



الجامعة الإسلامية العالمية ماليزيا  
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA  
يُؤْتِيهِمُ اللَّهُ مِنْ فَضْلِهِ يُغْنِيهِمْ  
وَيُؤْتِيهِمُ اللَّهُ مِنْ فَضْلِهِ يُغْنِيهِمْ

THE IMPLEMENTATION OF  
*SHARĪ'AH* COMPLIANCE IN ISLAMIC BANKING:  
THE ROLE OF THE *SHARĪ'AH* BOARD  
(A COMPARATIVE STUDY BETWEEN  
MALAYSIA AND INDONESIA)

BY

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A thesis submitted in fulfilment of the requirement for  
the degree of Doctor of Philosophy in Law

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International Islamic University Malaysia

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## ABSTRACT

This study examines the implementation of *sharī'ah* compliance in Islamic banking by comparing between two countries, Malaysia and Indonesia. This study seeks to answer whether or not along the rapid growth and development of Islamic banking, the issues on *sharī'ah* compliance take place. Another question is whether the legal and regulatory frameworks are sufficiently provided pertinent to *sharī'ah* compliance in Islamic banking. Lastly, the question on what is the role of the *sharī'ah* board members in ensuring *sharī'ah* compliance in Islamic banking is also in need for an answer. This research is a combination of library (documentary) research and field research. Statutory provisions, guidelines and other legal instruments are explored and analysed to understand the development of the Islamic banking business and whether the legal framework is adequate to cater to *sharī'ah* compliance in Islamic banking. The field research is made in revealing the practical process in assuring *sharī'ah* compliance in the industry, which is mostly conducted by interviews. In the analysis method, this study utilises the descriptive method combined with the analytic-interpretative and comparative approach. The study establishes that alongside the rapid growth and development of the Islamic banking business in both countries, the issues of *sharī'ah* compliance arose. The issues however, have been taken up by the Malaysian and Indonesian authorities with adequate regulatory instruments in the form of the statutes (the acts of parliament), guidelines, and circular letters. It is also provided in the regulations that any product development must be approved by the *sharī'ah* board members to ensure that they comply with *sharī'ah* principles. The research also concludes that in both countries, the clear duties and responsibilities conferred to the *sharī'ah* board members, good qualifications and the proper appointment procedures, supported by sufficient independence and recognition on their *fatwās* or decisions or resolutions, bring about more efficiency and effectiveness in the advisory or supervision roles for the sake of the implementation of *sharī'ah* compliance. However, in terms of the enforcement of *sharī'ah* compliance, some aspects need for enhancement. The study suggests that for Indonesia, besides repositioning the National *Sharī'ah* Council (NSC) is needed to enable the *fatwās* and decisions to be binding and enforceable, the concurrent membership of the *sharī'ah* board members is in need for reconsideration. In addition, a specific statute (the act of parliament) which covers the products and operations aspects of Islamic banking is very demanding to be enacted. In contrast, in Malaysia, the provision that the decisions and *fatwās* of the *Sharī'ah* Advisory Council (SAC) is only binding over the arbitration panel, needs to be reviewed in order that those may also be binding over the court of law. Further, it is also suggested that for both countries, the introduction for the regulations of the operational aspects (*sharī'ah* governance) of Islamic banking business need to be adopted soon to ensure the implementation in the whole aspects of the *sharī'ah* compliance.

## ملخص البحث

درس هذه الأطروحة تطبيقَ الإطاعة الشرعية في البنك الإسلامي المتمثلة في دور الرقابة الشرعية، دراسة مقارنة بين ماليزيا وإندونيسيا. تهدف هذه الدراسة إلى الإجابة عن قضية مكانة الإطاعة الشرعية خلف ما يجري من النمو السريع للبنوك الإسلامية، كما أنها تقوم بالإجابة عن سؤال آخر ألا وهو كفاءة النظم والقوانين لإطاعة الشرعية للبنوك الإسلامية، وأخيراً تحاول الأطروحة الإجابة عن الطريقة التي سلكها المراقبون الشرعيون لتطبيق الإطاعة الشرعية للبنوك الإسلامية. وتعتمد هذه الدراسة على عدة مناهج، وهي المنهج الوصفي والمنهج المقارن، فضلاً عن ذلك فإن هذه الدراسة تعتمد كذلك على مختلف المصادر، منها المصادر المكتبية والمقابلات الشخصية مع المراقبين الشرعيين والموظفين في البنوك الإسلامية والدواوين التي تتعلق بتنظيم البنوك. وصلت هذه الأطروحة بأن في النمو السريع للبنوك الإسلامية في كلا البلدين تكمن وراءه مشكلة في الإطاعة الشرعية. علماً بأن البلدين قد استدركا الوضع فأصدرت النظم والقوانين والتعاميم بغية الحصول على الحل لتلك المشكلة. كما قدمت المعايير التي وضعتها هيئة الرقابة الشرعية لأي منتج في البنوك، لتطبيقه على كل عقود التصرف تطبيقاً شرعياً. وتحتتم هذه الأطروحة بأن هذين البلدين متساويان في تمكّنها للمعيار الصريح حول الواجبات والوظائف التي فرضت على المراقبين الشرعيين ليلتزموا بها. وكذلك في وجود الشروط لأعضاء هيئة الرقابة الشرعية، وطريقة تصنيفهم واستقلالية هيئة الرقابة الشرعية. وهذه العناصر تعطي أثراً عميقاً في تطبيق النظم والقوانين للإطاعة الشرعية في البنوك الإسلامية. رغم أن الوصول إلى إيجاد الإطاعة الشرعية بشكل كامل، يحتاج إلى ترقية الجهود في جوانب شتى. وتوصلت هذه الدراسة إلى أن هيئة الرقابة الشرعية للبنوك الإسلامية في إندونيسيا لا بد أن تكون مكانتها أعلى من مكانتها الحالية حتى تكون فتاواها ملزمة، بالإضافة إلى ذلك فإن القوانين الخاصة التي تتعلق بالمنتجات والجوانب العملية في البنوك الإسلامية من الثقيل بمكان أن تسنّ من قبل أصحاب القرارات في الدولة. وأما في ماليزيا فإن الفتاوى الصادرة من هيئة الرقابة الشرعية العليا في حاجة إلى تغيير لتكون ملزمة للقضاء بعد أن كانت ملزمة لفريق التحكيم فقط. وبعد، فإن الأطروحة توصي بأن لكلا البلدين أن يعمما القرارات بشأن الجوانب العملية للبنوك الإسلامية وأن تطبق في أقرب وقت ممكن مع ضمان تنفيذ الإطاعة الشرعية في جميع جوانبها.

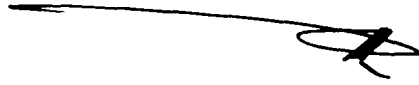
## APPROVAL PAGE

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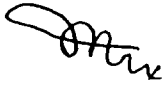
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## DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently Submitted as a whole for any other degrees at IIUM or other institutions.

Agus Triyanta

Signature.....

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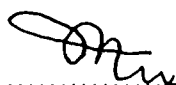
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**THE IMPLEMENTATION OF *SHARĪ'AH* COMPLIANCE IN ISLAMIC  
BANKING: THE ROLE OF THE *SHARĪ'AH* BOARD  
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## LIST OF STATUTES AND GUIDELINES

### MALAYSIA

Banking and Financial Institutions Act 1989

Civil Law Act 1956

Central Bank Act 1958

Companies Act 1965

Islamic Banking Act 1983

Guidelines on *Skim Perbankan Tanpa Faedah* (SPTF) 1993

Guidelines on the Governance of *Shari'ah* Committee for the Islamic Financial Institutions (BNM/GPS1) 2004

### INDONESIA

Act No. 7 of 1992 on Banking as amended by Act Number 10 of 1998 on Banking

Act No. 23 of 1999 on Bank Indonesia

Act No. 1 of 1995 on Limited Liability Company Act No. 1 of 1995

Bank Indonesia Regulation No. 6/24/PBI/2004 on Commercial Banks Conducting Business Based on *Shari'ah* Principles as amended by Bank Indonesia Regulation Number: 7/35/PBI/2005

Bank Indonesia Regulation Number: 7/46/PBI/2005 on Funds Mobilization and Financing Agreements for Banks Conducting Business Based on *Shari'ah* Principles

Bank Indonesia Regulation Number: 8/3/PBI/2006 on Conversion of Business of Conventional Commercial Banks to Commercial Banks Conducting Business Based on *Shari'ah* Principles and Establishment of Bank Offices Conducting Business Based on *Shari'ah* Principles by Conventional Commercial Banks

Circular Letter to All Commercial Banks Conducting Business Based on *Shari'ah* Principles in Indonesia No. 8/19/DPBS/2006

## THE LIST OF ABBREVIATIONS

BAFIA	:	Banking and Financial Institutions Act
BIR	:	Bank Indonesia Regulation
BIMB	:	Bank Islam Malaysia Berhad
BMI	:	Bank Muamalat Indonesia
BNI	:	Bank Negara Indonesia
BNM	:	Bank Negara Malaysia
CBA	:	Central Bank Act
IBA	:	Islamic Banking Act
IUC	:	Indonesian <i>Ulama</i> Council
NSC	:	National <i>Shari'ah</i> Council
SAC	:	<i>Shari'ah</i> Advisory Council
SC	:	<i>Shari'ah</i> Committee
SPTF	:	Skim Perbankan Tanpa Faedah
SSB	:	<i>Shari'ah</i> Supervisory Board

## TRANSLITERATIONS

أ	a	ز	z	ق	q
ب	b	س	s	ك	k
ت	t	ش	sh	ل	l
ث	d	ص	ṣ	م	m
ج	j	ض	ḍ	ن	n
ح	ḥ	ط	ṭ	ه	h
خ	kh	ظ	ẓ	و	w
د	d	ع	‘	ء	’
ذ	dh	غ	gh	ى	y
ر	r	ف	f		



# CHAPTER 1

## INTRODUCTION

### 1.1. BACKGROUND OF THE STUDY

The discourse of the Islamic financial system started to emerge when a small-scale financial institution was introduced in Mit-Ghamr in Egypt from 1963 to 1967,<sup>1</sup> which was soon followed by the incorporation of the Pilgrims Management Fund Board of Malaysia in 1971.<sup>2</sup> Following this success, in the seventies, many Islamic financial institutions were established, the most important among them was the Islamic Development Bank under the sponsorship of the Organization of Islamic Conference.<sup>3</sup> The industry developed tremendously since then.

Today, after approximately four decades since its first attempt, Islamic financial institutions are engaged in business with nationwide networks and in a great variety of enterprises ranging from banking, insurance, capital markets, mutual funds, and other financial institutions. However, among others, Islamic banking has showed its impressive development. It is even said that today Islamic banking is estimated to manage funds for about US \$ 250-300 billion. This could be substantially higher aggregating the retail and wholesale sectors. Islamic banking

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<sup>1</sup> Although the idea of the Islamic financial system has been established since the late of the first half of 19 century, it never came to reality until this experiment was undertaken.

<sup>2</sup> It is also called *Lembaga Urusan Tabung Haji*. Nik Norzrul Thani, Mohamed Ridza Muhamed Abdullah and Megat Hizaini Hassan in his monumental work, *Law and Practice of Islamic Banking and Finance* (Selangor: Sweet & Maxwell, 2003), 11.

<sup>3</sup> Ausaf Ahmad, *Development and Problems of Islamic Banks*, (Jeddah: Islamic Research and Training Institute Islamic Development Bank, 1987), 2-3

currently operates in more than 75 countries, not only in Muslim countries but spread over Europe, America and the Far East.<sup>4</sup>

Although financial institutions always evolve, the rise of Islamic banking cannot be called as being only a matter of an evolutionary process in the development of the prevailing financial institutions. It should be understood that the Muslims' worldview, which sees Islam as a set of rules of conduct for the overall areas of life including the economic sphere, is a driving force for the birth of Islamic banking.<sup>5</sup> As a faith-based financial institution, the Islamic banking business is therefore, strictly dictated by religious tenets, namely the Qur'ānic and prophetic teachings. Thus, it is obvious that the Islamic banking system is substantially different from conventional banking.

The above mentioned difference, in turn, affects the operational aspects and products offered in Islamic banking. As a financial intermediary institution, Islamic banks as well as conventional banks conducting Islamic banking business, offer products that encompass various depository and financing schemes based on various *mu'āmalah* contracts.<sup>6</sup> Through these products, the mission of Islamic banking can be accomplished, namely to provide liquidity needs that are free from interest, which are in contrast from its conventional counterparts which rely on interest for earning the gain.

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<sup>4</sup> 'Global Perspective on Islamic Banking and Insurance' in *New Horizon*, April-June, 2007, 24. J. Michael Taylor, 'Islamic Banking, the Feasibility of Establishing an Islamic Bank in The United States'. *American Business Law Journal*, 40, 2003, 389. Retrieved December 26, 2005, from Westlaw database. Shanty Rachagan, 'Islamic Banking in Malaysia' in *Journal of International Banking Law and Regulation*, 2, 2005, 88. Retrieved December 26, 2005, from Westlaw database.

<sup>5</sup> Abu 'Uwamair is of the opinion that the ideological force has played most significantly in the emergence of Islamic banking. In his opinion, Islamic banking can even be said to be *darūrah al-shar'iyah*. Jihād 'Abd Allah Abu 'Uwamair, *al-Tarshīd al-Shar'ī li al-Bunūk al-Qā'imah* (al-Ittiḥād al-Daul li al-Bunūk wa al-Iqtisād al-Islāmiy 1986), 23.

<sup>6</sup> Basically, there are five contracts; depositing, partnership, sale, leasing, fee based, and benevolent contract. Details of these contracts are explored in chapter 3 of this thesis.

As a result of such faith-based views, Islamic banking also demonstrates its striking particularity in terms of the relationship between the bank and customer. Islamic banks may experience a relationship with their customers in a manner which is quite different compared to their conventional counterparts. This is not to say that the economic factor is less important, but to the Muslim customers, their affiliation to Islamic banks may also be based on their reliance to religious sentiments. It is Islamic tenets which constitutes that *ribā* is an abomination, and hence, Muslims are prohibited to be involved in financial transactions containing *ribā*.<sup>7</sup> Thus, to a certain degree, affiliation of Muslim customers to the bank may not merely be due to economic reasons, but also due to ideological reasons.

By virtue of the above mentioned particularities, it is obvious that the association of Islamic banking with the word “Islam” or “*sharī‘ah*” is due to the tight connection between the conceptual as well as practical aspect of this banking business and Islam or *sharī‘ah* principles. In other words, it is always true that the most distinctive side of the Islamic banking system compared to that of conventional is in its compliance to *sharī‘ah* principles.

Accordingly, it is reasonable to presume that one among the important legal aspects in Islamic banking is the regulation on the *sharī‘ah* compliance. The issue of the *sharī‘ah* compliance is increasingly important in a situation whereby Islamic banks are always challenged by the demands of the customers, to be fully innovated and business oriented (such as in offering new products and instruments), as what

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<sup>7</sup> This statement on avoiding *ribā* may be issued from a formal legislative body which results in a binding regulation, such as the decision made by the High *Sharī‘ah* Court of Pakistan. Muhammad Taqi Usmani, *The Text of Historic Judgment on Ribā: The Supreme Court of Pakistan* (Malaysia: The Other Press, 1999). Or the decision is issued by a body which is not a formal body of legislation, such as a *fatwā* of *Majelis Ulama Indonesia* (Indonesia *Ulama* Council) on the prohibition of interest as a form of *ribā*. (*Fatwā Majelis Ulama Indonesia* no. 1 of 2004).

conventional banking used to be.<sup>8</sup> This fact could lead the position of Islamic banks into the middle of two forces. On one side, they have to accommodate the above mentioned customers' demands which may contradict *sharī'ah* principles but on another side, they are strictly bound by *sharī'ah* compliance.

In response to such demands, the Islamic banking business may be then conducted in such a way that at a glance, seem to be not much different from the conventional banking business. The imitation of products, the application of conventional measures for profit and performance, are cases in point. The question with regards to the *sharī'ah* compliance of Islamic banks, the commitment to avoid *ribā* and *gharar*, the need for the shift of interest based mindset to a free interest based mindset, is arising. In this context, the issue on the *sharī'ah* compliance of Islamic banks is relevant to be considered.

It is observed therefore that certain regulations which are designated to cater to *sharī'ah* compliance is inevitably important. The quest for the enhancement of a regulatory framework for *sharī'ah* compliance performs as a legal challenge which the countries proposing to develop Islamic banking industry encounter. Those countries are challenged to reformulate their legal framework to be capable of fully accommodating the particularities of Islamic banking.

Since the compliance towards *sharī'ah* principles is mandatory in Islamic banking, the *sharī'ah* advisory and supervision is another important aspect. It is also said that the *sharī'ah* advisory and supervision is part and parcel of *sharī'ah* compliance. In this regard, the regulation on *sharī'ah* advisory or supervision, which

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<sup>8</sup> Abdullah M. Noman, 'Imperatives of Financial Innovations For Islamic Banks' in *International Journal of Islamic Financial Services*, 3, 2003, 5-15. Accessed on December 26, 2005, from <<http://islamic-finance.net/>>

also covers the role of *sharī'ah* board, shall occupy the central part within the *sharī'ah* compliance regulatory framework.

In light of the abovementioned reasons, the research on *sharī'ah* compliance, together with the role of the *sharī'ah* board is very demanding and relevant to the current problems in the Islamic banking business. This research will focus on the regulatory framework of the *sharī'ah* compliance and its implementation in Islamic banking in Malaysia and Indonesia. Through the comparison between the two countries, some advantages will be identified.

Particular reference should be made to the regulations and their implementation in the Islamic banking in Malaysia and Indonesia since there are few valuable considerations. Malaysia experienced the advanced development of Islamic banking compared to the rest of the Asian Muslim countries in the Southeast Asia region. Malaysia began to embark on the Islamic banking business in 1983 when Bank Islam Malaysia Berhad (BIMB) was incorporated under the Companies Act of 1965.<sup>9</sup>

Further development of Islamic banks in Malaysia presents some impressive features. Almost all of the conventional banks offer *sharī'ah* services and there are eleven (11) Islamic banks, eight (8) commercial banks, and four (4) merchant banks that have taken part in the Islamic banking industry in this country.<sup>10</sup> There are two important acts issued as the legal basis for the operation of Islamic banks in Malaysia namely the Islamic Banking Act 1983 (IBA) and Banking and Financial Act 1989 (BAFIA).

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<sup>9</sup> M. Kamal Azhari, *Bank Islam, Teori dan Praktik*. (Kuala Lumpur: Dewan Pustaka Fajar, 1993), 133-136.

<sup>10</sup> *Key Statistics of Islamic Banking*, at, <[www.bnm.gov.my](http://www.bnm.gov.my)> (accessed September 20, 2007)

Compared to Malaysia, the Islamic banking in Indonesia, which started one decade later, has not developed much. The first Islamic bank established was Bank Muallamat Indonesia (BMI) in 1992. Currently Indonesia has three (3) Islamic banks, and 20 conventional banks with *shari'ah* services.<sup>11</sup> At present, the Islamic Banking Act has not been issued and this is seen as the lack of legal basis for the development of Islamic banking. Hence, a constructive evaluation is strongly needed in order to achieve a better development.

Last but not least, these two countries share in their affiliation to the same school of Islamic law, as well as some other traditional backgrounds.<sup>12</sup> These two countries, are also members of the D-7 countries; a group whose goal is “to promote mutual economic cooperation, build a common market and develop capital market” according to the principles of Islamic law.<sup>13</sup> Consequently, the differences in the development of Islamic banking system are among the interesting questions to be answered. Thus, the advanced development of Islamic banks in Malaysia – which is of course rich with experiences—is a very valuable contribution for the development of Islamic banks in Indonesia which is still in its crucial stage of development.

These are the reasons why the implementation of *shari'ah* compliance in Islamic banking both in Malaysia and Indonesia needs for a further study.

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<sup>11</sup> *Laporan Pengawasan Perbankan 2005*, (Bank Indonesia, 2006), 5, at <[www.bi.go.id](http://www.bi.go.id)> (accessed June 22, 2006) and, *Islamic Banking Statistics 2006*, 1.

<sup>12</sup> M.B. Hooker, *Islamic Law in Southeast Asia*. (Singapore: Oxford University Press, 1984), 4.

<sup>13</sup> J. Michael Taylor, Islamic Banking—The Feasibility of Establishing an Islamic Bank in The United States. *American Business Law Journal*, 40, 2003, 385-415. Accessed on December 26, 2005, from Westlaw Database.

## 1.2. STATEMENT OF PROBLEMS

In light of above discussions, the importance of *sharī'ah* compliance in the operation and products of Islamic banking is clear. It shapes the particularities of Islamic banking in such distinct features compared to that of conventional banking. Hence, this research needs to pay high attention on this aspect.

In comparison to other Muslim countries in the region, Malaysia experiences rapid development in Islamic banking ever since its first attempt in 1983. The advanced development is noticeable from both, the variety of products and the number of banks offering Islamic financial products. However, alongside this development, the question with regards to *sharī'ah* compliance is arising. Hence, it is important to identify the issue of *sharī'ah* compliance within its development and compare it with the similar aspects in Islamic banking in Indonesia, which is less developed and less matured compared to that of Malaysia.

Apart from the development of Islamic banking, the availability of a regulatory framework is very demanding, including clear guidelines in establishing *sharī'ah* compliance. *Sharī'ah* compliance is maintained through a set of regulations provided by the authoritative body, both in Indonesia and Malaysia. Since the framework of *sharī'ah* compliance greatly affects the practical implementation and determines the degree of compliance, the quest on how robust and exhaustive the existing legal framework of *sharī'ah* compliance is, is very valuable.

Another determinant factor in the implementation *sharī'ah* compliance is the role of the *sharī'ah* board. As this is the sole body designated for handling responsibility in assuring *sharī'ah* compliance, the search towards its duties and responsibilities is considered to be relevant. The possible differences on such duties and responsibilities between Malaysia and Indonesia may affect the implementation

of *sharī'ah* compliance. In addition, the differences are meaningful to identify strengths and weaknesses of the said implementation, which in turn, are very meaningful to further enhance the performance of the *sharī'ah* board members in Malaysia and Indonesia respectively. It is obvious therefore that the research towards this aspect is highly significant.

### 1.3. HYPOTHESIS

There are three hypothesis statements for this research:

*First*, the development of Islamic banking in Malaysia and Indonesia has brought about the significant increase in terms of assets as well as the number of banks conducting Islamic banking business. A great variety of products are offered in favour of the profit enhancement and to respond to the demands of customers. The product development may be innovated through a new initiative as well as imitating from the conventional banking products. This makes Islamic banking, to a certain extent, to be similar to interest-based banking. Here, a hypothetical statement can be raised, that alongside this rapid growth and development, the *sharī'ah* compliance of Islamic banking may be questioned.

*Second*, the more exhaustive legal frameworks; such as a clear regulation and guidelines of *sharī'ah* compliance, the better the implementation of *sharī'ah* principles in Islamic banking. Since details of regulations and guidelines are important for Islamic banks as well as conventional banks conducting Islamic banking business to be capable of implementing *sharī'ah* principles perfectly, the lack of this aspect leads to imperfection in the implementation of *sharī'ah* principles.

*Third*, the better the duties and responsibilities of the *sharī'ah* board, the higher the *sharī'ah* compliance of Islamic banks can be achieved. The role of the