While the government had not expressed its explicit support for the establishment of an Islamic bank in Indonesia, its involvement in the establishment of the IDB in 1975 implied that the state had no issue with the idea of a bank operating based on *Shari'ah* principles (Saefudin, 2002). This bolstered the confidence of the supporters of Islamic finance that they could transform their concept into a formal institution.

Nevertheless, not all stakeholders accepted the issue. Adrianus Moy, then governor of BI, was reported to have argued that the proposal should be subjected to rigorous evaluation before it was granted (in Choiruzzad, 2013). The government had recently tightened monetary policy and, thus, the proposed establishment of a bank without interest was met with scepticism in light of the liquidity problem within the banking industry (Ismail *et al.,* 2013). This scepticism was shared by leading figures in Muslim organisations, such as K. H. Abdulrahman Wahid, who was the chairman of *Nahdatul Ulama*, the largest Muslim organisation in the country. He questioned the efficiency of an

Islamic bank working on the principle of profit-and-loss sharing, arguing that it would offer a lower return on investment. As such, it was not possible, given the prevailing context, to directly facilitate the Islamic finance activists' proposal.

While the proposal elicited different views, the supporters of Islamic banking held firm that the key to the institutionalisation they proposed lay in earning Suharto's blessing. This confidence was proved following their successful meeting with Suharto, which resulted in the establishment of PT Bank Muamalat Indonesia (BMI) on 1 November 1991 and its operationalisation on 1 May 1992. Suharto's blessing led not only to the institutionalisation of the proposal but also helped in building public support for the establishment of an Islamic bank. Furthermore, it is notable that the bank received capital from various stakeholders, including 4,500 individuals that attended the meeting with the president (Noor, 2006).

Furthermore, the process of institutionalising the profit-and-loss sharing mechanism went beyond the establishment of PT. BMI to rest within the new Banking Act No. 7/1992. While this new act, which replaced the 1967 Banking Act, was intended to accommodate the 1983 banking deregulation initiative, it was also revised to facilitate Islamic banking operations under the profit-and-loss sharing mechanism. Thus, while it did not formally recognise the presence of an

Islamic bank in Indonesia, it did permit it to operate under two mechanisms, namely interest-based and profit-and-loss-sharing arrangements (Ismail *et al.,* 2013; Saefudin, 2002). This development marked the beginning of institutionalised Islamic financing practices that were present not only formally, in the shape of a bank, but also institutionally under the umbrella of the Banking Act.

2. Recognition Period (1993–2004)

The progress made by Islamic finance activists in institutionalising Islamic principles in the form of a bank and certain provisions within the Banking Act did not automatically strengthen their position. As a newly emerged entity, the Islamic bank faced a series of challenges related to its limited operationalisation, human resources and public awareness that hindered its ability to deliver an impact in line with the movement's initial agenda. Indeed, the firm stronghold of the existing financial operations and standards meant that BMI was forced to adopt them. However, the 1997/1998 Asian financial crisis and banking sector reform prompted a change in the status quo. These two events contributed to the accommodation of the unique orientation and operation of Islamic banking and the promotion of Islamic financial principles, which remained strong throughout the crisis. The changing environment also brought the movement more substantial support from the Central Bank, which was instrumental in increasing the capacity

of the Islamic financial industry and promoting the concept of Islamic economics and finance. In addition, this period witnessed the increasing involvement of civil society in maturing the industry.

a. Consolidation Phase

The establishment of BMI in 1992 and the accommodation of the profit–loss sharing mechanism in Banking Act No. 7 /1992 were hailed as successes by the proponents of Islamic finance in institutionalising the principle of Islamic finance in Indonesia. The Islamic finance activists believed that their collective action had led to a shift in the transformation of their marginal aspiration into a functioning institution, even without fully understanding the challenges and consequences of adopting a modern institution as a platform for realising their agenda. Indeed, they believed that an Islamic bank would provide access to funds for an economically marginalised segment of society through a partnership-based financial arrangement.

However, BMI faced various challenges. Aside from its limitations in internal capacity, product diversification and public awareness, the lack of understanding of the Islamic banking operation vis-à-vis the purely profit-and-loss sharing mechanism within the Banking Act 1992 led to the regulator treating the new bank similarly to a conventional one. Consequently, BMI was left to contend with a

standard that was often difficult to meet when the profit-and-loss-sharing mechanism was applied. During its early years of operation, this condition hindered it from taking off and functioning ideally as an Islamic financial institution.

Nevertheless, BMI's emergence empowered Islamic finance activists to further transform the financial sector. Many initiatives were introduced in its wake, including the formation of *Baitul Maal wat Tamwil* (BMT), the establishment of PT *Asuransi Takaful Indonesia* as the first Islamic insurance company in 1994, the proliferation of Islamic rural banks (BPRS) and the conducting of seminars and informal sessions propagating the Islamic banking concept. Moreover, ICMI's affiliated philanthropic organisation, *Dompet Dhuafa*, pushed to establish Islamic microfinance institutions, including BMTs, across Indonesia. This initiative was enabled primarily by the unregulated framework for cooperatives in Indonesia.

> *'Nevertheless, this unregulated cooperative framework has offered this entity greater flexibility in mobilising funds for financing small businesses.' (ALN)*

The consolidation of the two poles of development in Islamic finance, i.e. Islamic banking and Islamic microfinance institutions, was necessary to strengthen the presence of the Islamic financial institution. While the regulation

did not favour their operation, the sustainability of the Islamic commercial bank and the penetration of Islamic microfinance institutions such as BMT demonstrated an attempt to justify their cases by proving that an Islamic model of financial institution could serve the same function as a conventional one.

b. Change of Momentum and Field Reframing Phase

Two significantly interrelated events changed the faith of the Islamic finance movement and institution in the late 1990s: the Asian financial crisis of 1997/98 and the Indonesian Banking Reform in 1998. The financial crisis badly affected the Indonesian economy. The catastrophe also hit banks in the form of liquidity problems due to a rise in the non-performing loan rate, which had jumped to 25% by the first quarter of 1998, increasing the value of foreign debt and eroding their capital. Many banks also collapsed and were liquidated, which impacted the economy. Ultimately, the authorities sensed the need for reform to build a sound and resilient financial system and various measures to help resolve the crisis.

One significant reform was the proposal to replace Banking Act No. 7/1992 with a more rigorous act that would assist in the formation of a strong and resilient banking system. A draft of this act was formalised in 1998 and later became

Banking Act No. 10/1998. In addition to changes regarding the scopes of the banking authority, the new act formally recognised the uniqueness of the Islamic banking operation by extending the recognition of its operation from a solely profit-and-loss sharing principle to a broader Sharia-compliant operation including other partnership-based, sales-based and lease-based mechanisms (Sekretaris Jenderal DPR RI, 1998). In addition, the institutionalisation of the Islamic banking model covered law related to the establishment of such banks, the types of banks, the conversion mechanism, office opening, the role of *Dewan Syariah Nasional (DSN)* or the National Sharia Board, penalties for misconduct, and Central Bank supervision over Islamic banks.

The change in the Banking Act was followed by a revision to the Central Bank Act that resulted in the issuance of the New Central Bank Act No. 23/1999. The new act granted BI independence in conducting banking supervision and employed a Sharia-based instrument for monetary policy. Since this amendment, BI has been actively involved in nurturing the development of Islamic banking and finance. Although not stated explicitly in the series of reforms it introduced, the Islamic banking model came to the attention of the regulatory body as BMI was the only bank not affected by the crisis. Soon after the act was implemented, BI formed a team to oversee development and research in Islamic

banking and finance. This marked the beginning of BI's active involvement in the development of the Islamic bank, promoting the institution among the supporters of Islamic finance and further strengthening the position and bargaining ability of the Islamic finance movement.

3. Crystallisation Period (2005–2014)

The post-2004 development of the Islamic financial institution signalled that Islamic finance was becoming mainstream. The institution's burgeoning presence and increasing market size demonstrated the extent to which Islamic finance had already penetrated and accelerated within the country. The positive development was supported by the active involvement of BI through its supportive regulation and campaigning programme. It assisted in the promotion and laid the foundations of modern financial practices for Islamic financial institutions without forgoing the Shariah principle (Bank Indonesia, 2004). Furthermore, the Islamic financial institution benefited from another financial crisis in 2007 when, again, it proved resilient. Since then, the Islamic financial institution has become mainstream and has come to be seen as a concept with the potential to resolve the structural problem of conventional financial institutions, notably banks, which must contend with the interest-taking issue. This reflects the model's closer attachment to the real sector and its prudent economic practices, which contribute to sustainable economic and financial practices.

a. Legitimising Phase

The active involvement of BI in foreseeing the development of Islamic finance institutions was instrumental in the progress made by the movement. It made a significant contribution by assisting in the conversion of PT. Bank Susila Bhakti (BSB) into PT. Bank Syariah Mandiri (BSM), a fully fledged Islamic commercial bank, in 1999. This conversion was necessary for the Islamic finance movement given that the basis for forming BSM did not reflect political decisions but rather the economic opportunity for the market in the future. By 2004, another conversion was underway. This time, a financial institution owned by a private conglomerate, PT. Bank Mega, acquired Bank Tugu and turned it into Bank Mega Syariah. This demonstrated the potential of business opportunities within a Muslim-dominated environment.

> *'When BSB was taken over by PT. Bank Mandiri (BM), there were only two options, either a merger or conversion to an Islamic bank. When a merger seemed unviable, conversion was chosen.'* (AWK)

In response to the industry's progress, BI upgraded its supervision level from a small team responsible for supervisory and research duties in 1999 to a bureau level in 2001, followed by a directorate level in 2003. Furthermore, BI

and Islamic banks funded the establishment of *Pusat Komunikasi Ekonomi Syari'ah* (PKES), or the Islamic Economics Communication Center, an institution tasked with educating the public through talks, seminars and publications. It also encouraged and enabled the rise of professional associations such as the Islamic Bank Association (ASBISINDO), the grassroots-oriented Association of BMT (ABSINDO) and the Association of Islamic Cooperatives (INKOPSYAH) to mobilise resources and deliver awareness programmes.

The increasing legitimacy of the Islamic finance industry was also strengthened by solid commitment and support from MUI. The formation of the National *Shari'ah* Council (DSN) of the MUI in 1999 contributed to the formalisation and operationalisation of the Islamic financial institution. DSN-MUI functioned as a fatwa issuer that set the boundaries of what was acceptable by the Sharia and became a reference for BI to issue legally binding regulations. Indeed, MUI issued a fatwa on the prohibition of interest in 2004, which strengthened the position of the Islamic financial institution.

b. Mainstreaming Phase

This phase was characterised by changing attitudes and the mainstreaming of Islamic banks due to various strategic initiatives of the Central

Bank. Concerning the Islamic banking system, as explained earlier, BI's position had been clear from the outset: it saw the Islamic banking construct as an opportunity to improve financial inclusion through an alternative framework, especially for those that opposed interest-based practices (Bank Indonesia, 2004). Moreover, as reflected in its report on Islamic banking development in Indonesia, BI further emphasised several measures that should be carefully integrated into Islamic banking practice: compliance with the *Shari'ah* and prudential principles, efficiency in terms of the bank's operation, a systemic stability view, and its impact on the economy as a whole. The report's executive summary and body explicitly highlighted these 'strategic' initiatives. This coverage indicated that BI was concerned with implementing modern financial practices in Islamic banks, which might lead to further professionalisation.

While BI's report expressed the view of the regulator as an active external influencer, its recommendations would only create an impact when they were seriously considered by bank management and reflected in the actions and policies adopted. In this respect, as can be seen from the BSM and BMI annual reports, which mentioned compliance with the prudential banking and risk management policy set out by BI, the Islamic banks demonstrated a good commitment to such practices. Furthermore, regarding efficiency

indicators, both banks gradually included efficiency parameters in their CEO summaries, thus emphasising the importance of their increasing efficiency over time. Interestingly, there was a relative decline in the points concerning Sharia compliance in the reports over time, suggesting that the banks placed greater emphasis on their financial performance and compliance levels. These findings underscore the changing attitudes of Islamic banks, from stressing their uniqueness in adopting *Shari'ah* principles to adopting a more modern and mainstream institutional outlook.

c. Popularising Phase: Another Change in Momentum and the Institutionalisation of the Mainstream

The mainstreaming pattern was accelerated further by two key events that impacted the development of the Islamic financial industry in Indonesia: the global financial crisis of 2007/2008 and the issuance of the Islamic Banking Act and the Sukuk Act in 2008. Both events created a change in momentum and significantly shifted the institutionalisation of the Islamic bank into a more popular institution.

While the global financial crisis of 2007/2008 did not directly accentuate the strength of the Islamic finance model, it did raise a general question about the soundness and resilience of the conventional financial system with regard to

supporting Indonesian economic development. It created an argument that the latter's interest-taking practices were antagonistic as they did not align with the principle of just and equitable values adopted by Indonesia as the world's largest Muslim country. In particular, proponents of banking delegitimisation explicitly pointed to the increased potential for speculative behaviour in the market due to the flat-rate profit margin set by the conventional banking institution to meet its cost of funds. At the same time, this profit margin was toxic to banks as the increasing deposit rate did not always match the lending rate, leading to a negative spread. Thus, attention was focused on the rigidity of this flat-rate profit margin to lenders during an economic downturn, which often pushed them into bankruptcy in the face of a payment failure (Bank Indonesia, 2002).

Again, the solid and consistent performance of the Islamic banking sector ushered a positive wave in favour of the proponents of Islamic finance. This contributed to the rising popularity of Islamic banks and the Islamic financial concept. Nevertheless, it was not the main issue that triggered the discourse on the Islamic Banking Act in 2008. Instead, this has been highlighted as a case whereby the Islamic financial institution emerged as a response to the inequality and weakness of conventional financial standards and practices (DPR RI, 2008). The Islamic banking system is not

only centred on the *tawhidian* perspective of Islam but has also offered a greater legal certainty than the conventional system due to its reliance on the contractual basis (Chapra, 1992). Additionally, it conveyed a strong message of what it believed to be the true spirit and identity of Indonesia as a nation that recognised the multidimensional approach in its everyday practices. This situation implied that the crisis was inseparable from a multidimensional turmoil caused by the incompatibility of the developmental orientation and practices in the past. As such, the Muslim initiative was regarded as part of the solution to end this multidimensional crisis. The adoption of *Shari'ah* principles in the positive legal structure of the nation, including in the Islamic Banking Act, was therefore an initiative to realise a more just and equitable legal system for the nation.

The implementation of Islamic economic concepts also expanded into the capital market. Prior to 2008, the potential of the Islamic capital market in Indonesia was yet to match the accelerated growth of the mainstream institution. By the end of 2007, only 17 corporations in the local market issued *sukuk* (Islamic bonds) instruments, amounting to Rp 2.2 trillion. This constituted a lag in the development of the Islamic capital market compared to other sectors, such as banking, insurance and mutual funds. The situation inspired the Indonesian government to formulate

a proposal to accelerate the impact of the Islamic capital market by introducing the Act on Surat Berharga Syariah Negara (SBSN) or Sovereign Sukuk to legitimise the government's presence in expanding the size of the market via the issuance of state *Sukuk*. As mentioned by an activist among government officials, the government also saw the Islamic capital market instrument as a means of mobilising public funds and securing additional funding for the budget to finance its economic programme.

> *'Sukuk Republik Indonesia [Surat Berharga Syariah Negara] can assist the government in covering the budget deficit by mobilising public funds.'* (SMT)

Hence, the development of Islamic finance was regarded as a means to develop the market for more significant benefits. This move by the government highlighted the potential use of the Islamic financial market for government programmes and, importantly, demonstrated the government's interest in fostering the development of Islamic finance through direct action (i.e. the provision of a legal umbrella). This development led to the further mainstreaming of Islamic financial practices within the famous market.

d. Re-Orientation Phase

While the positive development of the Islamic banking industry was acclaimed as a success for the movement, its achievements did not necessarily please all factions within it. Some of the movement's early founders questioned the initial aspiration of Islamic finance regarding the redistribution of resources and opportunity.

> *'We are trapped in Islamic economic romanticism, believing that one institution can change the way we distribute resources and opportunity … when needs are used to justify any innovation.'* (JAS)

This perspective asserted that the institution was not in favour of preventing capital accumulation, and, as a consequence, its greater purpose was secondary to the interests of the capital owner. As a result, other voices looked towards another avenue for greater involvement. It was then decided to focus on developing the Islamic capital market.

> *'An Islamic capital market instrument, such as sukuk, has the potential not only to cover the budget deficit but also to improve public involvement in public projects that contribute to greater goods.'* (SMT)

However, the criticism made by Islamic finance activists concerning the inability of mainstream Islamic financial institutions to

redistribute resources and opportunity was not the only opposing voice. Indeed, another faction within the movement had raised its objection long before this voice was raised. This line of supporters highlighted their disagreement with the mainstreaming of the Islamic financial institution's development.

> *'The biggest mistake in the development of the Islamic financial institution was its banking-oriented development, disregarding its grassroots aspiration that rested in the form of the microfinance institution.'* (NTH)

Their objection was linked to the original aspiration of the Islamic finance movement. The emergence of Islamic finance in the form of microfinance was part of an agenda to provide access to capital to economically marginalised households and businesses. Nonetheless, the mainstreaming of the Islamic financial institution that resulted in a more banking-centric development led to a convergence of Islamic financial institutions around standard financial practices and purposes.

However, the supporters of Islamic finance did not entirely forgo the original goal. Two groups were responsible for the evolution of Islamic microfinance: PIN-BUK and the Dompet Dhuafa-affiliated association of BMT Indonesia (PBMTI). Each oversaw the development of its members in

addition to functioning as an incubator. Yet despite the two groups having similar purposes, each retained its own view and approach to developing Islamic microfinance in Indonesia.

Furthermore, dissatisfaction due to the Islamic banking institution's lack of a distributional effect was also reflected in and influenced the discourse on *waqf*. In the early 2000s, the concept of *waqf*, or an Islamic-based endowment system, captured the interest of the elites due to its potential to increase productivity and economic development. While initially proposed to strengthen Islamic financial institution funding, certain factions within the movement saw the *waqf* institution as a potential force to increase people's prosperity. As a result, the *waqf* movement resonated with and gained the support of organisations such as ICMI. However, primarily due to a lack of government support, the waqf movement failed to gain popularity at that time.

4. Centralisation Period (2014–Present)

The year 2014 was considered a transition towards a more centralised effort. A transformation began from within through a harmonising of the initiative and the rollout of a strategic intervention to continue the agenda. In 2016, the National Committee for Islamic Finance (KNKS) was established and coordinated under the Ministry of National Development Planning (Bappenas).

Its main task was to formulate and recommend issues in the Islamic finance sector, alongside coordination and advocacy to the relevant stakeholders. In 2018, the committee was expanded to include the economic aspect of Islamic economics and finance. Thus, the name was changed to the National Committee for Islamic Economics and Finance (KNEKS).

This shift towards a wider economic penetration demonstrated the snowball effect of the change from within, whereby the transformation was pushed within finance and spread towards the pursuit of identity-driven economic activities. According to one of the interviewees, the expansion of Islamic economics and finance was expected to lead to an interconnectedness between Islamic finance and the economic aspect that would represent the real sector. The presence of a national-level committee was expected to enhance coordination and communication among the stakeholders. However, another interviewee mentioned that the process was not easy because not all stakeholders understood the drive or distinguishing characteristics of the Islamic economy and finance. As a result, various proposals for Islamic finance to have specialised products, such as a profit-sharing investment account and special taxation treatment, still needed to be finalised. The expected growth is also yet to be achieved. In turn, the project was pushed to further develop the financial sector by strengthening Islamic banking through the merger process.

D. Discussion

This study aims to understand the emergence and development of the Islamic financial institution in Indonesia through social movement and institutional theories. We argue that the emergence and development of the Islamic financial institution in Indonesia resulted from the changing approach of the Islamic economic movement in realising its goals, evolving from an experimental outsider initiative to an internally generated one that framed and mimicked the tools and procedures of the original social movement. This dynamic marked the beginning of an Islamic financial movement. Furthermore, based on the framing of the movement's key events, the dynamic development of Islamic finance in Indonesia can be framed and categorised into several periods, namely an introduction period (1983–1992), a recognition period (1993–2004), a crystallisation period (2005–2014) and a centralisation period (2014–present).

It is worth noting that the issues of opportunity and legitimacy were crucial in the success of the Islamic finance movement in Indonesia. In its early years, Islamic finance was a marginal concept familiar only to a circle of Islamic economics enthusiasts. It emerged as a concept inspired by the desire to combat loan-shark financing practices that left households and small businesses in long-term financial difficulty. The first institutional experiment in which a cooperative used a profit-and-loss sharing mechanism and performed the microfinance function demonstrated the eagerness of the concept's early proponents to transform their aspiration into practice; that is, by providing an institution that could offer adequate

financing and protect households and small businesses from *rentier* practice.

However, despite these early activists' success in producing an authentic institution, it proved unsustainable due to poor managerial practices and a lack of capital. Hence, to generate a sustainable institution and solution to the issue, the movement shifted towards a more established and capitalised institutional form to pursue its dream. The realisation of this objective found opportunities in the financial sector deregulation undertaken by the government at the same time, as emphasised by the activist interviewed. Collective action was then recorded in the formation of BMI, the country's first Islamic bank, which involved more actors and groups. This collective attempt marked the beginning of the Islamic finance social movement aimed at transforming the financing sector, such that Islamic values and norms were considered in financial decisions as part of good management practice in the finance sector.

Nevertheless, the establishment of BMI did not necessarily transform standard institutional practices as the movement struggled to expand and achieve its goal in the early years. This condition persisted until the Asian financial crisis of 1997/1998, which strongly impacted the banking sector and eventually led to a series of financial reforms. This game-changing event benefited the Islamic finance institution as its resilience during the crisis period stimulated the interest of stakeholders in the concept, prompting a further recognition of its unique operation in the legislation and attracting the Central Bank as a strategic partner.

Since then, Islamic finance has transformed into a feasible business venture and attracted institutional investors to tap into the business opportunities, such as by establishing a second and third Islamic bank. This narrative demonstrates the critical role of external pressure in the movement's success. Moreover, it was only during the changing momentum that the proponents of Islamic finance were able to develop a structure for mobilisation to unify the different perceptions and expectations and, importantly, to signify its public presence. This evidence shows that the field framing of the Islamic finance movement facilitated its advancement.

While the financial crisis successfully altered the faith of BMI and the Islamic financial movement, it also changed the attitude of BI towards Islamic finance and triggered a professionalisation of the movement with the rise of MES (the Islamic Economic Society). It additionally changed the attitudes of the Islamic banks, which in turn created new challenges for the development of the Islamic financial institution and its movement.

More specifically, for the proponents, BI's active involvement was a double-edged sword. While it elevated the institution's presence and legitimacy, BI became increasingly interested in creating a sustainable financial institution by applying prudence and efficient banking practices. While the former was vital in raising the public's confidence and awareness of the Islamic financial concept and practices, the latter led to a discrepancy between the initial aspiration and the current orientation of the institution primarily due to the changing attitude of Islamic banks, where the latter appeared to prioritise these standard financial practices over their

shariah-based uniqueness. This situation was highlighted by the activists interviewed. However, this pattern is not new and has also been introduced previously. The deviation in a movement's motivation when it turns mainstream has been identified not only in the case of the Islamic finance movement but also in cases such as fair trade (Gendron & Turcotte, 2007), the recycling movement (Lounsbury *et al.,* 2003) and even the SRI movement (Arjaliès, 2010), albeit where the latter operated with a target to transform the dominant institutional logic.

The Islamic finance movement continued to advance and gain increasing legitimacy after the 2007/2008 global financial crisis. While Indonesia's financial sector suffered no systemic damage due to the crisis, the market's moral hazard problem damaged the reputation of the conventional financial industry and led to calls for reform. As a model that promoted a moral filter, Islamic finance gained greater exposure during this period, strengthened by the stability of the Islamic financial institution and signified by another round of reform in the banking sector. The tipping point was the release of the Islamic Banking Act and S*ukuk* Act in 2008, which not only recognised *shari'ah* principles as financial norms but also inserted Islamic financial practices into legitimate mainstream institutions. This also reflects the delegitimisation of conventional finance. Furthermore, the government viewed sukuk as being aligned with their objective to manage public finance more inclusively, as highlighted by the Islamic finance activist interviewed.

The popularisation of the Islamic financial institution and its success in earning legitimacy as a mainstream

institution suggests that the movement has achieved its goal of transforming financial logic. Nevertheless, as emphasised by some of the activists in this study, dissatisfaction emerged as the movement was seen as deviating from its original agenda of helping to provide financial access to the public and marginalised people. Hence, other initiatives such as the *waqf* movement, capital market movement and BMT movement have also been developed to re-ignite the movement agenda. These 'purification' programmes appeared to be aimed at reorienting the divergent social movement on Islamic finance towards an authentic purpose. The rise of these movements also indicates the presence of dissatisfaction within the movement due to its mainstream orientation. This situation has been mentioned in CSR discussions under the 'niche vs mainstream' issue. However, the main concern has not necessarily been this issue, but rather how the emergence of a new movement might lead to the death of the initial movement. Thus, for Islamic finance in Indonesia, the rise of these purification movements raises the question of whether mainstreaming has precipitated the end of the movement.

Considering the heterogeneity of the new initiatives, there are three possibilities. First, the new initiatives could extend the mainstreaming trend, leading to the death of the movement. Second, the movement finds a new home in the form of a peripheral Islamic financial movement, which uses the mainstreaming argument to justify its case that it has yet to achieve its goal and thus extends the movement to act on transforming institutional logic. Finally, a non-financial institution initiative would develop and revive the Islamic economic movement to transform the institution and society.

In the literature, while the rise of multiple initiatives suggests that the social movement is not always successful in resisting the market logic of generating profits (Déjean *et al.,* 2004; Déjean *et al.,* 2013), it also shows that collective action has succeeded in negotiating certain factors related to the moral expectation of the market outcome beyond business as usual, as Arjaliès (2014) pointed out. However, further analysis of this additional yet important issue is beyond the scope of the present study.

E. Conclusions

Despite the rapid growth of Islamic finance globally, studies have not yet attempted to rationalise how it emerged and developed. Therefore, this study aims to understand the process that led to the emergence and development of Islamic finance in Indonesia. It utilised the intersection between social movement observers and institutional theorists to understand an emerging institution and examine how the Islamic financial institution developed. To answer the inquiry, it collected primary data from 32 Indonesian Islamic finance activists and other relevant sources and analysed it using the field frame approach.

This study suggests that the emergence and development of the Islamic financial institution in Indonesia was an outcome of the changing approach of the Islamic economic movement in realising its goals, from an experimental outsider initiative to an internally generated one that attempts to effect change from within. This dynamic marked the beginning of an Islamic financial movement.

Furthermore, this study suggests that the development of Islamic finance in Indonesia can be framed and categorised into several periods and phases, including (1) the introduction period (1983–1992), consisting of an experimenting and initiating-and-institutionalising phase, (2) the recognition period (1993–2004), comprising a consolidating and reframing phase, (3) the crystallisation period (2005–2014), consisting of a legitimising, mainstreaming, popularising and re-orientation phase, and (4) the centralisation period (2014-present), marked by harmonisation by government.

It is also notable that the issues of opportunity and legitimacy were crucial in the success of the Islamic finance movement in Indonesia, particularly in the earlier periods. Furthermore, several 'new initiatives' have emerged since the crystallisation period, raising the question of whether this is the end or the beginning of a new era for the Islamic finance movement. Nevertheless, it is beyond the scope of the present study to consider this big question. It is hoped that future studies may continue this research in examining the development of Islamic finance in Indonesia.

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