

# **SHARÔÑAH COMPLIANCE OF ISLAMIC BANKING: A COMPARISON BETWEEN MALAYSIA AND INDONESIA**

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## **ABSTRACT**

*Islamic banking, different from its conventional counterpart, faces two pressures; obligatory duty to satisfy prudential aspect in one side, and Shari'ah compliance in other side. This is, for sure is as one among proofs that Islamic banking is one step ahead from that of conventional, it is a banking system which emerged with certain kind of a built-in ethical values, namely religious values. Though from skeptical view this is often seen as "a double burden" as compared to that of conventional which merely needs prudential requirements, however from a different perspective, this is a distinction of Islamic financial system. Corollary from what has been said, Shari'ah compliance is a 'condition sine qua non' for Islamic banking. Regulation on Shari'ah compliance is the only available legal tool to ascertain that the practice Islamic banking is always in line with Islamic principles. Hence, the search and review toward the legal framework of Shari'ah compliance is of a vital importance. Malaysia, as a pioneer in Islamic banking in Southeast Asia region is an interesting case of an experience, whilst Islamic banking in Indonesia which started a decade afterwards is also a promising player. Both countries share in the affiliation to Shafi'i madhhab and indeed, are Malay dominated population and therefore they share in some traditional backgrounds. Thus, the search on how Shari'ah compliance is regulated in the both is a matter of necessity. Through comparative perspective, the strengths and weaknesses of the regulation will be identified. The research discovers that regulation on Shari'ah compliance, in both countries, emphasizes at least three aspects: firstly, conditions as stated in the definition, secondly, application for a license, and thirdly, the operation of the bank. Whilst in the two aspects, namely application for license and the operational aspect of the bank are almost the same for both, in definition, slight differences apparent. Indeed, the types of contract offered in Islamic banking business are also pose some differences.*

## **Introduction**

It is generally understood that *Shari'ah* compliance is a condition whereby the whole aspects of Islamic bank are fully conducted based on *Shari'ah* principles. In contrast to this, the unparallel between the operation of the bank and the *Shari'ah* principles is deemed as

incompliance towards Shari'ah.<sup>1</sup> *Shari'ah* compliance, indeed, is a holistic coverage on both; product and operation of Islamic banking. Hence, to acquaint the problem properly, there should be a discussion on regulations issued pertaining to the implementation of Islamic principles in banking. Another important aspect to measure such compliance also noticeable on what contracts employed in banking business are. Though *Shari'ah* compliance depends mainly on the regulation in each particular bank or particular country, the incompliance, mostly leads to the termination of the operation of the bank.<sup>2</sup>

To view in detail how this aspect is regulated in Malaysia and Indonesia, it is obviously demanding to analyze the existing regulatory framework which consists of various acts and regulations as well as guidelines.

### ***Shari'ah* Compliance of Islamic Banking in Malaysia**

Based on the study undertaken towards the standing regulatory framework, there are three main areas whereby the regulation on *Shari'ah* compliance apparent, *first* in the definition, *second*, in the license requirements, and *the last*, in the principles of the operation of Islamic banking.

*First*, the definition on Islamic bank and Islamic banking business. Islamic Banking Act (IBA) 1983, as the most primary regulation in Islamic banking, clearly indicates that Islamic bank is, “any company which carries on Islamic banking business and hold a valid license; and all the offices and branches in Malaysia of such a bank shall be deemed to be one bank”.<sup>3</sup> This definition conveys an important message, that to be an Islamic bank, a financial institution must hold a license. In proposing for such license, respective institution must satisfy a set of requirements, one among those is which is specifically directed to ensure that the applicant is ready to comply to Islamic principles. This is, for sure, demonstrates that the power to grant a license is tantamount to an effective tool to endorse *Shari'ah* compliance for Islamic banking.

Apart from the definition of Islamic bank, “Islamic banking business” is another key word. The definition of Islamic banking business as, “banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam”<sup>4</sup> performs an important propose. This definition obviously a clear-cut limitation, which indicates that the bank has no chance to conduct any business which contradicts to Islamic tenets. In sum, the provision highlights significantly that the bank must conduct business in such a way that is always in line with Islamic principles. Though the definition

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<sup>1</sup> *SharĒĤah* compliance can be formulated in various definitions, such as, “the condition in which activities of a financial institution are in line with *SharĒĤah*”. Differently, it is also possible account it as “the submission of the totality of activities of Islamic financial institution unto *al-SharĒĤah al-IslĒmiyyah*.” QaĤĤĒn, MoĤd. AmĒn ĤAlĒ, *al-RiqĒbah al-SharĤiyyah fĒ MuassasĒt ŐinĒĤah al-KhudamĒt al-MĒliyyah al-IslĒmiyyah, DirĒsah SharĤiyyah TaĤbĒqiyyah*, (Al-Qahirah: DĒr al-NahĤah al-ĤArabiiyyah, 2004), 12-13

<sup>2</sup> The termination of the operation of the bank in the failure of *sharĒĤah* compliance is also recognized in Malaysia (such as what can be inferred from Islamic Banking Act [IBA] 1983 section 4 and 11 (1) and Indonesia (such as what can be inferred from Act Number 7 of 1992 on Banking as amended by Act Number 10 of 1998, section 52 and, Bank Indonesia Regulation Number: 6/24/PBI/2004 on Commercial Banks Conducting Business Based on *SharĒĤah* Principles as amended by Bank Indonesia Regulation Number: 7/35/PBI/2005, section 3[6] and section 77).

<sup>3</sup> Islamic Banking Act (IBA) 1983 section 2.

<sup>4</sup> IBA 1983 section 2

is designated for Islamic bank, however, conventional bank which offers Islamic banking business is also subject of the similar limitation since this definition is then adopted into the amendment of Banking and Financial Institutions Act (BAFIA)1989.<sup>5</sup>

Obvious from what has been asserted above, the definition as provided by the existing legal framework is a proper way to ascertain that the proposed Islamic bank, or any institution which aims to conducting Islamic banking business must in clear position that it is going to be compliant with Islamic tenets.

*Second*, license requirement. The act (IBA 1983), particularly in chapter 3 section (5), emphasizes two requirements which the proposal for a license must meet. Beside must be a fair statement that aims and operation of the institutions does not involve any element which is not approved by Islamic tenets, there also must be an established *Shari'ah* advisory body within the institution.<sup>6</sup>

The declaration pertaining to the aims and operation has laid down a strong foundation which will close any loophole for Islamic banking institution to breach Islamic principles in its business. This implies that such institution will never be able to change the operation, say, to be an institution offering interest-based business, for instance. Whereas the establishment of the *Shari'ah* Advisory Board (SAB), is just a logical consequence from the previous statement. This because, the aims and operation will be hardly possible to be maintained unless there is a special body which is assigned to resolve *Shari'ah* related issues.

At the early times of the operation of Islamic banking, such provision leaves question in regards to the source of *fatwÉ* from which the SAB may refer. Indeed, this also let the board in difficulties when conflict of laws is arising, how it can be maintained and harmonized. The problem, then only attained a clear position after the amendment of Central Bank Act of Malaysia 1958. Pertaining to *Shari'ah* Advisory Council (SAC), the act gives relatively exhaustive provisions. Section 16B states:

“The Bank may establish a *Shari'ah* Advisory Council, which shall be the authority for ascertainment of Islamic law for the purposes of Islamic banking business, *takÉful* business, Islamic financial business, Islamic development financial business, or any other business which is based on *Shari'ah* principles and is supervised and regulated by the Bank.”<sup>7</sup>

Apparent from the provision, that *Shari'ah* Advisory Council, different from *Shari'ah* Advisory Board, plays a national level roles in matters related to Islamic financial business. It is, indeed holds the higher level of authority to control all of decisions/ *fatwÉs* issued by all of banks conducting business based on Islamic principles.

More importantly, this body is granted a broad authority which includes the control over *fatwÉs* or decisions in *Shari'ah* matters over *takÉful* (Islamic insurance). So, it just makes sense if the requirements for the proposed members are tightly regulated.<sup>8</sup> Capital

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<sup>5</sup> Banking and Financial Institutions Act (BAFIA)1989, section 124 (7)

<sup>6</sup> IBA 1983 section 3.

<sup>7</sup> Central Bank Act (CBA) 1958, section 16B(1).

<sup>8</sup> The Central Bank, pursuant to the previous acts and regulation, has issued BNM/GPS1 *Guidelines on the Governance of SharÉÑah Committee for Islamic Financial Institutions*, December 2004.

market, is not ambit within this council, there is a such body which deals with the *Shari'ah* compliance of the capital market under Securities Commission.<sup>9</sup>

Considering such duties and responsibilities, in short, the implementation of *Shari'ah* compliance of Islamic banks and other licensed financial institutions carrying Islamic banking business lies significantly on *Shari'ah* Advisory Council. The availability of *Shari'ah* Advisory Board in each banking industry performs as a complementary instrument of the huge role of *Shari'ah* Advisory Council.

*Third*, operation of the bank. The existing legal framework also pays high attention on the operation of the bank. The act states that to ensure the business and operation are in line with the principles of Islam, “an Islamic bank may seek the advice of *Shari'ah* advisory council on *Shari'ah* matters relating to its banking business and the Islamic bank shall comply with the advice of *Shari'ah* Advisory Council”<sup>10</sup>. For conventional banks offering Islamic banking business, Banking and Financial Institutions Act 1989 provides, “Any licensed institution carrying on Islamic banking business, in addition to its existing licensed business may, from time to time to seek the advice of *Shari'ah* Advisory Council.....”<sup>11</sup>

There are, based on the asserted regulation, two main points highlighted. *Firstly*, the obligatory requirement for Islamic bank and any other licensed financial institutions conducting Islamic banking business to always maintain *Shari'ah* compliance in the operation. *Secondly*, there is an equal treatment for both Islamic banks and conventional banks opening *Shari'ah* window (Islamic Banking Division) in regards of the implementation of *Shari'ah* principles in the products and operation. It is clear that the different character between these two types of Islamic banking business is not an excuse for being treated differently, regardless of the difficulties that may be faced by one are higher than another.

Based on what is previously observed, regulation of *Shari'ah* compliance is clearly provided in few acts, namely, Islamic Banking Act of 1983, Bank and Financials Institutions Act 1989 and also the Central Bank of Malaysia Act 1958. The provisions, as far as these are concerned, addressing various issues and aspects of *Shari'ah* compliance, at least in three areas presented in above discussion, notably, definition/terminology, licensing process, and operation. These, in turn, play consecutively to gradually ascertain *Shari'ah* compliance.

Having said this, it is important to acquaint Islamic contracts used in Islamic banking business in Malaysia, as this is clearly urgent to be able to understand what is the position of such contracts in Islamic law. In addition to that, this also closely relates to the issue of *Shari'ah* compliance.

### **Financial Business Contracts Applicable in Islamic Banking in Malaysia**

For the sake of practical operation in Islamic banking business, the existing legal framework provides a number of *Mu'amalah* contracts applicable in such business. It is due

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<sup>9</sup> Securities Commission, *List of Securities Approved by Shar'ah Advisory Council of the Securities Commission* (Kuala Lumpur: Securities Commission, 2004), 17-20.

<sup>10</sup> IBA 1983 section 13A(1)

<sup>11</sup> BAFIA 1989, section 124(3)

to the issuance of *Skim Perbankan Tanpa Faedah* (Interest Free Banking Scheme) in 1993, then these various contracts found their legal definitions. The contracts, which are as much as 17 (seventeen) are enumerated as follow:<sup>12</sup> *Wad'Énah Yad al-ÖamÉnah* (savings with guarantee), *Mu'Érabah* (profit sharing), *MushÉrakah* (joint venture), *MurÉba'ah/ Bay' bi Thaman Ójil* "The (sale with cost and profit margin/ deferred payment sale), *BayÑ al-dayn* (debt-trading), *IjÉrah* (leasing), *IjÉrah thumma Bay'* (leasing and subsequent purchase), *Qar' al-×asan* (benevolent loan), *BayÑ Salam* (future delivery), *BayÑ al-IstijrÉr* (supply contract), *KafÉlah* (guarantee), *Rahn* (collateralized borrowing), *WakÉlah* (nominating another person to act), *Al-×iwÉlah* (remittance), *Al-Øharf* (foreign exchange), *Ujr* (fee), *HÉbah* (gift).

When these financial business contracts are measured through the *Mu'amalah* contracts, these pose major resemblances, as all of the contracts are not alien in *Mu'amalah* contracts. These are common contracts which were well recognized in the classical practices in Islamic world.

It is however, discussions remained directed, among other contracts, to *bayÑ al-NÉnah* and *bayÑ al-dayn*. Pertaining to *bayÑ al-dayn*, this mostly matter of different opinion on the permissibility rather than the difference of the terminological aspect. Malaysia, in case of *bayÑ al-dayn* and *bayÑ al-NÉnah*, inclines to the opinion of ShÉfiÑÉs. Historically, this just in conform with the Islamic legal tradition background in the country. Traditionally, Malaysia, as a part of Islamic world in Southeast Asia, is belong to ShÉfiÑÉ *madhhab* (school of law). The text of Malacca, Kelantan, an Pahang shows the proximity of the legal digest with the ShafiÑÉ *madhhab*.<sup>13</sup> Despite *madhhab* affiliation, it seems that this is also the common problem in the area of *ijtihÉd*, that scholars may be in disagreement on certain opinions based on certain reasons. This is as the nature of *ijtihÉd* itself as appear in the terminology of *ijtihÉd*.<sup>14</sup>

Considering reasons in the above, it is clear that Malaysian's view is as part of the problems of legal choice. Nevertheless, if Malaysia want to market its financial products globally, the wide gap between Malaysian scholars legal opinion and that of the Middle Eastern must be bridged through further consensus with authoritative method of *tarjÉl*.<sup>15</sup>

Apart from the effort to bring the opinion to be in conform with the Middle Eastern, in relation to minimizing conflict or disagreement (*ikhtilÉf*) among members of *Shari'ah* Supervisory Boards, AAOFI (Accounting and Auditing Organization for Islamic Financial Institutions) should initiate for a proposal to pave the way for future harmonization.<sup>16</sup>

### **Shari'ah Compliance of Islamic Banking in Indonesia**

Different from Malaysia, Indonesia does not have a specific act governing Islamic banking business. Regulatory framework pertaining to this business is comprising an Act on

<sup>12</sup> *Guidelines on Skim Perbankan Tanpa Faedah* (SPTF) 1993, Bank Negara Malaysia 1993, 3-6

<sup>13</sup> Hooker, M.B. *Islamic Law in Southeast Asia*. (Singapore: Oxford University Press, 1984), 9

<sup>14</sup> As quoted in, Mohd. Daud Bakar, "The *SharÉna* Supervisory Board and Issues of *SharÉna* Rulings and Their Harmonisation in Islamic Banking and Finance" in *Euromoney Books; Islamic Finance, Innovation and Growth* (London: First Islamic Investment Bank), 83.

<sup>15</sup> Adawiah, Engku Rabiah, "Development of Islamic Banking in Malaysia; Constraints and Opportunities from the Jurisprudential Perspective", *IJUM Law Journal*, Vol.11 no.2, 2003, 251.

<sup>16</sup> Bakar, "The *SharÉna* Supervisory", 83, 87-88.

Banking and some Bank Indonesia Regulations. Similar to the previous discussion on that of Malaysia, from this regulatory framework, three aspects of Islamic banking business will be analyzed, notably, *first* in the definition, *second*, in the license requirements, and *the last*, in the principles of the operation of Islamic banking.

*First*, the definition of Islamic bank. It is important to note that the only act dealing with Islamic banking is Act Number 7 of 1992 on Banking as amended by Act Number 10 of 1998. However, this act does not provide any definition on Islamic (*Shari'ah*) bank.<sup>17</sup> This because, in Indonesia, Islamic bank is regarded and as a part of commercial bank. Differently speaking, commercial bank comprises conventional and Islamic (*Shari'ah*) banks. This is clear from the provision in section 1 (3): “Commercial bank is banks which conduct financial business based on interest system and those which conduct such business based on *Shari'ah* principles which their activity is to provide service as a financial intermediary.”<sup>18</sup>

Further, in relation to Islamic banking business, the definition is given for “*Shari'ah* financing” which is defined as: “a financing agreed by bank and other related parties which rises obligation for the financee to payback the money after certain period of time compounded by certain fee or profit sharing” (section 1[12]).<sup>19</sup> Whereas “*Shari'ah* principle” means, “regulations on agreement derived from Islamic law, between bank and other parties for depositing money, project or other forms of financing, or other transaction which is approved by *Shari'ah*, such as profit and loss sharing (*muḥārabah*), equity participation (*musharakah*), property purchasing (*murābaḥah*), leasing (*ijārah*), or leasing and purchase (*ijārah wa iqtinān*)”.<sup>20</sup>

Based on various stipulations above, Indonesia also recognizes dual banking system. Islamic (*Shari'ah*) bank may take a form as a commercial bank which conducts financial business solely based on *Shari'ah* principles, or conducts financial business based on both, interest system side by side with *Shari'ah* system. In addition to this, the absence of a specific definition on Islamic banking, doesn't mean that *Shari'ah* compliance is less emphasized. This because in order to express “*Shari'ah* principles”, the contracts between bank with customers for any business involved, must be compliant with principles of Islamic law.

It is, however, unfortunate, that the use of two terms, “*Shari'ah* based principles financing”, and “*Shari'ah* principles”, seems to be over wording in explaining the operation and service of Islamic banking. It looks redundant, as the first term is defined with specific emphasis in rewards given to the financier, and the latter, is defined as general Islamic principles applicable in Islamic banking. It is confusing, and hence, need for only a single exhaustive definition.

*Second*, license requirements. It is obvious from Bank Indonesia Regulation Number: 6/24/PBI/, that application for approval (license), requires that letter of application shall be submitted by at least one of the proposed owners to the Governor of Bank Indonesia. The application is enclosing most importantly, draft of incorporation,

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<sup>17</sup> The legal term for ‘Islamic bank’ and ‘Islamic banking’ in Indonesia is ‘*sharīḥah* bank’ and ‘*sharīḥah* banking’.

<sup>18</sup> Act Number 7 of 1992 on Banking as amended by Act Number 10 of 1998, section section 1 (3).

<sup>19</sup> Act Number 7 of 1992 as amended by Act Number 10 of 1998, section 1(12).

<sup>20</sup> Act Number 7 of 1992 as amended by Act Number 10 of 1998, section 1(13).

including draft of articles of association, stating placement (appointment) and duties of the *Shari'ah* Supervisory Board (SSB).<sup>21</sup> It is the governor of Bank Indonesia who holds the authority to grant a license.<sup>22</sup>

In respect to the requirements for Islamic banking, conventional banks intending to open *Shari'ah* division –which enable them to offer Islamic banking business– must propose the application in which there are certain requirements. According to Bank Indonesia Regulation<sup>23</sup>, such application is forwarded to the Governor of Bank of Indonesia, includes attachments, one of which, draft of the amendment to the articles of association, and placement of the *Shari'ah* Supervisory Board and its duties and responsibilities approved by shareholders through a general meeting.<sup>24</sup> Moreover, the specific provision also given to emphasize that every *Shari'ah* Division also must set up a *Shari'ah* Supervisory Board which stands for supervision, which states;”The *Shari'ah* Supervisory Board must be installed within the *Shari'ah* Division.”<sup>25</sup>

*Third*, operation of the bank. In regard to the operational aspect of Islamic banking, there are some interesting features presented by the existing regulatory framework. It is stated clearly that the fulfillment of *Shari'ah* compliance in the operation is a compulsion. The very sound of the obligation Islamic bank to ensure that the business and the whole operation must be compliant to *Shari'ah* is clearly apparent in one of Bank Indonesia Regulations; “Banks are required to apply *Shari'ah* principles and prudential principles in the conduct of their business.....”<sup>26</sup>

The provision shows that the application of *Shari'ah* principles in their business and operation is not only a mandatory, but interestingly, *Shari'ah* compliance is put in parallel manner to the prudential principles. Meaning to say, these two aspects are equally important as the both perform as compulsory element for Islamic banking. The question arise is, if prudential principles is guaranteed by an established supervisory body, then, how is *Shari'ah* principles maintained?.

In this regard, the establishment of *Shari'ah* Supervisory Board seems to be a proportional answer addressing such question. Hence, the availability of this body in ascertaining *Shari'ah* compliance is given affirmation through various provisions of the regulations applicable to Islamic banking business. The very clear of which is in section 27(1.a.) and (1.e.) of Bank Indonesia Regulation Number: 6/24/PBI/2004, as says that the scope of duties, powers, and responsibilities of the *Shari'ah* Supervisory Board includes “ascertain and monitor the compliance of the Bank operations with the *fatwÉs* issued by the National *SharÉÑa* Council” and also “submit a report on the findings of *Shari'ah* supervision no less than every 6 (six) months to the Board of Directors, the Board of

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<sup>21</sup> Bank Indonesia Regulation Number: 6/24/PBI/2004 on Commercial Banks Conducting Business Based On *SharÉÑah* Principles as amended by Bank Indonesia Regulation Number: 7/35/PBI/2005, section 6 (2).

<sup>22</sup> Act section 16

<sup>23</sup> Bank Indonesia Regulation Number: 8/3/PBI/2006 on Conversion of Business of Conventional Commercial Banks to Commercial Banks Conducting Business Based on *SharÉÑa* Principles And Establishment of Bank Offices Conducting Business Based on *SharÉÑa* Principles by Conventional Commercial Banks, section 3.

<sup>24</sup> Bank Indonesia Regulation Number: 8/3/PBI/2006, section 3(1).

<sup>25</sup> Bank Indonesia Regulation Number: 8/3/PBI/2006, section 11(5).

<sup>26</sup> Bank Indonesia Regulation Number: 6/24/PBI/2004, section 3(6).

Commissioners, the National *Shari'ah* Council, and Bank Indonesia".<sup>27</sup> Though such above regulations are applicable for Islamic (*Shari'ah*) banks, however, for conventional banks offering *Shari'ah* banking business (*Shari'ah* window), its regulation on *Shari'ah* compliance does not show any differences.<sup>28</sup>

Corollary to what have been said, even though conventional banks conducting *Shari'ah* banking business fall under different authority of regulation, yet, the nature of regulation for ascertaining *Shari'ah* compliance, particularly in the operation of banking business, doesn't show significant dissimilarity. Section 12 of Bank Indonesia Regulation Number: 8/3/PBI/2006, indeed, renders more clearly this similarity.<sup>29</sup>

In conclusion from the discussions of the operation of Islamic banking, the implementation of *Shari'ah* compliance in the business operation is a compulsory. For this reason, it is just a clear consequence that supervisory body must be incepted in order to maintain such compliance.

Aside from the above provisions which seems to be exhaustive, factually a crucial problem in the process of assurance remained apparent. This due to the problem of the possibility of *fatwÉs* to come into enforcement. *FatwÉ*, so far has been considered for not binding in nature, therefore the problem is arising when a bank undertakes banking business which is proven as contravenes Islamic tenets. To undertake a legal action is hardly possible due to the lack of authority even if the bank proven to perpetrate the *fatwÉs*.

In bridging this gap, the *fatwÉs* issued by National *Shari'ah* Council (NSC) then undergo legislation process, it is then adopted into a legal instrument which is possible for enforcement. As a result, the *fatwÉs* then have been adopted into Bank Indonesia Regulation. Started by issuing Bank Indonesia Regulation Number 7/46/PBI/2005 Concerning Funds Mobilization And Financing Agreements For Banks Conducting Business Based On *SharÉÑa* Principles, though not all of the available *fatwÉs* have been adopted yet, the action to resolve the problem has been started ever since. Through promulgation of this regulation, the implementation of *Shari'ah* compliance is made more possible. The disputes in regard of how a contract is interpreted as well as what *madzhab* should be adhered, is something that needs no any longer consideration.

When the issuance of above asserted regulations is connected to *Blueprint of Islamic Banking in Indonesia*, it is clear that the adoption of *fatwÉs* into Bank Indonesia Regulation Number 7/46/PBI/2005, is a step to move forward for gaining the compliance towards international standards on *Shari'ah* principles. The issuance such regulation is seems to a part of sufficient effort to meet the targets set out by the blueprint.<sup>30</sup>

## **Financial Business Contracts Applicable in Islamic Banking in Indonesia**

Types of contract employed in Islamic banking business are usually similar among Islamic banks elsewhere. Yet, it is no less important to enumerate in detail the types of such thing which is approved by legal framework in Indonesia. In short, hereby various contracts in

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<sup>27</sup> Bank Indonesia Regulation Number: 6/24/PBI/2004, section 27(1.a. and 1e).

<sup>28</sup> Bank Indonesia Regulation Number: 8/3/PBI/2006, section, 40.

<sup>29</sup> Bank Indonesia Regulation Number: 8/3/PBI/2006, section 12.

<sup>30</sup> Bank Indonesia, *The Blueprint of Islamic Banking Development in Indonesia* (Jakarta: 2002), 20-21.



Islamic banking business in Indonesia; *WadiÑah*, *MuÈrabah*, *MushÈrakah MurÈbaÁah*, *IjÈrah*, *QarÈ al-×asan*, *IstishnaÑ*, and *Salam*<sup>31</sup>

Yet, there are some other contracts applicable in Islamic banking in Indonesia which have not received legal definitions yet, the most prominent among them are: *ijÈrah muntahiyah bi al-tamlÈk*<sup>32</sup>, *wakÈlah*, *kafÈlah*, *rahn*, *ujr*. Being not legally defined, the description about the nature and the conditions of such contract lies in the hand of National *Shari'ah* Council and *Shari'ah* Supervisory Board. The lack of legal definition raises problem, not only the danger of misuse, but also the problem in supervision. This because the exact measure (standard) is not fixed and subject to various interpretation. The possibility for *ikhtilÈf* (disagreement) is noticeable.

This fact is compounded by provision that the bank may offer certain products that approvable by both, National *Shari'ah* Council and Bank Indonesia. Thus, as above mentioned list is not final, there is still possibility for other types of contract to be implemented in Islamic banking business in Indonesia. This possibility is also facilitated by an all-inclusive provision, as the section 36 (o) of Bank Indonesia Regulation Number: 6/24/PBI/2004 amended by Bank Indonesia Regulation Number: 7/35/PBI/2005, which states that other contracts may be applied since these are permitted by Bank Indonesia and National *Shari'ah* Board.<sup>33</sup> It is, actually should not be happening in the statement of legal framework, as this will lead to adoption of unlimited number of contracts applied, which may result into difficulties in control and supervision.

Lastly, obvious from the above discussion, the provision of the legal definition of contracts applied is not made in a single regulation. They are spread out in an act, and various Bank Indonesia regulations. This makes the regulation on Islamic banking business, especially in the contracts offered, seems to be complicated.

## Conclusion

The whole discussion on the Framework of *Shari'ah* Compliance of Islamic Banking in Malaysia and Indonesia above exposes some interesting points, both in the form of similarity as well as dissimilarity.

First of all, the regulation on *Shari'ah* compliance in both countries emphasizes at least three aspects: the definition, the application for a license, and in the operation of the bank. Whilst in the two aspects, namely application for license and operational aspect of the bank are almost the same for both, in definition, slight differences apparent.

The existing legal framework in the both perform that the authority to grant a license is as a strategic tool, not only to avoid overcrowded in the number of banking industry, but indeed to ensure that the institution is compliant with *Shari'ah* principles. In Malaysia, authority for granting a license for a bank or a financial institution lies in the hand of the Ministry of Finance through the recommendation of the Central Bank. This differs from Indonesia as the Governor of the Central Bank is responsible for such license.

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<sup>31</sup> Bank Indonesia Regulation Number: 7/46/PBI/2005 Concerning Funds Mobilization And Financing Agreements For Banks Conducting Business Based On *ShariÑah* Principles, section 1(4) – (11).

<sup>32</sup> This term is similar to what is in Malaysian regulations called by *ijÈrah thumma bayÑ*.

<sup>33</sup> Bank Indonesia Regulation Number: 6/24/PBI/2004 amended by Bank Indonesia Regulation Number: 7/35/PBI/2005, section 36 (o).

It is similar in both countries that the application for a license must enclose the provision of aim to conduct banking business in accordance to *Shari'ah* in the article of association. Yet, the article of association also must stipulate the establishment of *Shari'ah* advisory or supervisory board (in the both), or even the duties of such body (in Indonesia).

In the operational aspect of the bank, two supervisory bodies are found in the both. The availability of *Shari'ah* Advisory Board (SAB) and *Shari'ah* Advisory Council (SAC) in Malaysia and *Shari'ah* Supervisory Board (SSB) and National *Shari'ah* Council (NSC) in Indonesia is a proof. Both Islamic bank and conventional bank conducting Islamic banking business, all the same in terms of the compliance to *Shari'ah* principles. Islamic bank business must be ascertained by establishing of such supervisory board in each bank or Islamic (*Shari'ah*) Division. The higher body, with nationally authority, is called as SAC in Malaysia and NSC in Indonesia. Different from Malaysia in which SAC ambit within the Central Bank, in Indonesia is ambit within National *Ulama* Council which has a coordinative relation with the Central Bank. However, the legal framework in the both is still in not clear in regard to the way to ensure that the operation, not mere products, must comply to *Shari'ah* principles.

The regulation in Malaysia defines clearly what Islamic banking and Islamic banking business are. In Indonesia, the exact definition on Islamic (*Shari'ah*) bank is not available, as the regulation constitutes that Islamic bank is only part of the definition of commercial bank, not a separated entity. Thus, Islamic (*Shari'ah*) bank can take a form as a commercial bank which conducts financial business solely based on based on *Shari'ah* principles, or conducts financial business based on both, interest system side by side with *Shari'ah* based system.

Apart from the above, in the both, Islamic contracts applicable are parallel to the general view of the contracts in *fiqh al-Mu'amalah*. However, there are some other contracts applicable in Islamic banking in Indonesia which have not received legal definitions yet, such as *ijÉrah muntahiyah bi al-tamlÉk*, *wakÉlah*, *kafÉlah*, *rahn*. Being not legally defined, the description about the nature and the conditions of such contract lies in the hand of *Shari'ah* Supervisory Board and National *Shari'ah* Council.

Another weakness of the regulation is, indeed, in all-inclusive provisions, as Bank Indonesia Regulation states that other contracts may be applied since are permitted by Bank Indonesia and National *Shari'ah* Board. This is, actually should not be happening in the statement of legal framework, as this will lead to adoption unlimited number of contracts applied, which may result into difficulties in control and supervision.

Lastly, different from Malaysia which regulate the contracts in a single Guidelines from the Central Bank, in Indonesia, the provision of the legal definition of contracts applied is not made in a single regulation, rather, they are spread out in the Acts, and more than one Bank Indonesia regulations. This makes the regulation on Islamic banking business, especially in the contracts offered, seems to be complicated.\*

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