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Transformation of Banking Law in Indonesia

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Abstract

Globalization development through the market economy system has created injustice for humankind, encouraging Muslims to implement the Sharia in their economic activities. The rapid growth of sharia economy in Indonesia, ultimately affects the financial industry, including the banking that implicates regulation and organizational structure causing two banking systems, namely conventional banking and sharia banking. Based on the description, this paper discusses the national banking law that applies two rules of law in Indonesia. To address these legal issues, conceptual approach, statutory approach and historical approach are used. Based on the analysis, since the enactment of Law Number 21 Year 2008 on Sharia Banking, the existence of sharia banking is getting stronger. Therefore, in Indonesia there is a dual bank system in one rule, namely banking law. Both banks are responsible to bank Indonesia as national central bank. Conventional banks may conduct business activities based on sharia principles, but not so for sharia banks.

Keywords: conventional bank; sharia bank; sharia principles.

Abstrak

Globalisasi yang digaungkan melalui sistem ekonomi pasar telah menimbulkan ketidakadilan bagi umat manusia, sehingga mendorong umat muslim untuk menerapkan sistem ekonomi syariah. Tumbuh pesatnya ekonomi syariah di Indonesia pada akhirnya berpengaruh pada industri keuangan termasuk perbankan yang membawa implikasi pada regulasi dan struktur organisasi yang menyebabkan adanya dua sistem perbankan, yaitu perbankan konvensional dan perbankan syariah. Berdasarkan uraian tersebut, tulisan ini membahas mengenai hukum perbankan nasional yang menerapkan dua aturan hukum di Indonesia. Dalam menjawab isu hukum tersebut, digunakan pendekatan konseptual, pendekatan perundang-undangan dan pendekatan historis. Berdasarkan analisis, sejak diundangkannya Undang-Undang Nomor 21 Tahun 2008 tentang Perbankan Syariah, eksistensi perbankan syariah semakin kuat. Oleh karenanya saat ini di Indonesia terdapat dual bank system dalam satu aturan, yaitu hukum perbankan. Kedua bank konvensional dan bank syariah bertanggung jawab terhadap bank Indonesia. Bank konvensional dapat melaksanakan kegiatan usaha berdasar prinsip syariah, namun tidak demikian dengan bank syariah.

Kata kunci: bank konvensional; bank syariah; prinsip syariah.

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Introduction

Globalization has brought advantages by creating an easy access for countries to the global market. However, globalization has also brought disadvantages, namely with the existence of inequality which in turn tends to bring injustice, because it prioritizes material values. Besides, globalization has also tended to only benefit developed countries. Government should anticipate the pace of globalization in terms of disadvantages so that it will not damage the economics.

Then this is the functions of bank, especially *Bank Indonesia* as the central bank to maintain stability and prevent economic crisis in Indonesia. As one of example, *Bank*

Indonesia has a significant function as lender of the last resort at the time when a bank is under crisis. However, this function may also create moral hazard as a result (Kurniawan, 2019).

In Asia, *Bank Indonesia* is among the central banks that pioneer in conducting studies on financial system stability by establishing the Financial System Stability Bureau (Suhartono, 2009). Nowadays almost all central banks all over the world are applying the financial system stability issue as their main topics on economic policy. Not only central banks, international financial organization such as IMF and ADB specifically form particular divisions or units to monitor and assess the financial conditions of their respective countries and publish it in a special report on financial stability.

Banking is a bridge for the real sector finance, both in the context of improving business and investment climate, also in terms of job creation. A strong and resilient banking system is the foundation for sustainable economic growth, as banks are the centre of the credit intermediation process between savers and investors (Benhayoun, et.al, 2014). The challenges faced by *Bank Indonesia* are indeed getting stronger since finance industry is always facing regulatory changes along with the technological developments and society cultures that impact on organizational changes. For instance, the urge of Muslims, who want to return on their belief especially in the economic field, has gained a momentum when the existing economic system, both capitalist and socialist apparently does not provide justice for the people. The momentum had taken place when International Conference on Islamic Economics was held for the first time in Makah in 1976, then held in Islamabad and in Kuala Lumpur respectively in 1983 and 1992 (Rizal, 2011). The demands of the world Muslims have the implications on sharia principles application in the system of Indonesia Banking Law in 1992, through the profit sharing principle regulated under Law Number 7 of 1992 concerning banking.

In fact, according to Thorsten Beck (2010) current global financial crisis does not only focus on the functioning of conventional banking but also Islamic banking, the bank with compliance of sharia principle and is more known as sharia banking in some countries (p.2). Policy makers likewise point to the advantages of sharia banking, as the mismatch of short-term, an on-sight demandable deposits contract with long-term uncertain loan contracts is mitigated with equity elements.

Sharia economic transformation in banking system continues and even today Sharia Banking has become an important element in Indonesia Banking Law system. The existence of Sharia banking is getting stronger because it is supported by various regulations, both regulations concerning institutions and business activities. The rapid growth of sharia banking is due to the desire of Muslims to be faithful in carrying out their Sharia, especially when conventional banking operations applies principle that are prohibited in the Sharia such as gambling (*maysyrir*), uncertainty/doubt (*garar*), as well as interest (*riba*) (Jobst, 2007).

Research Problems

The rapid development of Sharia Banking as one of the Muslims need in Indonesia at the end influence the finance market, including the banking system that brings implications on regulation and organizational structure. Therefore, now there are currently two banking system applied in Indonesia, namely conventional banking system and sharia banking system. Based on the description above, this paper discusses the national banking law system in Indonesia that applies two different legal rules.

Research Methods

In order to answer the problems regarding the application of *one-bank two laws* in Indonesia, the conceptual, historical and legal approaches are used. The legal sources used in this paper include primary legal sources, both in the form of legislation and the Quran, and secondary legal sources, in the form of textbooks written by influential legal experts (*the most highly qualified legal scholars' opinion*), legal research result, hadiths, legal journals, legal dictionaries and the latest symposium result related with the legal issued concerned. Legal materials are then analysed qualitatively. The analysis method is carried out by interpreting and discussing the results of research based on legal principles, legal theories, legal notions, legal norms, and concepts related to the subject matter.

Discussion

Dual Banking System in Indonesia

There has been three dominant theory defining the role and function of bank during the 20th century (Werner, 2014). *First, the credit creation theory of banking*, maintains that each bank can individually create money 'out of nothing' through accounting operations, and does so when extending a loan. *The fractional reserve theory* states that only the banking system as a whole can collectively create money, while each individual bank is a mere financial intermediary, gathering deposits and lending these out. *The financial intermediation theory* considers banks as financial intermediaries both individually and collectively, rendering them indistinguishable from other non-bank financial institutions in their behaviour, especially concerning the deposit and lending businesses, being unable to create money individually or collectively. Howard Choo argues:

"Normally, in business, when one fails to cope with the market forces due to shortcomings of a financial or non-financial nature, one will face the consequences of business closure. However, this cannot be applied to banks because they are doing business with public funds. Therefore, being a custodian of public funds, no matter how poorly a bank may have managed its funds, the central bank will not allow the bank leave the industry as other business do. Instead, the central bank, as experience has shown, will bail out the ailing financial institution. This referred to as the eventual safety net of the central bank. In that sense, financial institution cannot be disciplined by marketplace. Hence, being a lender of last resort, the central bank must have supervisor power over all aspect of banking, including issuing rules and regulations to avoid mismanagement of public funds by financial institutions" (Choo, 1995).

Islamic banking systems are aimed to provide halal financial services to Muslims and expected to contribute to the achievement of social and economic goals based on Islamic Law. Moreover, the main target of the development of Sharia banks is not only to increase economic welfare, but also to expand employment opportunities, high economic growth rates, socio-economic justice and the distribution of reasonable income and wealth, stability in the value of money, and mobilization of savings and investments for economic development (Tahir, 2017). Moslem scholars mostly relies on a single principle in defining and legitimizing the existence of Islamic Finance, avoidance of interest while mitigating risk (Souaiaia, 2014).

The rapid development of sharia economy has influenced the regulation and organizational structure in Indonesia banking system. Since the enactment of Law number 21 of 2008 concerning Sharia Banking, the existence of Sharia Banking gets stronger. Therefore, currently in Indonesia there are dual bank systems in one law, namely Banking Law. These dual bank systems are Conventional Bank and Sharia Banking. In Indonesia, the term of Sharia Banking has the same meaning with Islamic Banking.

Bank based on Article 1 point 2 Law number 10 of 1998 regarding changes to Law Number 7 of 1992 concerning Banking, is a corporate entity mobilizing funds from the public in the forms of Deposits and channelling them to the public in the forms of Credit and/or other forms in order to improve the living standards of the common people. In this law indeed there is no dichotomy in the terminology of Conventional Bank and Sharia Bank. The use of the terms conventional banks and Sharia Bank only emerges in Law No. 21 of 2008. Article 1 point 3 Law number 21 of 2008 concerning Sharia Banking defines Conventional Bank as the bank conducting business activities conventionally consisting of Conventional Commercial Bank and Rural Credit Bank, while the Article 1 point 7 defines Sharia Bank as the Bank conducting business based on the Sharia Principles consisting of Sharia Commercial Bank and Sharia People Financing Bank.

Generally speaking, Sharia Bank assists business world by providing all the services required to run economy smoothly, however, the philosophy and operations are different (Hanif, 2014). Economy under sharia principle is aimed to achieve three main principles, such as the principle of moderation (*I'tidal*), the principle of efficiency (*al-Kifayah*), and the principle of social justice (*al-'Adalah al-Ijtima'iyah*) (Mikail, 2013). Sharia Bank should balance the financial and social performances, in which it should provide a positive contribution to poverty alleviation, environmental, equality, justice, health, teaching and also spiritual (Nugroho, 2017).

Sharia banking does not allow for the charging of interest payments or known as *riba* (Bouheni, 2015), as only goods and services are allowed to carry a price. *Riba* is generally regarded as a measure that protects vulnerable debtors and guards against unjust enrichment by creditors, and clearly condemns interest on loans as a form of usury (Phull, 2011). For some reasons, *riba* in this case is still facing controversy whether it is exactly equivalent to interest in conventional bank (Farooq, 2009). However, *riba* is basically referring to two similar concepts of making money from money and any predetermined

payment over and above the actual amount of principal (Alexander, 2011). Besides the prohibition of *riba*, trading with unacceptable level of uncertainty (*garar*) is also prohibited and presumed to be invalid transaction (Tabari, 2010). Moreover, there are also some principles that applied which distinguish bank based on sharia and other systems such as *tawheed* principle, justice principle and *maslahat* principle (Rodliyah, 2018).

Sharia banking relies on the idea of profit loss and risk sharing, on both the liability and asset (Farooq, 2007). Bank Indonesia defines the sharia banking system as a beneficial mutual partnership that provides alternative in banking system as follows:

“The characteristic of Islamic banking operation is based on partnership and mutual benefits principle provide an alternative banking system with mutual benefits both for the public and the bank. This system will give priorities to aspects related to fairness in transaction and ethical investment by underlining the values of togetherness and partnership in production, and by avoiding any speculative activity in financial transaction. By providing various products and banking services supported by varieties financial scheme, Islamic banking will be a credible alternative that can be benefited by all of Indonesian people without exception” (Arshad, 2016).

Basically Sharia Bank is similar to conventional one, it can be either commercial bank or rural bank and Financial Service Authority (*Otoritas Jasa Keuangan* or *OJK*) supervises the activities of those banks (Shomad, 2017). Meanwhile the dispute concerning Sharia Bank falls under the competence of Religious Court (Bintoro, 2017). Furthermore, based on Explanation of Article 6 letter m Law number 10 of 1998 concerning Banking, a Commercial Bank that is conducting conventional businesses may conduct its activities based on Sharia Principles through: a) Establishment of new Branch Office or office under Branch Office; or b) Converting the existing Branch Office or office under Branch Office, which is previously conducting conventional Banking businesses to become an office which is conducting businesses based on Sharia Principles. In order to prepare the conversion of a Commercial Bank office to become an office based on Sharia Principles, Branch Office or office under Branch Office may initially form a separate unit, which conduct its businesses based on Sharia Principles within the office concerned.

Commercial Bank conducting businesses based on Sharia Principles shall not conduct conventional businesses. Salient features of Bank Indonesia provision includes among others, first business activities and bank's products based on Sharia Principles, second the formation and tasks of Sharia Supervisory Council, and the last is the requirements for the establishment of Branch Office conducting conventional Banking businesses to conduct business activities based on Sharia Principles.

There are several elements, which are included under the scope of Commercial Bank operation. If we take a look on Article 6 of the banking law (after the amendment in 1998), the operation of Commercial Bank encompass: *first*, mobilizing funds from the public in the form of deposits, comprising demand deposits, time deposits, certificate of deposits, savings and/or other equivalent forms of deposits; *second*, extending credits; *third*, issuing notes; *fourth*, purchasing, selling or guaranteeing against own risk or on behalf of and/or

at the request of a customer: (1) bills of exchange, including banker's acceptances of which the maturity is no longer than the common practice of trading such documents; (2) notes and other commercial paper of which the maturity is no longer than the common practice of trading such documents; (3) treasury bills and government guarantees; (4) Bank Indonesia Certificates (SBIs); (5) bonds; (6) commercial paper with a maturity of up to 1 (one) year; (7) other securities with a maturity of up to 1 (one) year; *fifth*, transferring money, either on own behalf or at the request of a customer; *sixth*, placing funds in, borrowing funds from, or lending funds to other banks, whether by letter, telecommunications device, or by sight draft, cheque, or other means; *seventh*, accepting payments in respect or claims for securities, settling accounts with or among third parties; *eighth*, providing safety deposits boxes for valuable goods and papers; *ninth*, undertaking custodial activities on behalf of another party based on contracts; *tenth*, undertaking placement of funds among customers in the form of securities not listed in the stock exchange; *eleventh*, conducting business in factoring, credit cards, and trusteeship; *twelfth*, providing financing and/or conducting other activities based on Sharia Principles, in accordance with the regulations stipulated by Bank Indonesia; and *thirteenth*, conducting other business commonly undertaken by banks providing that such activities shall not be in contravention of this Act and prevailing laws.

While the operation of Commercial Sharia Bank based on Article 19 point (1) and 20 point (1) of Law number 21 of 2008 are: *first*, mobilizing funds in the form of Deposits such as Demand Deposit, Savings, or other compatible forms based on *Akad wadi'ah* or other *Akads* which are not contradictory to the Sharia Principle; *second*, mobilize funds in the form of Investment such as Deposits, Savings, or other compatible forms based on *Akad mudharabah* or other *Akads* which are not contradictory to the Sharia Principle; *third*, distributing the production sharing financing based on *Akad mudharabah*, *Akad musyarakah*, or other *Akads* which are not contradictory to the Sharia Principle; *forth*, distributing financing based on the *Akad murabahah*, *Akad salam*, *Akad istishna'*, or other *Akads* which are not contradictory to the Sharia Principle; *fifth*, distributing financing based on *Akad qardh* or other *Akads* which are not contradictory to the Sharia Principle; *sixth*, distributing Financing of leasing moveable or immoveable goods to customers based on the *Akad ijarah* and/or lease purchase in the form of *ijarah muntahiya bittamlik* or other *Akads* which are not contradictory to the Sharia Principle; *seventh*, conducting loan/debt take over based on *Akad hawalah* or other *Akads* which are not contradictory to the Sharia Principle; *eighth*, conducting debit card business and/or financing card based on the Sharia Principle; *ninth*, purchase, sell, or secure on own risk securities of third parties issued based on obvious transactions based on Sharia Principle, among others, such as *Akad ijarah*, *musyarakah*, *mudharabah*, *murabahah*, *kafalah*, or *hawalah*; *tenth*, purchase securities based on Sharia Principles issued by the government and/or Bank Indonesia; *eleventh*, accept payment from calls on securities and conduct negotiation which third parties or inter parties based on the Sharia Principle; *twelfth*, conduct Custody for the interest of other parties based on a Sharia Principle based *Akad*; *thirteenth*, provide

safety boxes to store goods and securities based on Sharia Principle; *fourteenth*, transferring money, both for own interest and interest of Customers based on Sharia Principle; *fifteenth*, functioning as Trustee based on *Akad wakalah*; *sixteenth*, provide letter of credit facilities and bank guarantee based on Sharia Principle; and *seventeenth* conduct other activities usually executed in banking and social life as long as it is not contradictive to the Sharia Principle and according to prevailing laws and regulations; *eighteenth*, conducting foreign currencies transactions based on Sharia Principle; *nineteenth*, conducting capital equity participation in a Sharia (Islamic) Commercial Bank or financial institution conducting business based on Sharia Principle; *twentieth*, conduct temporary capital equity participation abilities to overcome failed result of financing based on Sharia Principle, on the condition of withdrawing its participation; *twenty first*, acting as founder and manager of retirement fund based on Sharia Principle; *twenty second*, conducting activities in the capital market as long as it is not contradictory to Sharia Principle and prevailing laws and regulations in the field of capital market; *twenty third*, operating activities or bank product based on Sharia Principle by using electronic means; *twenty fourth*, directly and indirectly issue, offer, and trade short-term securities based on Sharia Principle, through the money market; *twenty fifth*, directly and indirectly issue, offer, and trade long-term securities based on Sharia Principle, through the capital market; and *twenty sixth*, provide product or conduct other business activities of a Sharia (Islamic) Commercial Bank based on Sharia Principle.

Furthermore, the operation of Sharia Business Unit based on Article 19 point (2) and 20 point (2) of Law number 21 of 2008 are: *first*, mobilizing funds in the form of Deposits such as Demand Deposit, Savings, or other compatible forms based on *Akad wadi'ah* or other *Akads* which are not contradictory to the Sharia Principle; *second*, mobilizing funds in the form of Investment such as Deposits, Savings, or other compatible forms based on *Akad mudharabah* or other *Akads* which are not contradictory to the Sharia Principle; *third*, distributing the production sharing financing based on *Akad mudharabah*, *Akad musyarakah*, or other *Akads* which are not contradictory to the Sharia Principle; *fourth*, distributing financing based on the *Akad murabahah*, *Akad salam*, *Akad istishna'* or other *Akads* which are not contradictory to the Sharia Principle; *fifth*, distributing financing based on *Akad qardh* or other *Akads* that are not contradictory to the Sharia Principle; *sixth*, distributing Finance of leasing moveable or immoveable goods to customers based on the *Akad ijarah* and/or lease purchase in the form of *ijarah muntahiya bittamlik* or other *Akads* which are not contradictory to the Sharia Principle; *seventh*, conducting loan/debt take over based on *Akad hawalah* or other *Akads* which are not contradictory to the Sharia Principle; *eighth*, conducting debit card business and/or financing card based on the Sharia Principle; *ninth*, purchasing, selling, or securing on own risk securities of third parties issued based on obvious transactions based on Sharia Principle, among others, such as *Akad ijarah*, *musyarakah*, *mudharabah*, *murabahah*, *kafalah*, or *hawalah*; *tenth*, purchasing securities based on Sharia Principles issued by the government and/or Bank Indonesia; *eleventh*, accepting payment from calls on securities and conduct negotiation

which third parties or inter parties based on the Sharia Principle; *twelfth*,; providing safety boxes to store goods and securities based on Sharia Principle *thirteenth*, transferring money, both for own interest and interest of Customers based on Sharia Principle; *fourteenth*, providing letter of credit facilities and bank guarantee based on Sharia Principle; *fifteenth*, conducting other activities usually executed in banking and social life as long as it is not contradictive to the Sharia Principle and according to prevailing laws and regulations; *sixteenth*, conduct foreign currencies transactions based on Sharia Principle; *seventeenth*, conduct activities in the capital market as long as it is not contradictory to Sharia Principle and prevailing laws and regulations in the field of capital market *eighteenth*, conduct temporary capital equity participation abilities to overcome failed result of financing based on Sharia Principle, on the condition of withdrawing its participation; *nineteenth*, operate activities or bank product based on Sharia Principle by using electronic means; *twentieth* directly and indirectly issue, offer, and trade short-term securities based on Sharia Principle, through the money market; *twenty first*, provide product or conduct other business activities of a Sharia (Islamic) Commercial Bank based on Sharia Principle.

Both of those banking systems is responsible to Bank Indonesia since According to Article 8 Law number 23 of 1999, Bank Indonesia has its tasks to: *first*, prescribe and implement the monetary policy; *second*, regulate and safeguard the smoothness of the payment system; *third*, to regulate and to supervise Banks. Bank Indonesia as the central bank in Indonesia has five main roles in maintaining financial system stability. Those five roles include policies and instruments in maintaining financial system stability: *first*, maintaining monetary stability through interest rate instruments in open market operations. Bank Indonesia is required to be able to determine monetary policy appropriately and balanced. *second*, Bank Indonesia has a vital role in creating sound financial institutions performance, especially banks. The creation such performance is carried out through a mechanism of supervision and regulation. *third*, Bank Indonesia has the authority to regulate and maintain a smooth payment system. *fourth*, through its function in research and monitoring, Bank Indonesia can access information to maintain financial stability. *fifth*, Bank Indonesia has a function as a financial system safety net through the central bank's function as a Lender of Last Resort (LoLR).

Thus, the banking system in Indonesia adheres to the dual banking systems, which is the implementation of two banking systems (conventional and sharia) side by side (Usanti, 2015). Furthermore there are some essential characteristics that distinguish Sharia Bank from Conventional banks (Zamroni, 2013), namely: *first*, the functions and activities of the bank's mechanism and object of business are intermediation, investment manager, investor, social, financial services; *second*, the basic principle of its operation is anti-*riba* and anti-*maysir*; *third*, the priority of service is non value-free (Islamic sharia principles), money as a medium of exchange and not a commodity and profit sharing, buying and selling, leasing; *fourth*, the orientation of the public interest; *fifth*, Islamic socio-economic goals and profits; *sixth*, Evaluation of customers in the field of conventional banks,

development banks, universal banks or multi-purpose; *seventh*, in terms of customer relations, it is more prudent since customers participates in risk; *eighth*, in terms of short-term liquidity sources, customer is close as business partners; *ninth*, loans given are limited; *tenth*, Institutions for commercial and non-commercial dispute resolution, profit-oriented and non-profit; *eleventh*, Business risk can be settled in the court and the National Sharia Arbitration Board; *twelfth*, Supervisory Organizational Structure is faced jointly between banks and customers, with the principle of fairness and honesty and there is no possibility of negative spread; *thirteenth*, Investment by the Board of Commissioners, Sharia Supervisory Board and National Sharia Board; and *fourteenth*, the services provided must be *halal*.

The Development of Sharia Banking

The idea to hold Islamic Banking in Indonesia is already developed since 1970 (Anwar, 2016). However, the regulation about sharia banking has first implicitly regulated under Law number 7 of 1992 concerning banking. The banking law is enacted to accommodate any banking development and revokes Law Number 14 of 1967, which in its consideration outlined that banking based on the principles of economic democracy and having the primary function of mobilizing and channelling funds from the public, play a strategic role in support of the implementation of national development for the purpose of improving equitable distribution of development and its result, economic growth, and national stability, aimed towards improving the standard of living of the common people.

National banking sector, in carrying out its functions and responsibilities to the public, must always responsibly follow the rapid development of national and international economies, which is along with the extensive challenges. Law Number 14 of 1967 and other regulations applied in the past were unable to keep up with such rapid development, so a new Banking Law is enacted. Article 5 the Banking Law outlines that based on its type, banks consist of Commercial Bank and Rural Bank. Based on this law, steps were taken to accommodate and provide a legal basis for Islamic Banks, even though there is no explicit existence of sharia bank. Indeed there are only two Articles as the basis, namely Article 6 point (m) which mention the general banking scope and Article 13 point (c) in terms of the operation of rural bank encompass providing financing and placing fund based on profit sharing principle in accordance with regulations stipulated by Bank Indonesia. This phase is known as the introduction of sharia banking.

Thus the term that was used in this law is “Bank based on profit sharing principles”. Article 6 point (m) and Article 13 point (c) had provided any further regulation regarding neither the meaning of profit sharing itself, the legal basis for the operation nor the form of business activity. However, it worth to mentioning that the enactment of this law is a step forward from any parties struggle, because then there are other alternatives in banking system instead of conventional bank, which is bank with profit sharing based (Usanti, 2012: 408). Such reality provides great hope that fosters optimism for all of us to continue striving the development Sharia economy based in Indonesia.

Furthermore on 30th October 1992, a Government Regulation Number 72 of 1992 was enacted concerning Banks based on the Profit Sharing Principle. Article 1 point (1) stipulates that "a bank based on the profit sharing principle is a Commercial Bank or Rural Credit Bank that carries out business activities solely based on the principle of profit sharing". The explanation of this article states "what is meant by the principle of profit sharing in this government regulation is the principle of *muamalat* based on Sharia in conducting business activities of banks". This is what then changes to be based on "Sharia principles" and is briefly called as "Islamic Bank" or "Sharia Banking". So formally the term Sharia Bank or bank based on Sharia principles was introduced in the Government Regulation Number 72 of 1992 (Rahmi, 2013: 6).

After the enactment of Law number 7 of 1992, in 1998 then it was enacted Law number 10 of 1998 regarding changes to Law Number 7 of 1992 concerning Banking. (State Gazette Number 182 of 1998 and the State Gazette Supplement of the Republic of Indonesia Number 3790). This phase is known as the phase of Sharia Banking recognition, which the regulation concerning Sharia Banking was previously only mentioned "a bank based on the principle of profit sharing", has now been clearly stated in the law using the term of "Bank based on Sharia Principles". As stated in Article 1 point (3), Commercial Bank is a Bank which based its activities on conventional and/or Sharia Principles in doing so provides services in payment transactions, whereas point (4) stated that Rural Credit Bank is a Bank which based its activities on conventional or Sharia Principles in doing so shall not provide any service in payment transactions. The Sharia Principles referred to in this law are explained in Article 1 point 13, namely as the rules of agreement based on Islamic Law between Bank and other party for depositing fund and/or financing business activities, or other activities which is stated as in accordance to Sharia Principles.

The enactment of Law number 23 of 1999 concerning Bank Indonesia (State Gazette Number 66 of 1999, State Gazette Supplement of the Republic of Indonesia Number 3843), which now has been amended by Law number 2 of 2004, has included several specific provisions with regards to existence and development of Sharia Banking in Indonesia. In Article 10 of Law number 23 of 1999, regarding the monetary control, Bank Indonesia has been given the mandate to implement it based on Sharia Principles. The in order to Sharia Bank can operate optimally and to complete the legal system as the basis of Sharia Bank, Law number 21 of 2008 concerning Sharia Bank was enacted in 16 July 2008 (State Gazette Number 94 of 1992, the State Gazette Supplement of the Republic of Indonesia Number 4867). This phase is referred as the purification phase, because the existence of Sharia Banking has been returned to Islamic Law as the basis and life guide.

In 2002, Bank Indonesia published blue print, emphasizing the sharia banking mission to support real economic sector which covers, first, conducting continual studies and researches about conditions, opportunities and requirements for sharia banking; preparing the concept and conducting risk-based supervision that fit with its characteristics to maintain operational sustainability; preparing institutional structure that aimed at improving operational efficiency of the sharia banking; and designing an

appropriate framework for a sound entry and exit policy that is capable of maintaining systemic stability. In addition, the vision of sharia banking is a sound sharia banking system that is competitive, efficient and compliant with prudential practices, and capable of supporting real economic sector through the implementation of share based financing and trades with real underlying transactions in the spirit of brotherhood and good deeds to promote well-being for all society.

In order to support the realization of established vision, Bank Indonesia has set up realistic objectives such as *first*, compliance to sharia principles in banking operations as indicated by the establishment of standardization of sharia financial norms and efficiency on sharia supervisory framework; *second*, implementation of prudential principles in banking operation that covers implementation of risk based regulatory, good corporate governance in sharia banking operations, real time supervision and self regulatory system; *third*, a competitive and efficient sharia banking system as indicate by globally competitive players, effective strategic alliance, and good coordination with supporting institutions; and the last is systematic stability and benefits to society as indicated by the implementation of safety net arrangement, the implementation of sharia financial system comprehensively that serves all the society and the significant use of share base financing. Bank Indonesia does not only set up realistic objective but also some paradigms to help the objectives' achievements. The paradigms covers *market driven* (real demand based development), *fair treatment* (developing sound and fair competition based of its own characteristics; not by giving special treatment as an infant industry), *gradual and sustainable approach* (priority and focus are determined based on situation and condition to adopt gradual and sustainable approach) and *comply with sharia principles* (sharia based regulatory framework and supporting institutional structure).

Furthermore, according to Sharia Banking Law, in order to be categorized in the Sharia Economic sphere, it should be determined by the Indonesian Ulema Council (*MUI*) Fatwa. MUI as an institution that has authority in the religious field, is associated with the interests of Indonesian Moslems forms the National Sharia Council (known as DSN). National Sharia Council is intended to deal with problems related to the activities of Islamic Financial Institutions (known as DPS). While the Sharia Supervisory Board (known as DPS) is a body that is in the Islamic Financial Institutions and has the duty to oversee the implementation of National Sharia Council decisions on Islamic Financial Institutions

The idea for the National Sharia Council establishment actually first time appeared at the Alim Ulama workshop, which was held on 29th -31st July 1997 in Jakarta. The background is beside to establish an institution that can integrate and coordinate every Sharia Supervisory Board in each Islamic Financial Institutions, but also to oversee all Islamic Financial Institutions activities so it will not deviate from any Sharia Principles. In addition, the establishment of National Sharia Council is expected to be able to answer various financial and economic problems in which operationalization and resolution requires the involvement of Islamic Law (Anshori, 2008: 92).

The National Sharia Council institution was officially established on 10 February 1999 in accordance with the *MUI* Decree Number SK-754 / *MUI* / II / 1999. The strong authority owned by this institution is the determination and safeguarding of applying Sharia Principles in Islamic Financial Institutions' operations such as sharia banking, sharia insurance, sharia reinsurance, sharia mutual funds, sharia bonds and sharia securities. This is due to Islamic Financial Institutions or other Sharia business activities have special characteristics that are different from the management of financial institutions or conventional business activities.

One interesting thing about the proliferation of business activities based on Sharia principles is the pattern of disputes settlement regarding the authority of the Religious Courts. As stipulated in Law Number 3 of 2006 concerning Amendments to Law Number 7 of 1989 concerning Religious Courts, in Article 49 stipulates that the Religious Court has the authority to examine and decide disputes concerning the Sharia economy.

National Sharia Council is an institution that has the authority to issue fatwas relating to various forms of Sharia Financial Institutions products, especially Sharia Banks. The highest authority in banking both conventional banks and Sharia banks is held by Bank Indonesia, but the role of bank Indonesia in establishing regulations on Sharia banking must first refer to the fatwa issued by the National Sharia Council. This shows that National Sharia Council is an independent institution and has authority in terms of sharia matters.

National Sharia Council was formed by the Indonesian Religious Leader (*MUI*), which has the function of carrying out the duties of the *MUI* in dealing with issues related to the activities of sharia financial institutions. One of the main tasks of the National Sharia Council is to examine, explore and formulate the values and principles of Islamic law in the form of fatwas, to be used as guidelines in Sharia Financial Institutions transaction activities, through the Sharia Supervisory Board (DPS), which supervise the implementation of sharia principles in the system and management of sharia financial institutions (DPS). The authority of the National Sharia Council includes: *first*, issuing a fatwa that binds the Sharia Supervisory Board in each sharia financial institution and forms the basis of the legal actions of the related parties; *second*, issuing a fatwa which became the basis for the provisions/regulations issued by the authorized institutions, such as the Ministry of Finance and Bank Indonesia. *third*, provide recommendations and/or revoke recommendations for names that will sit as Sharia Supervisory Board (DPS) in a sharia financial and business institution. *fourth*, inviting experts to explain a problem that is needed in the discussion of Islamic economics, including monetary authorities/ domestic and foreign financial institutions. *fifth*, giving an admonition to Islamic financial institutions to stop irregularities from the fatwa issued by the National Sharia Board. *sixth*, proposing to the authorized agency to take action if the admonition is not heeded (DSN *MUI*, 2016).

Article 26 point 2 Law number 21 of 2008 stated that "Sharia Principle as considered in paragraph (1) is given as fatwa by the Indonesian Religious Leader". Furthermore, point

3 stated "Such fatwa as considered in paragraph (2) is stated in a Bank Indonesia Regulation". Thus it is clear that the position of National Sharia Council where its fatwa is not a positive law as the same as other fatwas issued by *MUI* in other fields, but it can be valid and bind as positive law. Therefore, the activities of sharia financial institution cannot be contrary with Sharia Principle, which issued by National Sharia Council and configured into Bank Indonesia Regulation.

Bank Indonesia Regulation (*PBI*) number 11/15/PBI/2009 has provided regulation regarding the Sharia Principle concerned, namely "Sharia Principles are the principles of Islamic law in banking activities based on fatwas issued by the National Sharia Council-Indonesia Religious Leader ". Bank Indonesia Regulation can be interpreted that as long as National Sharia Council had declared the Sharia Principles, then Sharia Principles for the law have been applied as positive law even though they have not or have not been stated in the Bank Indonesia Regulations (Sjahdeini, 2010). Thus, even though the fatwa has not been applied in the *PBI*, the fatwa still has legal force so every financial institution that uses the sharia system must obey it.

The position of National Sharia Council is as a member of Indonesia Religious Leader, which consists of scholars, practitioners, and experts related to the field of Islamic Law. The National Sharia Council's duties are as follows: *first*, developing the application of Islamic values in economy activities in general and finance in particular; *second*, issuing fatwas for financial activities; *third*, issuing fatwa on Islamic financial products and services; and *fourth*, supervising the application of fatwas issued.

Moreover, as a response to the enactment of Law no.21 of 2008 concerning sharia banking, Bank Indonesia establishes Grand Strategy of Islamic Banking Market Development. The Grand Strategy covers a comprehensive strategy of market development and strategic aspects. Under the strategy, there are three phase of vision with regards to Islamic Banking development. Phase I in 2008 is to build understanding in Islamic banking as Beyond Banking by reaching an asset target of Rp 50 trillion and industrial growth of 40% and phase II in 2009 with the objective of positioning Indonesian Islamic banking as the most attractive one in ASEAN. Furthermore Phase III in 2010 will have the objective of attaining Indonesian Islamic banking as a leading Islamic Bank in ASEAN.

The development of Islamic Banking is directed to provide the highest benefits to the public, and as consequences, every steps taken is always referred to other strategics plans such as Indonesian Banking Architecture (API), Indonesian Financial System Architecture (ASKI) as well as Medium Term National Development Plan (RPJMN) and Long-Term National Development Plan (RPJPN). Therefore, the policy in developing Islamic banking is a part and an activity supporting the achievement of a larger scale strategic planning in developmnet at national level.

Bank Indonesia, as part of its concrete effort in developing Islamic Banking, has formulated a Grand Strategy of Islamic Banking as comprehensive strategy of market development. There are several different concrete programs that have and will be

performed as the implementation stage of the Grand Strategy of Islamic Banking Market Development. *First*, Islamic Banking new image program, which creates new branding, and position of Islamic banking in society. Under the first strategy, Islamic Banking becomes available to all communities who are looking for mutual benefits, with more varieties on the product by using understandable terms besides Arabic. Islamic banking is expected to offer various products with variative scheme as well as its transparency and fairness among its clients. Therefore Islamic banking is using the brand of *more than just a bank (beyond banking)*, hoping that the brand can attract more customers. *Second*, Islamic Banking Market Segment Development Program, which map the customers based on their banking dimension. This mapping is believed to be more accurate on generally directing Islamic bank services as universal service or bank accessible for all kinds of people and all segments in accordance with the strategy of each Islamic bank. Customers understand the advantages and disadvantages of using conventional or Islamic banking. Indeed, conventional bank leads the customer to have reliable and numerous services facilities compared to Islamic bank. However, the strategy introduces the interesting and unique advantage from the Islamic banking products such as high profit sharing. On the hand, Bank Indonesia report found that Islamic banking customers, in fact, want to use both types of banking as they realize the advantages of both banking types are perfect if it is possible to be combined. Thus, Bank Indonesia comes to the conclusion where Islamic banking should perform a functional role that provides secure and good of both products and services. *Third*, Product Development Program, which materialized varies products and schemes with transparent and fairness principle. This scheme is also strengthened by a wide office network and the use of easily comprehended standards of product name. For instance, by using Indonesia Language on the product will create an image that Islamic banking is not perceived exclusively on for Moslems community. *Fourth*, Services Improvement Program, which generates the service quality enhancement supported by competent human resources and the supply of information technology. This scheme is aimed to meet customer's requirement and satisfaction by communicating products and services of Islamic banking to customer correctly and clearly. *Fifth*, Public Education and Communication Program, which comprehensive and integrated communication approached will be done to gain effective output and cost efficiency. In addition, creative concept to attract potential customers' interest is used through both direct or indirect communication channels as well as contributing comprehension on the advantages of Islamic banking products and services.

Along with the enactment of Sharia Banking Law in 2008, Bank Indonesia also establish the codification of Islamic Banking Product which gives the clear guidance on what types of products can be sold under the scheme of sharia banking. In fact, Islamic Financial Institutions create the modern products in two general ways, first by modifying conventional products and services to comply with Sharia Principles, and second by applying Sharia principles to develop new products and services (Sorenson, 2008). Thus

the products based on Bank Indonesia codification are divided into three main product which are deposit funds, financing and services.

Deposit funds for instance, is divided into three types which are demand deposit, saving deposit and time deposit. Demand and saving deposit use two types of contracts, *wadiah* and *mudharabah*, while time deposit only uses *mudharabah* based contract. *Wadiah* itself is a contract under the scheme that goods or money custody between the owner and the entrusted party with the obligation of the entrusted party to return the goods or money at any time. While *mudharabah* is a contract under the scheme that partnership between the fund owner (*shahibul maal*) and fund manager (*mudharib*) by sharing the business profit according to the contract.

Financing products in sharia banking differs into several types, most of them are distinguished by the types of contracts. Bank Indonesia under its codification differs the products as financing based on *mudharabah* contract, *musyarakah* contract, *murabahah* contract, *salam* contract, *istishna'* contract, *ijarah* contract, *qaradh* contract, and multiservice financing. *Musyarakah* contract is transaction of investment from two or more fund and/or goods owners to conduct a specified business activity in compliance with sharia principles, with a division of profit between those parties based on ratio agreed in advance while division of loss will be based on capital proportion of each party. *Murabahah* contract is transaction of buy and sell of specified goods with value equivalent to the price of the goods added by margin defined in advance by both parties, which the seller provides information on the price of the goods in advance to the buyer. *Salam* contract is transaction of buy and sell of goods using order method with specified requirements and full cash payment in advance. *Istishna'* contract is buy and sale transaction comprising an order for the production of goods with agreed specified criteria and requirements and with payment on agreed terms. *Ijarah* contract is leasing transaction on a specified goods and/or service between the owner of leased object including the right of use on leased object and the lessee in order to earn fee on the object leased. *Qaradh* contract is transaction of lending and borrowing of funds without any remuneration with the obligation to repay only the loan principal that can be made on bullet payment or installment basis over a specified period. While multiservice financing uses *ijarah* and *kafalah* contract. *Ijarah* contract is leasing transaction on a specified goods and/or service between the owner of the leased goods including the right of use on the leased goods and the lessee in order to earn fee on the object leased, and *kafalah* contract is guarantee transaction provided by insurer (*kafil*) to a third party or insured (*makful lahu*) to fulfill the obligation of the second party (*makful 'anhu/ashil*).

Obviously, if we clearly take a look on the products codified by Bank Indonesia, it is necessary to understand all the types of sharia-based contracts for all stakeholders to maximize the sharia banking business. At the same time, the products' development in Islamic Banking has been also largely followed by development of contract complying with Sharia (Kurniawan, 2017). Basically the relation between bank and customer can be seen from the clause in the contract which broadly which consists of 5 (five) terms as such, pure

savings system, profit sharing system, buying and selling system with profit margin, rental system and fee system. In order to implement those terms, sharia bank in this case must pay attention to the restrictions applied under sharia principles (Mansyur, 2011). Even though Indonesia has been applying Islamic financial systems since decades ago, but there are differences on what types of contracts applied in many transactions, compared to Malaysia – for instance, as one of country dominated with Islamic financial systems. Ismail (2011) found that even though Indonesia does not apply controversial Sharia contracts such as Bay al Innah, Bay al Wafa, Tawarruq, Bay al Dayn, which dominate the Islamic banking contracts in Malaysia and Middle Eastern countries, Sharia banking in Indonesia can still well-performed despite having small market share. In fact, the advancement and expansion of this industry in Indonesia depends on the performance of the Islamic banks and economic conditions, it does not rely on the application of controversial contracts. (Bank Indonesia, 2008).

Indonesia only use some contract that are non-controversial, in their perspective such as mudaraba and musharaka (equity-based products), murabaha and salam (Abdullah, 2017). The involvement of Indonesia's Islamic banking institutions in profit-and-loss sharing contracts forming 22.2% of all Islamic banks financing portfolios at the end of 2001 with musharaka 2.6% and mudaraba 19.6%. By 2013, the financing volume released in the form of mudarabah and musharakah increase from the amount in 2001 to IDR 50 079 billion or 28.23 percent.

Alike conventional bank, Sharia Banking also face a few risks inherent to the financial industry since it is like other banks which have to abide by some regulatory frameworks. Meanwhile, in order to measure the risk of a sharia banking properly, the applicable conventional bank risk need to be taken into consideration and complemented by additional risk types cater specifically for the risks undertaken by sharia bank (Archer, 2006). The risk management cannot be done smoothly without the proper knowledge of formation in Islamic mode of financing (Waemustafa, 2016). Then it is obvious that there must be differences of risks between conventional and sharia bank and consequently different prudential regulation must be enacted (Jalbani, 2009).

The development phase of Sharia Banking will continue to grow according to the people need. Moreover until now, Islamic banking tends to be more active in carrying out buying and selling based financing rather than profit sharing financing (Keenan, 2010). The reason is that the Sharia Bank funding atmosphere in Indonesia still assumes that customers are not those who are ready to bear the risk of investment. In addition, people's paradigm and also the capacity of Sharia Bank still consider that Islamic Banks in their business strategies business risks are *commercial banking* as Conventional Bank.

Conclusion

Since the enactment of Law number 21 of 2008 concerning Sharia Bank, the existence of Sharia Banking gets stronger. Therefore, currently in Indonesia there are dual bank systems in one law, namely Banking Law. These dual bank systems are Conventional Bank

and Sharia Banking. Both banks are responsible to Bank Indonesia. Conventional Bank can carry out business activities based on Sharia Principles, but not so with Sharia bank. In conducting its business, Sharia Bank must be based on Sharia Principles as stated by the National Sharia Council of Indonesia Religious Leader.

Suggestion

The dual system in Indonesia indeed cannot be avoided since the composition of customer in Indonesia its self is plural. However, this fact does not prevent the growth of Islamic finance especially Sharia Bank. This growth should be followed by the strong and detailed regulation to accommodate the rapid development of Sharia Bank, or at least Islamic finance in general.

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