



The Implementation of Islamic Principles in Sharia Financial Institutions

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Article Info	Abstract
<p>Keywords: Financial Institutions, Principles, Sharia.</p> <p>DOI: 10.25041/fiatjustitia.v17no2.2849</p>	<p><i>This study examines Islamic Financial Institutions (IFI), which are currently experiencing rapid growth across Indonesia, with numerous variations emerging, including various Islamic institutions. Operating in accordance with Islamic law, IFI initially provided an alternative for Muslims seeking to avoid the practices of conventional banks and financial institutions; however, they also serve as viable options for non-Muslims. The study addresses the pressing issue of implementing Islamic principles within IFI and explores the necessary conditions for their application. Employing a normative legal approach with case studies, the research highlights the challenges and frameworks surrounding IFI, concluding that IFI organizers must maintain a clear vision that aligns with Islamic principles to ensure their operations remain true to Islamic tenets.</i></p>

A. Introduction

As the country with the largest Muslim population in the world, it is both necessary and inevitable that many Muslims express reservations about engaging with banking institutions that implement usury systems. Muslim communities, often wary of exploitative practices, tend to utilize banking services primarily for the transfer of funds or for activities that require

banking involvement, subsequently withdrawing their funds as soon as their transactional needs are met.

The rise of Islamic banking and financial institutions is notable, illustrated by the emergence of a "dual banking system" that allows conventional banks to establish Islamic law-compliant business divisions. The Islamic financial system is not limited to clients with religious affiliations; rather, it is accessible to all individuals willing to adhere to Islamic law-compliant business practices. Communities require banking organizations that are robust, transparent, equitable, and dedicated to supporting the industries and enterprises of their clients.

Law No. 10 of 1998, which amends Law Number 7 of 1992 concerning banking, represents a significant advancement in the development of the banking sector, particularly in the context of Islamic finance. This legislation affords Islamic finance the same legal protections as conventional banking, thus broadening the opportunities for Islamic banks to expand.

The diversity and proliferation of Islamic banks and financial institutions operating within the dual banking system—where conventional banks establish Islam-compliant units—necessitate extensive and careful oversight of their operations. Islamic banking and financial institutions (*IFI*) were founded on the core principle of adhering to Islamic Regulations, explicitly avoiding the development of interest-bearing products to serve Muslims who are averse to usury, as well as those in the general population who wish to engage in transactions compliant with Islamic regulations. Islamic banking was not established solely to attract public funds; rather, it is characterized by practices distinct from conventional financial institutions. This underscores the importance of regulatory supervision to ensure that Islamic financial institutions continue to operate in accordance with Islamic principles.

The development of products within Islamic financial institutions must adhere to a paradigm distinct from that of conventional banks or financial institutions, which typically rely on interest-bearing loans (usury). Islamic financial products must be developed according to specific characteristics and features that differentiate them from one another.

The second critical factor, following the character and nature of the products, is risk and duration. For instance, the character of a Murabaha product is rooted in the buying and selling of goods, where Islamic financial institutions function as sellers and customers act as buyers. These institutions may require additional guarantees beyond the purchased goods. However, when applying this product to construction financing, it becomes inappropriate, as the items must be tangible goods, rather than projects that lack a concrete form. If applied to the purchase of construction materials, such as stones, sand, and cement, banks may struggle to specify the goods involved.

If a situation arises that necessitates the inclusion of elements that cannot be traded, such as labor, it is essential to utilize another product, namely *Ijarah* (rent). This indicates that *Murabaha* is not suitable for construction financing. In contrast, *Istisna*, another Islamic law-compliant product for buying and selling, may be more appropriate, wherein the bank acts as the buyer of goods to be constructed or manufactured. In this case, Islamic financial institutions make payments in stages to the contractor and subsequently sell the completed project to the debtor.

Supervision of the adherence to Islamic principles within Islamic financial institutions is both urgent and critical, as it lies at the core of their operations. Effective oversight is necessary to detect fraudulent practices or misconduct by corrupt Islamic financial institutions seeking profit, thereby protecting customers and parties engaging in transactions with these institutions.

Islamic Financial Institutions (*IFI*) are not only accountable for calculating profit figures quantitatively; they are also guided by the belief that they will ultimately be responsible to Allah for their operations. *IFI* must consistently uphold their obligations regarding the application of Islamic principles. As practitioners of Islamic finance situated within the broader civilization, it is essential for *IFI* to thrive and evolve in accordance with the rules. Otherwise, as Mulya E. Siregar notes, Islamic banking may not truly embody the Islamic system. According to Siregar, there are no authentic Islamic law-compliant banks, including the Islamic Development Bank (IDB).¹

This research aims to address two primary questions: Why is the application of Islamic principles by Islamic Financial Institutions (*IFI*) considered an urgent issue? What conditions must be met for the effective implementation of these principles by *IFI*?

The study is conducted from a normative legal perspective, focusing on the legal issues surrounding the application of Islamic principles within Islamic financial institutions. It analyzes relevant ideas, legal principles, and regulations. Data is gathered from various sources, including books, legal journals, newspapers, and other pertinent materials. Additionally, legal documents are examined and categorized based on discussions and interpretations related to key concepts relevant to the issues at hand. The analysis is presented qualitatively, employing both deductive and inductive reasoning to arrive at solutions to the identified problems. Furthermore, a case study approach is utilized to provide a comprehensive understanding of the topic.

The novelty of this research lies in its reflection on the application of Islamic principles within Islamic Financial Institutions (*IFI*) and Islamic

¹ Ahmad Fahmil Ulumi, 2020, "Implementasi Hukum Ekonomi Islam Pada Lembaga Keuangan Islam", *Al-Intifa': Jurnal Ilmiah Ilmu Syariah*, Vol 2, No 1, p 30-42

banking. It emphasizes the establishment of a supervisory framework that aligns with the intermediary function, guided by the fatwas of the National Islamic Council. This application is evaluated based on data from the Indonesian Islamic Financial Development Report (IFDR) over a specific timeframe.

B. Discussion

1. The Urgency of Implementing Islamic principles by *IFI* is an Urgent Problem

Islamic Financial Institutions (*IFI*) operating under Islamic principles offer a positive alternative for individuals who are unwilling to engage with conventional banks or institutions that implement interest-based systems, which are viewed as violations of Islamic law. This reluctance stems from a commitment to Islamic concepts that prohibit agreements and contracts containing elements such as *gharar* (uncertainty), *maisir* (gambling), and usury (interest). However, the question arises: Is the application of Islamic principles in *IFI* genuinely aligned with these tenets?

IFI, in conducting *muamalah* transactions, is founded on the principle of benefit. Islamic law permits various forms of transactions unless they involve elements of injustice, such as usury, hoarding, or fraud, or if they are likely to incite disputes or hostility among individuals due to factors like *gharar* or speculation. The primary concern in *muamalah* is the element of benefit. If a transaction leads to beneficial outcomes, it may be permissible. For instance, the *istisna* contract is allowed despite it being classified as a sale and purchase (*bai' al-ma'dûm*), where the object does not exist at the time of the contract, due to the necessity and benefit it provides to the community,² provided it does not generate disputes and aligns with societal practices.²

As an *IFI*, adherence to Islamic principles is imperative. Financial transactions and practices within *IFI* or Islamic banks should not be executed as mere strategies to circumvent the prohibition of *usury*, *maisir*, and *gharar*. The objective of an *IFI* should extend beyond merely generating profits; it should encompass the broader intent of fulfilling the financial needs of its customers while remaining true to the Islamic principles. Even though customers may approach *IFI* or Islamic banks primarily for cash to meet their needs, the institution's operations must prioritize compliance with Islamic law to uphold its integrity and purpose.³

² Neni Sri Imaniyati, 2011, "Pengaruh Perbankan Syariah Terhadap Hukum Perbankan Nasional", *Fakultas Hukum Universitas Islam Bandung, Syiar Madani*, Vo.4, No. 1, p. 205

³ Dudi Badruzaman, 2019, "Implementasi Hukum Ekonomi Syari'ah Pada Lembaga Keuangan Syariah", *Jurnal Ekonomi Syariah dan Bisnis*, Vol. 2, No. 2, p. 82.

Currently, Islamic Financial Institutions (*IFI*) or Islamic banks often do not engage in the direct purchase of goods; instead, they provide cash under contracts that imply the intention to acquire goods as specified by the debtor. Once the funds are disbursed, there is typically no oversight to ensure that the money has been used to purchase the proposed goods. This practice suggests that *IFI* may be employing *Hilah* (legal stratagems) or engaging in deceptive practices that appear to comply with Islamic Law but effectively involve usury. Such actions indicate a failure by *IFI* and Islamic banks to adhere to the Islamic principles that should govern their operations.

From their inception, *IFI* was designed to serve as intermediaries between fund owners and those in need of financing, facilitating mutually beneficial interactions and economic synergies. Thus, the profit and loss sharing (PLS) system is regarded as the optimal mechanism for aligning the interests of both parties, grounded in the values of empathy and humanism. However, when the PLS system is implemented within the context of *IFI* institutional financing, several challenges arise that lead to a reluctance to allocate a significant portion of asset portfolios to PLS financing.

Moreover, *IFI* have yet to fully develop an agreement system that promotes equity partnerships with customers while maintaining adequate cost monitoring and addressing moral hazard issues that may occur due to asymmetric information regarding operating profits. The necessity for rigorous oversight of *IFI* operations has fostered the perception that the moral standards prevalent in the Muslim community inhibit the use of profit-sharing as a viable investment mechanism. It is crucial to recognize that intensive supervision should not be construed as restrictive; rather, it should be viewed as a supportive role played by *IFI* in assisting their debtors to develop their businesses. Ultimately, under a PLS framework, if a debtor experiences bankruptcy or financial loss, *IFI* will also incur losses.

The role of *IFI* is to provide financial instruments that align with Islamic principles and regulations. However, these efforts are often hindered by existing banking regulations that inadequately accommodate *IFI* operations, particularly given the differences in operational implementations between *IFI* and conventional financial institutions.⁴

2. Conditions of Application of Islamic principles by Islamic Financial Institutions (*IFI*)

The Indonesian Islamic Financial Development Report (IFDR) exemplifies the Financial Services Authority's commitment to fostering the growth of the Islamic finance industry. This report provides comprehensive information regarding the development of Islamic finance throughout the year and the various factors influencing it.

⁴ Zainuddin Ali, *Hukum Ekonomi Syariah*, (Jakarta: Sinar Grafika, 2003).

The IFDR outlines the implementation of the IFSA's responsibilities across three sectors of Islamic finance: Islamic banking, Islamic non-bank finance, and the Islamic capital market. It details industry performance, policy development, and progress toward achieving the Islamic finance roadmap. Furthermore, the report highlights the steps taken by the IFSA to enhance literacy in the Sharia financial services sector among all societal elements, as well as Indonesia's active involvement in international Sharia financial activities. The report concludes with an overview of the prospects and strategic policy plans of the IFSA for each Islamic finance sector.⁵

To date, the IFDR remains the sole report providing comprehensive insights into the development of Islamic finance in Indonesia. Its contributors include internal personnel from the IFSA and representatives from institutions related to Islamic finance, such as the Department of Economics and Islamic Finance of Bank Indonesia and the Directorate General of Financing and Risk Management (*DJPPR*) of the Ministry of Finance.⁶

Despite being a key component of the Islamic finance sector, Islamic banking in Indonesia has not fully adhered to Islamic principles. The banking sector, driven by capitalist competition, often prioritizes profit maximization over the welfare of its customers, contravening Islamic economic principles. As a result, some Islamic banks have been accused of pursuing profits while engaging in usurious practices.

Foreign banks are increasingly establishing Islamic Banks branches in Indonesia due to the potential for significant profits. To prevent compromising the principles of Islamic economics, it is essential for all stakeholders—including scholars, economists, and banks—to engage in dialogue regarding the challenges faced by Islamic banking.⁷

A critical principle in the application of Islamic Law is gradualness (*tadarruj*). According to this principle, there are two conditions: First, if the Islamic aspect can be implemented simultaneously, it should be applied as such. Conversely, if simultaneous application is not feasible, gradual implementation is permissible under Islamic law.

The principle of gradualness is evident in the da'wah (missionary work) of the Prophet Muhammad, particularly in the gradual prohibition of *khamr* (alcohol) and usury in the Qur'an. This concept is echoed in the advice of Umar bin Abdul Aziz to his son: "O my son! Don't be in a hurry! Verily, Allah has removed the prohibition of *khamr* in the Qur'an twice before

⁵ Yusman Alim Djasmin Maku, 2017, "Penerapan Prinsip-Prinsip Tentang Perbankan Syariah Hubungannya Dengan Otoritas Jasa Keuangan", *Lex Crimen*, Vol. 7, No. 1, p. 40.

⁶ Muhamad Rifky Fernanda, 2020, "Penerapan Prinsip Syariah di Lembaga Keuangan Syariah", *Aktualitas Jurnal Hukum*, Vol. 3, No. 1, p. 85.

⁷ Maulana, Hafiih, 2014, "Implikasi Kewenangan Dewan Pengawas Syariah Terhadap Sistem Pengawasan di Bank Aceh Syariah", *SHARE: Jurnal Ekonomi dan Keuangan Islam*, Vol. 3, No. 1. p. 11.

prohibiting it for the third time. I fear that if I invite people to the truth all at once, they will reject it completely and it will lead to discord."⁸

3. Institutional Problems of Islamic principles Compliance Supervisor

As institutions fulfilling intermediary functions, Islamic Financial Institutions (*IFI*) must effectively engage in these roles to achieve the objectives of economic activity as *rahmatan lil 'alamin* (a blessing for all creation). The intermediary function transcends merely connecting individuals with excess funds to those in need of financing; it embodies a partnership aimed at enhancing welfare.⁹ In this context, the roles of fund depositors and *IFI* are not hierarchically superior to those of fund-seekers; rather, all three parties constitute a cooperative chain characterized by interdependence and equality. This principle of equality among stakeholders, known as *al-musawah*, fundamentally differentiates *IFI* from conventional financial institutions.¹⁰

In terms of adherence to Islamic principles, institutional challenges, particularly in monitoring, contribute to the ineffectiveness of compliance. The legal framework mandates that every *IFI*, whether structured as a Limited Liability Company (PT) or a cooperative, must establish at least three Islamic Supervisory Committees (ISC). This committee is tasked with overseeing all Islamic Law-compliant activities and transactions conducted by the *IFI*. Relevant legal provisions, including Article 32 of the Islamic Banking Law, Article 109 of Law Number 40 of 2007 concerning Limited Liability Companies, and Decree Number 16/Per/M.KUM/IX/2015 regarding the implementation of Savings and Loans Business Activities and Islamic Financing by Cooperatives, necessitate the presence of ISC in each *IFI*.¹¹

The role of the ISC in the administration of *IFI* parallels that of the *hisbah* in traditional or classical Muslim societies. Both institutions share similar goals and functions, striving to promote community *muamalah* activities in alignment with Islamic principles.¹² In contemporary Muslim society, the ISC or *muhtasib* is required to perform advisory roles and

⁸ Rahmat Ilyas, 2021, "Peran Dewan Pengawas Syariah Dalam Perbankan Syariah", *JPS (Jurnal Perbankan Syariah)*, Vol. 2, No. 1, p. 46

⁹ Kasim, Nawal Binti, Shahul Hameed Mohamad Ibrahim dan Maliah Sulaiman, 2009, "Shariah Auditing in Islamic Financial Institutions: Exploring the Gap between the "Desired" and the "Actual"", *Global Economy & Finance Journal*, Vol. 2 No. 2, p. 130.

¹⁰ Bagya Agung Prabowo, Jasri Bin Jamal, 2017, "Peranan Dewan Pengawas Syariah terhadap Praktik Kepatuhan Syariah dalam Perbankan Syariah di Indonesia", *Jurnal Hukum Ius Quia Iustum*, Vol. 4, No. 1

¹¹ Nelli Fitra, 2015, "Problematika Kiprah Dewan Pengawas Syariah (DPS) di Perbankan Syariah", *Jurnal Al-Masharif*, Vol. 3, No. 1, p. 85.

¹² Irwan Misbach, 2015, "Kedudukan Dan Fungsi Dewan Pengawas Syariah Dalam Mengawasi Transaksi Lembaga Keuangan Syariah Di Indonesia", *Jurnal Minds: Manajemen Ide Dan Inspirasi*, Vol.2, No. 1, p. 83.

supervise activities to ensure compliance with Islamic Law. This underscores the significance of the ISC as a crucial component of governance within *IFI*, enabling them to conduct operations in accordance with Islamic principles.¹³ The role of the Islamic Supervisory Committee (ISC) is pivotal in the operations of an Islamic Financial Institution (*IFI*), yet it often proves to be ineffective. The authority and functions of the ISC are delineated in Bank Indonesia Regulation Number 6/24/PBI/2004, which designates the ISC as an internal supervisory body for the *IFI*. Within the organizational structure of an *IFI*, the ISC holds a position that is coordinative with that of the *IFI* directors. Consequently, the ISC possesses the right and authority to offer advice and input regarding the activities and transactions of the *IFI*, ensuring their compliance with Islamic principles. However, this equal positioning carries implications: the ISC operates under the oversight of the Board of Commissioners and the Shareholders, complicating its ability to effectively fulfill its advisory and supervisory roles. The ISC's considerations and recommendations must align with the interests of shareholders and the board of commissioners, which often prioritize profit maximization. This situation can lead to the ISC being perceived as merely a participant in fulfilling the interests of other stakeholders rather than an independent supervisory body.¹⁴

Additionally, another challenge in the administrative oversight of the *IFI* arises from the practice of permitting members of the National Islamic Council - Indonesian Ulema Council (NIC-MUI) to serve on the ISC. This dual membership creates a conflict of interest regarding the managerial functions of these individuals. While the DSN-MUI serves as an external monitoring authority for the *IFI*, the ISC's oversight role is more internal. This can result in biased outcomes, as the dual role may compromise the independence of both supervisory entities. According to PBI Number 6/24/PBI/2004, a ISC member at an *IFI* is required to report on the outcomes of monitoring related to the application of Islamic principles to the DSN-MUI as needed. If a member of the DSN-MUI also serves on the ISC, potential conflicts of interest may arise in the reporting process, undermining the integrity of the findings.

Furthermore, research conducted by Wafik and Pallegriani on the role of ISC in Islamic institutions worldwide indicates that one of the significant challenges faced by ISC members is their lack of autonomy in expressing their opinions.¹⁵

¹³ Minarni, 2013 "Konsep Pengawasan, Kerangka Audit Syariah dan tata Kelola Lembaga Keuangan Syariah", *Jurnal Ekonomi Islam La Riba*, Vol. 7, No. 1, p. 30.

¹⁴ Taufik Kurrohman, 2017, "Peran Dewan Pengawas Syariah Terhadap Syariah Compliance Pada Perbankan Syariah", *Surya Kencana Satu: Dinamika Masalah Hukum dan Keadilan*, Vol. 8, No. 2, p. 53.

¹⁵ Akhmad Faozan, 2014, "Optimalisasi Peran Dewan Pengawas Syariah pada Lembaga Keuangan Syariah" *el-JIZYA*, vol 2, No 1, p 38

C. Conclusion

The application of Islamic principles within Islamic Financial Institutions (*IFI*) and Islamic banking is imperative. To facilitate the implementation of Islamic Law, a supervisory framework has been established, guided by the fatwas issued by the National Islamic Council. While certain laws and regulations have supported these objectives, there remain significant gaps in regulatory compliance. Discrepancies persist in banking practices and *IFI* operations that fail to align with the fatwas of the DSN or do not adhere to Islamic principles, necessitating rectification. Furthermore, some *IFI* engage in *hilah*—strategic legal maneuvers designed to circumvent the prohibition of usury.

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