

## Sharia Financial Institutions Compliance Towards Islamic Principles in Performing Intermediation Functions

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**Abstract.** *This study aims to determine the factors of non-compliance with Islamic principles in Islamic Financial Institutions (IFIs). This article argues that IFIs must comply with Islamic principles based on the DSN-MUI fatwa, even though in the Indonesian legal hierarchy, DSN-MUI fatwas are not binding. IFIs show ambiguity in complying with Islamic principles when carrying out their intermediation function. Several other factors also cause IFIs' lack of compliance with sharia principles. These include the lack of applicability of the DSN-MUI fatwas, the conflict of interest of the Sharia Supervisory Board (SSBs), and competency issues among SSBs members. To address these issues, it is necessary to strengthen the regulations that make DSN-MUI an authoritative institution in establishing the sharia principles and the fatwas methodology. Thus, the fatwas are more applicable and avoid ambiguity. Furthermore, SSBs need re-structurization to be independent internal supervisory agencies.*

**Keywords:** *Islamic Principles, DSN-MUI, Sharia Supervisory Board, Islamic Financial Institutions, Sharia Compliance*

**Abstrak.** *Penelitian bertujuan mengetahui faktor-faktor ketidakpatuhan lembaga keuangan syariah (LKS) pada prinsip-prinsip Islam. Artikel ini menyebutkan LKS harus mematuhi prinsip-prinsip Islam sesuai fatwa DSN-MUI, walaupun dalam hierarki hukum Indonesia, DSN-MUI bukanlah sebuah lembaga otoritatif yang menerbitkan hukum mengikat. LKS tampak ambigu dalam mematuhi prinsip-prinsip Islam saat menjalankan fungsi intermediasinya. Ketidakpatuhan LKS kepada prinsip-prinsip syariah juga disebabkan oleh beberapa faktor lain, seperti: tidak aplikatifnya fatwa DSN-MUI; munculnya konflik kepentingan DPS; dan masalah kompetensi anggota DPS. Untuk mengatasi masalah-masalah tersebut, perlu adanya perbaikan regulasi yang menjadikan DSN-MUI sebagai lembaga otoritatif, agar fatwa yang dikeluarkan lebih aplikatif dan tidak menimbulkan multi tafsir. Sementara dari sisi DPS, perlu adanya regulasi merestrukturisasi organisasi DPS dengan menepatkannya sebagai lembaga pengawas internal yang independen.*

**Kata kunci:** *Prinsip-Prinsip Islam, DSN-MUI, DPS, LKS, Kepatuhan Syariah*

## Introduction

This study examines the level of compliance of IFIs towards Islamic principles in conducting their intermediary financial functions. It will discuss why the Islamic principles in intermediation activities at IFIs have not been well integrated. In this article, the discussion on the compliance of Islamic principles in the activities of sharia financial institutions is carried out through a study of the norms governing Islamic principles and the supervision of IFIs.

The issue of Islamic principles compliance in the intermediation function by IFIs is motivated by three reasons. First, compliance with Islamic principles in the intermediation activities of IFIs is a mandatory matter. This obligation is due to IFIs being a financial institution that uses Islamic values and principles in all its financial transactions, making it impossible for a financial institution that has used the word "sharia" not to comply with the provisions stipulated in Islamic principles. In addition, the background of the presence of IFIs itself aims to provide a guarantee of the compliance of its financial products in accordance with Islamic principles (Jaballah et al., 2018).

Second, the existence of IFIs in Indonesia has now reached an age of more than 30 years. In the two decades of its journey, of course, it becomes important to reflect on how it adheres to Islamic principles. The presence of IFIs has actually existed since 1991 (Kristianti, 2020). However, its presence is formally marked by the stipulation of a dual banking system in Indonesia through Law Number 10 of 1998 concerning Amendments to Law Number 7 of 1992 concerning Banking (Widyastuti et al., 2020). During this period, the practice of financial contracts in IFIs was widely questioned by the public regarding their halalness. Data from Indonesia Central Bank shows that 67% of Indonesians believe that the difference between IFIs and conventional financial institutions lies in the name of the financial product offered (Bank Indonesia, 2021). This proves that the issue of sharia compliance has always been problematic because it has not been fully integrated into the activities of IFIs.

Third, various studies have revealed there are indications that Islamic principles are not complied with by IFIs. This is known from the various studies that have been produced. Aris Biyantoro and Nunung Ghoniyah, for example, highlighted that the implementation of the intermediation function in IFIs is not much different from conventional financial institutions (Biyantoro & Ghoniyah, 2019). Anip Dwi Saputro also criticized IFIs for having a low commitment to carrying out their business activities in accordance with Islamic principles (Dwi

Saputro et al., 2018). Eko Rial Nugroho's study also concludes that various regulations related to IFIs have not fully supported Islamic principles (Nugroho, 2021). The three studies above also reveal the same argument behind the non-compliance of IFIs to Islamic principles, namely the high orientation of IFIs to economic profits, which tends to ignore business ethics in Islam. Hence, the disparity between the fatwa of the National Sharia Board-Indonesia Ulama Council (DSN-MUI) and the practices conducted by IFIs is unavoidable.

Meanwhile, Fitriyani Zein's research found that many IFIs in Indonesia has problems with sharia compliance due to poor governance, as well as the role of the sharia supervisory board (SSBs) that has not been maximized in supervising sharia compliance by IFIs (Zein, 2018). The results of the study by Muhammad Dulal Miah and Yasushi Suzuki also conclude that the *murābahah* financing model does not meet the definition and understanding of *murābahah* based on Islamic principles, which indicates there are problems related to compliance with Islamic principles through *murābahah* contracts (Miah & Suzuki, 2020).

To discuss the above problems, this article will firstly discuss the Islamic principles that IFIs must comply with in carrying out their intermediation function. This study is important because these principles will later become a measuring tool in assessing whether the intermediation function of IFIs has reflected sharia compliance contained in Islamic law. In the second section, the discussion focuses on legal norms regarding Islamic principles in the intermediation activities of IFIs, as stated in a number of Fatwas of DSN-MUI, Bank Indonesia Regulations, Financial Services Authority Regulation, and contracts which is a product of IFIs. The third section discusses the problems of institutional supervision of Islamic financial institutions in complying with Islamic principles. The article closes with the presentation of conclusions and suggestions for improvement regarding the reasons why sharia principles have not been well integrated into IFIs in conducting their intermediation function.

## **Islamic Ethics as a Principle in Performing the Intermediation Function**

Basically, IFIs has the same function as conventional financial institutions, namely as intermediary institutions (Satibi et al., 2018). An intermediary institution is an institution tasked with bridging people who have excess funds that are not used and people who lack funds to fulfill their respective interests (Miah & Suzuki, 2020). In the definition of an IFIs, it is stated that an IFIs is a business entity or institution that activities in the field of sharia finance by raising funds and

distributing funds to the public, especially in financing development investments (Herry et al., 2019).

In carrying out the intermediation function, IFIs are given the flexibility to be able to conduct business transactions to meet the needs of human life and achieve prosperity (Biyantoro & Ghoniyah, 2019). However, there are a number of restrictions on transactions or business activities that are permitted and forbidden. These rules are a manifestation of Islamic law, which aims to protect society from transactions that are contrary to the objectives of Islamic law (*maqāṣid syar'iyah*) (Achmad Soediro, 2018). Business in Islamic ethics is not allowed to contain several things, including The first principle is *ḥarām*. *Ḥarām* is any behavior that is prohibited in Islamic law. If the unlawful act is violated, it will result in an illegal act and get a sin. The second principle is *bāṭil* or *fāsid* (invalid transaction), namely transactions that do not meet the requirements and pillars of transactions regulated in Islamic law. This causes the transaction to be considered invalid, such as reducing the scales, manipulating goods, hoarding, monopolies, transactions under coercion or threats, and transactions made when the time for Friday prayer (Al-Zuhaili, 2007). The purpose of prohibiting *bāṭil* transactions is an effort to reduce business transactions that will cause a lot of losses for the parties involved in the transaction.

The third principle is *ribā* (usury), which is the advantage gained over the exchange between two or more similar goods. According to Wahbah Al-Zuhaili, usury is considered an act of exaggerating assets originating from a transaction that is actually prohibited from providing compensation in any form (Al-Zuhaili, 2007). This means that *ribā* is related to additional goods or money originating from an activity or loans, debts, or deposits transaction that must be repaid in accordance with the agreed time period. Included in the usury transactions are the increasing, growing, increasing, or exceeding that occur in contracts, such as exchange transactions for similar goods, but there is no similarity in the quality and quantity of the goods, and the delivery of goods is not carried out at the same time as the goods are exchanged. Likewise, transactions that provide conditions will provide an excess of the loan principal because it passes the time limit (*nasī'ah*) (Al-Nawawi, 2017).

The fourth principle is *maysir*, which literally means gambling or transactions that are uncertain and contain the nature of mere luck (Al-Mawardi, 2020). *Maysir* is prohibited because the business transactions carried out will cause great damage compared to the benefits. This is because a business transaction that contains elements of *maysir* is not a productive business activity in the form of economic

activity in the real sector, which has an impact on increasing the supply of goods and services, but a form of activity that wants a quick profit without having to work hard. The fifth principle is *gharār*. The Arabic root for *gharār* means fraud, but in practice, the term is employed quite widely, encompassing risk, hazard, uncertainty, and deception (Zein, 2018). *Gharār* is prohibited because it refers to uncertainty or hazard caused by ambiguity regarding the object agreement or price agreed upon in a transaction. The prohibition of *gharār* aims to promote transparency in transactions and avoid ambiguity in business. Thus, it is hoped that all parties involved in the business have sufficient knowledge of the business and know the risks that may arise from the business.

As an intermediary institution, IFIs has several characteristics. First, IFIs must be able to improve the economic welfare of the community through real sector financing activities that provide broad employment opportunities for the community; thus the rate of economic growth will grow optimally (Widyastuti et al., 2020). IFIs must pay attention to the concept of economic welfare in the Islamic economic system, not to the high growth rate. This is because the operationalized economic system seeks to implement real welfare through the production of goods and services that do not conflict with Islamic principles. IFIs must also be able to reduce the gap between rich and poor through fund distribution activities. This means that Islamic financial institutions must be able to pay attention to equity in economic growth. In addition, IFIs, in distributing funds, are prohibited from carrying out financing activities for business activities that have the potential to damage the environment and natural resources.

Second, IFIs should pay attention to socio-economic justice in carrying out wealth and income distribution activities in order to achieve the goal of economic equity at every level of society (Azid & Sunar, 2019). Third, IFIs must be able to carry out savings mobilization activities through investment activities for economic development in a fair manner. Therefore, IFIs can provide profit sharing that can be felt by everyone involved. Savings mobilization is very important to realize socio-economic goals. This is because savings collected by IFIs must be productive funds for the welfare of the community. Consequently, IFIs must be able to provide literacy education to the public who deposit funds regarding the concept of property in Islam which strictly prohibits the act of accumulating unproductive assets (Nugroho, 2021). Fourth, IFIs must be able to optimize zakāt (almsgiving), *infāq* (pious spending), and *sadaqah* (voluntary charity). In the concept of Islamic finance, IFIs is an institution that functions as a *bayt al-māl* (collector and distributor of social funds) and *bait al-tamwīl*

(an institution that collects and distributes for-profit financing funds) at once (Satibi et al., 2018).

The intermediation function carried out by IFIs as business entities are to conduct the financial sector based on contract principles in Islamic law. This shows that every stipulation regarding the agreement in Islam is a legal norm that regulates and must be obeyed and applied in the IFIs's activities. Islamic legal norms regarding financial institutions, according to *uṣūl al-fiqh* (the principles of Islamic jurisprudence), are the result of developing *mu'amalah* (commercial and civil acts or dealings) contracts in Islamic law, the application of which is frequently based on Islamic principles. Islamic legal norms regarding *mu'amalah* contracts are norms that regulate contracts in all business transaction activities, whether carried out by individuals or companies such as IFIs.

The intermediation function of IFIs is more varied than the intermediation function of non-sharia financial institutions. That matter due to the system for obtaining profits at IFIs consists of various kinds, including profit and loss sharing, profit margins, and profits through the provision of fees (Satibi et al., 2018). The various systems of obtaining these benefits result in the various contracts performed by each IFIs, and customers have many options in choosing transaction contracts that are appropriate to the needs and goals of the IFIs's customers. Customers who want their funds to be stored safely and not exposed to any risk are offered savings products shaped like clearing accounts or deposits based on the *wadī'ah* principle (deposit of assets by a customer with an IFIs) (Widyastuti et al., 2020). Meanwhile, if the customer wants his funds to be saved to pursue economic benefits, then a savings product is offered to him based on the profit-sharing principle (*'aqd al-mudārabah*) (Miah & Suzuki, 2020).

IFIs will collect funds from the public through various types, including savings, deposits or investments, and clearing accounts (Herry et al., 2019). After collecting funds from the public, IFIs will redistribute them through financing activities in the real sector with the aim of being productive using commerce-based financing and investment-based financing. Commerce-based financing is a financing pattern through buying – selling, and leasing, while the investment-based financing model is a profit-sharing pattern. In addition, IFIs shall provide bailout funds with a loan pattern.

All financing in IFIs will be tied to various financing contracts, including aiding on the basis of trade-based financing transactions. This financing consists of two types of transactions, namely: first, financing with a buying and selling pattern by exchanging assets between both parties on the basis of an agreement in

exchange for something permitted by using several contracts, including *murābahah* (cost-plus financing), *salam* (a trade agreement which involves preceding payment for the specific commodity to be consignment later) and *istiṣnā* (a sale by order of property) (Nur'aeni & Setiawan, 2020). Second, financing with a lease transaction pattern by including compensation which is carried out on the basis of a benefit in exchange for services. In such a pattern, frequently, the contract used is *ijārah* (rental agreement) and *ijārah mumtahiyah bi al-tamlīk* (lease agreement which leads to the transfer of ownership to the lessee) (Achmad Soediro, 2018).

Another form of disbursement of funds is by financing using an investment-based financing pattern. This pattern is financing with a profit-sharing pattern which is carried out by means of a partnership between both parties, namely the owner of capital and the manager of the business. The contract commonly used is *mudārabah* or *musyārakah* (joint enterprise) (Biyantoro & Ghoniyah, 2019). In addition to the two patterns already mentioned, the distribution of funds to IFIs can also be carried out with a financing pattern with a bailout using a *qarḍ* contract (an interest-free loan).

The description above shows IFIs as institutions that carry out intermediation functions widely and in various ways with various contracts. Therefore, IFIs must pay attention to certain variants of provisions relating to all rights and obligations between customers and IFIs, including paying attention to the types of responsibilities of the parties arising from each type of contract or agreement. IFIs must be able to adjust funding needs for customers as agreed with the Islamic principles, whether in the form of contracts or agreements for commerce-based financing, investment-based financing, or financing with bailouts, including banking services. IFIs should as well meet obligations as a provider of funds and goods as agreed. This must be done by IFIs as a form of fulfilling the responsibilities of IFIs to customers. Customers also cannot be separated from various obligations that must be fulfilled as a responsibility of the existence of contracts or agreements that have been made with IFIs. Furthermore, to include incumbency, a contract or agreement must also include responsibilities that confirm Islamic principles.

The intermediation function in IFIs requires the existence of an underlying transaction and/or underlying assets as a basis for transactions in IFIs (Narayan & Phan, 2019). Whereas in conventional financial institutions, there are no such requirements. The legality of a transaction is mutually beneficial to the financial institution and the customer (Meslier et al., 2020). Based on such a contract scheme, the halalness of a transaction can be ensured. Thus, the intermediation



function of IFIs is closely related to the characteristics of Islamic financial products based on the real sector.

### **DSN-MUI Half-Hearted Authority in Formulating Islamic Principles**

Based on the foregoing explanation, the intermediation function of IFIs in various financing by following various patterns of sharia contracts, placing IFIs possible carry out business practices on a broad scale, which is not limited to distributing funds needed by the community. Therefore, the role and position of IFIs in carrying out the intermediation function do not only place IFIs as credit distribution institutions.

The various intermediation functions in IFIs should comply with Islamic principles. The Islamic principles in this article refer to all the principles that have been established by Law Number 21 of 2008 regarding Sharia Banking (Sharia Banking Law) and the Fatwa of DSN-MUI. Nevertheless, Sharia Banking Law regulations follow the fatwa of DSN-MUI in determining Islamic principles that must be adhered to by IFIs. Thus, the difference between both regulations lies in the area of their application.

According to Article 1 Paragraph 12 of the Sharia Banking Law, Islamic principles are Islamic legal principles in banking activities based on fatwas issued by institutions that have the authority to issue fatwas in the sharia sector. Furthermore, in Paragraph 13, it is stated that a contract is a written covenant between an Islamic bank or Islamic business unit and another party that contains incumbency for each party in conformation with Islamic principles. Although the regulation doesn't explicitly state what is meant by an institution that has the authority to define a fatwa in the sharia sphere, the only institution that has such authority in Indonesia is DSN-MUI.

Even though the Sharia Banking Law has provided legitimacy for the DSN-MUI to stipulate Islamic principles applied to IFIs, these fatwas contain abstract provisions (Adinugraha et al., 2021). The fatwa material only gives consideration to a contract from the *halāl-harām* viewpoint without mentioning any elements that make a contract halal or haram. This encourages interested parties to interpret these fatwas. These interpretations have an impact on the emergence of a diversity of understandings that frequently clash with one another. For example, the DSN-MUI fatwa Number 4/DSN-MUI/IV/2000 concerning *murābahah* states that banks and customers must enter into a usury-free *murābahah* contract without further explaining how the *murābahah* contract is free of usury. This causes each bank to have its own understanding of the usury-free *murābahah* contract. It is not



uncommon to find in a bank a *Murābahah* contract is forbidden, but in another bank, it is permissible. Moreover, the DSN-MUI in the Indonesian constitutional system is not a state as an institution that has the authority to issue regulations. This raises questions about the legitimacy of the fatwas issued by the DSN-MUI.

As explained earlier, several Islamic principles have been stated in the DSN-MUI Fatwa in the Indonesian context. The fatwa stipulated by the DSN-MUI then became a legal opinion used by a number of stakeholders. Fatwa itself is a ulemas response to an event that is formulated in the form of explanations and legal decisions on the matter. The legal basis used in producing a fatwa is the *Al-Qurān*, *ḥadīth* (prophet tradition), *ijmā'* (consensus), *qiyās* (analogy), and *ijtihad* (the thoughts of the ulemas). In the Indonesian context, the formulation of the DSN-MUI Fatwa, which is applied to IFIs, must comply with the Guidelines for Determining the MUI Fatwa Number U-596/MUI/X/1997. These guidelines were prepared by the MUI Fatwa Commission. In this Guideline, it is stated, "every issue discussed in the Fatwa Commission (including fatwas on sharia economics) must be found on the *Al-Qurān*, *ḥadīth*, *ijmā'* and *qiyās*." Before the fatwa is stipulated, the scholars are obliged to review the fatwa with the opinions of the school's priests. From the explanation above, it is known that every fatwa made by DSN-MUI for IFIs has basically made every effort to fulfill Islamic principles. Each type of transaction in various sharia contracts that apply to IFIs can be ascertained to be in compliance with general Islamic principles.

Recently, three categories of fatwas have been issued by the DSN-MUI relating to IFIs (Zein, 2018). first, fatwas related to fund-raising activities, namely sharia demand deposits (Fatwa Number 1/DSN-MUI/IV/2000); sharia savings (Fatwa Number 2/DSN-MUI/IV/2000); and sharia deposits (Fatwa Number 3/DSNMUI/IV/2000). Second, fatwas related to funding distribution activities, namely transactions through *muḍārabah* contracts (Fatwa Number 7/DSN-MUI/IV/2000); transactions through a *musyārahah* contract (Fatwa Number 8/DSN-MUI/IV/2000); transactions through *murābahah* contracts (Fatwa Number 4/DSN-MUI/IV/2000). Third, fatwas related to service activities, namely foreign exchange (*ṣarf*) (Fatwa Number 28/DSNMUI/III/2002); transaction Letter of Credit (L/C), imported sharia (Fatwa Number 34/DSN-MUI/IX/2002); and activities regarding Sharia Bank Guarantee (Fatwa Number 11/DSN-MUI/IV/2000) (Kristianti, 2020).

The fatwas issued by DSN-MUI are only for consideration (Adinugraha et al., 2021). This means the formulation in these fatwas is a general guideline that must be elaborated further into various policies or regulations that apply to every transaction activity of Islamic financial institutions. More details, for example, the

provisions in Fatwa Number 137/DSN-MUI/IV/2020 regarding *ṣukūk* (financial certificate), will be described in the table below.

Table I. DSN-MUI Fatwa Regarding *Ṣukūk* (Financial Certificate)

General Requirements	Special Requirements
<div>1. <i>Ṣukūk</i> are Islamic guarantee in the pattern of certificates or legal paper which has the identical value, and represents an indeterminate share of ownership of the elemental asset after receipt of the <i>ṣukūk</i> funds, closing of the order and the commencement of the use of the funds according to their designation.</div> <div>2. <i>Ṣukūk</i> assets are assets that form the basis for the issuance of <i>ṣukūk</i> consisting of tangible assets (<i>al-a'ḃān</i>), the value of benefits on tangible assets (<i>manāfi' al-a'ḃān</i>), services (<i>al-khadamāt</i>), certain project assets (<i>maujūdat masyrū' mu'ayyan</i>) and/or assets predetermined investment activities (<i>nasyah istitsmār khāṣ</i>).</div>	<div>1. <i>Ṣukūk</i> assets (<i>uṣūl al-ṣukūk</i>) used as the basis for issuing <i>ṣukūk</i> must comply with sharia principles;</div> <div>2. <i>Ṣukūk</i> assets belong to the <i>ṣukūk</i> holders</div> <div>3. Each unit of <i>ṣukūk</i> must have the same value (<i>mutasāwiyah al-qīmah</i>);</div> <div>4. <i>Ṣukūk</i> at the time of issuance do not reflect the debt of the issuer to the <i>ṣukūk</i> holder, but rather reflects the <i>ṣukūk</i> holder's ownership of the <i>ṣukūk</i> assets;</div> <div>5. <i>Ṣukūk</i> can be turned into debt/receivable (<i>dāin</i>) in terms of assets the <i>ṣukūk</i> turns into receivables of the <i>ṣukūk</i> holder;</div> <div>6. In principle, the issuance of <i>ṣukūk</i> must have a certain term of time unless otherwise agreed in the contract or regulated by applicable laws and regulations;</div> <div>7. Issuers are required to discharge income to <i>ṣukūk</i> holders in the pattern of sharing the margin fee and repaying the <i>ṣukūk</i> funds when due date in accordance with the contract scheme;</div> <div>8. <i>Ṣukūk</i> yields with <i>muḃārabah</i> and <i>musyārakah</i> contracts must be derived from business activities that become <i>ṣukūk</i> assets.</div>

The fatwa formulation, as shown in the table above, seems to regulate more general matters. Therefore, when an IFIs makes sharia contracts using the fatwa, it still has to interpret the transactions related to the fatwa, which do not violate Islamic principles. In addition, the structure and format of the Fatwa is also limited to determining the basis or legal status of a transaction for which a fatwa is requested and determining the possibilities of what activities are lawful and unlawful.

Thus, the nature of the fatwa is exhortations, which is an effort to provide education to the public and IFIs regarding transactions in Islam. The fatwas must again be reinterpreted by the SSBs in every IFIs. Frequently, the reinterpretation conducted by the sharia supervisory board at every IFIs differs greatly from the

intent and purpose of the DSN-MUI fatwa. Interpretation gaps can be found, for instance, in the reinterpretation made by IFIs toward the DSN-MUI fatwa regarding *murābahah* financing. In fatwa Number 04/DSN-MUI/IV/2000 concerning *murābahah*, DSN-MUI stipulates that the financing offered by banks to customers must be in the pattern of real commodity with a selling cost equal to the purchase price plus revenue. However, in current practice, Islamic banks seem to offer sharia financial products such *murābahah*, *muḍārabah*, and *musyarakah* contracts, but in fact, they offer conventional loan financing schemes (Miah & Suzuki, 2020). The consequence that occurs is not buying and selling financing based on a *murābahah* contract but buying and selling money wrapped in a *murābahah* contract (Ibrahim & Salam, 2021).

Differences in interpretation are also inevitable between the SSBs in an IFIs and the SSBs at another IFIs. These differences in interpretation can be found, for instance, in the condition that Islamic banks are unable to provide goods offered to customers in *murābahah* financing, as required in the DSN-MUI fatwa. Some SSBs at certain Islamic banks allows *murābahah* financing to be carried out by lending money to customers under *wakālah* contracts. It is hoped that with this loan, customers can represent Islamic banks to find their own goods. However, this practice is not justified by the SSBs in other IFIs, such as Bank Muamalah. These interpretive gaps have made policy makers at Islamic financial institutions unable to fully comply with the DSN-MUI fatwas.

The essence of the fatwa issued by the DSN-MUI is to give signs for Islamic financial institutions not deviating from Islamic principles. However, the DSN-MUI Fatwa is still difficult to implement because the rules are still general and not operational. The reason behind the non-operation of the DSN-MUI fatwa is due to the ambiguity of the *ijtihad* method used (Hasyim, 2019). DSN-MUI, on the one hand, still respects the fatwas of classical scholars contained in various classical books. But on the other hand, DSN-MUI is aware that many of the classic fatwas are no longer relevant to modern economic developments (Lindsey, 2014). For example, in its fatwa, DSN-MUI states that the current practice of interest-bearing money has met the criteria for usury that occurred at the time of the Prophet. However, DSN-MUI, for reasons of emergency, allows Muslims to interact with conventional banks in areas where there are no sharia banks. Whereas sharia banks also practice bank interest like conventional banks, although with different names. To overcome this methodological problem, DSN-MUI must develop a fatwa methodology that respects the latest economic developments while still upholding sharia principles.

In addition, the non-compliance of IFIs with Islamic principles regulated by DSN-MUI is since DSN-MUI is not included as one of the institutions authorized to establish regulations and laws as formed in Law No. 12 of 2011 regarding the formulation of Legislation. The absence of such authority causes the DSN-MUI fatwas to have no binding legal implications (Ibrahim & Salam, 2021). This is found, for example, in the Indonesia Central Bank Regulation Number 10/16/PBI/2008 concerning the Implementation of Islamic Principles in Fundraising and Funding Scheme as well as Sharia Bank Services. In this Regulation, the intermediation purpose of IFIs is interpreted as equal to the capital distribution in the form of debt financing. In Article 1, point 8, it is stated that "... financing is the stipulation of funds or claims that can be equated with it". When referring to the DSN-MUI fatwa, the intermediation function of IFIs must be based on the agreed contract.

The Indonesian Central Bank regulations concerning sharia financing activities in IFIs also do not include the DSN-MUI Fatwa as one of their legal considerations, as found in the Indonesian Central Bank Regulation Number 10/16/PBI/2008. Although the DSN-MUI is not an authoritative institution with the power to make laws and regulations, several other regulations issued by the Indonesia Central Bank and the Financial Services Authority (OJK) have referred to the DSN-MUI fatwa.

To overcome these problems, strategic steps are needed to improve the regulatory system regarding Islamic financial institutions. Improve the authority of DSN-MUI from just a fatwa council to becoming an institution authorized to issue regulations that are more binding and enforce unavoidable actions. Initially, such a scenario was planned in the Draft of the Islamic Banking Bill; however, it was rejected due to the MUI's opposition to placing DSN-MUI as part of BI's regulatory body. This opposition makes the issue even more complicated to resolve. On the other hand, DSN-MUI must also transform its fatwa method. The development of the fatwa methodology can be carried out in three ways: (1) Fatwas must be more appreciative of the latest findings in modern economics; (2) The utilization of fiqh and other Islamic sciences is limited to seeking principles and values, not as a sich law; (3) The employ of clear and firm legal terms, and avoiding the use of ambiguous words that have the potential to give rise to multiple interpretations. These fatwas will be understood by IFIs more as binding and coercive regulations than just an advisory fatwa. These improvements are expected to increase the level of compliance of IFIs to Islamic principles in carrying out the intermediation function.

## Effectiveness of SSBs Supervision Toward IFIs Compliance

Regarding institutional structure, the distinction between conventional financial institutions and IFIs lies in the presence or absence of a SSBs as an internal sharia compliance supervisory agency (Salman & Nawaz, 2018). Every IFIs is required to have at least three supervisors on the SSBs. The existence of a SSBs in the structure of IFIs is regulated in Article 109 of Law Number 40 of 2007 concerning Limited Liability Companies; Article 32 of Law Number 21 of 2008 concerning Sharia Banking and Regulation of the Minister of Cooperatives and Small and Medium Enterprises of the Republic of Indonesia Number 16/Per/M. Kum/IX/2015 concerning Implementing Sharia Savings, Loans and Financing Business Activities by Cooperatives. In these regulations, the SSBs supervises every sharia activity or transaction carried out by IFIs.

In the governance of IFIs, the position of the SSBs is compatible with the *hisbah* concept in classical Islamic law (Jaballah et al., 2018). The similarity lies in the goals and functions of the *hisbah* and the SSBs, which are both trying to encourage community activities in conformability with Islamic principles. In the *hisbah* concept, supervisory institutions such as SSBs are called *muhtasib*, while supervised institutions such as IFIs are called *muhtasib 'alai* (Al-Zuhaili, 2007). *Muhtasib* is in charge of providing advice and supervision. Such advice and supervision are expected to direct IFIs to comply with Islamic principles in the execution of their business activities. Therefore, the SSBs is a highly prominent element in the structure and governance of IFIs.

The SSBs position, which is highly crucial in the IFIs activities, is, in fact, often ineffective (Nugroho, 2021). The function of the SSBs is regulated in Indonesian Central Bank Regulation Number 6/24/PBI/2004. The regulation states that the SSBs performs supervisory duties at the internal level of IFIs. Structurally, the position of the SSBs as the internal supervisor of the sharia financial institution is equivalent to the directors' board position of the IFIs. Thus, the relationship between the SSBs and the directors' board of IFIs in an organizational structure of IFIs is coordinating, in which a SSBs has the right and competency to serve advice and feedback to the directors' board of IFIs regarding all IFIs business activities related to Islamic principles. The equal position between the SSBs and the directors' board in an IFIs also has the consequence that as a company has an organizational structure, internally, IFIs puts SSBs position under the Commissioner's board and the Shareholders. Such an organizational structure is problematic for the SSBs in conducting its duties as advisory and supervisory. This is because the SSBs consideration of IFIs business activities also must adjust to the interests of

shareholders and the commissioners board to pursue the maximum profit. This cross-interest often lead the SSBs frequently involved in conflicts of interest with these stakeholders.

Another problem related to institutional supervision of IFIs is the concurrent position of a SSBs in several IFIs. This has actually been regulated in Indonesia Central Bank Circular No. 12/13/DPbS/2010, a member of the SSBs can only hold concurrent positions on the SSBs for no more than four sharia financial institutions with details, a maximum of concurrent positions on the SSBs in two banking institutions and two non-banking institutions. A SSBs is also prohibited from concurrently serving as a consultant in other financial institutions outside the four Islamic financial institutions (Biyantoro & Ghoniyah, 2019). However, the legality of these dual positions creates problems. These problems originate from the unfocused supervision work carried out by the SSBs. Moreover, these overlapping positions create the bias of policies and decisions made by the SSBs in supervising IFIs under its authority. Generalizing problems with the character and needs of each different IFIs requires different considerations. This is often ignored by the SSBs who concurrently holds positions in several IFIs.

Furthermore, other problems in the supervisory institutions of IFIs are the permissibility of DSN-MUI component to become fellow of the SSBs. This actually causes the occurrence of multiple positions, not even double positions, but also dual supervisory functions of a member of the DSN-MUI and the SSBs. Whereas the supervisory function carried out by members of the DSN-MUI is an external supervisory agency, the supervision of SSBs focuses on internal supervision (Meslier et al., 2020). Therefore, the overlap of these positions can appear biased toward internal and external supervision. The dual membership of the DSN-MUI members and, at the same time, serving as a fellow of the SSBs raises problems regarding the independence between the functions of the two supervisory institutions. According to Indonesian Central Bank Regulation Number 6/24/PBI/2004, a member of the SSBs at an LSK has an obligation to compile a supervisory report related to the implementation of Islamic principles in an IFIs to the DSN-MUI periodically. This has great potential to create an acute conflict of interest and the loss of checks and balances in business activities and the intermediation function of IFIs.

Lastly, apart from the issue of concurrent positions, matters related to the absence of regulations governing the competency testing of the SSBs also contributed to the inability of IFIs to fully adapt to Islamic principles. The competence of the SSBs in Indonesia is more concerned with Islamic religious figures and not with the competence of sharia economics and finance.

To unravel this problem, it is necessary to revamp the rules governing the traffic of sharia supervisory organizations. The new regulation clearly and firmly regulates the duties and functions of each sharia supervisory agency. Thus, tiered supervisory work can overcome overlapping positions and conflicts of interest that cause IFIs to not comply with Islamic principles. SSBs focuses on internal monitoring of an IFIs without concurrent positions in other IFIs. And periodically report the results of the internal control to the DSN-MUI, whose members only focus on external supervision and do not serve as members of the SSBs. In addition to regulatory issues, it is also essential to increase the competence of SSBs. Especially competence in the field of modern economics and Islamic economics. The current practice is that IFIs prefers to recruit religious leaders who have significant influence in society as SSBs. The recruitment of religious figures aims to strengthen the image of an IFIs as a sharia financial institution that implements Islamic economic principles, which in turn affects the marketing of financial services and products of an IFIs. Unfortunately, most of these religious figures have less knowledge about the development of modern economics and Islamic economics.

## Conclusion

In carrying out the intermediation function, IFIs are required to comply with Islamic principles decreed by the DSN-MUI. In its implementation, there are obstacles frequently faced by IFIs in complying with these principles. These include regulatory, supervision agency structure, and the competence of supervisory agency members-related constraints. Regulatory obstacles stem from the absence of the DSN-MUI authority as an institution with the power to make regulations equivalent to laws. This absence of authority causes IFIs to regard the fatwas issued by the DSN-MUI as mere advice or appeals and not binding. The DSN-MUI's fatwas are very abstract and have not accommodated technical and operational provisions, leading to multiple interpretations at the level of implementation by IFIs. The discourse of making DSN-MUI an authoritative institution appeared in the Draft Islamic Banking Law.

The compliance of IFIs with Islamic principles also faces problems related to supervisory institutions. Even though the Sharia Supervisory Board's (SSB) position is equal to the directors' board, it still finds difficulties carrying out its supervisory duties and is repeatedly trapped in the interests of the shareholders and the commissioners' board. The concurrent position of DSN-MUI members as sharia supervisors in four different SSBs and IFIs is caused by the unfocused sharia compliance supervision. Eventually, this leads to the lack of compliance of IFIs with Islamic principles.



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