



TOWARDS A COMPREHENSIVE FRAMEWORK OF
SHARĪ'AH GOVERNANCE FOR ISLAMIC BANKS IN
INDONESIA

BY

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requirement for the degree of Master of Islamic Banking
and Finance

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ABSTRACT

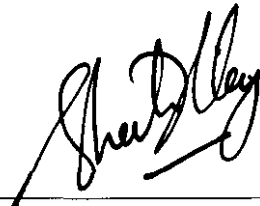
Conventional banks are unlike Islamic banks. The distinguishing factor between conventional banks and Islamic banks is compliance with Shari'ah principles. Therefore there is a need for a mechanism that can monitor and ensure the compliance of Islamic banks with Shari'ah principles. Hence, Shari'ah governance has the potential to act as the requisite guiding mechanism. In view of the dearth of literature and specific studies on Shari'ah governance of Islamic banks in Indonesia, this study aims to explore the state of Shari'ah governance as practiced by Islamic banks in Indonesia, particularly in reference to the Shari'ah public bank (Bank Umum Syari'ah). This study proposes a comprehensive framework of Shari'ah governance for Islamic banks in Indonesia. This study examines the existing Good Corporate Governance guidelines for Islamic banks in Indonesia, the Regulation of Central Bank of Indonesia (Peraturan Bank Indonesia) No. 11/33/PBI/200 2009 and Circulatory Letter (Surat Eadaran) BI No.12/13/DPbS 2010. This is done by looking at the comprehensiveness as well as the issues missing from the existing guidelines. A comparison is then ventured with standards issued by top leading organizations and country, namely IFSB (Islamic Financial Services Board), AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) and BNM (Bank Negara Malaysia). In view of the relative dearth of available data and information on Shari'ah governance practices, structured and semi-structured interviews were conducted to obtain the real picture of Shari'ah governance practices in Indonesia. This study found that the existing guidelines are not sufficiently comprehensive. Additional elements such as risk management which oversees the Shari'ah non-compliance risk and Shari'ah audit must be integrated in the existing guidelines. However, the limitation of this research is that it only proposes the most comprehensive framework for Islamic banks in Indonesia. There is therefore a need for future research to ascertain the levels of implementation of the proposed framework.

ملخص البحث

البنوك التقليدية ليس كمثل البنوك الإسلامية. والتميز الأساسي بينهما أن البنوك الإسلامية تتمثل وتتبع مبادئ الشريعة. بناء على هذا فهناك حاجة إلى وجود آلية تمكن من مراقبة البنوك والتأكد من مطابقتها لمبادئ الشريعة. و بالتالي فحوكمة الشريعة لديها القدرة لتكون بمثابة آلية الإرشاد المطلوبة. ونظرا لندرة المؤلفات والدراسات المحددة في حوكمة الشريعة في البنوك الإسلامية في إندونيسيا. لذا فهذا البحث يهدف إلى اكتشاف حالة حوكمة الشريعة كما هو مطبق في البنوك الإسلامية في إندونيسيا، خاصة في البنوك لإسلامية العامة. فالباحث هنا يقترح إطارا شاملا لحوكمة الشريعة للبنوك الإسلامية في إندونيسيا. وأيضا فهذا البحث يفحص التنظيم الحالي لحوكمة الشريعة للبنوك الإسلامية في إندونيسيا، والتي صدرت كضوابط أصدرها البنك المركزي الإندونيسي. ويجدر التنويه إلى أنه يتم هذا من خلال امتحان الشمولية والقضايا المفقودة في تنظيم الحالي. بعد ذلك سيقوم الباحث بمقارنته بالضوابط التي أصدرتها المنظمات والدول الرائدة في هذا المجال كمجلس الخدمات المالية الإسلامية، وهيئة المحاسبة و المراجعة للمؤسسات المالية الإسلامية، والبنك المركزي الماليزي. وبالنظر إلى البيانات المتاحة و المعلومات الموجودة في هذا المجال، ومن أجل الحصول على الصورة الحقيقية عن حوكمة الشريعة في إندونيسيا، فإن الباحث قد أخذ بطريق المقابلات المنظمة وشبه المنظمة. وقد تم التوصل في هذا البحث إلى أن الضوابط الموجودة في إندونيسيا لم تكن شاملة بعد. فلذلك هناك عناصر إضافية لا بد وأن تضاف في تلك الضوابط. والعناصر الإضافية هي إدارة المخاطر والتي تراقب مخاطر عدم مطابقة الشريعة، بالإضافة إلى إدخال عامل المراجعة الشرعية في تلك المنظومة. لكن يجدر الإشارة إلى أن هذا البحث اقتصر على أن يقدم إطارا شاملا للبنوك الإسلامية في إندونيسيا. ولذلك فهناك حاجة للبحث في المستقبل حول التأكد من مستويات التنفيذ لهذا الإطار المقترح.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion; it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Islamic Banking and Finance.



Sheila Nu Nu Htay
Supervisor

This research was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science in Islamic Banking and Finance.

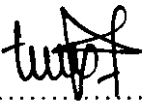


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DECLARATION

I hereby declare that this research paper 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 my other degrees at IIUM or other institutions.

Tri Yudountoro

Signature  Date 10/07/2013

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SHARĪ‘AH GOVERNANCE FOR ISLAMIC BANKS IN
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To my father, mother, brothers and friends, throughout the finalizing process of this paper.

ACKNOWLEDGEMENTS

Say: "Truly, my prayer and my service of sacrifice, my life and my death, are (all) for Allah, the Cherisher of the Worlds

(Al-Anaam, Chapter 6, Verse, 162)

In the beginning, I would like to thank Allah (S.W.T), for all of the blessings and graces that He has generously given me. My thanks and prayers go to my supervisor, Dr. Sheila Nu Nu Htay for her guidance and help.

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CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

This study is as an exploratory study of Shari'ah governance practices in Indonesia. It intends to review the existing good corporate governance guidelines for Islamic banks in Indonesia. This research examines the degree of comprehensiveness of existing guidelines in order to identify and address the lacunae. To do this, the research examines current practices of Shari'ah governance in Indonesia. The leading frameworks for Shari'ah governance is reviewed, namely the frameworks proposed by Bank Negara Malaysia (BNM), AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) and IFSB (Islamic Financial Services Board).

This research consists of data derived from a number of structured and semi-structured interviews that consists of specific instruments designed to acquire the significant data and information on the current practices of Shari'ah corporate governance. From the collected data, a number of suggestions and recommendations are offered that aim to lend particular insights to the Islamic banking industry, particularly to the Indonesian Islamic banking industry.

This chapter consists of eight sub sections, namely the background of the study, problem statement, research question, research objectives, scope of the research, significance and contribution of the study, limitation of the study and conclusion.

1.2 BACKGROUND OF THE STUDY

The development of Islamic banking in Indonesia has passed through several stages. The earliest stage can be attributed to the opinion of the prominent scholar, Mas Mansur, head of Muhammadiyah organization, regarding the services of conventional bank. Mansur argued that Muslims in Indonesia are presented with no choice other than to accept interest laden loans as there were no interest free options during the 1933-1944 period (Perwataatmadja, 1996). The wish of Indonesian Muslim for an Islamic financial institution was realized when the first *Bayt al-Tamwīl* began operations on a cooperative basis. The *Bayt al-Tamwīl* was established in Bandung in 1980 (Ali, p. 6). Eight years later the second *Bayt al-Tamwīl* under the name Koperasi Simpan Pinan Ridho Gusti was established on 25th September 1988 in Jakarta (Ali, p. 61). Eventually the first Islamic bank in Indonesia was established in 1991 and from 1992 onwards operates officially under the name of Bank Muamalat Indonesia.

The growth of Islamic banking industry during that time (1992) was relatively slow. A tremendous surge in popularity can be seen when the Central Bank of Indonesia became increasingly aware of the Islamic banking industry, particularly by enacting Undang Undang No. 10 1998 (the Act) pertaining to the rules of Islamic banks in the country. This Act facilitated the establishment of a number of Islamic banks in Indonesia. The demand for Islamic banking also increased with the growth of the Islamic business sectors when conventional banks were given permission by the Central Bank to form Shari'ah business units (Unit Usaha Syariah, Indonesia term).

It is important to note that the enactment of Act no. 21 of 2008 issued on July 16, 2008 has provided a more adequate legal base for the development of Islamic banking in Indonesia. The Islamic banking and finance industry is a fast growing industry and continues to stage impressive performance. It started off as a single bank

during the 1992-1998 period, and as of 2013 there are 11 Shari'ah Public Banks (Bank Umum Syariah), and 24 Shari'ah Banking Units (Unit Usaha Syariah).

With the growth of Islamic banking, Act (No 21 of 2008) which governs Islamic banks is no longer sufficient to accommodate this growth. By their nature Islamic banks differ from conventional banks *inter alia* the prohibition of usury, uncertainty and gambling. Second in order for the products offered by Islamic banks to be legal it must be permissible in the light of *Shari'ah*. It should be legal in the sense that it does not contradict with established laws, and it should be permissible in the sense that it must comply with Shari'ah principles. In light of the fundamental role of Shari'ah, Islamic banks need to adopt Shari'ah governance standards in their activities to ensure the permissibility of the products offered.

Minhas (2012) opined that the growth of Islamic finance demands that Islamic Financial Institutions (IFIs) must be regulated through set standards that are capable of raising early warning signals of Shari'ah non-compliance. This might be achieved by having a framework for Shari'ah governance. Minhas defined Shari'ah governance as "the set of institutional arrangements, policies, processes, procedures rules, regulations and laws which leads the organization toward Shari'ah compliance". He added, "Shari'ah governance is needed in order to maintain the trust of clients of Islamic financial institutions in the Islamic banking and finance and to safeguard the interests of investors and other stakeholders in the Islamic financial system".

1.3 PROBLEM STATEMENT

Similar to the majority of Muslims countries like Malaysia, Bahrain and Saudi Arabia, Indonesia continues to witness progressive growth in the Islamic banking industry. Iqbal and Molyneux (2005) stated that Islamic banking and finance emerged as one of

the fastest growing industries. It has spread to all corners of the globe and received wide acceptance by both Muslims and non-Muslims. However, naturally, there are some engines of growth, which triggers development especially large Muslim populations, support from the government, banking regulators, parliament and Islamic scholars. However, besides the robust performance of the industry, there are some challenges that face the industry such as providing Shari'ah corporate governance to Islamic banking and financial institutions.

Shamshad Akhtar (2006) stated that nature of permissible transactions in Islamic banking tends to have different risks associated with it compared to conventional banking. In other words, on top of the credit risk is the risk of solvency and market risk. Islamic banks have to bear different types of risk such as the risk of Shari'ah non-compliance for instance (Khniiffer, 2010). Over the past decade the Islamic finance industry has become increasingly exposed to this kind of risk which creates banking products that may not comply with established Shari'ah principles.

However, the presence of a Shari'ah advisory board in every Islamic bank does not render Islamic banking free from disputes and problems with their customers. In fact there are a lot cases happened between Islamic banks and their customers so far. Cases arose due to arguments concerning *ibra'*, *ta'widh*, transparency or the permissibility of the facility. This is clearly exemplified in the Malaysian Case *Affin Bank Bhd v Zulkifli Abdullah* [2006] 1 CLJ 438 High Court, KL 29 December 2005. In this case, the main issue was the outstanding amount that the defendant (Zulkifli Abdullah) has to pay under the revised facility. Under a conventional interest based loan, upon the default of the borrower, a financier is only entitled to the loan amount plus accrued interest and other charges including late payment interest. The interest (together with late payment interest) is limited to the period from the release of the

loan until the full settlement and not the whole tenure of the loan. Nevertheless, in this case where the facility is a BBA facility, the plaintiff (Affin Bank Bhd) has claimed for the revised selling price which according to the court consists of the purchase price and the profit margin thereon for the full tenure of the facility, even if the full tenure has not been reached. The court granted the plaintiff an order for sale of the property charged but reduced the outstanding sum entitled to the plaintiff (Affin Bank Bhd). The court was of the view that the plaintiff (Affin Bank Bhd) was not entitled to recover a profit margin for unexpired tenure of the facility, since the defendant (Zulkifli Abdullah) did not enjoy the benefit of unexpired tenure of the facility.

The second case example is the case of *CIMB Islamic Bank Berhad v LCL Corporation Berhad & Anor* (2011). In this case, among the issues which the dependant (LCL Corporation Berhad & Anor) argued: (1) the BBA facility is null and void, the counsel said the parties are bound by the agreement that have duly perfected. (2) the defendant claimed it was entitled to the *ibra'* but the court ruled that defendant is not entitled to the *ibra'* because the BBA facility was terminated by the plaintiff (CIMB Islamic Bank Berhad) before the expiry of its tenure. *Ibra'* is given to the customer only in the case of early settlement, while in this case the plaintiff made the early termination. (3) The calculation of the *ta'wīdh* which was imposed on the defendant was wrong. This argument was rejected by the court by saying the imposed *ta'wīdh* amount was correct.

There are many other such cases. This research argues that if *Sharī'ah* corporate governance is implemented and enforced on Islamic banks, it can minimize the arguments and disputes between bankers and customers. This is because *Sharī'ah* corporate governance ensures the products offered in Islamic banking comply with the

Shari'ah by means of appointing a competent and capable Shari'ah supervisory board, and conducting Shari'ah reviews and auditing.

Shari'ah governance standards are important precisely to help avoid problems such as those mentioned above. On top of that Islamic financial institutions must be managed professionally in accordance with Shari'ah objectives. The management of Islamic financial institutions must ensure professionalism and observe the unique values of Islam. All such factors have to be integrated in the financial institution.

Indonesia does not yet have a Shari'ah governance framework. They do however have Good Corporate Governance Guidelines (GCG) for banking institutions including Islamic banks. These regulations concern the implementation of Good Corporate Governance for Shari'ah Public Banks and Shari'ah Business Units, especially Section 62 and Section 63 concerning the bank's duty to release the report of GCG implementation to Bank Indonesia and other stakeholders. This is evident in the case of Peraturan Bank Indonesia (Regulation of Bank Indonesia) No. 11/33/PBI/200 dated 7 December 2009 and Surat Eedaran (Circulatory Letter) BI No.12/13/DPbS dated 30 April 2010.

It should be noted that although the Central Bank has passed guidelines regarding good corporate governance, each Islamic bank can have their internal GCG. Example of such include the internal GCG of Bank Muamalat Indonesia, in addition to the stipulations from the Regulations of Bank Indonesia and Circulars Letter of Bank Indonesia. The implementation of GCG in Bank Muamalat Indonesia is also based on the internal stipulations and other applicable laws and regulations such as the Board Manual of Bank Muamalat Indonesia and Bank Muamalat's Policies and Compliance Procedures (Tata Kelola Perusahaan).

Indirectly, it can be said that either the guidelines passed by the Central Bank of Indonesia is not comprehensive or it is not enforced on Islamic banks. For this reason Islamic banks in Indonesia have to practice their own standards to complete the existing guidelines issued by the authority. It is therefore important to ascertain its comprehensiveness by means of analysis and comparison with the guidelines issued by leading Islamic banks country or organizations.

1.4 RESEARCH QUESTIONS

In developing the scope and limitation of this study, the following research questions are asked:

1. What are the current Shari'ah governance practices in Indonesia?
2. To what extent are the current Shari'ah governance practices in Indonesia similar with the Shari'ah governance guidelines issued by AAOIFI, BNM and IFSB?
3. What is the best Shari'ah corporate governance framework for Indonesian Islamic banks?

1.5 RESEARCH OBJECTIVES

In view of the prevailing issues surrounding Shari'ah corporate governance in Indonesia, this study aims to examine the current practice of Shari'ah corporate governance (if any) in Indonesia. The specific objectives of this study are:

1. To develop a clear understanding of Shari'ah governance practiced by Islamic banks in Indonesia;

2. To examine the extent to which the current Shari'ah governance practices in Indonesia are similar with the leading Islamic financial institutions such as AAOIFI, BNM and IFSB ;
3. To propose the best practices of Shari'ah corporate governance for Indonesian Islamic banks.

1.6 SCOPE OF RESEARCH

This study intends to examine the comprehensiveness of the Shari'ah governance framework for Islamic banks in Indonesia. To achieve this, the research focuses on the existing good corporate governance guidelines for Islamic banks as well as the 5 AAOIFI governance standards. The guidelines of IFSB and Bank Negara Malaysia for a Shari'ah governance framework are also taken into consideration.

1.7 LIMITATION OF THE STUDY

This research solely focused on Shari'ah public banks. This means that the researcher will not address Shari'ah business units, Shari'ah rural banks as well as Islamic insurance or takaful companies. It should be noted here that as yet there are no good corporate governance guidelines for Islamic banks in Indonesia in English. As such, this research includes a degree of translation to translate the material into English.

1.8 SIGNIFICANCE AND CONTRIBUTION OF THE STUDY

This research is significant to many different sectors, namely market players, regulators, the public, researchers, Shari'ah advisors as well as academicians. Exploring the existing framework of Shari'ah governance practiced by Islamic banks in Indonesia will help promote greater public awareness of the issue. Regulators may

take this research as consideration in revising the existing GCG to improve the Islamic banking industry in their respective countries. At the same time this research will enrich the literature in this field since there is limited research on this topic particularly in the Indonesian context. Last but not least, it may give Shari'ah supervisory bodies either in the bank or at the national level new insight regarding what they are supposed to do in regards to supervising Islamic banks.

1.9 ORGANIZATION OF THE RESEARCH

This research is organized as follows. Chapter two consists of a literature review. This section aims to enrich this study and provide a better understanding of a Shari'ah governance framework by highlighting the standards issued by leading Islamic financial institutions. This is followed by a description of the existing Act and Shari'ah governance guidelines in Indonesia. Chapter two discussed the prior researches on this topic. Chapter three outlines the research methodology adopted in this study. Chapter four presents the finding and data analysis and the last chapter concludes this research through a summary of the results of this study followed by limitation as well as a number of suggestions for future research in this area.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

The main purpose of this study is to describe the current practises of Shari'ah governance and attempt to propose the most comprehensive framework of Shari'ah governance for Islamic banks in Indonesia. This research examines (a) the current Indonesian Good Corporate Governance (GCG) standards, particularly for Islamic banks, (b) the frameworks from leading Islamic financial institutions, namely AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions), IFSB (Islamic Financial Services Board), and Bank Negara Malaysia (BNM) standards on governance. It is hoped that this will lead to the proposal of a comprehensive framework of Shari'ah governance for Islamic banks in Indonesia.

To fulfil the objective of this research, it is an important to review the current and past literature. This research draws from several sources to conduct literature review including primary and secondary data, namely books, research papers, internet sources, academic journals, articles as well as professional financial reports.

The literature review is divided into seven sections. Section one consists of the introduction, followed by a review of the current Shari'ah governance guidelines for Islamic financial institutions, namely AAOIF, IFSB, Bank Negara Malaysia. Section three is a comparative analysis between AAOIFI, IFSB and BNM guidelines. The fourth section discussed the current predicament of Islamic banks in Indonesia. The fifth section discusses the prior researches in this area. The sixth section discusses the

importance of Shari'ah non-compliance risk and risk management. The last section concludes the chapter.

2.2 REVIEW OF CURRENT SHARI'AH GOVERNANCE GUIDELINES FOR ISLAMIC FINANCIAL INSTITUTIONS

2.2.1 AAOIFI Shari'ah Governance Standard

Basically, there are 7 standards under governance standards for Islamic Financial Institution which issued by AAOIFI. Nevertheless, researcher only focuses on 5 of them. There are, (1) Shari'ah Supervisory Board: Appointment, Composition and Report, (2) Shari'ah Review, (3) Internal Shari'ah Review, (4) Audit & Governance Committee for Islamic Financial Institutions, (5) Independence of Shari'ah Supervisory Boards.

2.2.1.1 Shari'ah Supervisory Board: Appointment, Composition and Report

Definition of Shari'ah Supervisory Board

A Shari'ah supervisory board is an independent body of specialized jurist in fiqh *al mu'amalat* (Islamic commercial jurisprudence). However, the Shari'ah supervisory board may include a member other than those specialized in fiqh *mua'malat*, but who should be an expert in the field of Islamic financial institutions and with knowledge of fiqh *mua'malat*. Their duty is to direct, review, supervise, the activities of the Islamic financial institution in order to ensure that they are in compliance with Shari'ah rules and principles. Their fatwas and rulings shall be binding on the Islamic financial institution.

Appointment of Shari'ah Supervisory Board and Fixing of its Remuneration

Every Islamic financial institution shall have a Shari'ah supervisory board which appointed by shareholders in their annual general meeting upon the recommendation of the board of directors. At the same time, the legislation and regulation shall be taken into consideration. Shareholders also may authorize the board of director to fix the remuneration of Shari'ah supervisory board.

There must be an appointment letter which recorded the agreement of engagement of Shari'ah supervisory board by Islamic financial institution

Composition, Selection and Dismissal of Shari'ah Supervisory Board

The Shari'ah supervisory board should consist of at least three members. Besides, they may seek the service of consultants who have expertise in business, economics, law, accounting and etc. they also should not include directors or significant shareholders of the Islamic financial institution. The dismissal of the member shall require a recommendation from the board of directors and subjected to the approval of the shareholders in a general meeting.

Basic elements of the Shari'ah Supervisory Board's Report

There are 7 elements should exist in their report, they are:

1. Title, the report should have appropriate title;
2. Addressee, the report must be appropriately addressed as required by the circumstances and local laws and regulations;
3. Opening or Introductory Paragraph, it should identify the purpose of the engagement, for example "In compliance with the letter of appointment, we are required to submit the following report".
4. Scope paragraph describing the nature of the work performed;

5. Opinion paragraph containing and expression of opinion on the compliance of the Islamic financial institution with shari'ah rules and principles;
6. Date of report; and
7. Signature of the members.

2.2.1.2 Sharī'ah Review

Definition and principles of Sharī'ah review

Sharī'ah review is an examination of the extent of an IFI's compliance in all its activities. The examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc.

Objective of the review

The objective of a Sharī'ah review is to ensure that the activities carried out by an IFI do not contravene the Sharī'ah

Responsibility for compliance with the Sharī'ah

Although the SSB is responsible for forming and expressing an opinion on the extent of an IFI's compliance with the sharia, the responsibility for compliance therewith rests with the management of an IFI. Nevertheless, the Sharī'ah review of an IFI does not relieve management to undertake all transactions in accordance with the shari'ah. The management's responsibility is to provide all information relating to the IFI's compliance with the shari'ah.

Shari'ah review procedures, Shari'ah review is to be carried out in the following stages:

- Planning review procedures, the Shari'ah review procedures should be planned so that it is completed in an effective and efficient manner. The plan also must be properly documented including the sample selection criteria and sizes, taking into consideration complexity, and frequency of transactions.
- Executing Shari'ah review procedures and preparation and review of working papers, it can be done so by (1) obtaining an understanding of the management's awareness, and commitment, (2) reviewing contracts, agreement, etc. (3) ascertaining whether transactions entered during the year were for products authorized by the SSB, (4) reviewing other information and report in detail, (5) discussing the finding with an IFI's management.
- Documenting conclusions and report,

Quality assurance, The SSB should implement adequate quality control policies, procedures to ensure the review is conducted in accordance with this standard. Quality control procedures may include review all work papers.

2.2.1.3 Internal Shari'ah Review

Objectives

The primary objective of the internal review is to ensure that the management of an IFI is doing their responsibilities in relation to the implementation of the Shari'ah rules and principles as determined by the IFI's SSB.

Internal Shari'ah Review