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## Misleading Development and Economic Policies in Indonesia and the Solution Based on Shariah Economics System (Case Study on Indonesia Banking Policy Scandal)

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### Abstract

Indonesia, nowadays is the 16<sup>th</sup> largest economy in the world, and has the potential to be the seventh biggest by 2030. The population also starting by this decade will enter a cycle of so-called “demographic bonus” when the productive age of people dominate in about 69% of the national population. Within these facts, the Indonesia economy has enormous promise in the future. However, historically, the economic developments in Indonesia have been misled by government policy that tends to nepotism and corruption. Such scandals, as BLBI (Bank Indonesia Liquidity Assistance) in 1998 and Century Bank scandal one decade later are the examples of the weakness of the conventional system of banking. Therefore because of that weakness, it is necessary to pursue legal reform, especially to the creation of new legislation that is accommodative to include the establishment of the Sharia system of banking which is more transparent, just, and profitable according to Sharia law.

### Keywords:

Government Policy, Islamic Banking, Sharia System

### I. Introduction

Indonesia as a country which has majority population of muslims, needs the involvement of muslims people on its national development. Starting by this decade, Indonesia will enter a cycle of so-called “demographic bonus”, a condition when the productive population (aged 15-64 years) dominate the national population.<sup>110</sup> Indonesia has performed remarkably well during the past decade, emerging as a vibrant democracy, a strong economy, and a serious player on the international stage. Within Asia, Indonesia is the fifth most important economy behind China, Japan, India, and South Korea, and an established member of the G-20 leading economies.<sup>111</sup> Indonesia’s economy has enormous promise. Already the 16<sup>th</sup>-largest economy in the world, this dynamic archipelago has the potential to be the seventh biggest by 2030.<sup>112</sup> However, in the capitalistic system of economy, Indonesia has passed economic crises, caused by some misleading policy that has been taken by the government based on the conventional system of banking. How bad is the impact of the conventional system to the morality and economic problem? And how the Islamic banking system could be the solution to the economic

<sup>110</sup>Investor daily Indonesia, Thursday, 11th October 2012 | 11:31 <http://www.investor.co.id/tajuk/zero-growth-demi-bonus-demografi/46624> accessed on November 4, 2012 at 10.43.p.m

<sup>111</sup>McKinsey Global Institute, “The Archipelago economy: Unleashing Indonesia’s potential”, Mckinsey & Company, September 2012, pg. 11.

<sup>112</sup>Op.cit. pg. 1.

problem and relevance for the development of Indonesian? Those are two problems that would be explain and elaborated in this paper.

## II. Some lessons from the past: misleading development in economic policies in Indonesia

Within a decade after the reform of Indonesian politics, there were at least two mega banking scandal cases. First, in 1998, is the mega scandal of Bank Indonesia Liquidity Assistance (Bantuan Likuiditas Bank Indonesia/BLBI) of 650 trillion rupiah. The amount is the largest in the history of banking losses of Indonesia. Second, a decade later, in 2008, came the scandal of Bank Century bail-out total 6.7 trillion rupiah.<sup>113</sup> Indeed, in terms of number, the loss due to the scandal of Bank Century bail-out is not as powerful as BLBI scandal. However, the political fuss generated in the scandal bail-out was incredible due to the involvement of top rank people in this country.<sup>114</sup> Based on information from Attorney General Republic of Indonesia, Rafat Ali Rizvi and Hesham Al Warraq, the owners of foreign capital in banks Century, flee the state money worth \$ 1.4 billion spread over a number of accounts worldwide.<sup>115</sup> However, it was denied that Rafat Ali Rizvi were assessing the charge was only pass judgement.

### II.1. BLBI Case

In the BLBI case, Bank Indonesia (BI) acting as the central bank conducting monetary arrangements as well as supervision of the banking sector. In addition, BI was almost bankrupt due to the monetary crisis. Due to excessive intervention by the government, BI was forced to give bailouts to banks nationwide that are affected by the "rush" action of the bank customers. That bailout became known as the Bank Indonesia Liquidity Assistance (BLBI).

The government and BI take the wrong step when the monetary crisis. The business license of 16 national commercial banks revoked at 1 November 1997, according to IMF advice. Most banks had capital deficiency. The capital adequacy ratio (CAR) most national banks totally inadequate. To prevent banks from collapse, the government announced a recapitalization of the total 650 trillion rupiahs.

How does this condition happened and what has caused it is has to do with the conventional system of banking that uses interest as the base source of income. The monetary crises process caused by the system can be explained by the scheme 1 made by Karnaen Perwataatmadja.

The process of obtaining loan interest in conventional banking system is started from the conventional bank deposit money from depositing customer and give an interest as a reward. The exact amount of interest specified at the beginning of the transaction. The money deposited in the bank used as a loan to the borrowers by charging interest on loans. The conventional banks have to compete with other banks that deposit interest rates in which they should provide a higher interest rate than the rate of inflation, because if they use a lower interest rate, the fund value will be eroded by inflation. The conventional banks should be more competitive in the country, because depositors will choose the bank offering the highest interest rate savings and provide various kinds of bonuses or gifts. The conventional bank interest should be higher than the real interest rate abroad due to a lower interest rate with the embrace of free foreign exchange system, the funds will be more profitable to invest abroad.

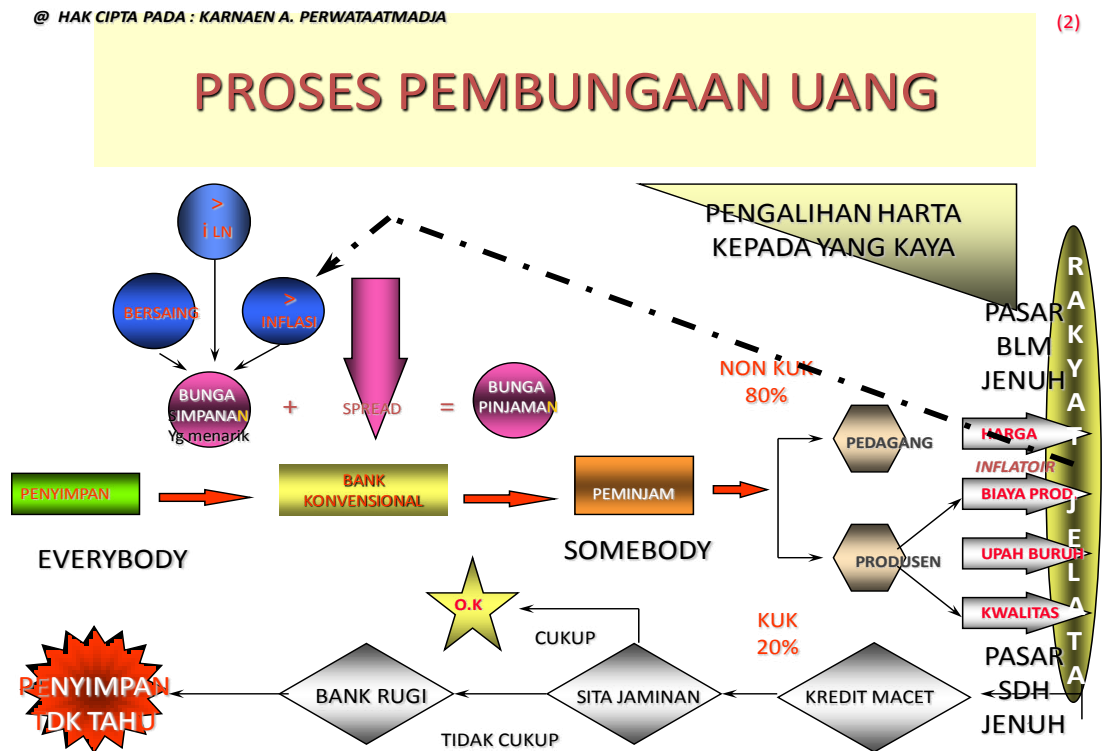
Deposited interest rate plus a spread, then charged to the borrower of funds in the form of interest on the loan. If the borrowers are a trader then the loan interest burden was shifted to the price of goods sold. If the borrowers are manufacturer the burden of loan interest shifted to the price of goods sold, labor costs, and quality of goods. If the situation has become saturated the borrower cannot pay the loan principal plus interest will be confiscated bail. If sequestration cannot meet the loan to be paid the conventional banks will suffer losses that ended in the squalor.

<sup>113</sup>Chudry Sitompul, "Century Bank scandal: the escape of Controlling Shareholders", Assessment centers procedural law and judicial system, The Faculty of Law University of Indonesia, Jakarta, December 2012.

<sup>114</sup>Behind this is the alleged involvement of the finance minister (at that time) Dr. Sri Mulyani Indrawati, Governor of Bank Indonesia (at that time, who is now a vice-president) Dr. Boediono, and even allegedly President Susilo Bambang Yudhoyono. (Id, pg. xii).

<sup>115</sup> *Op.Cit.* pg. 7.

Scheme 1. The process of Interest based income in conventional banking system.<sup>116</sup>



Knowing that the banks has bankrupt there are “rush” actions by the depositors to withdraw the fund due to get returned money that was not enough to pay all of the bill. This happened caused by the lack of transparency. If the depositors know in advance the monetary situation of the banks, they will not end up with rush. Then each banks could responsible for their own customers, does not need bailout

### II.2. Century Bank Case

Century Bank case began on 20 November 2008, when the bank was declared a "Failed Bank Systemic Impact" by the Financial System Stability Committee (KSSK). There is a missing link that big spotlight in Parliament until September 2012, that there was a big difference between BI scenario, the Ministry of Finance and LPS, resulting in the loss of Bank Century audit potentially worth Rp 7.3 trillion.<sup>117</sup> The former Vice President, Jusuf Kalla was not informed well and the Minister of Finance at that time, Sri Mulyani seems to be cheated. This could be understood that in the process of KSSK meeting, before the Bank Century was decided as "Failed Bank Systemic Impact", Sri Mulyani complained because BI was not transparent about the amount of funds that will be launched. In fact, based on the management of Bank Century to the central bank, they just need a bailout amounting to Rp 1 trillion, while the disbursed is \$ 6.7 trillion. What went wrong in this case?

Century bank is a merger of three banks (CIC, Pikko and Danpac). The merger into Century Bank could occur because Rafat Ali has a special relationship with BI officials. (Sitompul 1, 2012 : 27-28). Though the merger was not eligible on the basis of the facts as follows: CAR negative 132.5% in February 2005, CIC troubled about the certificates of deposit are used as reserve capital worth USD 130 million, Bank Pikko has Bad Bebts of Texmaco in retail issue, and Bank Danpac troubled with Corporate Banking.

Target Rafat Ali in this regard is clear, namely to increase to Rp 8 trillion of assets and optimize Century Bank as a bank foreign exchange and trade financing. Because, when it was in-merger, Century

<sup>116</sup> Karnoen Perwataatmadja series of lecture at the faculty of law University of Indonesia, 1994 -2012.

<sup>117</sup>Chudry Sitompul, "Century Bank scandal: the escape of Controlling Shareholders", Assessment centers procedural law and judicial system, The Faculty of Law University of Indonesia, Jakarta, December 2012.

Bank branch total to 65 branches in 20 major cities and for Rafat Ali, this is a vehicle for global business networks.

With respect to liquidity problems faced, Century Bank repo apply for loan assets to the central bank on October 30, 2008 amounting to Rp 1 trillion. BI then processes the request as a request FPJP. When filing FPJP applicant, the position of Bank Century by calculating CAR BI is positive 2.35% (positions 30 September 2008). Meanwhile, PBI No.10/26/PBI/2008 dated October 30, 2008 requires that to obtain FPJP, a bank must have a CAR of at least 8%.

Thus, the Bank Century is not eligible to obtain FPJP. On 14 November 2008 BI change PBI about 8% minimum CAR requirement to obtain such FPJP, be positive only if the CAR. So with those facts, reasonably suspected to have occurred engineered in order to obtain FPJP Century Bank. so much by the government policy.

### III. Islamic banking system as solution

#### III.1. Islamic Bank System

The main difference of the principles in Islamic banking system is the avoidance the collection of interest, simply because Islamic law prohibits the payment and collection of interest, which also commonly called as *riba (usury)*.<sup>118</sup> In the conventional bank practice, interest is the core of their business. The main argument against interest is that money is not used as a commodity to make profit via providing lending and borrowing facilities. Money is considered as medium of exchange. However, profit can be earned by entering into contracts of exchange such as dealing in goods (*murabahah*) and services (*ijarah*) or via an investment such as contracts of partnership (*mudharabah* and *musarakah*).

As a contribution to the development welfare of the economy, we can see the profile of Islamic banking system in compare to the conventional banking system as follows.

On the mobilization of funds in Islamic banking system, shown in the form of togetherness for the results obtained from the banking business, either at the time of the economy and the economy is sluggish passionate, automatic savings account holders and deposits *mudharaba, mudharaba* follow the ups and downs along with the ups and downs of revenue for banks operating results, because the situation economy prevailing at that time. On the other hand, the holders of savings accounts and fixed deposit accounts at conventional banking system should be given the agreed rate, although banks are actually experiencing difficulties.

On the distribution side in Islamic banking shown in the form of community between banks and customers to obtain the results of the business, which of course could not free himself from the influence of the national economy. Customer financing recipient, and the recipient of *Musharaka* financing is not subject to any fixed charges, except share proceeds in accordance with the agreement that has been agreed upon. Of course, only the results that the execution should be in accordance with the results actually obtained. Thus, the amount of revenue that the bank give, will be small at the time of lethargic, and great at passionate times. Meanwhile, clients receiving a conventional bank loan to pay interest on the loan is fixed and on time despite its lethargic. Delays in paying interest on the loan at the time set will be an additional burden, since interest on loans that are not paid will creates interest (compound interest).

The other thing that is obviously as the difference between Islamic banking than the conventional bank is the existence of *Qard al Hassan* product. This product prepare business for its customers using the charity fund that is collected by the bank during the day by day transactions with its customers. In case the bank got permission by the government, the bank also can accept cash waqf to be managed. In Indonesia, this product helpful to solve the unpaid debt problems caused by force major or catastrophe, to create continuation of payment by the customer. In Malaysia, *Qardhul* used as a lending by the country's citizens to their Government.<sup>119</sup>

Relations between the Islamic bank customers are more partners (partner) of the lender or the borrower, so that Islamic banks act sebagai buyers, sellers, or those who rent. Products offered by Islamic banks varies with the principle of mutual benefit (fairness) and uphold the principles of justice. Products offered by Islamic banks in the form pengrahan distribution of public funds and other

<sup>118</sup>The meaning and the forms of *Riba*.

<sup>119</sup>Bank Islam Malaysia Berhad, "*Islamic Banking Practice From The Practitioner's Perspective*", (Kuala Lumpur: Bank Islam Malaysia Berhad, 1995), p. 35.

banking services. Products mobilization of public funds realized in the form of demand deposits, time deposits, savings accounts wadi'ah, deposits and savings mudaraba mudaraba. Porduk distribution and to the community in the form of financing products, financing murabaha, *bai bittaman ajil* financing, *alqardhul hasan* financing, and Musharakah. Products of other banking services such as sale and purchase of foreign exchange, bank guarantees, service publishing L / C, deposit, box, and transfer services.

In Article 2 of Regulation of Bank Indonesia Circular Letter No.9/19/PBI/2007 following BI No.10/14/DPbS dated March 17, 2008 regarding implementation of Sharia in fund-raising activities and Disbursement Services and Islamic Banking Services which then has amended by PBI No.10/16/PBI/2008, emphasized several principles in the implementation of the Islamic banks. These principles are contained in the explanation of Article 2 paragraph (2) Bank Indonesia Regulation No.9/19/PBI/2007. These provisions include the following: 1). 'Adl (enacting something of its portion), 2). Tawazun (balance), 3). Maslahah (all forms of goodness), 4). Alamiyah (can be done by, with, and for all parties), 5). Gharar (the object is not clear, it is not owned by, is not known), 6). Maysir (speculative), 7). Riba (addition) 8). Dzalim (injustice), 9). Risywah (bribes), 10). Attractions Haram (a good or service that is forbidden under Islamic Law).

### III.1. The Solution for the case

#### III.1.1. BLBI Case

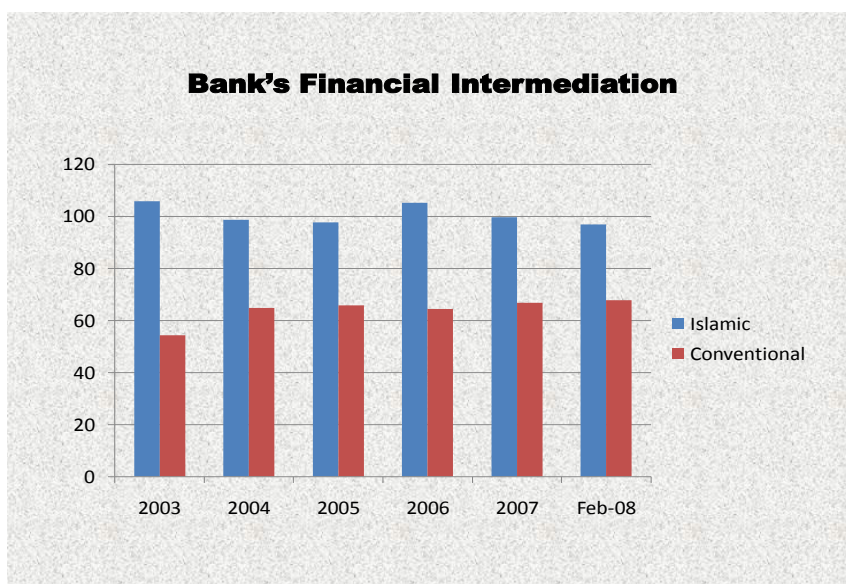
For the BLBI case, we have seen of the main problem is the application of interest conventional banking system. If we see the principle in Islamic banking system which avoiding the collection of interest on which in the conventional bank practice as the core of their business, the crisis did not give much impact to the bank. It is simply because Islamic law prohibits the payment and collection of interest, which also commonly called as *riba* (usury). The main argument against interest is that money is not used as a commodity to make profit via providing lending and borrowing facilities. Money is considered as medium of exchange. However, profit can be earned by entering into contracts of exchange such as dealing in goods and services or via an investment such as contracts of partnership. With this system Islamic banking can be operated in the concept of *murabaha*, *mudharaba* and *ijarah* principles. The relevance of Islamic banking system with the nation building effort to create better development of Indonesia, would be such as in the following table.

**Table 1.1** The relevance of Islamic banking system with the national development

#### THE RELEVANCE OF A "KAFFAH" ISLAMIC BANKS WITH NATION-BUILDING EFFORTS

SCHEME OF NATION-BUILDING EFFORTS		ISLAMIC BANKS OPERATING SCHEME			
Improve Welfare	Spiritual Welfare	Avoid the practice of <i>riba</i> , <i>gharar</i> and gambling and all un-Islamic behavior			
	Material Welfare	Application of the Principle		Islamic Banking Products	
		Creating stability	the balance sum of money and goods	Sale and buy (no money no goods)	Murabahah, BBA, Ijarah, Istisna
		Creation of growth (employment)	Equal business opportunities for the community	Venture capital investments in short-term (1 to 15 years)	Mudharabah, Musyarakah, Musyarakah Mutanaqibah
Creation of equitable distribution of income	Profit and Loss Sharing System	Share the results and risks	Mudharabah, Musyarakah, Musyarakah Mutanaqibah		

As a nation Indonesia has a goal to have development in material and spiritual welfare. The material welfare showed in the achievement of creating stability, creating growth and creating equitable distribution of income. In the era of Soeharto these three goals were mentioned in the trinity of national building. The application of the principle basically by creating the balance sum of money and goods, equal business opportunities for the community, and profit and loss sharing system. The point is syariah by banking is the solution can be seen by the necessary function of bank as an intermediary institution, that is because the industry is able to play its role as intermediary between depositors and borrowers from the variety of transactions that the bank could use as the replacement for credit system. With this system Islamic banking can be operated in the concept of *murabaha*, *mudharaba* and *ijarah*. Those variations of ways in gaining profit in Islamic banking, actually as a value added to the advanced system of banking. Therefore, it was natural if we measure the bank's role in the economy of a country that based on how much intermediation can be played. Of intermediation, Islamic banks performed admirably. It can be seen from one year to the amount of their intermediation function close to 100%, even above 100% never surpassed. In other words, almost 100% of third-party funds in Islamic banks, is channeled back to the community. While on the other side, conventional banks are at best close to 70% only.<sup>120</sup>



### III.1.2 Century Case

In Century bank case for example, the government policy is in the favor of wealthy people. The affluent people does not need incentives from the government more over by the big amount of money. This policy is against the characteristic of Indonesian Democracy. Prof. Sri Edi Swasono said that Indonesia's Economic Democracy based on the Constitution of The Republic of Indonesia. The Article 33 of the 1945 Constitution is the soul of the Indonesia's economic democracy, which is socialistic (stated explicitly), that the substantive orientation is placed in the interest of society.<sup>121</sup> This is the socialistic trait of article 33 of the 1945 Constitution, which Dr. Hatta named it is as religious socialism (*sosialisme religius*) based upon national *ukhuwah*.<sup>122</sup> So if in the Century bank case the government

<sup>120</sup> Amin, A Riawan, "Perbankan Syariah Sebagai Solusi Perekonomian Nasional", Ringkasan Pidato Ilmiah Penganugerahan Gelar Doktor Kehormatan (Doctor Honoris Causa) di Bidang Perbankan Syariah, 11 Juli 2009, UIN Syarif Hidayatullah, Jakarta, dimuat di tabloid i-syariah edisi September 2009, hal. 41.

<sup>121</sup> The article says:

#### CONSTITUTION OF THE REPUBLIC OF INDONESIA

##### Article 33:

- 1) The economy shall be organized as a mutual endeavour based upon the principle of the brotherhood.
- 2) Branches of production which are important for the State and vital for the life of most people shall be controlled by the State.
- 3) Land and water and the natural riches contained therein shall be controlled by the State and shall to the greatest be made use of for the people.

<sup>122</sup> Sri-Edi Swasono, "Islamic Economics Within Pancasila", paper on International Seminar on Implementation of Islamic Economics; Annual Meeting of Indonesian Economics Experts Association, Surabaya 1-3 August 2008, pg. 10.

was trying to bailout the bank in favour of the affluent people who place their money on that bank, on the opposite the Islamic banking system on the side of the Small and Medium Economy (SME).

The concerned about the SME sector Another thing that was carried by Islamic banks in an effort to improve the social welfare in Indonesia which is the bottom of the pyramid in the economic sectors in Indonesia. Toughness of the SME sector in the face of changing economic conditions has been proven. The sector continued to grow during the crisis. From year to year, the number of employers who engage in this sector continue to increase so that SMEs and the main drivers of the Indonesian economy. In Islamic banking system the principle of *mudharabah* is the concept of the cooperation of the capital and the entrepreneurship this is typical of social equality system in the community.

In this case, the economic democracy system of Indonesia must not be fully interpreted as the application of the "principle of equal treatment" in an absolute manner. The Indonesian economic democracy system ideally aims at the realization of social justice for the entire people of Indonesia (economic justice, fairness, equity, equality), so that it is concerned with partisanship to the weak, the poor, and the left-behind is not a discriminatory stand for certain ethical, religious, racial group, but give a positive moral value to the doctrine of mutualism in the principle of brotherhood of Indonesia.

Islamic goal in to create social welfare is supposed to be the soul and spirit to the Islamic banking industry as the institution itself to attribute a sharia. Thus, Islamic banks are not banks just concerned with the formal-legal aspects that are formulated with the ban "*maghrib*"-which is an acronym of gambling (gambling), *gharar* (speculation) and *riba* (usury). But more than that, Islamic banks are the financial industry too *shibghah* the spirit of social welfare as the embodiment of universal human values (*habl minannās*) in the context of worship and devotion to Him (*habl minallāh*).

This fact suggests that the more pro Islamic banks in developing the real sector in Indonesia or the function of Islamic banking in the engine to lubricate the economy the more resilient than the aggregate national conventional bank.<sup>123</sup> In this case, after the two scandals that happened and the superiority of the Islamic banking system, should be a lesson for the government to move toward Islamic banking system.

#### IV. Indonesia Legal Reform for Establishing Islamic Banking System

Islamic banking resilience in the face of the economic crisis since 1997, is of particular notice to the Indonesian people and government of Indonesia. In 2002, the government has expressed its seriousness to assess the urgency of the bill of Islamic Banking in Indonesia<sup>124</sup>. In the same year, Bank Indonesia issued a "blue print of Islamic Banking Development in Indonesia," the 10-year planning time frame to the next (2002-2012)<sup>125</sup>. However, the plan extended. The blue print applies six initiative programs to be implemented within 10 years starting from 2005 (2005-2015), which are (Bank Indonesia, 2006):<sup>126</sup>

- a. Increasing the sharia compliance
- b. Increasing the quality of prudential banking operations
- c. Increasing the operational efficiency and competitiveness
- d. Increasing the stability of banking system
- e. Increasing the expertise and quality of human resources
- f. Optimizing the social roles of Islamic banks in developing the small and medium enterprises (SME).

Cronologically, the history of Indonesian banking regulation policy regarding Islamic banking system has taken a long steps of span time in an evolution way.

The evolution of banking legislation in Indonesia began with Law No 14 year 1967, which states that there can be no bank without interest. In accordance Deregulation June 1, 1983, it is

<sup>123</sup>Amin, A Riawan, "*Perbankan Syariah Sebagai Solusi Perekonomian Nasional*", Ringkasan Pidato Ilmiah Penganugerahan Gelar Doktor Kehormatan (Doctor Honoris Causa) di Bidang Perbankan Syariah, 11 Juli 2009, UIN Syarif Hidayatullah, Jakarta, dimuat di tabloid i-syariah edisi September 2009, hal. 29-53.

<sup>124</sup>See "*Journal of Business Law*", welcome the Bill of Islamic Banking, (vol.20, 2002) p. 6.

<sup>125</sup>Setiawan, Budi Utomo, "*The development of Islam in Indonesia: Historical Development and Strategy Development*", (loose paper published on 17 September 2004 in Jakarta), p. 10.

<sup>126</sup>Rifky Ismal,

possible there is a bank without interest but no permission to set up a new bank, for example, Cooperative ridho Gusti and Cooperative Teknosa. In Pakto 1988, it is possible there is a bank without interest, and has already produced a new bank permits (using the system on the basis of production sharing agreements pure). Law No 7 year 1992 was accommodated by the bank without interest to the system for yield. Then in Law No 10 year 1998, the possible existence of a conventional bank conducting business based on profit-sharing system (the bank without interest / Islamic principles). The latter is a bill of Islamic banking, is an attempt purification Indonesian banking practices.

### Summary

As the 16th largest economy in the world, and potentially to be the seventh biggest by 2030, Indonesian economic development is promising. Additionally, with the growth of population that starting by this decade will enter a cycle of so-called “demographic bonus” when the productive age of people dominate in about 69% of the national population, the Indonesia economy should be enormously developed in the future. However, based on the fact that the economic development in Indonesia which have been misled by the government policy that was capitalistic, nepotism and corrupt. Such scandals, as BLBI (Bank Indonesia Liquidity Assistance) in 1998 and Century Bank scandal one decade later are the examples of the weakness of the conventional economic system, specifically due to the weakness of conventional banking system. In the BLBI case, as the result of monetary crises caused by high inflation, the government issued 650 trillion just to provide a bail-out for the conventional banking system is not able to cope with inflation. Whereas in the case of Century Bank, the Bank was not eligible to obtain “FPJP”. On 14 November 2008 BI change PBI about 8% minimum CAR requirement to obtain such FPJP, be positive only if the CAR. So with those facts, reasonably suspected to have occurred engineered in order to obtain FPJP Century Bank. So much by the government policy, the government is not transparent and too easy to change policies to help the bank should not have qualified for assistance FPJP to save the bank. In Islamic banking, the policy has no effect because the system of Islamic banks are directly related to the real sector is not much affected by the inflation caused by the cost push inflation and ethics in Islamic banking with a bank that requires a clean, honest, transparent and did not violate provisions of Sharia promises a better future for the nation and the state. Indonesia requires not only material but also the spiritual welfare welfare. Both of these welfare goals can only be obtained through a banking system that meets the needs of both. The principles of Islamic banking has characteristics that can meet those needs. So that needs to be strengthened by government policies that support the development of Islamic banking.

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