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Thanks a lot. Thank you for your response. Thank you so much.

## REVIEW FORM

Review Date : 25 Maret 2022

Manuscript ID : 25632

Title : Sharia Financial Institutions' Compliance Towards Islamic Principles in Performing Intermediation Functions

Reviewer :

**Review Results:**

Very Good: 4      Good: 3      Fair: 2      Poor: 1

No.	Section	4	3	2	1	Specific Comments
1.	<b>TITLE</b>		v			
	<i>Suggestions: Please think of a more substantive title to reflect the central issue discuss and the core argument of the author in order to attract the readers' interests to read!</i>					
2.	<b>ABSTRACT</b>					
	a. Aims		v			
	b. Methods		v			
	c. Results/ Finding		v			
	d. Conclusion		v			
	e. 3-5 keywords		v			
	<i>Suggestions: Please include the main elements in the abstract consisting of problem, aim, methodology, findings, implications/policy recommendations!</i>					
3.	<b>INTRODUCTION</b>					
	a. Problem Statements		v			
	b. Purpose of Study		v			
	c. Research questions		v			
	d. Significance of Study		v			
	e. Outline of the paper		v			
	f. Introduction reaches 10% of the total paper		v			
	<i>Suggestions: Please state the research problem clearly! Furthermore, please more elaborate the gap and the debate in the literature that motivate this study!</i>					
4.	<b>LITERATURE REVIEW</b>					
	a. Review the most updated literature (5 to 10 recent years)		v			
	b. Providing academic argumentation or debate		v			
	c. Identify gap in the literature		v			
	d. Variations of literature (Nat and Int. Journals, books, research reports, etc)		v			
	e. Developing a theoretical framework Literature review reaches 20% of the total paper		v			
	<i>Suggestions: The literature review seems to be missing in this paper, please add it by analysing previous research and literature addressing similar topics with this paper's topic.</i>					

No.	Section	4	3	2	1	Specific Comments
5.	<b>RESEARCH METHOD</b>					
	a. Method and approach		v			
	b. Research object		v			
	c. Data collection method		v			
	d. Data analysis		v			
	e. Research methodology reaches 5% of the total paper		v			
<i>Suggestions: Please state the research method of this paper more clearly!</i>						
6.	<b>RESULT AND DISCUSSION</b>					
	a. Description of findings		v			
	b. Interpretation of findings (Interpretation of findings by answering the questions 'why' and 'so what?' and contextualizing data analysis result with the context of the research object)		v			
	c. Significance of findings (producing new theories or modifying existing theories)		v			
	d. How do the results answer research questions?		v			
	e. Table and Graphic (if available)		v			
	f. The elaboration of theoretical frameworks or previous studies with findings		v			
	g. Result and discussion reach 60% of the total paper		v			
<i>Suggestions This section should discuss the issues in more dialectical ways!</i>						
7.	<b>CONCLUSION AND RECOMMENDATION</b>					
	a. Does the conclusion restate the topic; restate the thesis; summarize the main points; state the significance of the research; and conclude the author's thoughts?				v	
	b. Does the author provide recommendation theoretically and practically?				v	
	c. Conclusion and recommendation reach 5% of the total paper				v	
<i>Suggestions: Please write a conclusion that is generalizable from the conclusion!</i>						
8.	<b>CITATION AND BIBLIOGRAPHY</b>					
	a. Does the bibliography include the latest publications (at least the last 5 years)?		v			
	b. Does the bibliography include papers from reputable international academic		v			

No.	Section	4	3	2	1	Specific Comments
	journals?					
	c. Does the citation style used consistently according to the requirement of the journal?		v			
	d. Does the bibliography style used in accordance with the requirement of the journal?		v			
<i>Suggestions: Please follow the author's guidelines!</i>						

COMMENTS AND SUGGESTIONS	
General Comments	The paper promises good results, however, it lacks of literature review and academic debates.
Strength	The paper addresses one of important issues in the development of sharia supervision of Islamic financial institutions.
Minor Weakness	Some problems with language, grammar, and syntax. Furthermore, the English language used should be more academic one.
Major Weakness	The discussions lack of dialectical debates while they are needed in order to see the issues from both perspectives.
Suggestions for revision	Please revise the paper based on above suggestions!

Final Result:

<input type="checkbox"/>	<b><i>Accepted</i></b>
<input type="checkbox"/>	<b><i>Accepted with some revisions by editorial board</i></b>
<input checked="" type="checkbox"/>	<b><i>Accepted with some revision by authors</i></b>
<input type="checkbox"/>	<b><i>Rejected</i></b>
<input type="checkbox"/>	<b><i>To be considered with major revisions</i></b>

....., .....

[Reviewer]

## Sharia Financial Institutions' Compliance towards Islamic Principles in Performing Intermediation Functions

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### ABSTRACT

In carrying out its business activities, LKS are required to comply with Islamic principles. The Islamic principles referred to are Islamic principles regulated in the DSN-MUI fatwas. However, in the Indonesian legal hierarchy, the DSN-MUI does not have binding rules at the level of the law. This makes LKS half-hearted in complying with Islamic principles in conducted its intermediation function. In addition to these factors, disobedient LKS to Islamic principles is also due by DSN-MUI fatwas that are not applicable, conflicts of interest caused by the DPS structure which is under the shareholders and the commissioners' board, concurrent positions in several DPS and the competence of DPS' members. By using normative legal research methods, this study finds the need for regulatory improvements both related to DPS-MUI and DPS. From the DPS-MUI side, there is a need for regulations that confirm the authority of DSN-MUI in establishing binding Islamic principles to be carried out by LKS. Internally, DSN-MUI also needs to adjust its fatwas to be more applicable so that they no longer cause multiple interpretations at the implementation level. Meanwhile, from the DPS side, there needs to be a new regulation that explicitly and clearly places the DPS as an independent internal supervision agency thus that its free from conflicts of interest of interested parties. The regulation also needs to emphasize the prohibition of concurrent positions, therefore supervisory work can be maximized. Finally, increasing the qualifications of DPS members could be done by providing seminars and trainings in modern economics and sharia economics.

**Keywords:** Islamic Principles, DSN-MUI, DPS, LKS, Sharia Compliance

### A. Introduction

This study examines the level compliance of sharia financial institutions (LKS) towards Islamic principles in conducting their financial intermediary functions. The problems discussed here is why the Islamic principles in intermediation activities at LKS 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 LKS.

The issue of Islamic principles compliance in the intermediation function by LKS is motivated by three reasons. *First*, the compliance of Islamic principles in the intermediation activities of LKS is a mandatory matter. This obligation due to LKS is a financial institution that uses Islamic values and principles in all its financial transactions, making it impossible

**Commented [i-1]:** The abstract needs to be written more structurally. It should consist of: problem statement, aims, methodology and data, findings, implications and/or policy recommendations.

**Commented [i-2]:** It is Indonesian abbreviation, for the first time state it in English and put it in brackets in Indonesia term., e.g. Islamic Financial Institutions (Lembaga Keuangan Syariah/LKS)

**Commented [i-3]:** Do you mean DSN-MUI here?

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 LKS itself aims to provide a guarantee of the **halalness** of its financial products in accordance with Islamic principles (Jaballah et al., 2018).

**Commented [i-4]:** Is the term 'halalness' already accepted? Is it better to replace it with 'compliance'?

*Second*, the existence of LKS in Indonesia has now reached the age of more than 25 **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 LKS 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 LKS was widely questioned by the public regarding their **halalness**. This proves that the issue of sharia compliance has always been problematic because it has not been fully integrated into the activities of LKS.

**Commented [i-5]:** Is it 25 or 30 years?

**Commented [i-6]:** Please give proof and evidence!

*Third*, various studies have revealed there are indications that Islamic principles are not complied with by LKS. 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 LKS is not much different from conventional financial institutions (Biyantoro & Ghoniyah, 2019). Anip Dwi Saputro also criticized LKS that have low commitment in 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 LKS have not fully supported Islamic principles (Nugroho, 2021). Hence, the disparity between the fatwa of the National Sharia Board-Indonesia Ulama Council (DSN-MUI) and the practices conducted by LKS is unavoidable. Meanwhile, Fitriyani Zein's research found that many LKS in Indonesia have problems with sharia compliance due to poor governance, as well as the role of the sharia supervisory board (DPS) that has not been maximized in supervising sharia compliance by LKS (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 *murabahah* contracts (Miah & Suzuki, 2020).

**Commented [i-7]:** Give the reasons why

**Commented [i-8]:** Give the reasons why

**Commented [i-9]:** Give the reasons why

To discuss the above problems, this article will explain firstly what are the Islamic principles that LKS must comply with in carrying out their intermediation function. This study is important to convey because these principles will later become a measuring tool in assessing whether the intermediation function of LKS 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 LKS, as stated in a number of Fatwas of DSN-MUI, Bank Indonesia Regulations and contracts which is a product of LKS. The discussion of legal norms from the general to the specific becomes important to find an understanding in viewing Islamic principles. 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 LKS in conducting their intermediation function.

Commented [i-[10]: What does it mean?

Commented [i-[11]: Please also give policy recommendations to improve the system!

## B. Islamic Ethics as a Principle in Performing the Intermediation Function

Basically, LKS have 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 fulfil their respective interests (Miah & Suzuki, 2020). In the definition of a LKS, it is stated that a LKS is a business entity or institution that its 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, LKS are given the flexibility to be able to conduct business transactions in meeting the needs of human life and achieving 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 ethic is not allowed to contain several things, including: The first principle is *ḥarām*. *Ḥarām* is any behaviour 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 as 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 exchange between two or more similar goods. According to Wahbah Al-Zuhaili, usury is considered as an act of exaggerating assets originating from a transaction which is actually prohibited to provide 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 *maysīr*, which literally means gambling or transactions that are uncertain and contain the nature of mere luck (Al-Mawardi, 2020). *Maysīr* 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 *maysīr* 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, encompass 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 a business and know the risks that may arise from the business.

As an intermediary institution, LKS have several characteristics. First, LKS 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). LKS 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. LKS 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, LKS 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, LKS should pay attention to socio-economic justice in carrying out wealth and income distribution activities, in order to achieve the goal of economic equity in every level of society (Azid & Sunar, 2019). Third, LKS must be able to carry out savings mobilization activities through investment activities for economic development in a fair manner. Therefore, LKS 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 LKS must be productive funds for the welfare of the community. Consequently, LKS 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, LKS must be able to optimize *zakāt* (almsgiving), *infāq* (pious spending) and *ṣadaqah* (voluntary charity). In the concept of Islamic finance, LKS is an institution that functions as a *bait 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 LKS as business entities is 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 LKS'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 LKS.

The intermediation function of LKS is more varied than the intermediation function of non-sharia financial institutions. That matter due to the system for obtaining profits at LKS 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 LKS, and customers have many options in choosing transaction contracts that appropriate with the needs and goals of the LKS'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 a LKS) (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-muḍārabah*) (Miah & Suzuki, 2020).

LKS 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, LKS 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, LKS shall provide bailout funds with a loan pattern.

All financing in LKS 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 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 mumtahiyyah bi al-tamlīk* (lease agreement which lead to 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 a 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 *muḍārabah* or *musyārahah* (joint enterprise) (Biyantoro & Ghoniyah, 2019). In addition to the two patterns already mentioned, the distribution of funds to LKS can also be carried out with a financing pattern with a bailout using a *qarḍ* contract (an interest free loan).

The description above shows LKS as institutions that carry out intermediation functions widely and in various ways with various contracts. Therefore, LKS must pay attention to certain variants of provisions relating to all rights and obligations between customers and LKS, including paying attention to the types responsibilities of the parties arising from each type of contract or agreement. LKS 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. LKS should as well meet obligations as a provider of funds and goods as agreed. This must be done by LKS as a form of fulfilling the responsibilities of LKS 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 LKS. Furthermore, to the inclusion of incumbency, a contract or agreement must also include responsibilities that conformation with Islamic principles.

The intermediation function in LKS requires the existence of an underlying transaction and/or underlying assets as a basis for transactions in LKS (Narayan & Phan, 2019). Based on such a contract scheme, the halalness of a transaction can be ensured. Thus, the intermediation function of LKS is closely related to the characteristics of Islamic financial products based on the real sector.

**Commented [i-12]:** Please more elaborate this issue by comparing with the conventional one!

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

Based on the foregoing explanation, the intermediation function of LKS in various financing by following various patterns of sharia contracts, placing LKS 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 LKS in carrying out the intermediation function does not only place LKS as credit distribution institutions.

The various intermediation functions in LKS should comply with Islamic principles. The Islamic principles in this article referred to all the principles that have been established by the 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 terms of determining Islamic principles which must be adhered by LKS. Thus, the difference between the both regulations are 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 LKS, these fatwas contain abstract provisions (Adinugraha et al., 2021). The fatwa material only gives consideration to a contract from the halal-haram view point 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 which frequently clash with one another. Moreover, the DSN-MUI in the Indonesian constitutional system is not a state as institution that has the authority to issue regulations. This of course raises questions about the legitimacy of the fatwas issued by the DSN-MUI.

In the Indonesian context, as explained earlier, several Islamic principles have been stated in the DSN-MUI Fatwa. 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 *ijtihād* (the thoughts of the ulemas). In Indonesia context, the formulation of the DSN-MUI Fatwa which is applied to LKS 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 qiyas". 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 LKS has basically made every effort to fulfill Islamic principles. Each type of transaction in various sharia contracts that apply to LKS can be ascertained to be in compliance with general Islamic principles.

Recently there are two categories of fatwas that have been issued by the DSN-MUI relating to LKS (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 fund 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

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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).

Basically, 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
<p>1. <i>Sukuk</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 sukuk funds, closing of the order and the commencement of the use of the funds according to their designation.</p> <p>2. <i>Sukuk</i> assets are assets that form the basis for the issuance of sukuk consisting of tangible assets (<i>al-a'yān</i>), the value of benefits on tangible assets (<i>manāfi' al-a'yan</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>).</p>	<p>1. <i>Sukuk</i> assets (<i>uṣūl al-ṣukūk</i>) used as the basis for issuing <i>sukuk</i> must comply with sharia principles;</p> <p>2. <i>Sukuk</i> assets belong to the <i>sukuk</i> holders</p> <p>3. Each unit of <i>sukuk</i> must have the same value (<i>mutasāwiyah al-qīmah</i>);</p> <p>4. <i>Sukuk</i> at the time of issuance do not reflect the debt of the issuer to the sukuk holder, but rather reflects the sukuk holder's ownership of the sukuk assets;</p> <p>5. <i>Sukuk</i> can be turned into debt/receivable (<i>daīn</i>) in terms of assets the sukuk turns into receivables of the sukuk holder;</p> <p>6. In principle, the issuance of sukuk must have a certain term of time unless otherwise agreed in the contract or regulated by applicable</p>

	<p>laws and regulations;</p> <p>7. Issuers are required to discharge income to sukuk holders in the pattern of sharing the margin fee and repaying the sukuk funds when due date in accordance with the contract scheme;</p> <p>8. Sukuk yields with <i>muḍārabah</i> and <i>musyārahah</i> contracts must be derived from business activities that become sukuk assets.</p>
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**Commented [i-14]:** Please describe the issue in more detail instead of only showing the issue in the table, explain the problem with this fatwa clearly!

The fatwa formulation as shown in the table above seems to regulate more general matters. Therefore, when an LKS will make 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 LKS regarding transactions in Islam. The fatwas must again be reinterpreted by the DPS in every LKS. Frequently, the reinterpretation conducted by the sharia supervisory board at every LKS differs greatly from the intent and purpose of the DSN-MUI fatwa. Interpretation gaps can be found, for instance, in the reinterpretation made by LKS 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 offer conventional loan financing models (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).

**Commented [i-15]:** Please more elaborate this by explaining what 'Islamic banks offer conventional loan financing models' here means!

Differences in interpretation are also inevitable between the DPS in a LKS and the DPS at another LKS. 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 DPS at certain Islamic banks allow

*murābahā* 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 DPS in other LKS. These interpretive gaps have made policy makers at Islamic financial institutions unable to fully comply with the DSN-MUI fatwas.

**Commented [I-16]:** If there are differences, tell such differences by demonstrating the contrasts among different interpretations of different DPS members! Some interpret such... and the other interpret ...

**Commented [I-17]:** Give the reason why! And give the evidence by indicating which DPS members in which LKS?

The essence of the fatwa issued by the DSN-MUI is to give signs for Islamic financial institutions to not deviate from Islamic principles. However, the DSN-MUI Fatwa itself 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 *ijtihād* 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). To overcome this methodological problem, DSN-MUI must develop a fatwa methodology that respects the latest developments in the economy while still upholding sharia principles.

**Commented [I-18]:** Please give an example of such ambiguity!

In addition, the non-compliance of LKS with Islamic principles regulated by DSN-MUI is due to the fact that 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 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 Implementation of Islamic Principles in Fundraising and Funding Scheme as well as Sharia Bank Services. In this Regulation, the intermediation purpose of LKS is interpreted as equal as 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". In fact, when referring to the DSN-MUI fatwa, the intermediation function of LKS must be based on the agreed contract. Such as profit-sharing fund based on both the *muḍārabah* or the *musyārahah* principles; Selling-buying fund based on the *murābahah* or the *istiṣnā'* or the *salām* principles; and lease fund based on both the *ijārah* or *muntahiyah bi al-tamlīk* (lease contract which result removal of ownership) principles.

**Commented [I-19]:** This paragraph is not clear. Please rewrite it in order to convey the meaning clearly!

The Indonesian Central Bank regulations concerning sharia financing activities in LKS 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 that has the power to make laws and regulations,

several other regulations that have been 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 in improving the regulatory system regarding Islamic financial institutions. **Improve** the authority of DSN-MUI from just a fatwa council to become an institution authorized to issue regulations that are more binding and enforce unavoidable **actions**. On the other hand, DSN-MUI must also transform its fatwa **method**. These fatwas will be understood by LKS more as a binding and coercive regulation than just an advisory fatwa. These improvements are expected to increase the level of compliance of LKS to Islamic principles in carrying out the intermediation function.

**Commented [i-[20]]:** Word choice?

**Commented [i-[21]]:** Such scenario has been initially planned in the Draft of Islamic Banking Law, however, it was rejected due to the MUI's opposition to place DSN-MUI as part of BI's regulatory body. Please also discuss this!

**Commented [i-[22]]:** Please tell how to do such transformation of DSN MUI's fatwa methodology!

#### **D. Effectiveness of DPS Supervision Toward LKS Compliance**

In the matter of institutional structure, the distinction between conventional financial institutions and LKS lies in the presence or absence of a DPS as an internal sharia compliance supervisory agency (Salman & Nawaz, 2018). Every LKS are required to have at least three supervisors on the DPS. The existence of a DPS in the structure of LKS 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 Implementation of Sharia Savings, Loans and Financing Business Activities by Cooperatives. In these regulations, the DPS has the supervising function toward every sharia activity or transaction carried out by LKS.

In the governance of LKS, the position of the DPS 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 DPS, which are both trying to encourage community activities in conformability with Islamic principles. In the *hisbah* concept, supervisory institutions such as DPS called *muhtasib*, while supervised institutions such as LKS are called *muhtasib 'alai* (Al-Zuhaili, 2007). *Muhtasib* is in charge of providing advice and supervision. Such advice and supervision are expected to direct LKS to comply with Islamic principles in execution their business activities. Therefore, the DPS is an extremely prominent element in the structure and governance of LKS.

The DPS position which is highly crucial in the LKS activities is in fact often ineffective (Nugroho, 2021). The function of the DPS is regulated in Indonesian Central Bank Regulation Number 6/24/PBI/2004. The regulation states that the DPS performs

supervisory duties at the internal level of LKS. Structurally, the position of the DPS as the internal supervisor of the sharia financial institution is equivalent to the directors' board position of the LKS. Thus, the relationship among the DPS and the directors' board of LKS in an organizational structure of LKS is coordinating, in which a DPS has the right and competency to serve advice and feedback to the directors' board of LKS regarding all LKS business activities related to Islamic principles. The equality position between the DPS and the directors' board in an LKS also has the consequence that as a company has organizational structure, internally LKS putting DPS position under the Commissioners board and the Shareholders. Such an organizational structure is problematic for the DPS in conducting its duties as advisory and supervisory. This is because the DPS consideration to LKS 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 DPS frequently involved in conflicts of interest with these stakeholders.

Another problem related to institutional supervision of LKS is the concurrent position of a DPS in several LKS. This has actually been regulated in Indonesia Central Bank Circular No. 12/13/DPbS/2010, a member of the DPS can only hold concurrent positions on the DPS for no more than four sharia financial institutions with details, a maximum of concurrent positions on the DPS in two banking institutions and two non-banking institutions. A DPS 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 DPS. Moreover, these overlapping positions create the bias of policies and decisions made by the DPS in supervising LKS under its authority. Generalizing problems with the character and needs of each different LKS requires different considerations. This is often ignored by the DPS who concurrently holds positions in several LKS.

Furthermore, other problems in the supervisory institutions of LKS are the permissibility of DSN-MUI component to become fellow of the DPS. 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 DPS. Whereas the supervisory function carried out by members of the DSN-MUI is as an external supervisory agency, while the supervision of DPS focuses on internal supervision (Meslier et al., 2020). Therefore, the overlap of these positions has the potential to appear bias of internal and external supervision. The dual membership of the DSN-MUI' members and at the same time serve as

follow of the DPS 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 DPS at a LSK has the obligation to compile a supervisory report related to the implementation of Islamic principles in an LKS 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 intermediation function of LKS.

Lastly, apart from the issue of concurrent positions, issues related to the absence of regulations governing the competency testing of the DPS also contributed to the inability of LKS to fully adapt to Islamic principles. The competence of the DPS in Indonesia is more concerned with Islamic religious figures and not on 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, overlapping positions and conflicts of interest that cause LKS to not comply with Islamic principles can be overcome by tiered supervisory work. DPS focuses on internal monitoring of an LKS without concurrent positions in other LKS. 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 DPS. In addition to regulatory issues, it is also important to increase the competence of DPS. Especially competence in the field of modern economics and Islamic economics.

## E. Conclusion

In carrying out the intermediation function, LKS are required to comply Islamic principles that have been decreed by the DSN-MUI. In its implementation there are obstacles frequently faced by LKS in complying with these Islamic principles. These constraints consist of regulatory constraints and supervision agency structure constraints.

Regulatory obstacles stem from the absence of the authority of the DSN-MUI as an institution that has the power to make regulations equivalent to laws. This absence of authority causes LKS to regard the fatwas issued by the DSN-MUI as mere advice or appeals and not a binding law. The DSN-MUI' fatwas themselves are very abstract and have not accommodated technical and operational provisions, giving rise to multiple interpretations at the level of implementation by LKS.

The compliance of LKS with Islamic principles also confronts many problems related to supervisory institutions. Even though there is a DPS, its position which is equal to

**Commented [1-[23]:** The paper needs to discuss the issue in more dialectical ways by addressing the issues from both sides of perspectives, the pro and contra positions so it can proceed from discussing the pro arguments (thesa), the the contra arguments (the antithesa), and the rebuttal, before the author provides the synthesis.

the directors' board; and under the shareholders and the commissioners' board makes it difficult for the DPS to carry out its supervisory duties and is repeatedly trapped in the interests of the shareholders and the commissioners' board. The permissibility of concurrent positions of DSN-MUI on the DPS and a sharia supervisor on four DPS at four different LKS due supervision of sharia compliance unfocused and non-optimal.

Therefore, improvements in terms of regulation and restructuring of supervisory institutions are important issues to be addressed. In terms of regulation, DSN-MUI needs to be given additional authority to be able to make binding laws, not just appeals such as fatwas. DSN-MUI must also improve its regulatory methodology to prevent the rules from triggering multiple interpretations from LKS.

Reforms in the DPS structure are carried out by provide the rules strictly regulate the organizational structure of DPS which governing the prohibition of concurrent positions in the DPS. Likewise, the restructuring of DPS is carried out by placing the DPS as an independent institution outside the organizational structure of LKS. Thus, the DPS has independence in exercising control over LKS in compliance with Islamic principles.

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