CHAPTER 1

INTRODUCTION

1.1 Introduction

Islamic banking in Indonesia has been in operation since 1992, marked by the establishment of Bank Muamalat, an Islamic bank initiated by a group of people concerned with Islamic finance. Until today, it is the only Islamic bank in Indonesia to provide pure Islamic banking services, as it has no conventional counterpart. Later, in 2008, some conventional banks began implementing the dual-banking system and established full-fledged Islamic banks or Islamic business units. Presently, there are 32 Islamic commercial banks operating nationwide. However, only 12 of them are full-fledged Islamic banks, while the others are merely a division of conventional banks. Additionally, some Islamic banking units have a limited scope of operation and capital. These are called Islamic Rural Banks (BPRS), and currently 198 units are operating in the country (OJK, 2020b).

While Muslims make up 87 percent, or 222 million, of Indonesia's population, Islamic banking represents only 6.51 percent of the Indonesian banking industry as of 2021, a slight increase from 5.96 percent in 2019 and 5.78 percent in 2018 (OJK, 2020b). Nonetheless, as Indonesia has the largest Muslim population globally, Islamic banking has the opportunity to grow at a higher rate than its conventional equivalent. However, this positive outlook is not shared by most Indonesian bankers, who believe that the market share of Islamic banking over the next eight years would only increase slightly, if not unchanged. Few expect it to reach the government's 2025 target of 15 percent share, of which two-thirds are expected to come from state-owned Islamic banks (OJK, 2020a).

1.2 Background of the Study

1.2.1 Functions of Islamic Banks

The main function of Islamic banking in Indonesia is as a financial intermediary, as it still mainly operates alongside conventional banks in a dual-banking system (BI, 2005). Islamic banks in Indonesia also play the role of active traders that seek to generate profit from their investments and ensure equitable benefits to the society that it serves, as embodied in the *maqasid al-Sharia* in banking and finance. The functions of Islamic bank as an intermediary and to carry out social functions, as written in the Islamic banking act, are clearly stated on Financial Services Authority's (OJK) website (www.ojk.go.id).

OJK is a government agency that regulates and oversees the financial services sector. OJK is an autonomous agency whose functions are to regulate, supervise, inspect, and investigate activities in the financial services sector. Among OJK's missions are to ensure that all activities in the financial sector are conducted fairly, transparently, and accountably, as well as to protect the interests of consumers and the public. Meanwhile, Bank Indonesia as the central bank, on top of acting as the monetary policy authority, also regulates and supervises banking and payment systems (Bappenas, 2015).

1.2.2 Financing by Islamic Banks

Islamic banking in Indonesia serves both retail and corporate customers. According to the latest statistics report, most customers engage with banks to finance consumption (50.71%), working capital (29.37%), and investment (19.92%). The five largest customer segments are households (for purchase of properties and vehicles) (48.10%), followed by the wholesale and retail industry (10.91%), contractors (9.24%), manufacturing (6.61%), and farming & forestry (3.98%). Other segments, for instance agriculture, tourism, real estate and mining, have low average figures (OJK, 2020b). According to the same report, the most common types of contracts (*aqad*) in the five years period of 2017-2021 was *murabahah* (49.12%) and *musharakah* (39.6%). The most uncommon contract was *istishna*, representing only 0.5 percent of the total. There are also other contracts that have never been used.

1.2.3 Indonesian Plan for Islamic Banking and Islamic Economy

OJK has recently introduced Islamic Banking Roadmap 2020-2025, a continuation of the previous roadmap (2015–2019). This Roadmap comprises three pillars and twelve objectives. These pillars are establishing a new identity for Indonesian Islamic banking, synergy with current banking ecosystems, and improvement of coordination and controlling (OJK, 2020a).

Besides Islamic banking, the government has also introduced a strategic plan for the Islamic economy, the Indonesian Islamic Economy Masterplan 2019–2024. This plan also includes the Islamic banking industry. It continues the previous plan, Indonesian Islamic Finance Architecture Masterplan 2015–2019 (Bappenas, 2018). This masterplan places Islamic banking as the most important cluster of the Islamic economy. It recommends the improvement and expansion of the Islamic banking industry.

1.2.4 Infrastructure Construction

The current government heavily focuses on infrastructure construction projects. While the previous presidential cabinet prioritized housing construction and suburban development (i.e., to induce transmigration), the present cabinet emphasises public infrastructure, such as national roads, tolls, airports, dams, irrigations, and other civil infrastructure projects.

The private sector demonstrates a strong interest to participate in the infrastructure sector. It bears noting that the expected involvement of state-owned banks in public infrastructure financing is significantly higher than foreign banks. Given that the government has acknowledged that foreign investment is essential to meet the country's needs, especially in infrastructure development, it is believed that this gap will be addressed by the government, the industry, and stakeholders (PWC, 2018).

Following a significant upward adjustment in 2017, the budget for infrastructure development has been relatively unchanged. The budget for infrastructure projects in 2017 was Rp379 trillion, a 41 percent increase from Rp269 trillion in 2016. Over the years, the figure has constantly grown. In 2018, the budget marginally rose to Rp394 trillion, then Rp399 trillion in 2019, Rp419 trillion in 2020, and finally Rp414 trillion in 2021 (Dep Keu RI, 2021). The infrastructure budget covers various projects, including roads (tolls and public roads), satellites, railroads, airports, seaports, and irrigation dams. The budget for public roads in 2021 is Rp35.81 trillion (831 km for new road and 1,279 km for maintenance). The government targets the completion of 2,650 km of public road in 2015–2020. As much as 756 km and 406 km have been completed in 2018 and 2019. In 2020, the government reported that it had constructed another 837 km. The construction target for toll roads in 2015–2020 is 1,000 km and 3,000 km in 2024, while for road maintenance 46,770 km (Kemenkeu, 2019).

Construction financing represents only nine percent of total Islamic banks' financing (2016: 6.3%, 2017: 7.9%, 2018: 7.2%, 2019: 7.9%, 2020: 9.2%, 2021: 9%). Since 2016, the financing value provided by Islamic banks to construction firms has been growing (2016: Rp14 billion; 2017: Rp22 billion; 2018: Rp24 billion; 2019: Rp31 billion; 2020: Rp38 billion; 2021: Rp37 billion). Though these figures indicate a steady upward trend, they are disproportionately lower than those of the conventional banking sector. Infrastructure financing from conventional banks was Rp214 billion in 2016, Rp362 billion in 2019, Rp 376 billion in 2020, and Rp380 billion in 2021. Islamic banks, therefore, are only able to capture nine percent of the construction segment.

In an earlier period (2006-2012), the share of Islamic bank financing for construction showed a downward pattern (Kusumawati, 2013). While the cash values of the financing themselves were increasing — from Rp1.4 billion in 2006 to Rp7.1 billion in 2012 — the share of total financing of Islamic banks was decreasing. In 2006, it was 9.53 percent, shrinking to 4.84 percent in 2012. This downturn was also marked with higher instances of nonperforming financing (NPF) (Kusumawati et al., 2017).

The Indonesian construction sector is immense in size. In total, about 159,000 firms of various capabilities and specialisation operate in the sector. Of this figure, only 9 percent is classified as large firms, some of which are state-owned. Despite their scale, they do not fully perform all the works of any one infrastructure project. These large contractors focus on a wide range of specialties, such as toll concession, high-rise building, airport, seaport, rail track and mass rapid transit (MRT), township and property, concrete fabrication, and engineering-procurement-construction (EPC) for the energy and mining sectors. They also create opportunities for smaller contractors to act as subcontractors for certain works under a given project (BPS Indonesia, 2020).

There are some common forms of cooperation and partnerships in a project. In Indonesia, these include subcontracting, joint operation (JO; *kerja sama operasi*, KSO), public-private partnership (PPP), and public-private initiative (PPI) (Ready & Hardjomuljadi, 2019).

Based on the Indonesian construction procurement law, all qualifying contractors are invited to submit their tenders for public infrastructure projects, such as national roads. The project is typically established on a build-transfer (BT) and unit price contract, and so payments are made at the completion of each milestone. This means that the contractor must bear the initial cost of construction, as the payments are only disbursed after the works are approved by the consultant. The contractor, therefore, requires funding during procurement, and this presents an opportunity that Islamic banking can exploit.

1.2.5 Infrastructure Planning

The government has introduced a medium-term infrastructure plan, the Medium-Term National Development Plan 2020–2024. The plan consists of four pillars: politics, welfare, economic structure, and biodiversity. The plan has seven agendas, two of which are related to infrastructures: development of all regions to minimize inequality and strengthening infrastructure to support basic economic needs. With regards to minimizing inequality, there is a plan to build a new city, which means that infrastructure is necessary to support it. There are five areas in infrastructure planning, one of which is specifically about public roads. Several plans have been laid to construct and maintain national and local roads to improve logistics and connection to prioritized areas. These plans include the construction of toll roads, such as the Sumatera toll road; construction of national main roads in economically strategic areas, such as the Special Economic Zone (KEK) and National Tourism Strategic Zone (KSPN); and improvement and maintenance of existing roads. There is also plan to improve city roads and construct flyovers or underpass junctions (Bappenas, 2019).

1.2.6 Cost of Construction Financing

One of the most important considerations in financing is the interest rate (conventional banking) or financing cost (Islamic banking). While the prevalent belief is that the financing cost of Islamic banking is higher that its conventional counterpart, in reality its difference appears insignificant. According to the Islamic Banking Statistics report, the financing margin for the construction sector in Islamic banks was as low as 8.20 percent in 2020 and 9.17 percent in 2021, a decline from 13.45 percent in 2015 (OJK, 2020b). In conventional banking, the lowest interest income of construction loans was 9.03 percent in 2020 and 8.09 percent in 2021, a decrease from 12.5 percent in 2015 (OJK, 2021a). Therefore, the cost of financing of Islamic banks is not always higher than that of conventional banks.

1.2.7 Islamic Financing Contracts for Contractors

In the guidelines of Indonesian Islamic banking, the *istishna* contract is used to finance a contractor's works. *Istishna* is used in 2002 through the adoption of the Statements of Financial Accounting Standards (PSAK) 59 on the Accounting Principles for Islamic Banking (IAI, 2002). Since this standard illustrates *istishna* with housing construction, almost all accounting and finance textbooks for Islamic banking later use construction projects as an example of the *istishna* contract (IAI, 2007). Following the issuance of new principles in 2007, PSAK 59 was abrogated, and *istishna* is now regulated by PSAK 104 (IAI, 2016).

Istishna is defined as a financing contract with the principle of sale and purchase. However, road infrastructure cannot be sold, so this may explain why its application in such projects is rare, if any at all, as the focus is merely on housing construction.

Musharakah is also used to finance contractors. *Musharakah* is a contract founded on the principle of partnership. A construction project is also a partnership between the land (project) owner, contractor/builder, engineer, labour, material supplier, equipment owner, and, most importantly, the financier. The *musharakah* concept and construction thus share many similarities.

Istishna and *musharakah* financing is provided to state-owned contractors. In their annual reports, the contractors report the financing that they receive as a loan. They also do not specify the projects that receive financing. Since those listed state-owned contractors are not only operating in infrastructure construction, but also in property, concrete fabrication, toll concession, among others, it is not easy to determine, using publicly available information, which of these projects are financed with a *musharakah* contract.

1.2.8 Bank's Rights in *Musharakah*

In a *musharakah* contract, each partner is given the authority to manage assets, and each partner may represent the other partners (OJK, 2016). The bank's capacity as a partner in a *musharakah* contract, such as in a project or partnership, is equal to that of other partners. This is based on the *al-musawamah* (equality) principle. The Islamic bank, therefore, has the authority to supervise, inspect, or investigate whenever it deems necessary to do so. Mutual approval is also required in the purchase or sale of assets, such as in the case of material procurement. The bank can therefore perform internal control (IAI, 2007).

1.3 Problem Statement

The Islamic banking industry in Indonesia has been operating and growing in the last thirty years. The first series of fatwas, relating to savings and financing, were issued in 2000 (DSN-MUI, 2000). The Islamic Banking Act was then introduced in 2008 (Presiden RI, 2008). In the same year, Bank of Indonesia also introduced the Grand Strategy for Islamic Banking. The strategy was then continued by OJK, which was established in 2011.

OJK has recently launched a new 2020–2025 roadmap for the Indonesian Islamic banking industry to support its growth, a continuation of the previous roadmap (OJK, 2020a). Another government agency, Bappenas, has also recently introduced the Sharia Economy Masterplan 2019–2024 to improve the Islamic economy in Indonesia. This is also a continuation of a previous plan (Bappenas, 2018). Among the strategies of these two plans is to grow Islamic banking, including increasing its involvement in public projects. This strategy indicates that Islamic banks should direct their business orientation towards infrastructure projects so that they can grow along with the consistently increasing infrastructure budget.

At the same time, the current presidential cabinet highly prioritises the infrastructure construction industry, as indicated in the Midterm National Development Planning 2020-2024 (Bappenas, 2019). In line with this focus, the national budget allocation for infrastructure has been increasing since 2017, demonstrating the seriousness of the government in realising this plan (Dep Keu RI, 2021).

These factors — authorities' plans, Islamic banking, the Islamic economy, and infrastructure plans — together provide the best opportunity for Islamic banking to grow along with the infrastructure construction segment. Islamic banks should enhance its focus on construction financing, particularly for infrastructure contractors.

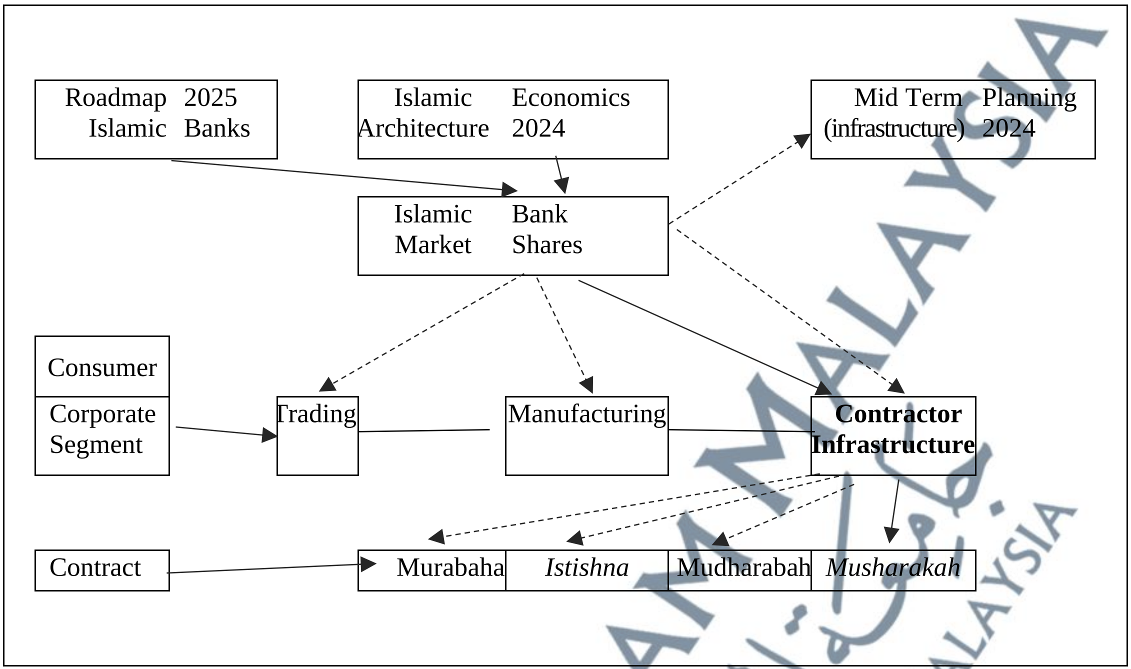

Figure 1.1: Islamic Banks, Supports, Segments, and Contracts

The first research problem is the lack of knowledge of Islamic banks on the practice and operations of contractor financing. This issue applies to all types of contractor financing from Islamic banks. Thus, it is difficult to identify previous studies that are relevant to the current study. Figure 1.2 indicates that Islamic banks have not

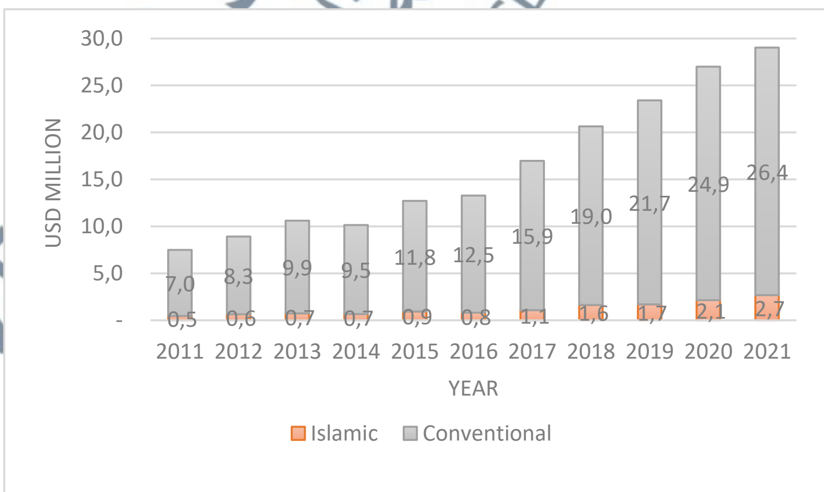

Figure 1.2: Financing to Contractors by Islamic Banks and Conventional Banks in Indonesia

taken the opportunities emerging from the government's infrastructure development policies. Almost all contractor financing opportunities have been exploited by conventional banks. Over a period of ten years, Islamic banks on average only constitute 9 percent of total contractor financing.

It is imperative to understand the current practices and approaches of Islamic bank to finance contractors so that appropriate solutions can be proposed. Construction and contractor seem to be similar, and so understanding where both terms overlap is very important for the study. Islamic construction financing, such as home financing (Ibrahim & Sapian, 2022), infrastructure projects (A. Rarasati et al., 2019), and road belt projects (Chu & Muneeza, 2019), has become a prominent topic. (These will be discussed further in Chapter 2). However, research on financing to contractors is still lacking (Gundes et al., 2019). More specifically, this topic is not covered by research on Islamic banking financing (Rashid et al., 2019). Meanwhile, in engineering research, financial resources are identified as a major issue in the operations of all types of contractors. The most important entity in the success of infrastructure construction projects is contractors that specialise in infrastructure projects (Gundes et al., 2019).

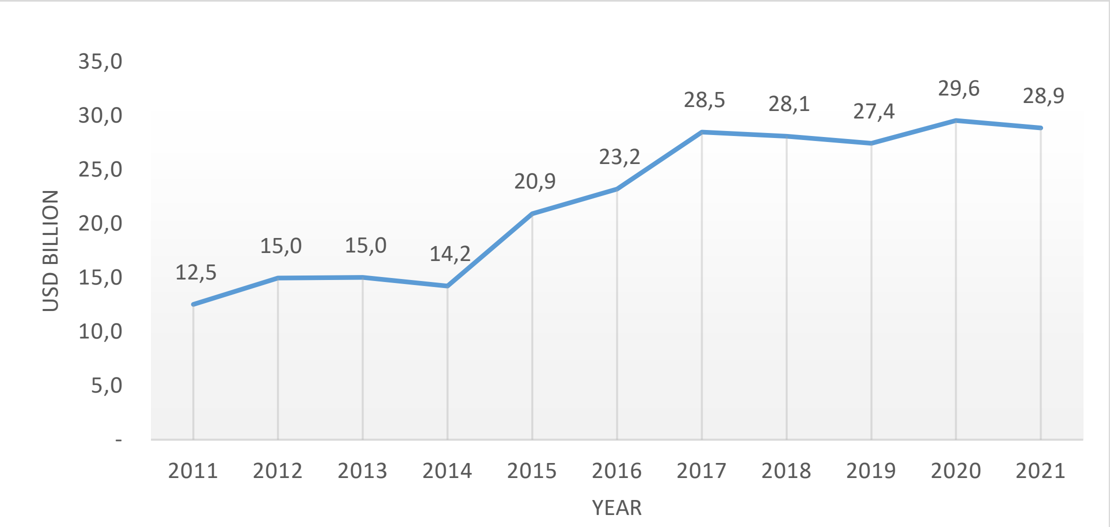

Figure 1.3: Government Infrastructure Budget

The second problem of the study is the low share of financing of Islamic banks to the construction segment. Thus, this study investigates the reasons for the under-financing of the construction segment by Islamic banks in Indonesia.

As discussed in Section 1.2.4, the government is currently focusing on infrastructure projects. Figure 1.3 shows that infrastructure budget increased by 47 percent in 2015, and the level has maintained until today. Under the previous president, before 2015, the average infrastructure budget was $13 billion. During the first term of the current president (2015–2019), the budget increased to an average of $25 billion. In his second term, during the pandemic (2020–2021), the budget was increased to $29 million. At the same time, the government also focuses on developing the Islamic economy, particularly Islamic banking, through the introduction of the Islamic Banking Roadmap and Islamic Economy Masterplan. However, as Figure 1.2 shows, both initiatives have not resulted in any increase in the share of construction financing of Islamic banks (Figure 1.3).

Combining Figures 1.2 and 1.3 in Figure 1.4, it is clear that over the last ten years, Islamic banks have not benefitted from the increasing infrastructure budget. Though the amount of financing to construction has been increasing, this is simply a general growth trend and unrelated to the current government policy (OJK, 2021b).

Figure 1.4 shows that the total bank financing to contractors has increased over the last ten years, although this increase is unrelated to the increase in the government's infrastructure budget. The total value of construction financing has increased by almost four times, from $7.5 million in 2011 to $29.1 million in 2021. The graph shows an increase in financing by both conventional and Islamic banks, though it clearly shows that the share of financing is dominated by conventional banks.

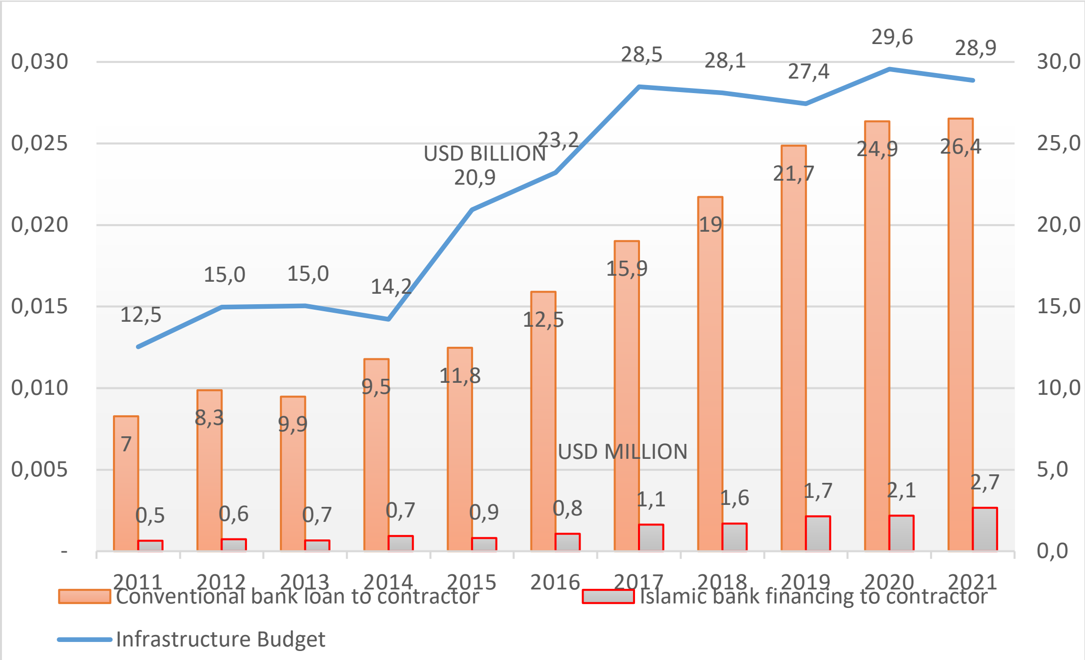

Figure 1.4: Government Infrastructure Budget and Financing to Construction

Islamic banks' financing to the construction segment over the last ten years increased by five times. The financing value increased by 7.4 percent on average and ranged between 6 and 9 percent. Conventional financing has doubled during the same period, with an average of 15 percent. However, the growth in 2020 and 2021 was respectively 4 and 1 percent. Islamic banks are therefore still unable to compete with their conventional counterparts despite the available opportunities. A possible reason is because of the number of conventional banks is larger than Islamic banks. Another reason may be the age of the banks. Therefore, it is very important to conduct an in-depth investigation about the causes for the low share of financing of Islamic banks, so that appropriate recommendations can be proposed to increase their market share.

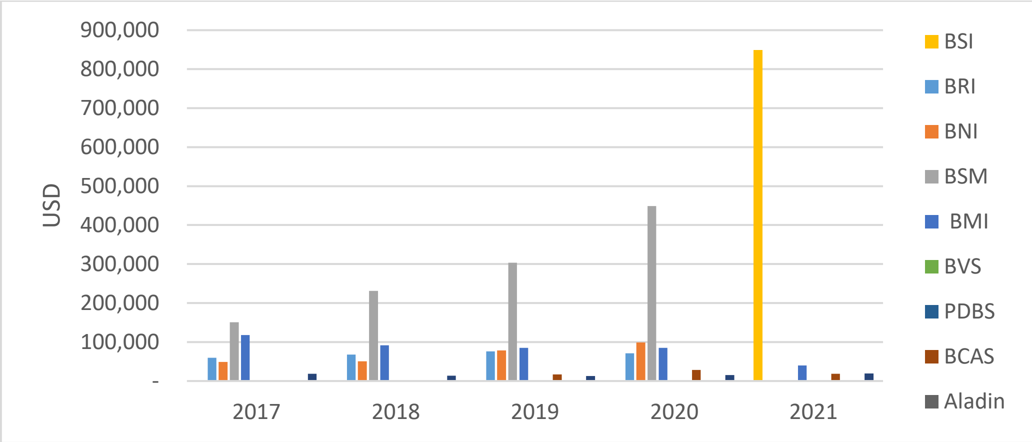

Figure 1.5: *Musharakah* Financing to the Construction Segment

The third research problem is related to the discussion in Section 1.2.2, that Islamic bank financing in Indonesia is mostly for the retail sector, not for the corporate sector. This strategy is not in line with the government focus on construction.

As shown in Figure 1.5 above, based on information from the annual reports of the Islamic banks, in 2017–2020, only four banks provided a significant financing value to contractors using *musharakah*. The other Islamic banks did not provide any financing to contractors.

Contractor's works are unique and requires coordination between multiple parties and resources, such as material suppliers, manpower management, equipment optimisation, as well as cooperation with consultants to construct the project with the predetermined specifications (Tang, 2015). The uniqueness of the contractor is similar to the principle of *musharakah* contract. *Musharakah*, translated as joint venture partnership, combines the various resources of Islamic banks. They not only provide funds but also their management expertise to create a successful project venture (AAOIFI, 2017). *Musharakah* is one of the most common forms of Islamic financing contracts across the world (Moriguchi et al., 2016). However, it is not a preferred contract in Indonesia (OJK, 2021b). At the global level, *musharakah* is only used in less than 6 percent of financing offered by Islamic banks (Hakeem, 2019). *Musharakah* is constrained by some challenges, such as high risk and difficulty in selecting a good partner (A. A. Rahman & Nor, 2016). The success of *musharakah* is also influenced by the competence of Islamic bank employees (Nugraheni & Alimin, 2020).

The use of *musharakah* contract to finance contractors would support the growth of Islamic banks by enhancing their competitive advantages. It would also attract, infrastructure contractors, a target segment that has eluded many Islamic banks. *Musharakah* contract will also increase the banks' share of corporate customers.

1.4 Research Questions

This study aims to explore the current practices of Islamic banks in providing financing to the construction segment, in particular infrastructure contractors, and to propose improvements that can increase Islamic banking's share of the segment using the *musharakah* contract. To accomplish these objectives, the study attempts to answer the following research questions:

1. How are current practices and approaches of Islamic banks in Indonesia to finance construction companies, in particular infrastructure contractors?
2. Why financing from Islamic banks to infrastructure contractors are at the low portion in Indonesian banks?
3. How appropriate is the *musharakah* contract to fulfil the financing needs of infrastructure contractors?

1.5 Research Aims and Objectives

The study aims to support the Indonesian government to promote the strategic growth of Islamic banking as indicated by the Islamic Banking Roadmap and Islamic

Economy Masterplan. Islamic banking, despite already operating for more than 30 years in Indonesia, remains an emerging industry, unable to compete with its conventional counterpart.

Islamic banks have now before them a valuable opportunity to increase its market share in the construction segment. The present presidential cabinet has identified infrastructure construction as one of its major policies. To exploit this opportunity, Islamic banks must be able to provide solutions to the financing needs arising from this policy direction. Therefore, this study attempts to investigate why Islamic banks in Indonesia have not been able to satisfactorily capture the construction segment and to propose the appropriate approach to attract more clients from the segment. These objectives are:

1. To investigate the current practices of Islamic banks in Indonesia to finance construction companies, in particular infrastructure contractors.
2. To examine the reasons for the low share of financing from Islamic banks in Indonesia to infrastructure contractors.
3. To examine the appropriateness of *musharakah* contract to fulfil the financing needs of infrastructure contractors.

1.6 Scope and Limitations of the Study

There are three types of Islamic banks in Indonesia: Islamic Commercial Banks (BUS), Islamic Business Units (UUS), and Islamic Rural Banks (BPRS). BUS and UUS generally have similar operations, the main difference being their legal form. BUS is a stand-alone corporation, whereas UUS is a division of a conventional bank. UUS is, therefore, a part of a conventional bank and not a separate legal entity. Most Islamic banks in Indonesia are part of conventional banks, formed either as a stand-alone spinoff

(BUS) or a division (UUS). The sole exception is Bank Muamalat Indonesia, the only BUS that is not part of a dual banking system. Islamic Rural Banks (BPRS), on the other hand, are small in both size and scope due to restrictions placed by the law. Such banks may only operate in a single city or province and are not allowed to do cheque transactions. Some Islamic banks are publicly listed, some are state-owned, either by the national or provincial government, and some partner with foreign banks. The study was conducted on 12 banks with unique characteristics.

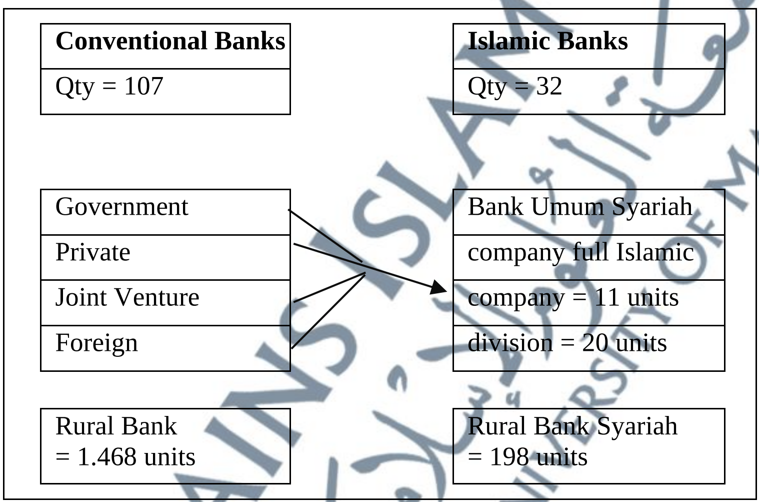

Figure 1.6: Ownership of Islamic Banks

Construction firms in Indonesia can be categorised by specialisation, namely building, infrastructure, and specific construction. There are around 159,000 construction firms in Indonesia. Building contractors work according to the instructions of private or public owners, so there are no standardized specifications or guidelines for construction projects. Infrastructure contractors, on the contrary, work according to the general specifications set by the government. Their works are open to the public, and the completed infrastructure property will be used by the public. Specific contractors are those that carry out specific projects, such as interiors, electrical, hauling, powerhouse, irrigation, and so forth. Only infrastructure works are guided by standards set by the state.

This study focused on Islamic bank financing to construction companies that specialize in road infrastructure, such as national roads and interstate roads. These roads are owned by the government, which is responsible for their upgrade, repairs, and maintenance. There are also other types of roads in Indonesia, such as toll roads, urban roads, and city roads. Toll roads are not directly owned by the government, but they are conceded to private firms. Therefore, toll roads and any particular roads were excluded from the study.

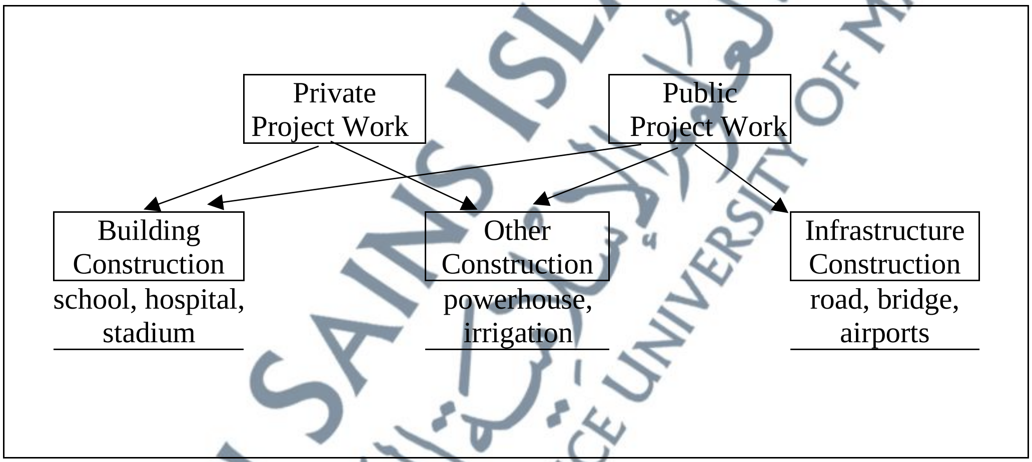

Figure 1.7: Contractors and Projects

The government itself owns construction companies, but these state-owned construction companies would later transform the contract into an EPC (engineering-procurement-construction) project. While these state-owned construction companies are among the largest in the country, they account less than 10 percent of total contractors. Most of their works are subcontracted to medium and small construction companies.

From those contractors, only a few are listed on the stock market. There are only 18 listed construction companies, so only their financial information is publicly available. Only five of those listed contractors, one private and four public, engage in road infrastructure. Even so, the four state-owned firms do not entirely focus their business on road infrastructure. A preliminary review of their financial reports revealed some information relevant to this study. In the notes to the accounts, the companies reported that they have obtained financing from Islamic banks in the form of long and short-term financing, supply chain facility, and L/C facility. Analysed further, some reported that the financing contract is implemented based on the *musharakah* principle. Most state-owned firms declared that the loan originates from a related company (as the banks and contractors are both owned by the government). One of the contracting firms also received syndicated financing from 24 banks, among them Islamic banks, for the construction of toll roads in central Java.

While the Indonesian Stock Exchange (IDX) has a specific category for infrastructure, the companies that belong to this classification are not solely operating in infrastructure construction. Rather, they are also operators of toll roads or properties, besides their main business as contractors for buildings, airports, or seaports.

1.7 Significance of the Study

This study is expected to assist the implementation of the Indonesian Islamic banking and Islamic economy roadmaps by proposing theories, models, practices, and policies related to Islamic banking and construction operations. Theoretically, it will broaden the growing body of knowledge and literature on *musharakah* contract, which has been theoretically identified as a financing solution for contemporary Islamic financial institutions, such as Islamic banks, Islamic capital markets, and takaful (Moriguchi et al., 2016).

The study proposes a *musharakah*-based financing method that Islamic banks can use for infrastructure contractors. Current financing typically comes from the interest-bearing loans of conventional banks, so that the condition is not in accordance with Islamic principles. A contractor may have a limited set of resources that is adequate for some specific quantity of works. However, if it intends to work on larger or more projects, it should obtain additional resources, such as equipment and labour. The contractor needs external financing to procure, rent, or invest in equipment or to hire more labour. Few research has discussed construction financing, Islamic or otherwise (Gundes et al., 2019). In particular, however literature on Islamic construction financing is still limited (Rashid et al., 2019). Therefore, the study aims to fill this gap. It also aims to extend the present policy that regulates financing from Islamic banks to contractors.

1.8 Operational Definitions

The capability of a construction firm is defined by its eligibility to tender for a project, supplemented with previous experience. A medium firm, say Grade 4, may only bid for a project with a maximum valuation of Rp4 billion. If it has no experience in constructing roads, though it has previously built a high-rise building, it may not qualify for large road infrastructure projects. Similarly, a construction firm that has previously built ten kilometres of city road will have to be able to redesign its capability to build a road with the same length in a different location, as they have to able to work with different workers, material suppliers, equipment providers, and construction method.

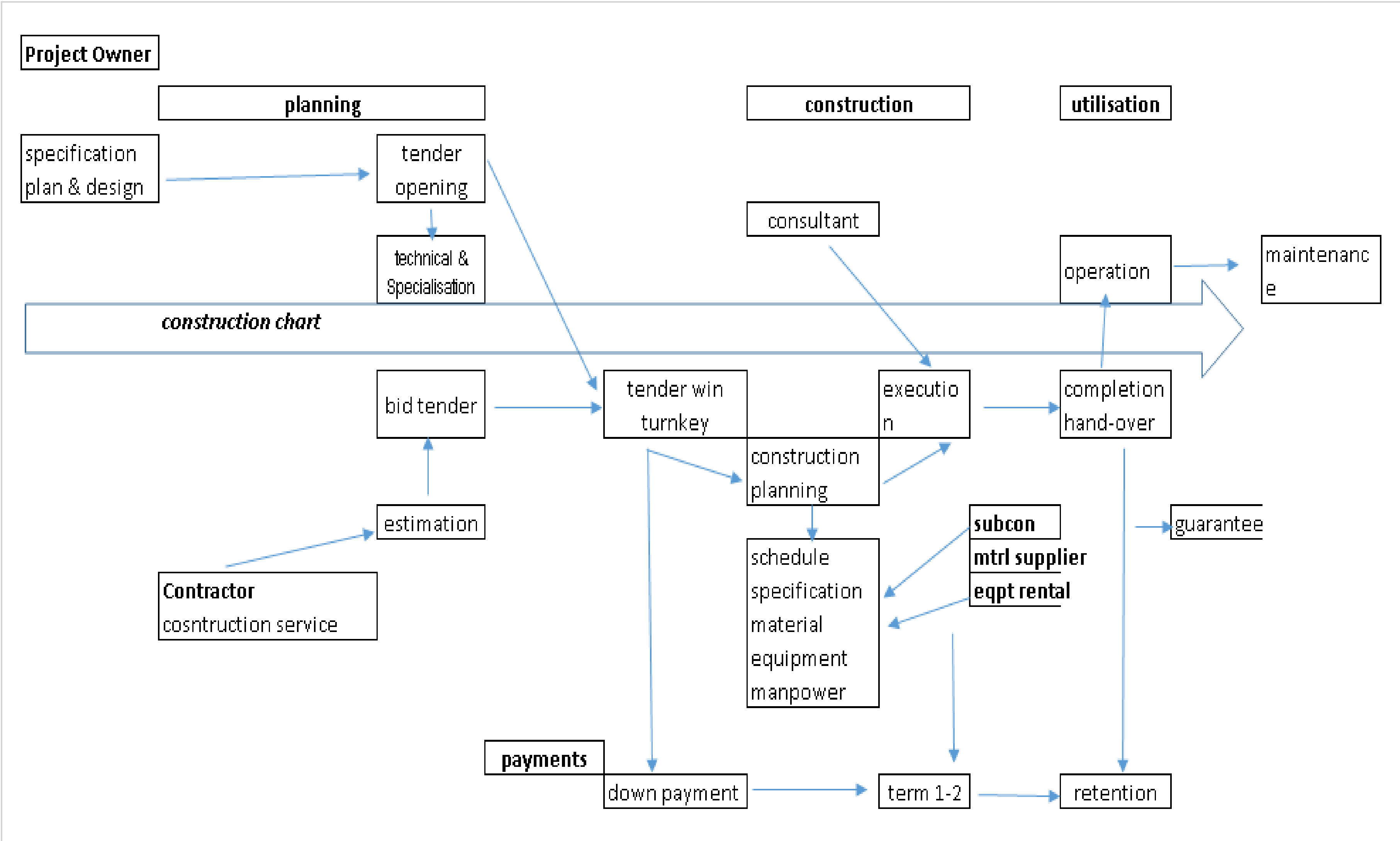

Figure 1.8: Infrastructure Project Flow

Infrastructure construction faces various risks, such as environmental risks, price changes, and assumption changes. Islamic finance encourages risk sharing to foster the equitable distribution of risks, profits, and losses. It also means that the due diligence of an Islamic bank covers not only the credit worthiness of the customer but also the financial viability of the project, so as to enhance transparency and to promote mutual trust and fairness in the dealings (Zawawi et al., 2013). By contrast, conventional finance is typically based on the promise to pay and not tied to the transactions (Bacha et al., 2015).

For construction contracts, payments from the owner or client to the contractor are made periodically. The length of the interval depends on the type of construction contract. For a traditional contract, disbursements are usually on a monthly basis; for a design-and-build lump sum contract, payments are usually made based on the accomplishment of milestones that have been agreed at the time of contract signing (Tang, 2015). Some factors, however, may delay payments to the contractors, causing cash flow deficits (Gundes et al., 2019).

1.9 Conclusions

This chapter has explained the purpose of the study, which is to examine why Indonesian Islamic banks are unable to capture the construction segment and to propose how they may remedy this situation. This chapter has also discussed some issues related to financing faced by Islamic banks in Indonesia and about infrastructure construction business in the country.

Islamic banks in Indonesia have been in operation for 30 years, offering services for retail and corporate customers from all segments, including construction. The construction sector is now growing because the government focuses on infrastructure development, including roads. However, this opportunity has not been captured by Islamic banks properly, and so their share in construction financing remains an insignificant figure relative to conventional banks. Construction, contractor, contract, construction work, construction property, are terminologies that will be used and discussed in this study.