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Analysis of Financial Regulatory Challenges for the Development of Islamic Banking in Indonesia

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Abstract

This article aims to present an analysis of the regulatory challenges in Islamic banking supervision on the sustainability of business and financial models, with a case study on Bank Syariah Indonesia (BSI). In the context of the growth of the Islamic banking industry in Indonesia, the main question raised is how regulation affects the sustainability of the business and financial models of Islamic banks, particularly BSI. This research uses a qualitative approach by analyzing relevant laws and regulations and a case study of BSI. The results show that complex and constantly changing regulations can be an obstacle to the sustainability of Islamic banks' business and financial models. Although BSI has adapted itself to the changes, challenges remain, especially in terms of meeting capital requirements, product diversification, and enforcement of sharia rules. In answering the research question, the author concludes that to achieve optimal sustainability, regulations need to be adjusted to better support the development of the Islamic banking industry, including providing incentives for innovation and consistent fulfillment of sharia principles.

Introduction

The development of Islamic banking in Indonesia is a manifestation of public demand that requires an alternative banking system that in addition to providing sound banking/financial services, also meets sharia principles. Public demand is characterized by the concept of profit sharing in Islamic banks so that the public will enjoy balanced profits in accordance with the performance of Islamic banking. Basically, Islamic bank entities in Indonesia have been started since 1983 with the issuance of the December 1983 Package (Pakdes 83) which contains a number of regulations in the banking sector, one of which is a regulation that allows banks to provide loans with 0% interest (zero interest). The development was followed by a series of policies in the banking sector by the Minister of Finance Radius Prawiro which was contained in the October 1988 Package (Pakto 88). Pakto 88 was essentially a banking deregulation that made it easier for new banks to be established, so that the banking industry at that time experienced very rapid growth. The growth is marked by an increase in the number of Islamic bank branch offices in various regions. (Harahap & Soemitra, 2022) (Masiga & Rafidah, 2023) (Batubara & Harahap, 2022) (Anshori, 2008)

The service products issued by the sustainable finance policy consist of twelve categories of sustainable business activities, namely: renewable energy, energy efficiency, pollution prevention and control, management of biological natural resources and sustainable land use, conservation of terrestrial and water biodiversity. Environmentally friendly transportation, as well as other environmentally friendly business activities. The existence of these twelve categories is a priority for sustainable banking business, so that there is no conflict between

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standard operational procedures and practices in the field. (Ichsan et al., 2020) (Nurlaila et al., 2020)

The priorities for the implementation of sustainable finance regulations have three priorities, namely; First, the development of financial products and/or services, increasing the financing portfolio, investing or placing in financial instruments or projects that are in line with sustainable finance policies. Second, the development of the internal capacity of Financial Services Institutions (LJK). Third, organizational adjustments, risk management, governance, and/or standard operational procedures (*Standard Operating Procedure*) financial services institutions in accordance with laws and regulations. However, in contrast to business practices that occur in the field, there is still financing to companies that have not met sustainable finance policy standards in accordance with the provisions of applicable laws and regulations. Then Sharia Banks and Conventional Banks implementing sustainable finance policies are still limited to fulfilling the substance to make reports to the public, not fully in accordance with POJK 51/POJK.03/2017 concerning the implementation of sustainable finance (Law of the Republic of Indonesia Number 32 of 2009 concerning Environmental Protection and Management, 2009; Nasution et al., 2020).

The description of the researchers above shows that in a sustainable business policy strategy, there are four principles that need to be considered, namely equity, participation, diversity, integration and a long-term perspective. Then in terms of financing, the Bank determines the requirements to obtain environmentally friendly financing in accordance with laws and regulations. Among the requirements that have been determined is environmental certification in order to minimize the negative impact of business operations. So the purpose of this study is to analyze the regulatory challenges in the supervision of Islamic banking on the sustainability of business and financial models, a case study of Bank Syariah Indonesia.

Sustainable finance practices in Indonesia have been researched by previous researchers such as those conducted by , on the Effectiveness of Implementation Yuliawati et al. (2017) *Green Financing* As an Alternative to Sustainable Financing for MSMEs in the Footwear Processing Industry Sector in the City of Bandung (2017). The results of this study show that in providing financing using the *Green Financing*. The purpose of the scheme is to support sustainable economic growth and implement *Reduce, Reuse, and Recycle* (reduce, reuse and recycle the products produced). The article titled "Financial Regulation Challenges for the Development of Islamic Banking: A Literature Study written by , shows that Islamic financial institutions have their own regulations as they are faced with seven challenges, such as Gultom et al. (2022) *profit and loss sharing* (PLS), contract implementation practices, model regulations, and so on. The article is entitled "Capital Analysis of Sharia Banks After Conversion (Case Study of Bank Aceh Syariah)" written by . The results of the study showed that there were differences in regulations that must be met between conventional banks and Islamic banks set by the Financial Services Authority (OJK). The article is titled "Risk Management Analysis in Islamic Banks: A Literature Review written by . The results of the study are the risks that must be faced by Islamic banks and how to manage the risks that must be faced. The article is titled "Sharia Banking Innovation Model in Indonesia" written by . The results of the research are the challenges that must be faced by Islamic banks with conventional banks so that they are required to innovate. Nadzilla & Mahendra (2023) Nelly et al. (2022) Apriyanti (2018)

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Methods

The research method used in the analysis of financial regulatory challenges for the development of Islamic banking in Indonesia is a literature *review* supported by the analysis of the latest phenomenon. The qualitative approach in this study involves an in-depth analysis of various sources of literature relevant to the topic, such as scientific journals, books, research reports, and policy documents. Through this *literature review*, researchers can collect various viewpoints and findings related to financial regulatory challenges for Islamic banking in Indonesia from leading experts and researchers in the field. In addition, by paying attention to the current phenomena in the Islamic banking industry, this research also enriches the understanding of the practical context and evolving dynamics in industry regulations and practices. This approach allows researchers to combine theoretical understanding with the practical realities faced by Islamic banking in Indonesia, so as to present a more complete and in-depth picture of the relationship between regulation and the development of the industry.

The study will collect data from various relevant literature sources, such as academic journals, textbooks, research reports, and official documents from financial supervisory authorities and other related institutions. The data obtained will be systematically analyzed to identify the regulatory challenges faced by Islamic banks in Indonesia in developing and expanding their operations. Recent phenomena such as the latest policy or regulatory changes, market trends, and actual issues affecting the Islamic banking industry will be taken into account in the analysis (Rahmani, 2021) (Parera, 2020)

In addition, this research will also consider the perspectives of experts and practitioners of the Islamic banking industry through interviews or literature reviews to gain a deeper understanding of the challenges faced. By combining a comprehensive literature review with an analysis of current phenomena, this study aims to provide a more holistic understanding of the challenges of financial regulation for the development of Islamic banking in Indonesia.

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This analysis is expected to provide valuable input for regulators, practitioners, and academics in an effort to improve the regulatory environment that supports the growth of Islamic banking and strengthen its contribution to Indonesia's overall economic development (Efendi & Ibrahim, 2016).

Results and Discussion

Financial Regulation

Financial regulation is a rule created to prevent risks faced by financial institutions, especially banks. The regulatory is whether the prevention of systemic risks provides a strong reason for regulation. Financial regulation is specifically designed to: (a) ensuring compliance with internal controls within regulated entities. (b) ensuring efficiency in the allocation of resources, therefore the regulatory framework must include financial institutions as well as financial markets. (c) the establishment of certain rules of conduct and business conduct, as well as the supervision and monitoring of regulated entities to ensure the compliance of financial institutions with regulatory standards (Nurbaiti et al., 2023).

The financial stability system was created to allocate economic resources that are wide enough efficiently and economically so that it can increase the growth of the real sector. A stable financial system must be strong and resilient in dealing with economic problems, especially crises. A stable financial system must still be able to perform the functions of intermediation, payment and manage risk well, especially in conditions of uncertainty. In order to create financial stability, especially for banks, countries that are members of the G-10 in 1975 formed *the Basel Committee of Banking Supervision* (BCBS) in Switzerland which aims to make guidelines or regulations for banks. (Sukardi, 2012)

BCBS has issued 3 guidelines from 1988 to 2009, namely Basel 1, 2 and 3 to maintain credibility and strengthen banking supervision throughout the country. Basel 1, which was issued in 1988, focuses on avoiding bank risks in terms of capital. Therefore, the minimum ratio of banking capital is set at 8%. This situation is mirrored by the 1980s Latin American financial crisis. The minimum capital ratio (CAR) came into effect in 1992. Furthermore, to continue to improve the credibility of banking, Basel 2 was established in 2004 and fully implemented in 2006. Basel II consists of 3 concepts that are often called "three pillars", namely minimum capital requirements, strengthening supervision, and full disclosure of information. The first pillar maintains a CAR of 8% by considering the risks faced by banks, namely credit risk, market risk and operational risk. The second pillar is the importance of supervision to deal with other risks such as systemic risks, liquidity risks or legal risks. Then the third pillar requires banks to make disclosures to avoid other unforeseen risks. (Nuraini & Cheumar, 2023)

In fact, although Basel 1 and 2 were implemented in 2008, the world was again hit by a financial crisis with the collapse of Lehman Brothers. The 2008 crisis showed that existing regulations have not been able to overcome systemic risks, regulations made by countries are still very weak and banking entities often behave excessively, especially in managing debt (credit). This situation led BCBS to update and reform the existing guidelines by issuing Basel 3. The Basel 3 Regulation also consists of three parts, namely improving the ability to reduce financial and economic risks from anywhere, improving risk management and banking governance; and strengthen bank transparency and disclosure. Additional regulations that must be met are not only a minimum capital ratio of 8% but must require banks to meet the minimum general equity and minimum liquidity ratio. The implementation of Basel III has started in stages since January 2013, and is expected to be fully implemented on January 1, 2019 even though several countries have not yet followed this regulation (Technical Guidelines for Banks Related to the

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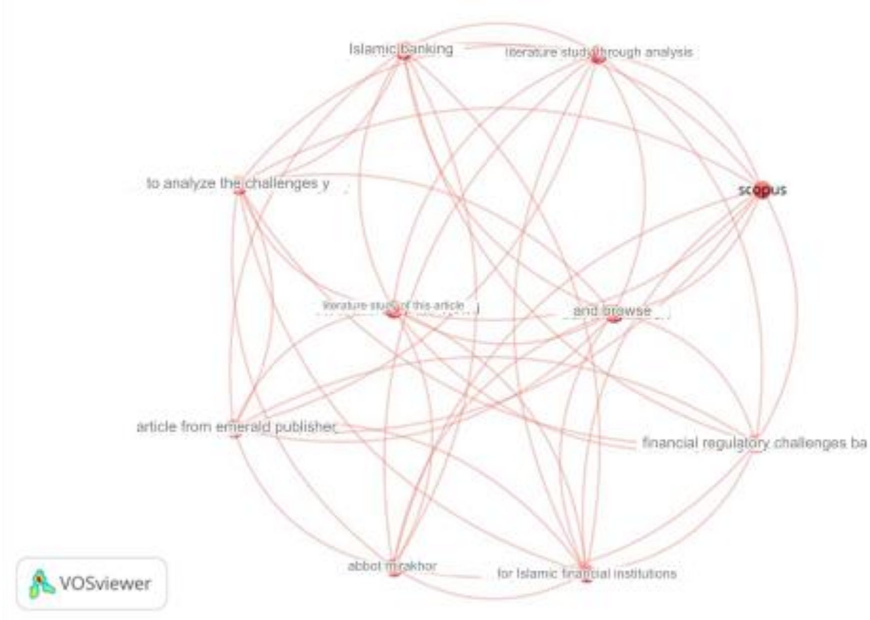
Implementation of Financial Services Authority Regulation No. 51/Pojk.03/2017 concerning the Implementation of Sustainable Finance for Financial Services Institutions, Issuers, and Public Companies, 2018).



Based on the conceptual mapping on the image, it can be seen that the literature study and analysis carried out focuses on the topic of Islamic banking. The literature study through the analysis aims to analyze the challenges faced, which may be related to the regulation or practice of Islamic banking itself.

In conducting this literature study, some of the main sources used as references are articles from Emerald publisher, a leading publisher of scientific journals and books. In addition, the study also searched the literature from the Scopus database, which is a large database for reputable scientific publications. There are also references to literature studies of a particular article or research that are not specifically mentioned. One of the challenges highlighted in this mapping is related to financial regulation for banks, which of course is an important issue in the context of Islamic banking. In this case, there is a reference to a figure named Abbas Mirakhor who is an economist and writer in the field of Islamic economics. (Rahmawati, 2011)

Overall, this mapping shows that the literature study and analysis carried out includes efforts to integrate various sources of literature, both journal articles, books, and scientific publication databases. The goal is to comprehensively understand the challenges faced in Islamic banking, especially from the perspective of financial regulation and practices in accordance with Islamic principles. In addition, this mapping also emphasizes the importance for Islamic financial institutions to consider the results of such literature studies and analyses in their operations.

The author presents 5 previous studies related to Financial Regulation in Indonesia, which are as follows: (a) Research by entitled "Sharia Banking Regulation in Indonesia". This study analyzes Islamic banking regulations in Indonesia and finds that there are several challenges such as the absence of a special law on Islamic banking, lack of public understanding of Islamic banking, and lack of adequate human resources Anshori (2008). (b) The research by is entitled "A Study of the Development of Sharia Banking Regulations in Indonesia". This study examines the development of Islamic banking regulations in Indonesia and concludes that existing regulations are still not optimal in supporting the growth of the Islamic banking

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industry, especially in terms of the consistent application of Islamic principles. Al-Hakim (2013). (c) The research by the title "Basic Principles of Islamic Economics Perspective of Maqashid Sharia". This study analyzes the basic principles of Islamic economics based on sharia maqashid and highlights the importance of regulations that are aligned with these principles in supporting the development of Islamic banking in Indonesia Fauzia (2014). (d) The research by was entitled "Analysis of the Problem of Islamic Banking Development in Indonesia: Application of Rusydiana (2016) *the Analytic Network Process* Method". This study identifies the main challenges of Islamic banking development in Indonesia, including regulatory aspects, and proposes solutions using the Analytic Network Process method. (e) Research by entitled "Sharia Banking Regulation in Indonesia: Opportunities and Challenges". This study examines Islamic banking regulations in Indonesia and analyzes the opportunities and challenges faced, such as regulatory harmonization between conventional and sharia banking, as well as the need to strengthen supervision and enforcement Imaniyati (2009).

Internal Supervision of Sharia Banking

Internal supervision of Islamic banking is carried out by DPS. In Article 50 of Law Number 21 of 2008 concerning Sharia Banking, the supervision of Islamic banking is carried out by the Sharia Supervisory Board (DPS). Sharia Banking and Conventional Commercial Banks that have UUS must form a Sharia Supervisory Board, which is elected by the General Meeting of Shareholders on the recommendation of the Indonesian Ulema Council. The Sharia Supervisory Board is responsible for supervising the bank's activities in accordance with sharia principles and providing advice and advice to the board of directors. (Usman, 2022)

DPS is a board formed to ensure that the operation of Islamic banks does not violate sharia principles or is consistently in accordance with the principles of Islamic muamalah principles. Sharia principles are Islamic law on banking activities stipulated by fatwas issued by the National Sharia Council of the Indonesian Ulema Council (DSN-MUI), which is the holder of the highest authority in issuing fatwas on bank products and services. (Srairi, 2019)

The difference between DPS and DSN is that DPS ensures that operational activities, products, and services of Islamic banking remain in accordance with sharia principles, while DSN provides recommendations for DPS members who have qualified sharia expertise and competence, and issues fatwas on sharia banking products and services that are national in nature so that they can be used as consistent guidelines for DPS. Thus, DSN and DPS function as institutions that direct Islamic banks to apply sharia principles. (El-Hawary et al., 2007)

In carrying out its duties and functions, DPS must have independence to prevent potential conflicts of interest because DPS is appointed by the GMS while its duty is to supervise the management by the Board of Directors. In addition, the independence of DPS is also useful to ensure that sharia principles for stakeholders have been fulfilled and increase public trust in Islamic banking. In order to realize all of this, it can be done to the competence of DPS members which is fulfilled in the following way: (1) It has fulfilled the certification process by the appointed institution where there is currently no standard qualification, certification or accreditation standard that can guarantee the quality of DPS members in Islamic banking. (2) Not only mastering sharia principles but also in the field of banking, the development of Islamic banking products and services. (3) Member recruitment must be open and meet all the requirements set, including certified academics. (Grassa, 2013)

The goal is that DPS members are not only represented by sharia experts, but also from various other experts such as accountants, business management, and legal experts. Now the arrangements related to DPS members refer to the Financial Services Authority Regulation Number 16/POJK.03/2022 of 2022 concerning Sharia Commercial Banks.

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External Supervision of Sharia Banking

Law No. 6 of 2009 concerning the Stipulation of Government Regulations in Lieu of Law No. 2 of 2008 concerning the Second Amendment to Law No. 23 of 1999 concerning Bank Indonesia into Law

As stipulated in Article 8 paragraph (3) of this law, the responsibility for banking supervision lies with Bank Indonesia. The provisions of the task of regulating and supervising banks by BI are regulated in Chapter VI starting from Article 24 to Article 35 of the BI Law. In accordance with laws and regulations, BI is responsible for establishing regulations, granting and revoking licenses for certain institutions and business activities, supervising banks, and imposing sanctions on banks. BI also conducts direct supervision, namely supervision followed by corrective actions and indirect supervision in the form of research, analysis and evaluation of bank statements. However, in particular, the supervision of Islamic banking by Bank Indonesia is regulated in the Sharia Banking Law in Chapter VIII concerning Guidance and Supervision, that Bank Indonesia as the central bank is tasked with fostering and supervising Islamic banks and Sharia Business Units (UUS). Thus, it is further regulated that the authority inherent in BI makes BI have the right to: (1) examine and retrieve all documents and information related to the Bank; (2) examine and take all persons who, in the judgment of Bank Indonesia, have an impact on the Bank; and (3) request the Bank to block all accounts, both Savings and Financing accounts. (Grassa, 2015)

Law Number 21 of 2011 concerning the Financial Services Authority

With the establishment of this regulation, Indonesia has implemented an integrated regulatory and supervisory model. This system has the advantage of dealing with ever-changing financial trends and it is expected that since this system is integrated under one roof, the issues of licensing, regulation, supervision, and exit politics will become easier. As Article 1 number 1 of the OJK Law jo. Article 8 number 1 of Law Number 4 of 2023 states that the OJK is an independent state institution responsible for regulating, supervising, inspecting, and investigating the activities of financial services institutions. Thus, based on the principle of lex posterior derogat legi priori that the new law (effective later) cancels the previous law, as long as the law regulates the same object, thus since the promulgation of this OJK Law, the responsibility for external supervision of banking as a whole which was initially carried out by BI with DPS has shifted to the OJK, including Islamic banking. However, not all BI supervision has switched, the supervisory tasks that have shifted are only related to microprudential. BI continues to carry out supervisory duties related to macroprudential. Microprudential supervision includes supervision of institutional systems, health, prudence, and bank inspections. Apart from that, it is the macroprudential aspect that is the responsibility of BI. (Mihajat, 2018)

Analysis of Regulatory Challenges in Sharia Banking Supervision on the Sustainability of Business and Financial Models, Case Study of Bank Syariah Indonesia

Sharia banking as one of the national banking systems requires various supporting facilities in order to make maximum contributions to the national economy. One of the vital supporting facilities is the existence of adequate arrangements in accordance with their characteristics. The existing banking law is still felt to be insufficient to accommodate the operational characteristics of Islamic banks.

In order to ensure legal certainty for *stakeholders*, provide confidence to the public in using Islamic bank products and services, ensure the fulfillment of Sharia principles, the principles of the health of Islamic Banks and especially to mobilize funds from other countries that require

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regulation of Sharia Banks in the relevant laws, it is very urgent to draft and promulgate the Sharia Banking Law. (Muqorobin & Cahyo, 2019)

The Sharia Banking Law, in addition to providing more diverse business opportunities for Islamic banks and the possibility to accelerate the growth of Islamic banking in the future, also has sharper competition challenges. These challenges include: For national Islamic bank actors with the birth of the Sharia Banking Law, the exemption of ownership of Islamic commercial banks by Indonesian legal entities with foreign citizens and/or foreign legal entities in direct partnership (Article 9) or through the stock exchange is a very big challenge for Indonesian citizens and legal entities in the ownership of Islamic banks in the future. The provision on exemption from the use of foreign workers (Article 33 paragraph (1) can be a big challenge for Indonesian citizens as managers and/or workers in Sharia banking. Another challenge is that the sharia principles that are the basis for Islamic banking products/services are outlined in Bank Indonesia Regulations by the Sharia Banking Committee based on the fatwa of the Indonesian Ulema Council (Article 26). This can limit the products/services that can be carried out by Islamic banking in Indonesia. An Islamic banking product/service that can be done by Islamic banking in the international world may not be able to be done in Indonesia. The provision regarding prospective controlling shareholders (owning more than 25% or less than 25% shares but can be proven to have directly or indirectly controlled the company) must pass the ability and propriety test from Bank Indonesia (Article 27), is also a challenge because this will limit investors from owning Sharia banks. The settlement of Islamic banking disputes can be carried out by the courts within the Religious Court or other channels as long as it has been promised in the contract (Article 55) is 38 challenges for Islamic banks to choose the right path in each agreement agreement to resolve disputes in the future, which can be submitted to the Religious Court and which one can be submitted to other institutions (Technical Guidelines for Banks Related to the Implementation of Financial Services Authority Regulations No. 51/POJK.03/2017 concerning the Implementation of Sustainable Finance for Financial Services Institutions, Issuers, and Public Companies, 2018).

From the description above, the challenges for Sharia Banking must be responded to with the spirit of improving the quality of National Sharia Banking, this is both related to Human Resources (Bank owners, controlling shareholders, employees) and Islamic banking products. This is because Islamic banking products must be in accordance with the Fatwa of the Ulema Council, even though the product is used internationally.

The academics proposed a new sharia governance framework by involving the authority of the Sharia Supervisory Board (Sharia Supervisory Board Authority) under the commissioner of the OJK to supervise, regulate, and supervise sharia issues for Islamic financial institutions in Indonesia. The results of the study recommend a sharia governance framework for the Indonesian Financial Services Authority to mitigate elements of sharia non-compliance that will affect the trust of LKI stakeholders that harm their reputation and consequently may have serious implications for the development of the sharia finance industry in Indonesia. The current Islamic financial system in Indonesia, namely all LKIs, is supervised and regulated by the Indonesia Financial Services Authority, namely the OJK. It is a general consensus that some of the risks faced by LKI differ from the conventional financial system. Therefore, the sharia governance framework system in Indonesia under the OJK needs to be reformed. (Dafterdar, 2011)

Research on banking supervision and transparency. Discipline in disclosure will minimize the risk of banks, both Islamic and conventional banks. The four variables chosen are bank size, deposit rate, efficiency and total asset growth related to bank risk (Risal, 2019). The transparency index of Islamic banks is still low, so Islamic banks must improve corporate

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governance, Islamic governance and mitigate all risks. Disclosure and transparency in Islamic banks must be stronger and more effective than conventional banks because this will increase the ethical behavior and credibility of Islamic banks. For better oversight regulators should create reporting models tailored to AAOIFI, IFSB and IFRS standards and should consider sharia boards. (Ribowo & Nurdin, 2022)

If reporting and disclosure are in accordance with the application of standards, it will increase the credibility of Islamic banks to the community and their environment as well as sharia compliance. Regulators must therefore develop data compilation process regulations that allow for proper risk measurement, including through the development of credit and equity records that are appropriate for Islamic finance. These two studies are in line with research that has been conducted by the regulatory challenge for Islamic banking to more widely carry out disclosure and transparency. Furthermore, regulation and supervision in the banking industry are useful for controlling the risk-taking behavior of sharia banking and to strengthen the financial stability of the sharia banking industry as a whole (Soemitra et al., 2022)

There are still many gaps in the practice and implementation of Sharia governance regulations in Islamic financial institutions in 25 OIC member countries. Most of these shortcomings are related to the current regulatory framework, the roles and responsibilities of national sharia authorities and the institutional duties and attributes of the standards board (Grassa, 2013).

The results of the study propose three main suggestions for building an efficient sharia supervision system. First, national sharia authorities need to play an even more important role in monitoring and ensuring governance practices in Islamic financial institutions. Second, the existing Sharia governance framework needs further improvement in order to strengthen the development and growth of Islam in the financial industry. Third, international and national Islamic financial organizations need to do more effective work to build an effective sharia governance system. Previous research has confirmed that the standards council must be independent in carrying out the supervisory function and consistency in sharia rules. The Sharia Council must be centralized in the governance system and part of the government in order to truly benefit the Islamic finance industry in terms of the effectiveness and credibility of Islamic banks.

Conclusion

This study concludes that Law Number 21 of 2011 concerning the Financial Services Authority, supervision of Bank Syariah Indonesia is divided into internal supervision by the Board of Commissioners, Board of Directors, and Sharia Supervisory Board, and external supervision by Bank Indonesia. After the OJK Law was enacted, according to the principle of lex posterior derogat legi priori, banking supervision as a whole, including Islamic banking, switched from BI to OJK, but only microprudential supervision switched, while BI continued to supervise macroprudential aspects. Microprudential supervision includes supervision of institutional systems, health, prudence, and bank inspections. Financial regulation faces a range of challenges to achieving comprehensive financial stability, given recurring crises and ongoing instability. The seven main challenges that regulators need to overcome include: profit and loss sharing calculations that still refer to the interest system, the implementation of contracts that are still influenced by conventional contracts, minimum capital and liquidity regulations that follow general regulations, fixed efficiency assessments based on conventional models, weak regulations in the disclosure and supervision of Islamic financial institutions, weak controls in the implementation of good corporate governance, and the unavailability of special courts to handle Islamic financial violations.

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