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System Implementation and Governance in Sharia Financial Institutions

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Abstract

Islamic finance institutions (IFIs) are bound by principles that extend beyond profit making; they must ensure accountability to Allah SWT in their operations. These institutions are required to adhere strictly to Sharia standards, which guide their governance and systems. This study aims to examine the implementation of systems and governance in IFIs in Indonesia. A descriptive qualitative approach, utilizing library research, was employed to explore this subject. The findings reveal that the primary goal of the Islamic financial system is to redistribute wealth, facilitating the transfer of funds from savers to borrowers in need, thereby promoting economic growth and enhancing social welfare. Shariah governance (SG) is a unique framework that ensures compliance with Islamic laws, akin to the historical concept of hisbah. Effective governance is essential for the success of Islamic finance institutions, ensuring that they operate in accordance with Sharia principles. This study underscores the significance of SG in regulating these institutions, highlighting the role of the Sharia Supervisory Board (SSB) in maintaining Sharia compliance. Furthermore, regulatory frameworks in Indonesia, including laws and guidelines from the National Shariah Board (DSN), ensure that IFIs adhere to these standards, thereby reinforcing their commitment to Islamic ethics and promoting trust within the community.

1. Introduction

Humans fulfill their life needs independently. As civilization advances and populations grow, economic activities become increasingly complex. Consequently, individuals require institutions that manage and oversee their financial resources. This necessity led to the establishment of financial institutions, which are generally categorized into banking and non-banking financial institutions. These entities play a crucial role in mobilizing and distributing public funds (Fure, 2016).

In Islamic economics, regulations governing muamalah (business activities) extend beyond prohibiting involvement in industries related to alcohol, gambling, and immoral activities. Islamic finance also emphasizes achieving socio-economic objectives that benefit the community. These institutions operate within a framework that ensures financial transactions are Sharia-compliant, promoting a fair and ethical business environment. The principles governing Islamic financial institutions originate from the Quran, Hadith, scholarly consensus (ijma), and analogical reasoning (qiyas) (Hudribiq, 1988).

Islamic financial institutions facilitate economic activities in accordance with Islamic law. Muslims are obligated to adhere to divine guidelines in all aspects of life, including financial transactions. Islam strictly prohibits acquiring wealth through unlawful means, such as engaging in usury (riba) (Ministry of Religion of the Republic of Indonesia, 2012). The Quran explicitly condemns usury, as stated in Surah Ali Imran (3:130):

Translation: "O you who believe, do not consume riba in doubles, and fear Allah so that you may prosper."

According to Usul Fiqh, this verse serves as a direct prohibition (Hudribiq, 1988). In Islamic jurisprudence, a prohibition carries the weight of a command to cease a particular activity. Thus, the prohibition against riba implies an obligation to refrain from all usurious transactions. Linguistically, the Arabic term "riba" means "increase" or "growth." In a financial context, it refers to charging excessive interest on loans, which leads borrowers to repay more than the principal amount (Syafii Anthony, 2009).

Islamic financial institutions form an integral part of the economic system, functioning as intermediaries between surplus and deficit units. Initially, Indonesia's financial institutions operated on an interest-based system, prioritizing profit maximization. However, the 1998 monetary crisis revealed the vulnerabilities of conventional banking, particularly its reliance on unsustainable interest rates (Ghozali, 2018). Many conventional banks faced bankruptcy due to excessively high interest charges, whereas Islamic banks remained resilient by employing profit-sharing mechanisms instead of interest-based financing. This demonstrated the stability of Islamic financial institutions and attracted widespread interest in their ethical and sustainable approach.

In recent decades, Islamic financial institutions have expanded significantly, particularly in countries with Muslim-majority populations (Ghozali, 2018). Their development is driven by multiple factors, including the shortcomings of conventional economic systems, religious motivation, and pragmatic economic objectives. Islamic financial institutions are structured to uphold Sharia principles, integrating both philosophical and technical dimensions into their operations.

Beyond financial profitability, Islamic financial institutions bear a responsibility to uphold ethical and religious standards. They are accountable not only to their stakeholders but also to Allah SWT. The principles of Islamic finance require institutions to operate transparently, ensuring compliance with Sharia law while adapting to contemporary economic conditions (Syafii Anthony, 2009). This study aims to analyze the operational framework of Islamic financial institutions, assess their adherence to Sharia principles, and evaluate their impact on economic stability. By bridging theoretical discourse with empirical evidence, this research contributes to a deeper understanding of Islamic finance and its role in modern economic systems.

2. Literature Review

2.1 Islamic Financial System

Islamic finance is a financial system that operates based on Sharia principles, which prohibit interest (riba), uncertainty (gharar), and gambling (maysir). Instead, Islamic finance emphasizes profit-and-loss sharing (PLS) and ethical investments that align with Islamic values (Soemitra, 2018). The core principles of the Islamic financial system include risk-sharing, asset-backed transactions, and social justice (Rodoni & Hamid, 2020).

2.2 Islamic Financial Institutions

Islamic financial institutions (IFIs) have grown significantly over the past few decades, providing an alternative to conventional banking. IFIs operate based on Sharia principles and offer products such as murabaha (cost-plus financing), musharakah (partnership financing), and ijarah (leasing) (Dusuki & Abdullah, 2007). The role of IFIs in economic development is particularly evident in countries with significant Muslim populations, where they contribute to financial inclusion and ethical financing (Chapra, 2016).

2.3 Comparison of Islamic and Conventional Financial Institutions

Islamic financial institutions differ from conventional financial institutions primarily in their adherence to Sharia principles. While conventional banks operate on an interest-based system, Islamic banks use profit-sharing mechanisms.

The following table highlights key differences between the two systems:

Aspect	Islamic Financial Institutions	Conventional Financial Institutions
Basis of Operation	Sharia compliance (no riba, gharar, or maysir)	Interest-based transactions
Relationship	Partnership-based (PLS system)	Debtor-creditor relationship
Investment Approach	Ethical investments only	No ethical restrictions
Risk Sharing	Risk shared between bank and customer	Bank transfers risk to customers
Governing Authority	Sharia Supervisory Board	Central Bank and Financial Authorities

(Source: Soemitra, 2018; Rodoni & Hamid, 2020)

2.1 Profit and Loss Sharing (PLS) System

One of the fundamental characteristics of Islamic banking is the Profit and Loss Sharing (PLS) system, which fosters a more equitable financial environment. This system operates through two primary contracts: mudarabah (profit-sharing) and musharakah (partnership). In a mudarabah contract, one party provides capital while the other manages the business, with profits shared according to a pre-agreed ratio and losses borne by the capital provider (Dusuki & Abdullah, 2007). In musharakah, both parties contribute capital and share profits and losses proportionally.

Despite its advantages, the implementation of the PLS system faces several challenges. Empirical studies indicate that the proportion of PLS-based financing in Islamic banks remains relatively low compared to debt-based instruments such as murabaha (Ahmed, 2011). For instance, data from Bank Negara Malaysia show that profit-sharing contracts constitute less than 20% of total Islamic financing, as banks often perceive them as riskier and more complex to manage (IFSB, 2020).

2.5 Challenges and Opportunities in Islamic Finance

a. Regulatory and Legal Challenges

One of the primary challenges faced by Islamic financial institutions is the lack of a standardized regulatory framework across different jurisdictions. While countries such as Malaysia and Bahrain have established comprehensive Sharia governance structures, others still rely on conventional banking regulations, leading to inconsistencies in the implementation of Islamic finance (IFSB, 2020).

b. Market Development and Awareness

Another critical challenge is the limited awareness and understanding of Islamic finance principles among potential customers. Many individuals and businesses remain unfamiliar with Sharia-compliant financial products, which affects their adoption and market penetration (Chapra, 2016). Educational initiatives and financial literacy programs are essential to bridge this knowledge gap and promote the benefits of Islamic finance.

c. Technological Advancements and Fintech Integration

The integration of financial technology (fintech) in Islamic finance presents significant opportunities for growth and innovation. Digital platforms, blockchain technology, and smart contracts can enhance transparency, reduce transaction costs, and improve compliance with Sharia principles (Ahmed, 2021). The rise of Islamic fintech startups has further accelerated the digital transformation of the industry, making Islamic financial services more accessible and efficient.

3. Research Methods

This study employs a qualitative descriptive approach with a library research strategy to obtain a comprehensive understanding of social reality as perceived by participants. A qualitative approach is suitable for exploring complex social phenomena by analyzing existing literature and theoretical frameworks.

The library research strategy involves a systematic process of data collection, evaluation, and synthesis from various scholarly sources, including peer-reviewed journals, books, government reports, and academic proceedings. The key stages of this methodology are as follows:

1. Data Collection: Relevant literature was selected based on specific inclusion criteria, including recency, credibility, and relevance to the research topic. Databases such as Scopus, Web of Science, and Google Scholar were used to ensure high-quality sources.
2. Data Analysis: A content analysis technique was employed to categorize, interpret, and synthesize key findings. Thematic analysis was also used to identify patterns in the reviewed literature.
3. Validation and Reliability: To ensure rigor, source credibility was assessed using the CRAAP test (Currency, Relevance, Authority, Accuracy, and Purpose), and findings were cross-checked across multiple references.

This methodological approach follows established frameworks in qualitative research (Creswell, 2014) and document analysis (Bowen, 2009). By applying these systematic steps, this study ensures valid, reliable, and analytically rigorous research outcomes.

4. Results and Discussion

4.1 Implementation of Islamic Financial Institution Governance System

a. Introduction to Islamic Financial Institution Governance System

Islamic banking operates under a unique governance framework that ensures compliance with Sharia principles (Ahmed, 2020). Unlike conventional banking, which relies on standard corporate governance models, Islamic banking integrates Sharia governance to oversee financial transactions, ensuring they align with Islamic law (Chapra & Ahmed, 2018). Effective governance in Islamic financial institutions (IFIs) requires a structured framework that balances corporate objectives with Sharia compliance.

b. Concept of Sharia Governance and Its Differences from Conventional Governance

Sharia governance refers to a set of mechanisms designed to ensure that all operations and financial transactions within IFIs adhere to Islamic principles (Dusuki & Abdullah, 2007). It differs from conventional corporate governance in several aspects, primarily in its emphasis on ethical considerations, prohibition of interest (riba), and risk-sharing principles (Hassan & Lewis, 2014). While conventional governance primarily focuses on shareholders' interests, Sharia governance extends its scope to include compliance with religious guidelines, ensuring that financial activities are morally and socially responsible (Iqbal & Mirakhor, 2011).

c. Structure of Sharia Governance in Islamic Financial Institutions

The structure of Sharia governance in IFIs typically includes three main components (Hasan, 2021):

1. Board of Directors (BoD) – Responsible for overall management and strategic decision-making.
2. Sharia Supervisory Board (DPS) – Ensures that all financial activities comply with Sharia principles (Alam et al., 2019).
3. Internal Sharia Compliance Unit – Monitors daily operations and provides recommendations for Sharia compliance (Grais & Pellegrini, 2006).

This governance model aims to integrate regulatory requirements with religious compliance, promoting financial integrity and transparency (AAOIFI, 2015).

d. Role of the Sharia Supervisory Board (DPS) and National Sharia Council (DSN)

The DPS plays a crucial role in ensuring Sharia compliance within individual IFIs. Their primary responsibilities include (Obaidullah & Latiff, 2008):

- Reviewing and approving financial products before they are introduced to the market.
- Conducting periodic audits and evaluations of financial transactions (Hassan, 2016).
- Advising management on compliance-related issues (Usmani, 2002).

At a national level, the National Sharia Council (DSN-MUI) serves as the highest authority in determining Sharia compliance standards (Ascarya, 2020). It provides guidelines and fatwas that IFIs must adhere to, ensuring uniformity in Sharia compliance across the financial sector (Rosly, 2010).

e. Regulatory Aspects and Implementation in Indonesia

In Indonesia, the implementation of Sharia governance is regulated under Law No. 21/2008 on Islamic Banking and overseen by the Financial Services Authority (OJK) (Karim, 2019). The regulation mandates that every Islamic bank must have a DPS to ensure compliance with DSN-MUI fatwas (Muhammad, 2021). Additionally, Islamic financial institutions must regularly submit Sharia compliance reports, which are reviewed by regulatory bodies to ensure adherence to established standards (Ismail, 2020).

f. Challenges and Solutions in Implementing Sharia Governance

Despite significant progress, several challenges persist in implementing Sharia governance effectively, including (Archer & Karim, 2017):

- Lack of qualified Sharia scholars – The shortage of experts with both Islamic jurisprudence and financial expertise limits effective governance (Ahmed, 2011).
- Regulatory inconsistencies – Differences in regulatory interpretations may lead to variations in compliance practices (Kamali, 2008).
- Public awareness and trust – Ensuring that customers and stakeholders understand Sharia governance principles remains a challenge (Dusuki, 2008).

To address these issues, the following solutions are recommended:

1. Capacity building programs for Sharia scholars to enhance their understanding of modern financial instruments (Hasan, 2021).
2. Harmonization of regulations to create standardized Sharia compliance frameworks across jurisdictions (Lewis, 2020).
3. Public awareness campaigns to educate customers and stakeholders about the benefits of Sharia governance (Rahman, 2019).

5. Closing

5.1 Conclusion

Islamic financial institutions play a crucial role in the economy by channeling funds from savers to borrowers in accordance with Sharia principles. Unlike conventional financial systems, Islamic finance prohibits riba (interest), gharar (uncertainty), and maysir (gambling) while promoting risk-sharing, ethical investment, and social responsibility. The concept of falah, which emphasizes both material and spiritual well-being, serves as the foundation of Islamic economics, ensuring that financial transactions align with broader societal and ethical values. The implementation of Sharia Governance (SG) in Islamic financial institutions ensures compliance with Islamic law through a structured system involving the Sharia Supervisory Board (DPS) and oversight by the National Sharia Council (DSN-MUI).

This governance structure differentiates Islamic financial institutions from conventional ones by embedding ethical considerations, transparency, and accountability into financial operations. Despite its significance, challenges such as regulatory inconsistencies, limited expertise in Sharia finance, and public awareness gaps remain obstacles to the full implementation of Sharia governance..

5.2 Suggestion

1. Strengthening Sharia Governance Frameworks
   Regulators and policymakers should work towards harmonizing Sharia governance regulations to ensure uniformity in compliance standards across financial institutions. A more structured legal framework will enhance regulatory efficiency and promote investor confidence in Islamic finance.
2. Capacity Building for Sharia Experts
   Educational institutions and financial regulators should collaborate to develop training programs for Sharia scholars and financial professionals, equipping them with both Islamic jurisprudence knowledge and financial expertise. This will help bridge the gap between Sharia compliance and modern financial practices.
3. Enhancing Public Awareness and Financial Literacy
   Islamic financial institutions should engage in public awareness campaigns to educate consumers, investors, and businesses about the principles and benefits of Islamic finance. Increased literacy in Sharia-compliant financial products will encourage greater market participation and trust in Islamic banking.

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