

# Development and Legal Basis of Sharia Banks in Indonesia

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**Abstract-** Indonesia is a dominant Moslem country in the world. This condition makes the Sharia Banking growing easily. As a consequence, the education and socialization processes of the Sharia banking system in this country are done intensively. These processes are expected to increase public awareness and interests to use Sharia banks. However, literatures on the development and the legal basis of Sharia banks in Indonesia have been limited. For this reason, this paper aims at discussing the development and the legal basis of Sharia banks in Indonesia. The method used to discuss is by using secondary sources advance in literature with particular concern on both national and Islamic rules and laws concerning with Sharia banking systems. This study found that the large number of Muslim population in Indonesia have not been well-informed about the development of Sharia banking systems, although National rules and laws to support the development of Sharia Banks have been many. In addition, it was also argued that the development of Sharia banks can be one solution to improve the economic development in Indonesia. However, much remain to be done by the Sharia banks to promote their financial activity to public at large in Indonesia.

**Index terms-** Sharia Banks, Sharia Principles, Islamic laws, economic development

## I. INTRODUCTION

Bank is a very important financial institution in the economy of a country. In general, the Bank is defined as a financial institution in which the main business is collecting funds and channeling it to the community in the form of credit as well as providing services towards public transactions and circulation of money. In addition, Bank is also a financial intermediary institution generally established with the authority to accept deposits of money, lend money, and issue promissory notes or banknotes. The word Bank comes from the Italian word *Banca* which means a money changer. The word *Banca* was popular in the Renaissance era to indicate the need of bankers to sit behind the desks when they do any economic transactions.

According to the Law Number 10 Year 1998 on the Amendment of Law Number 7 of 1992 concerning Banking system, especially in the Article 1 of paragraph (2), a bank is defined as a business entity that collects funds from the public in the form of savings and distributes it to people in the form of credit and or other forms in order to improve the lives of many people. Based on this definition, the bank is a company engaged in the field of finance, meaning that banking activities are always related in the field of finance. The bank can also be considered as a social institution that provides financial services.

In terms of the banking principles, Indonesia has regulated the banking principles. These principles are regulated in the Article 2 of the Act Number 7 of 1992. In this act, it was stated that Indonesian banking when it runs its business should be based on economic democracy by using the principle of prudence. The words economic democracy refer to Pancasila and the 1945 Constitution of the Republic of Indonesia. Whilst the principle of prudence has no explanation formally. But in practice, it can be meant that business activities must be conducted or run by people who have experiences and professionalism in banking activities. For this reason, the principle of prudence is a must in running banking activities. However, in the context of the objectives of Banking in Indonesia, this was regulated in the Article 4 of the Law Number 7 Year 1992, which states that: "Indonesian banking aims to support the implementation of national development in order to improve equity, economic growth and national stability towards the improvement of the welfare of the people".

In terms of the type of Banking it is regulated in the Article 5 paragraph (1) of the Law Number 7 of 1992. In this article it was stated that banking types are divided into two. The first is the Commercial Banks as explained. The commercial Bank is specialize to carry out certain activities or give greater attention for certain activities. The meaning of "carrying out certain activities" is that the banks have objectives to conduct a long term financial activity, financing cooperative development, the development of micro, small and medium enterprises, exporting non oil and gas products, and financing housing development. The second type is the rural bank, that is, banks that are established and serve financial transactions in rural areas

The different between conventional bank and Sharia bank is that the later is managed and organized based on Islamic law. This aspect makes the Sharia bank has advantages in comparison with the conventional banking systems. Sharia bank is implemented based on justice values as outlined in the Islamic teaching. Other differences are that the decisions made are based on the *fatwa* of the National Sharia Council of the Majelis Ulama Indonesia (MUI). In addition to this council, there is another independent institution that participates in Sharia banking activities. This institution is called the Sharia Supervisory Board. This is also an independent institution which has the main function to supervise the bank in compliance to both Islamic and national laws.

This study, by using library research, aims at discussing the development and the legal basis of Sharia Bank in Indonesia. The significant reason why these issues are discussed is partly because literatures that elaborates the development of Sharia Banks in Indonesia are still limited. Also, it is because Sharia bank has not been well understood by many people in this country. However, as a background information, definition and the scope of Sharia Banking system is addressed in section 2. Section 3 highlights the development of Sharia bank and factors caused the development of Sharia bank in Indonesia. Section 4 explores the legal basis of Sharia Bank and the role of the Central bank. Finally, concluding notes are given in section 5.

## II. DEFINITION AND SCOPE OF SHARIA BANK

According to Siamat Dahlam as cited by Djawahir (2012), Sharia bank is a bank that runs a banking business based on the principles of Sharia contained in the Qur'an and Hadith. Whilst Schaik cited in Djawahir (2012) defined Sharia bank as a form of modern bank based on Islamic laws. This type of bank was developed in medieval Islam. This bank is based on the concept of profit sharing for any risks as the main system and abolishing the financial system based on assumption of predetermined profit certainty. Similarly, Sudarsono cited in Lewis and Algaoud (2007) argued Islamic bank is one of the state financial institutions that provide credit and other banking services in the payments and circulation of money that operate on the basis of religious principles or Sharia principles. In addition, Perwataatmadja (Djawahir, 2012) defined Sharia bank as a bank that operates by following the principles of Sharia or Islamic laws outlined in Al - Qur'an and Hadith.

Islamic banking systems are introduced to provide halal financial services to the Muslim community. In addition to this objective, this institution is expected to contribute to the achievement of socio-economic goals of Islam. The main target of the development of Sharia banks is not only to increase economic welfare, but also to expand employment opportunities, high economic growth rates, socio-economic justice and the distribution of reasonable income and wealth, stability in the value of money, and mobilization of savings and investments for economic development.

Other important aspects of the Sharia banking principles are that this type of bank eliminated the use of interests for any kind of financial transactions in accordance with Islamic principles. This principle is purely religious that differs the Sharia bank with other conventional bank. This suggests that any payment and withdrawal of interests contradict Sharia principles. There are two kinds of individual assets recognized in Sharia. The first is the assets that combine one's creative work and natural resources. The second is the assets of which the right has been transferred from the first owner to others due to the exchange, payment, donation granted by the owner to the needy, and the inheritance to name a few.

Due to the above principles, the present of Sharia banks has given Muslims opportunity to conduct free-interest financial transactions and, therefore, *halal*. However, there are two models proposed to show how this transaction should be done. The first as supported by Shiddiqi, is based on the two-row or three-point *mudaraba* scheme. This means that any banks' revenue that are obtained from various activities are unified and then shared with the depositors and shareholders in accordance with the terms set forth in the contract. Banks are allowed to accept demand deposits that do not generate profits, but they are able to impose fees. The second model, as proposed by Khan cited in Lewis and Algaoud (2007) in that the bank's balance sheet liabilities are divided into two windows, namely, demand deposit or transaction balance and investment balances. However, both models consider the losses incurred as a result of the investment activity should be undertaken by the bank.

In one model, there is an opportunity to make interest-free investments on the individual level. Undeniably, there is disagreement about the way some (or possibly most) Islamic banks operate. Some scholars argue that not all forms of

legitimate Islamic financial agreements meet Shari'a requirements (Lewis and Algaoud, 2007). The most acceptable form of financing, they argued, is the pattern of equity participation conducted under the principles of *mudharaba* and *musharaka*. The bulk of the banking business should follow this scheme. However, most Islamic bank financing is done by using *murabaha* (mark-up) and *ijarah* (leasing) techniques. These contracts generate revenues that are previously determine, and, thus, they have the same effect as interest. This position is considered to be different from the value system in the Islamic economy.

Furthermore, some authors question the emphasis on equity-oriented transactions in Islamic banking, particularly the *mudaraba* model. The effort to change the pre-determined interest with uncertain profit does not necessarily make an Islamic transaction. This is because the excessive profit is the same as interest. One response to this criticism states that it must distinguish between profit and profiteering, and Islam prohibits excessive profit taking as it prohibits interest. Naqvi cited in Lewis and Algaoud (2007) also states that the *mudaraba* scheme is not a concept that was derived from Al Qur'an and hadith. This concept is the custom of pre-Islamic Arabs. In the past, *mudaraba* allowed elderly women and children who have capital to trade by investing their funds to traders. If this activity generates profits, they get a share of the profits, and if they loss, all losses are borne by the owner of the capital. For this reason, *mudaraba* cannot be regarded as a special concept. Nevertheless, the Prophet Muhammad is not against *mudaraba*.

### III. THE DEVELOPMENT OF SHARIA BANK AND ITS CAUSES

Sharia bank has existed in Muslim countries since the 60s, beginning with the establishment of *Mit Ghamr* Local Saving Bank in Egypt. However, due to the political situation at that time, the bank was taken over by the National Bank of Egypt and Central Bank of Egypt in 1967. This was then operated on the basis of usury. In 1972, the interest-free bank system was reintroduced by the establishment of Nasser Social Bank in Egypt which subsequently led to the birth of the Islamic Development Bank (IDB) in 1975 in Jeddah which was organized by the Conference Organization Lam (OKI). The IDB then became a milestone of development as well as motivating the establishment of Islamic financial institutions in several Islamic countries and played an important role in providing the funds needed by Muslim countries for development. By the late 1970s these type of banks have sprung up in Egypt, Sudan, Gulf countries, Pakistan, Iran, Malaysia, Bangladesh and Turkey. In Indonesia the first Sharia banking emerged was Bank Muamalat which was established in 1991. The emerging of other Sharia banks in Indonesia was since 1998. This includes Bank Sharia Mandiri, Bank BNI, Bank BRI, Bank IFI, Bank Bukkopin, and Bank Danamon. In recent years, there are many foreign banks that open Sharia branches including HSBC Bank.

PT. Bank Muamalat Indonesia Tbk was established on November 1, 1991. It was initiated by the Indonesian Ulema Council (MUI) and the Government of Indonesia, and commenced its operations on May 1, 1992. With the real support of the exponents of the Association of Indonesian Muslim Intellectuals (ICMI) and some Muslim entrepreneurs,

the establishment of Bank Muamalat also received public support, as shown by the commitment to purchase shares of the Company valued at Rp 84 billion at the time of the signing of the agreement of establishment of the Company. Additional support of Rp 106 billion was also obtained from the West Java community at the meeting in Bogor Presidential Palace.

On October 27, 1994, only 2 (two) years after it was founded, Bank Muamalat has been successful in bearing the title as a Reserve Bank. This recognition further accentuates the position of the company as the first and leading Sharia Bank in Indonesia with a variety of services and products that continue to be developed. However, in the late 1990s, Indonesia was hit by a monetary crisis which devastated most of Southeast Asian economics. The National Banking Sector was rolled up by bad debts and Bank Muamalat was affected by the crisis. In an effort to strengthen its capital, Bank Muamalat have been supported by the Islamic Development Bank (IDB) based in Jeddah, Saudi Arabia. In 1999 IDB officially became one of the shareholders Bank Muamalat. Since then the development of Islamic banking system in Indonesia began to be conducted in the framework of dual-banking system, namely, Sharia banking system and conventional banking. These two types of banking systems synergistically support the mobilization of public funds more broadly to improve financing capabilities for the sectors of the economy

It should be noted that the development of Sharia bank in Indonesia is very rapid. The rapid development of Sharia banks in Indonesia is because of fatwa (religious supports) that were provided by the National Sharia Council (DSN). This institution is an independent institution. This is different as in other countries in that fatwas issued by individual scholars. In Malaysia, the organizational structure of the fatwa institution is under the State Bank of Malaysia (BNM). However, this institution is not independent. Therefore, the development of Sharia banks in Indonesia has been very rapid. This development will increase in the near future as the population of this country dominated by the Moslems.

The factors that cause the development of Islamic Banking are as follows. The first is because of potential market of Sharia banks in Indonesia is quite large especially when associated with the number of Muslims. At the moment, the number of Sharia bank users among Muslims today is still very small compared to the number of Muslims. Secondly, Muslims themselves will ultimately choose Sharia banks than conventional banks. This is because Islamic banks are guaranteed halal, while for conventional banks have no guarantee for halal. This is especially after the MUI states that the system of interest and all transactions following it are haram. Thirdly, Sharia Banks did not cause resistance for those who are not Muslims. Fourthly, Sharia banks have a competitive advantage. This can be seen from the ability of Sharia banks to provide a larger share of funds to the owner compared with conventional bank. Fifthly, Sharia Bank will not experience a negative spread because Islamic banks do not pay interest on deposits. This bank is based on profit-sharing principle. Six, Sharia banks have succeeded in mobilizing the economic potential of Sharia. Finally, through Sharia bank, jurisprudence can be applied optimally. In fact, there have been a number of market demand to review economic transaction made by the people based on Islamic law. Thus, Sharia bank seem to be a promising bank for the people of Indonesia as it is for conventional bank.

#### IV. LEGAL BASIS OF SHARIA BANK

The rapid development of Sharia Bank in Indonesia is because this bank, like the conventional bank, fulfill criteria that was established in the Article 33 of the 1945 National constitution. The criteria that were fulfilled by Sharia Bank are as follows. The first is that Sharia bank is structured as a joint effort based on the principle of kinship. The second is that this bank has role to increase the livelihood of the people. The third is that this bank can be used for the greatest prosperity of the people. The fourth is that this bank is organized on the basis of economic democracy with the principle of togetherness, efficiency, justice, sustainability, environmental insight, independence, and maintaining a balance of progress and national economic unity.

In addition, the Sharia bank fulfills other criteria as follows. The first is that the bank is able to accommodate the aspirations of the community and it is very appropriate for the Indonesian people who are mostly engaged in micro, small and medium enterprises activities. The second, Sharia bank prioritizes the common progress of individual progress. The third is that Sharia bank is very suitable to finance small communities and it can empower the people. Finally, this bank is assumed to be able to combine the balance between today's life and here after (ukhrawi).

Due to the above conditions, the government issued the following laws that are worth to be mentioned in relation to the development of Sharia bank. The first is the Law No. 7 of 1992. In this law the Sharia bank is positioned as commercial bank and rural bank. The government has granted permission for the existence of Islamic bank or bank based on Islam to perform any action or banking activities like a conventional bank. However, this law does not use the term Islamic Bank or Sharia Bank. It mentions that a commercial bank may provide financing for customers on the basis of profit-sharing principles in accordance with the provisions set out in government regulations (Djawahir, 2013).

In addition to the above law, there is another law number 10 Year 2008 containing the refinement and explanation of the Law Number 7 of 1992. In the articles 1 and 6 of this law, it was mentioned as follows. The first is that Sharia bank as a commercial bank has tasked to complete all business activities based on Sharia principles. The second is that Sharia bank as a rural Bank has tasked to complete all business activities based on Sharia principles. The Sharia Principle is a rule of agreement or provision which is based on Islamic law in conducting financial activities. These activities include financing based on profit sharing (*mudaraba*), financing principle based on capital participation (*musyarakah*), the sale and purchase product principle (*murabaha*), the lease principle (*ijara*), and the transfer of ownership of leased goods principles (*ijarah wa iqtina*).

Apart from the above two laws, there are other laws that worth mentioning here. The first is the Law Number 23 Year 2003. This law contains the protection of the existence of Sharia Bank. The protection is given in the form of assignment to Bank Indonesia to prepare all forms rules and facilities to support the operations of Sharia bank. Also, there is the law no. 21 of 2008. This law, however, is more specific among other regulations. This law is actually formed when Sharia bank is growing rapidly. In this law it is clearly stated the difference between conventional banks and Sharia banks. This law also explains that the operation of Sharia Bank should be based on Islamic law such as *mudaraba*, *wadi'ah*, *masyarakah*, and others.

Although the Sharia bank has been accommodated in the Indonesian banking system, the economic performance of this bank is supervised by the Bank Indonesia as the central bank. There are several regulations issued by Bank Indonesia in regulating the performance of Bank Sharia Indonesia, namely, the regulation No. 9/19 / PBI / 2007 concerning the implementation of Sharia principles in the activities of fund raising and channeling of funds and Sharia services, and the regulation No. 6/24 / PBI / 2004 concerning the commercial Bank conducting business activities or duties based on Sharia principles.

The supervision given by Bank Indonesia is to maintain the health level of Sharia bank which includes at least the capital adequacy, asset quality, liquidity, profitability, solvency, quality of management that describes financial capability, compliance with Shari'a Principles and Islamic management principles, and other related aspects to Sharia Bank business. In addition, the Sharia Bank is obligated to convey all information and explanation of its business to Bank Indonesia in accordance with the established procedure.

Bank Indonesia may assign the public accountant office or other party for and on behalf of Bank Indonesia to perform the inspection as referred to in Article 52 paragraph (2), as well as the requirements and inspection procedures set forth in paragraph (1) of the regulation of Bank Indonesia. Bank Indonesia has the authority to take action against Sharia Bank in case of difficulties that endanger their business continuity. These authorities are as follows : (a) limiting the authority of the General Meeting of Shareholders, commissioners, directors and shareholders; (b) Ask shareholders to increase capital; (c) requesting shareholders to replace members of the board of commissioners and / or board of Bank Sharia; (d) requesting the Sharia Bank to remove the bookkeeping of the disbursed funds and take into account the loss of the Sharia Bank with its maturity; (e). requesting a Sharia Bank to merge or merge with another Sharia Bank; (f) requesting a Sharia Bank to be sold to a buyer willing to take over all of its obligations; (g) requesting a Sharia Bank to hand over the management of all or any of the activities of a Sharia Bank to another party; and (h) requesting a Sharia Bank to sell part or all of the assets and / or obligations of Sharia Bank to another party.

If the Sharia Bank in conducting banking activities faces a dispute, the settlement of the Sharia Banking dispute will be solved by the court within the Religious Courts. If the parties have agreed to settle the dispute other than as referred to in paragraph (1), the dispute settlement may be made in accordance with the contents of the Agreement and in the dispute settlement it should be contradictory to the Sharia Principles / Islam. The legal basis based on such basic policy is to prove that the Sharia banking is ready to participate in implementing and assisting the economy of Indonesia. Also, it aims to show to the international community that Sharia banking can carry out economic activities both nationally and internationally, as well as to attract foreign investors.

## V. CONCLUDING NOTES

Sharia bank in Indonesia grows rapidly in Indonesia. The number of Sharia banks in Indonesia currently stands at 199 Bank Sharia consisting of 12 Commercial Banks, 22 Sharia Business Units, and 165 Sharia Rural Banks. This rapid

grow has been due to many factors, including the number of Muslims and the business activities of Sharia bank are guaranteed halal. As the Sharia bank will grow faster in the future there is a need for the government to issue the laws to support the development of Sharia Banks. These government's supports will increase public confidence to Sharia Banks. Also, there is a need for Sharia banks to improve and innovate their Sharia products as well as their management system, human resources quality, services, and their operations. In addition, the image that Sharia banking is only for Muslims should also be changed immediately. These improvements are important for the Sharia Banks to compete with the conventional banks. If this is not done, it is certain that Sharia bank will not be accommodated by the majority of Muslims community in Indonesia. Thus, much remain to be done by Sharia bank as well as by the government of Indonesia.

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