

## THE EMERGENCE OF LEGAL SYSTEM IN ISLAMIC FINANCE

Nuha Qonita  
MSc Islamic Finance  
Durham University Business School  
Email: nuha.qonita104@gmail.com

### *Abstract*

*Legal system and jurisdiction take an important role in developing system or product innovation. The principle of Islamic financial transaction is recently elaborated in different frames of finance. It describes the challenge of Islamic finance in several countries which is linked with the perspective of stakeholders, consumer, industry, and the existing regulation. Various problems and recent decision making concept should be solved properly. This article aims to re-emphasize the rationality of Islamic finance regulation adjusted with consumer's need. In some points, this study is used as the analysis on Islamic finance regulation. This is a study case categorized in qualitative research. The in-depth analysis is done on the basis of legal appeal in the court of Indonesia and is referred to Indonesian law about Islamic finance.*

*Yurisdiksi dan sistem hukum mengambil peranan penting dalam mengembangkan sistem atau inovasi produk. Prinsip transaksi pembiayaan Islam dewasa ini dielaborasi dalam kerangka pembiayaan yang berbeda. Menggambarkan tantangan pembiayaan Islam di beberapa negara, dikaitkan dengan pandangan banyaknya pengguna, konsumen, industri dan peraturan-peraturan yang ada. Banyaknya permasalahan yang berbeda dan konsep pengambilan keputusan yang baru harus diselesaikan dengan tepat. Tujuan penulisan ini adalah untuk menekankan kembali rasionalitas dari pengaturan pembiayaan Islam yang disesuaikan dengan kebutuhan konsumen. Pada beberapa poin kajian ini digunakan sebagai analisis terhadap pengaturan pembiayaan Islam. Metode penelitian yang digunakan adalah studi kasus dengan metode kualitatif. Analisis mendalam yang didasarkan pada putusan banding di Pengadilan Indonesia, dan mengacu pada dasar hukum di Indonesia dalam hal pembiayaan Islam.*

*Keywords: Islamic finance, jurisdiction, legal system, murabahah*

## Introduction

One opinion needs to be avoided that Islamic economy is a new branding of system and new paradigm in this era. Islamic economy can be traced back into 7th century as theoretical basis how Islamic economy was shaped under sharia. Sharia took a place as main guidance in any dimensions of life, it has covered worship, prayer, etiquette and morals, marriage, inheritance, criminal and commercial transactions. In other words sharia encompasses many aspects that are not considered as law in other places.<sup>1</sup>

In the economic area, reforming financial institution in the harmony of Sharia is a huge challenge. Since, the environment in interest based was formidable task to structure sharia principles in financial institutions. Referring to sharia, interest free loans in Islamic finance describes cooperative and charitable activities that unusually occurred in commercial transaction. Cooperative works is described to share the risk and profit among parties, while charitable scheme is lending the amount of money with no additional amount.<sup>2</sup>

Al Quran has mentioned much of attentions on trade and commercial activity based on lawful and fair. This basic is applied as foundation of human being to earn in a lawful way. As Islam regulates and influences all areas of life, as well as it regulates business and commercial conduct. As the principles of Islamic financing, there are several principles and norms that should be applied in investment behavior; 1) free from usury; 2) prohibition of production and services on haram product; 3) free from gambling; 4) cooperated each other.

## Research Method

This research method applies a case analysis with qualitative descriptive approach, the researcher describes the challenge of Islamic financing in several countries and analyzes more deeply against the legal appeal verdict of Islamic financing system in Indonesia.

## Discuss

### The Principles of Islamic Finance

#### 1. Riba

The principle of Islamic financing shows that sharia does not justify enriching themselves in unethical way and harm others so as to provide an unequal value. Al

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1 Mervyn Lewis & Latifa M. Algoud. *Perbankan Syariah: Prinsip, Praktek dan Prospek* (Jakarta: Serambi Ilmu Semesta, 2007), pp. 67.

2 M.T. Usmani. *An Introduction to Islamic Finance* (The Netherlands: Kluwer Law Internasional, 1998). Pp. 28-29.

Quran distinguishes profits derived from business and usury practices (Al Baqarah – 275), it means different additional value from its process. Prohibition of Riba has impacted on larger aspects; harming others and deprivation, Riba has blocked people perspective on effort and trade thus raising inequality among social, Riba also has hampered the relation of society in helping each other.

## 2. Gharar

The prohibition of gambling is mentioned in Al Maidah 90-91. Al Quran prohibits risky games earned by the easy way of unemployed property. So Islam not only forbids clear gambling form but also activities that contain the element of gambling. Additionally, Islam also has prohibited unknown business or transaction and uncertain. It is because the transaction between two persons has related with both responsibility for any negligence. Therefore, it is unacceptable when speculation exist. The complexity of financial transaction has raised the issue of the existence of the counter-values. Thus the prohibition of gharar considered an unjust result.<sup>3</sup>

## Legal System of Islamic Finance

Legal system of financial sector plays as an important role for different aspects; financial transactions, consumers, institutions. Legal system may not clearly solve the market and financial failures, nor assisting the original problem. However, the financial systems are prone in instability. Financial regulation is shaped to fulfill the objectives; to sustain systemic stability; safety of financial sectors and consumer protection.<sup>4</sup> Additionally, regulation is shaped to shore up confidence in financial system then mitigate systemic risk.<sup>5</sup>

Rationalizing the economic regulation has covered banking and financial services; business rules, supporting the potential problem, correcting market failures, monitoring financial firms and economies of scale, improving consumer confidence, moral hazard problems, regulation demand for consumer.<sup>6</sup> The legal framework is important due efficiency and effectiveness for financial market and sectors. Following that, the legal framework of Islamic finance also has elaborated to different characteristics depend on legal system of the countries. In that case, the empirical studies reports that stability of financial system has strongly relevant and related with the ability of legal environment in supporting contractual use in

3 J Ercanbrack. *Transformation of Islamic Law in Global Financial Markets* (Cambridge University Press, 2015). Pp. 73-75.

4 David Llewellyn. *The Economic Rationale for Financial Regulation. Financial Services Authority Occasional Papers in Financial Regulation* (London: The Financial Services Authority, 1999). Pp. 112-113.

5 Ercanbrack, J., *Transformation...*, pp. 98.

6 David Llewellyn, "The Economic...pp. 119.120.

financial institutions.<sup>7</sup> It is identified there are three stages of institutions relevant in Islamic finance industry; 1) Relevance of law and rules in property rights and contract, 2) Regulatory and supervision frameworks on stability of financial system, 3) Courts and dispute resolution. Following that, since Islamic financial sectors use Islamic law on its transactions, sharia governance system may be required.

Law is incomplete as given,<sup>8</sup> it is designed to be more or less complete to enable change and more dynamic to face the changes and challenges. The lawmakers choose the different stages of incompleteness for some reasons; the existing law enforcement and its effectiveness. In this area, the courts can play its role to fulfill the gaps of law and followed by open-ended provisions rather than specific. Therefore, the courts play as reactive law enforcers while regulators enforce the law proactively.

### Legal System of Islamic Finance Gulf Cooperation Council (GCC)<sup>9</sup>

Despite different segment and histories of Arab world, there is resemblance in various judicial systems. Some Arab countries addressed French rule, while others were occupied by Great Britain, some of countries are republics while others are monarchies.<sup>10</sup> Arab judicial structures tend to have some weaknesses and strengths; respected judicial corps has been built in most Arab world. Many Arab countries have taken strong steps to develop the integrity and the professionalism of judiciary.

#### 1. Bahrain

Legal system of Bahrain is based on British Common Law and mixed on Sunni Shi'a and Shari'a traditions in general. The major codifications of Bahraini law include the Code of Civil Procedure, the Law of Commerce, the Criminal Code and Judiciary Act. The courts are organized into Civil Law Courts and Shari'a Law Courts. The first is authorized in resolution of all commercial, civil and criminal cases including the disputes related with non-muslim disputes. The second, Sharia courts cover all the issues of personal status of Muslim for both Bahraini and non – Bahraini. It implies the Islamic finance judiciary is organized with sharia courts, since it refers to Islamic law.

7 H. Ahmed. *Islamic Banking and Shari'ah Compliance: A Product Development Perspective*. Journal of Islamic Finance Vol. 3 No. 2, pp. 015-029, 2014.

8 Katharina Pistor. *Rethinking the Law and Finance Paradigm* (Brigham Young University Law Review. BYU Law Review, Issue 6 Volume 2009), pp. 210-212.

9 Gulf Cooperation Council is a regional intergovernmental political and economic union, the member states are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

10 Saif, A. A. *Arab Gulf Judicial Structures* (Chambridge: Gulf Research Center, 2004), pp. 92-94.

## 2. Kuwait

Legal system of Kuwait is based on civil law system as one of the oldest in the Arabian Peninsula. The status issues are not assigned to different sharia judiciary. The courts system based on codified Sunni law or Shi'a law depending on the litigants, while non-muslims are addressed by their own laws. The judges of Kuwait are formally appointed by Amir who acts in advising Supreme Judicial Council whereas a more powerful body and responsible over judicial affairs.

## 3. Oman

Legal system of Oman is based on Islamic tradition and custom. Sharia has an important role of guides in judicial decision and verdict. Oman's principles of commercial law were drawn from Kuwaiti commercial code of 1981, French civil code and Egyptian Law. Sharia courts of Oman cover all civil and minor criminal cases. The commercial cases are handled by the Authority for Settlement of Commercial Disputes as a part of the codification of commercial laws. The authority's jurisdiction includes shipping, insurance, construction, contractual disputes, bankruptcy.

## 4. Qatar

Legal system of Qatar is defined into traditional Muslim society and the independence of Qatar in the termination of British jurisdiction over non-muslim. Therefore, the Amir of Qatar established civil court in order to cover the needs which caused from termination of British jurisdiction. The Qatar's legal system has addressed three stages; tribal law, sharia law and modern law. Following that, the jurisdictional division is implemented into different courts; the Sharia court, contains of Petty Sharia Court, Grand Sharia Court and Presidium of the Sharia Courts. Another court, Adlia court was addressed by Qatar criminal laws in responsibility of criminal cases; Civil Court, Labor Court and Court of Appeal.

## 5. Saudi Arabia

Saudi Arabia is the one different system from the rest of the Arab world whereas Sharia courts has its crucial place on the nation. The Sharia in Saudi Arabia took a core place in legal system, whereas other Arab countries have mixed with civil or common law. Saudi Arabia's court system is based on Sharia courts with two levels of trial courts. Appeal court may seek greater information from the trial court. In the sense of sharia court as general jurisdiction then there is no specific set of personal status courts or a personal status code.

## 6. UAE

The United Arab Emirates is shaped in federal structure. The country was structured by seven member emirates in 1971 but most judicial structures are initially emirate rather the federal. Federal judicial system is shaped as comprehensive law since 1983 although the member of emirates remains in vary stages of judicial autonomy. The UAE has two system of civil courts, they are federal and local system. The federal system was established on a framework of judiciary and the local system is older that traced to pre-independence era, this local system also consisted into sharia courts and rulers courts. The absence of code in personal status of UAE law, the personal cases can be dealt with sharia courts therefore remain the dominant court in personal status cases.

#### 7. United Kingdom

United Kingdom is the ninth largest country of biggest Islamic asset, valued at US \$19.4 billion in 2011.<sup>11</sup> There are five Islamic financial institutions in UK that complied with Islamic finance, the sharia-compliance is applied in financial products and services and seventeen conventional banks that have established Islamic finance windows. Additionally, the City of London has reached as the third largest market for Islamic finance after GCC and Malaysia. Therefore, despite a relative small size of muslim compare with France and Germany, United Kingdom has high liquidity of market in Islalmic finance, moreover, the commercial law under English law is protected to facilitate free trade and business activity.

The regulation of financial institutions such Islamic financial institution is complex issue that need broader analysis in different stages of legal system. Islamic financial services in United Kingdom are influenced by the stages of regulatory requirements on consumer preferences on particular modes of investment due market drivers. The regulatory framework of Islamic financial institution in United Kingdom is the same system approaches of conventional industry. Particular risks arising in Islamic banking because of classification of Islamic products. Further complex risk in Islamic finance is non-recognition in global system, therefore the case of disputes in courts is prone to become invalid and uncertain.

In English courts, financial disputes are resolved in the same way as cases of divorce and domestic violence. In addition, religious and cultural traditions are only referring to English law. By its nature, Islamic law might not be rejected as an alternative form of dispute resolution with other religions.<sup>12</sup> However, legal risk cannot be avoided since Islamic finance concerned as general contract.

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11 Ercanbrack, J., *Transformation...*, pp. 58-59.

12 R. Griffith-Jones. *Islam and English Law*. pp. 119-125 ed.(s.l.:Cambridge University Press, 2013), pp. 119-125.

## 8. Indonesia

### Institutional

The character of legal basis Indonesia has comprehensively built, there are multiple departments who have been concerned in developing Islamic finance. The Act No 7 Series 1992 about Islamic banking is the legal basis that Islamic finance is widely approached as a new development instrument. However, importantly to note that Indonesia cannot fairly be compared with other countries, since Indonesia is more oriented on retail. It moves from a lower segment, which carries less of the industry's name, to an international one, but provides a strong foundation in the country. Indonesia now has expanded into the Banking sector, Non-Banking Sector, Capital Market and Social Fund. Meanwhile, structural bodies in regulation, legal framework and fatwa are crucially supervised.

Indonesia has established the Financial Services Authority (FSA) which takes an important place for regulation and supervision. Meanwhile, FSA has an important role in the development of Islamic Finance in Indonesia. The Financial Services Authority carries out a statutory mandate to oversee and develop the Islamic financial services sector (banking sector, non-banking sector and capital market; excluded sukuk). As a supervisory institution, FSA has prepared risk-based supervision infrastructure in the form of prudential regulations and special surveillance systems for the sharia financial services industry.

The set standards have also adopted internationally recognized supervisory standards to ensure that the Islamic finance industry has an established capacity to tackle any turmoil in the financial system. Following that, the FSA has developed strong recognition with the National Sharia Council of Indonesian Ulama (DSN-MUI) as an independent body to give the fatwa, sharia guidance and sharia reasoning. Uniquely, the DSN-MUI retains its independence with no mutual structure with the bank central, regulatory body and other governmental agency or department. This body operates under the Indonesian Council of Ulama which provides all the guidelines in sharia compliance.<sup>13</sup>

### Legal Basis

Indonesia as a civil law country has contained the codes for legal proceedings. Civil law is derived from Roman law that supports the supremacy of national legislation, meanwhile the standing of the court has no authority to create the types of law that are used in the patterns of common law cases. The judges of civil law country acts to construe the related codes of the case and settlement with

<sup>13</sup> *Masterplan Arsitektur Keuangan Syariah*, (Masterplan of Architecture of Islamic Finance, 2014), pp. 158-162.

identification of relevant case. The structure of law cannot contradict each other, such lower regulation cannot contradict with higher regulation, for instance; the institutional law must be linked and cannot contradict with the national law.

The challenge was identified in the framework of Islamic finance and law. Some common and civil law countries does not recognize with Islamic financial law. Uniquely, Indonesia as Muslim majority country has a huge demand of Islamic financial law. The Publication of the Act number 21 Series 2008 about Islamic banking is the beginning of various businesses dedicated to developing the regulatory framework which was followed by a number of various Islamic banking regulations. It was published on July 16, 2008 in order to support the development of Islamic banking and encourage the growth.

As reactive law, Sharia court in Indonesia is an important part in the development of Islamic finance. Sharia courts in Indonesia is established since 1957 which returned as legal body for resolving Islamic law disputes and was codified in the Act No. 7 Series 1989.<sup>14</sup> Arguing that, the jurisdiction in the disputes concerning of Islamic finance is the role of Sharia court is enacted on the Act No. 3 Series 2006 amendment Act No. 7 Series 1989 regarding the role of Sharia Court. Supporting that, the issue is also enacted in the Act of Constitutional court No.93 / PUU-X / 2012 dated March 28, 2013. It is decided that Sharia Courts have the jurisdiction of Islamic financial disputes unless there is enforcement on security<sup>15</sup>. Alternatively, the Basyarnas (National Syariah of Arbitration Board) which formed in 1993 also can gain more legal and institutional support as the center of domestic law for the settlement of Islamic financial disputes.

## Dispute

The Banking Law in Indonesia is mentioned in the Act 7 series 1992 is amended into banking law series 1998 and the Act 21 series 2008, it has showed the facility in development of Islamic and conventional banking as dual system. The law defines sharia compliance of Islamic banking as commercial bank that complies with Islamic law. Juoro (2008) argued that Indonesia has a huge potential to grow greatly in volume due to product development and risk management procedur and also when they can raise people's awareness among society. However, there are many issues are recognized on the product of Islamic finance and related to the broader frames of consumer, regulation and risk.

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14 A. Qodri Azizy. *Elektisisme Hukum Nasional* (Yogyakarta: Gama Media Press, 2002) pp.48. Ercanbrack, J. *Transformation of Islamic Law in Global Financial Markets* Cambridge University Press, 2015). pp. 153-161.

15 *Masterplan Arsitektur Keuangan Syariah*, pp. 48-53.



Importantly to note such principles are crucial for any product in Islamic financial sector. The sharia compliance was not only required for the product of the sector but due consideration on consumer demands. The principles cannot be apart from the product that applied. As an ideal product, Islamic Banking system should have addressed following principles;<sup>16</sup>

1. Risk sharing, symmetrical risk and return distribution among parties,
2. Materiality, financial transaction must have material or directed linked to real asset or underlying economic transaction
3. No exploitation, for any parties involved.
4. No financing on sinful activities, the transaction cannot be distributed for the things that banned in Sharia.

Theoretically, profit and loss sharing in Islamic banking can be elaborated in the frame of partner or borrow the money. When the venture fails, the borrower would not bear the risk alone or lose the collateral, since the financial investor take an important part in the venture. While, when the venture succeeds, the financial investor would receive a larger return rather interest rate that allowed. However, on profit loss sharing modes is permissible in Islamic banking theorist as long as there is sharing of risk between parties.

### **Murabahah**

Murabahah contract is defined as cost-plus financing structured as intermediary of the buyer and the seller in the cost of the underlying commodity on the agreement that a specific amount of profit (mark-up) will be added. Ideally, the bank obtains the asset and sells it at profit, thus the bank's ownership should be clear. In this sense, banks need to observe the good customer since bank also bear the risk. The changing system from real asset to commodity value of asset has defined different scheme of murabahah.

Risk in murabahah can be caused from installment issue whereas it creates debt. When the customers has agreed to pay installment in the periodical term then in difficulty or late in making payment murabahah they cannot charge additional amount of interest. However, the penalties for delayed payment must be allocated for charity as mitigation of moral hazard (Ahmed, 2014). The risk becomes complex when penalties applied and the consumer brings the case to the court due dissatisfaction of Islamic banking product.

Court of Appeal Indonesia has recorded that there are more than 12 cases of Islamic finance has reached to the cassation level. The types of case are vary

<sup>16</sup> Khan, F., "How 'Islamic' Is Islamic Banking?". *Journal of Economic Behavior & Organization*, Vol. 76, Issue 3, (2010): pp 805-820, 76(3), pp. 805-820.

but remarkably Murabahah cases is the most popular transaction among Islamic banks. The main guidance of the judges is written in the Act No. 50 Series 2009 which procedural law is the main reference in sharia court with nothing excluded of Islamic financial case. The compilation of Islamic finance law and the fatwa of National Sharia Council are the guideline in resolving the disputes.

The contractual dispute of Murabaha is occurred in cassation courts, the results of analysis of the verdict<sup>17</sup> can be concluded as follow;

1. The needs of consumer in Murabahah contract due needs of financial resources on venture. While, the consumers are lack of acknowledgement the meaning of Murabahah in both theory and practice as the product of Islamic banking.
2. The collateral in case of penalty always applied administratively is such the certificate of land and vehicle.
3. When the plaintiff comes from consumer side then brought the case to the court it is mostly because difficulty of making payment, such failure of venture but the collateral is threatened to be auctioned off. In this sense, the practice is lack of risk sharing system.
4. The sharia courts in the structure of civil law country has applied the basis of Exceptio Non Adimplete Contractus<sup>18</sup> whereas each party bears the obligation to meet the achievement in reciprocity, the plaintiff cannot sue until fulfill the obligation.

Vary of disputes potentially to be occurred, the case may arise in country with different legal systems because the product of Islamic finance is popular in financing product worldwide. The stages of courts and multiple layers of legal structure may support the development of Islamic finance, however certainty on Islamic finance and transaction should have help more the ideal scheme and regulation of the product of Islamic finance. Furthermore, it may supported certain legal basis and procedural on Islamic financial transaction is crucially needed. Precisely, the basis and foundational definition on contract should be defined.

### **Human Resource in Islamic Finance Law**

The demand of Islamic finance show the crucial issue of standard; whether on product standard, the accounting and auditing issue and further fatwa in different innovations of product development. Some of relevant institutions has described its qualification on organization such The Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) which registered on 1991 in Bahrain,

<sup>17</sup> The Verdict of Court of Appeal 50 8/K/AG/2017.

<sup>18</sup> Rebuttal that the opponent in a state of negligence as well, then thus cannot demand fulfillment of achievement

it is set up by Islamic financial institutions including Islamic Development Bank in the division of Accounting and Auditing Standards Board and Sharia Board.

Sharia board is built in order to achieve harmonization among Sharia supervisory boards of Islamic financial sectors in the context of Islamic finance. It is aimed to avoid any contradiction and inefficient between theory of fatwas and the practices of transactions in Islamic financial sectors (AAOIFI). It may necessary to invest the human resources on sharia but advanced with financial or economy or management acknowledgement to create appropriate scheme of transaction with risk mitigation for both parties, it is due needs of ethical financing of sharia compliance product. Furthermore, law acknowledgement is crucially needed in two different aspects of law; first, Islamic law that emerged with the transaction of sharia compliance in the product, second, legal jurisdiction to see the pathway of product Islamic finance that applied to the market.

General perception of Islamic financial institutions between the consumer of retail market and SME sectors that Islamic financial institutions is secondary option with lower clases compared with conventional player. Lack of product variation and relatively higher cost that offered by Islamic financial sector further proved the perception.<sup>19</sup> Therefore, significant effort in expanding product variation and improving service quality in various Islamic financial institutions are crucially needed to create much more attractive among different types of consumers. The needs to invest more on human resources development can be done by offering structured pathway to career advancement through specialization of qualification.

## Conclusion

Implementing sharia compliance product is prone to be invalid due uncertainty of legal basis. Basis product in the sector and legal system need to be addressed in order to elaborate different of products in Islamic finance. Lack of standard on product need to be sufficiently addressed as main guidance how the product in the sector is well applied. This may help the development of Islamic finance as benefecial for any involved parties; consumers and financial sectors, it is due certainty of product that mentioned on contract. All in all, when the standard of product in Islamic finance applied thus reduce the issue of invalidity in Islamic finance in any legal system and jurisdiction in any countries.

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<sup>19</sup> (MAKSI, 2015).

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