Islamic Bank has unique risk due to its Sharia-compliance principles. Two of risks known in Islamic Banking are legal risk and sharia risk. This paper aims to explain the legal risk and sharia risk faced by Islamic Banking in Indonesia. Moreover, this paper also will discuss the cause of these risks and its mitigation strategy using Shariah Governance concept. This paper using literature studies from previous research and existing regulation in Indonesia. This research shows that Islamic Banking in Indonesia has unique legal risks and sharia risk due to its adherence to a dual law system: shariah law and national law. There are several causes of legal risk and sharia risk in Islamic Banking in Indonesia, such as lack of supporting legal system and regulation, lack of standardization contract in Islamic Banking, and lack of Court Systems to resolve Islamic Banking’s problem. Moreover, there are several issues on the product development process in Islamic Bank. In addition, this paper explores the role of Shariah Governance such as Sharia Supervisory Body and National Shariah Board as a solution to address the problem stemming from legal risk and sharia risk.

**Keywords:** Risk Management; Legal Risk; Sharia Risk

1. **Introduction**

   Islamic Banking has distinctive characteristics from their conventional counterparts due to its compliance with Shari‘ah principle, derived from Islamic Law sources in Al-Qur’an, Sunnah, and Hadits. Since its character is unique, the Islamic Bank also has a slightly different risk than those in a conventional bank. One of the significant risks is legal risk, which will arise when the Islamic bank contract is unenforceable due to non-compliance with the country's law and regulation. Since the Islamic Banking contract uses Islamic Law as the source of law, it is possible there will be a condition where shariah rules conflicting with the laws and regulations in the operating countries, thus create the legal risk. Besides, the legal risk may be conflicting with sharia risk, where the contract is non-compliance with sharia principle.\(^1\) Previous research by Djojosugito (2008) points out the legal risk faced by Islamic Banking due to the regulation that not fully accommodated Sharia requirements in Islamic Banking. When a legal rule makes the bank should sacrifice the shariah aspect, it can harm the shariah spirit in Islamic Banking.\(^2\)

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Indonesia, as Muslim majority country, has been providing the regulatory frameworks for the operation of Islamic Bank. Since 1992, Act Number 7 of 1992 of Banking has allowed the bank with profit-sharing principle operated in Indonesia. Furthermore, its amendment in Act Number 10 of 1998 enables bank operation based on Shariah principle. Finally, the Law Number 21 of 2008 concerning Islamic Banking issued in 2008 provided specific regulation for Islamic Banking in Indonesia. However, the existing regulation is not sufficient to accommodate Islamic Banking’s need. The rigid character of Civil Law system in Indonesia makes a loophole in the Islamic Banking regulation, where the transactions aspect in Islamic Banking has not been accommodated yet in the existing regulations. Therefore, this circumstance may cause a conflict between legal interest and shariah interest. This paper explores the extent of legal risk and shariah risk in Islamic Banking practice in Indonesia and the Shariah Governance aspect, which can prevent those risks, particularly in Indonesia.

This paper will describe the legal risk and shariah risk in Islamic Banking and how proper Shariah Governance can address this issue. Firstly, this essay will describe the legal risk and shariah risk in Islamic Banking. Secondly, this essay will analyze the cause of conflict between both risks. Last, this essay will suggest Shariah governance as a tool to mitigate legal risk and shariah risk. This essay concludes that legal risk and shariah risk can be mitigated by using internal factors such as lawyer and Sharia Supervisory Body, and external factors by Government role in regulation and the involvement of legal institution.

The research methodology of this paper is doctrinal legal research approach. Doctrinal research is research which provides a systematic exposition of the rules governing a particular legal category, analyses the relationship between rules, explains areas of difficulty and, perhaps, predicts future developments. This approach is used to identify legal risk and sharia risk in Islamic Banking through literature study of existing articles or journals about this topic. In addition, this paper observe how sufficient the existing regulation about Islamic Banking in Indonesia to prevent legal risk and shariah risk. Furthermore, this paper aims to study whether Indonesia has the proper Shariah Governance system to prevent those risks.

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2. Discussion

2.1. Risk Management in Islamic Banking

The sustainability of financial organisations depends on their risk management. Risk management is a process to identify, quantify, understand, and control the risk faced by a financial institution. Islamic Banking, like any other financial institution, has its own risk. There are two types of risk faced by Islamic Banking. The first type of risk is similar to the conventional banks, while the second type is the unique risk due to its compliance with Shari‘ah principle. Moreover, Khan and Ahmed (2001) divided the unique risk into two categories: financial risk (including market risk and credit risk) and non-financial risk (consist of operational risk, regulatory risk, and legal risk). Therefore, risk management is crucial for the development of the Islamic Banking industry.

One of Islamic Banking's primary concern is an operational risk, which is the risk resulting from inadequate or failed internal processes, people and systems, or external factors. Djojosugito (2008) includes the legal risk and shariah risk to the operational risk. Islamic Bankers perceive operational risk as one of the most important risks since it plays an essential role in banks' profitability. Several financial institutions bear massive losses due to lack of operational risk management. Therefore, both legal risk and sharia risk as operational risks need further attention in risk management.

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7 Djojosugito, “Mitigating Legal Risk in Islamic Banking Operations.”
2.2. Legal Risk in Islamic Banking

Legal risk is the risk in the enforceability of a financial contract or the legality of financial instruments that are affected by law and regulation related to the contract and transaction.\textsuperscript{11} It may be caused by external factors such as uncertainty in laws and regulations, or internal factors in the bank, such as fraud or violation of law and regulation. Legal risks also can be considered as a part of the operational risk. Since Islamic Banking has unique nature due to its adherence to shariah principle, it is exposed to a particular legal risk. Islamic banks face legal risks due to the differences between principles of Shariah and law. Although Islamic Bank is obliged to comply with shariah principle, the law regulating Islamic Banking is not fully accommodated Shariah requirement. Therefore, in the case of conflict, sometimes the implementation of Shari‘ah principle at the contract may need to be compromised due to limitation from the legal and regulatory framework in which Islamic Banking is operated.\textsuperscript{12}

2.3. Sharia Risk in Islamic Banking

Shari‘ah risk is one of the unique operational risks of IB. Sharia risk is the risk where the contract is void for being invalid due to non-compliance with Islamic law.\textsuperscript{13} There are two categories of the Shari‘ah risk: risk due to different standard of contracts in different jurisdictions and the risk due to the failure to comply with Shari‘ah rules.\textsuperscript{14} The first type of shariah risk is related to the legal risk, while the second type of Shari‘ah risk arises from the failure of Islamic Banking to comply with the Sharī`ah rules and principles determined by its Shari‘ah board.\textsuperscript{15}

Shari‘ah risk may lead to legal risk; for instance, the Islamic Bank that claims its product adheres to shariah requirement yet failed to comply may face a lawsuit from stakeholders that demand the fulfillment of its claim.\textsuperscript{16} Moreover, Shari‘ah risk is closely interrelated with reputational risk. Reputational risk is the result of irresponsible actions or mismanagement

\textsuperscript{12} Djojosugito, “Mitigating Legal Risk in Islamic Banking Operations.”
\textsuperscript{13} Balz, Sharia Risk. How Islamic Finance Has Transformed Islamic Contract Law.
\textsuperscript{14} Hennie and Zamir Iqbal Van Greuning, Risk Analysis for Islamic Banks (Washington DC: The World Bank, 2007).
\textsuperscript{15} IFSB, Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services (IFSB, 2005).
\textsuperscript{16} Karim Ginena, Sharī ‘ah Risk and Corporate Governance of Islamic Banks (Corporate Governance, 2014).
behaviour that harms clients’ trust in Islamic Banking. Reputational is essential for Islamic Bank as the growing industry that relies on customer trust. For Islamic banks, the consequences can be harmful since their entire operations' integrity can be questionable if its practice not according to Sharia. Therefore, Islamic Banks’ inability to complies with Shari’ah principles can damage customer trust, thus cause reputational risk.

Product or transaction that violates the shari’ah principle may harm Islamic Banking in short-run and long-run. In short-run, sharia non-compliance transaction can affect the profitability of the bank since the income derived from such transaction will be considered as non-permissible income. Moreover, Chapra and Ahmed’s research shows that most Islamic Banking depositors would move to another bank if their bank violates shari’ah principle. Thus, sharia non-compliance activities may cause liquidity issues due to deposit withdrawal, affecting financial instability.

In long-run, Shari’ah non-compliance product may create reputation risk. If the Islamic Bank is unable to maintain customer expectation to comply with Shari’ah, it will cause reputation risk because the customer lost confidence in the institution's integrity. The reputation of Islamic Banking is important because it is associated with the bank's higher profitability and sustainability, thus affecting people’s decision to choose the banks. Moreover, reputation risk in an Islamic Banking can harm other Islamic banking companies' reputations. Since Islamic financial services is a relatively young industry, a single failure of Islamic Banking...
can harm the others’ reputation, thus affect the long-term integrity and growth of the industry.²⁷ It can be concluded that Shari’ah non-compliance risk could be a severe risk that will affect the profit and reputation, thus harm the sustainability of Islamic Banking.

2.4. Legal Risk and Shariah Risk in Islamic Banking in Indonesia

As discussed above, Islamic Banking may be exposed to several operational risks, such as legal risk and shariah risk. There are several causes of legal risk and shariah risk in Islamic Banking:

2.4.1. Lack of support from legal system and regulation

The elements that support the legal system are called legal infrastructure, which consists of the regulation and law that define the formal rules, the regulator who creates and supervises the law's application, and the court's system to enforce the law itself. In the Islamic Banking industry, not all countries have legal infrastructure that acknowledges and accepts Sharia law. Almost all Muslim countries adopted Western legal system. Specifically, ex-British colonies have adopted the English common law system, while the ex-French colonies adopted the civil law system.²⁸ Therefore, most Islamic banks have to operate within the conventional Western legal systems, either civil law or common law, which most Muslim countries have adopted either due to colonization or imitation. Unfortunately, both legal system does not fully conform to the Islamic value. Their legal systems and regulation do not have specific regulation that supports the unique features of Islamic financial products.

Furthermore, legal risks appear as a result of legal uncertainty, either in regulation or legal action. Legal uncertainty will cause the law interpretation of some transactions are not following sharia principle. Even though Islamic Banking is recognized in many jurisdictions, not all countries acknowledge and accept Islamic Law (Shari’ah). Compared to its conventional counterpart, the development of Islamic Banking laws are still in early period. Currently, most Islamic banks must operate in a conventional legal environment. As the impact, some aspects of Islamic Banking are not accommodated by laws, especially those related to Islamic Banking's operational aspects.²⁹

²⁹ Djojosugito, “Mitigating Legal Risk in Islamic Banking Operations.”
In addition, shariah law is supposed to be the regulating law in the Islamic Banking contract. However, there may be a possibility that Islamic Banking cannot fully apply the shariah principle in its contract or transaction due to the conflict between shariah law and regulating law in the country. In regimes where Islam is not the state faith, the problem may arise when Shariah conflicts with the country's laws. Although Islamic Banking contracts are made using shariah principles, it is created in the legal environment which highly supported conventional bank operation. Sometimes, even if individuals agree to use Islamic contracts, the laws and courts may not interpret and enforce the Islamic Banking contracts.\(^{30}\) Thus, in some cases, the ideal implementation of Shari’ah principle may need to be compromised due to limitations from conventional legal and regulatory framework in which Islamic Bank is operated.

In Indonesia's case, this country uses civil law system due to Netherland's long history of colonialization. The civil law system emphasizes the codification of laws and written law. This system dictates that lower-level laws/regulations cannot contradict higher-level laws/regulations.\(^ {31}\) This type of legal system leave no room for the innovation or improvement of law due to its rigid nature. According to, Islamic Banking who operates in a country with a rigid civil law system has a higher probability of having legal issues than in a country with a common law system.\(^ {32}\) For instance, in Indonesia, the Islamic Banking law is only regulated general terms yet no further details regarding modes of Islamic financing.\(^ {33}\) This may cause a double-edged sword in favor of Islamic Banking industry. On one side, Islamic banks have the freedom to create various Islamic contracts. On the other side, lack of specifics law causes uncertainty and increases the legal risks.\(^ {34}\) In addition, the enforcement of Islamic Contacts is depends of the interpretation of the courts. Therefore, the detail codification for Islamic Banking regulating various mode of financial transactions is essential.\(^ {35}\) This is because the unavailability of Islamic contracts codification may be risking Islamic Bank due to misinterpretation of Islamic contract

\(^{30}\) Ahmed, “Islamic Law, Adaptability And Financial Development.”
\(^{31}\) Djojosugito, “Mitigating Legal Risk in Islamic Banking Operations.”
\(^{32}\) Ahmed, “Islamic Law, Adaptability And Financial Development.”
\(^{34}\) Ahmed, “Islamic Law, Adaptability And Financial Development.”
\(^{35}\) Ibid.
using civil code. Therefore, in jurisdictions where civil and religious law applied, public policy plays an important role in ensuring that banking activities comply with Sharia principles.

However, sometimes amount of regulations concerning sharia banking supervision do not always guarantee legal certainty in the implementation of duties and banking supervisory bodies in the management of banking institutions and business activities. Islamic Banking in Indonesia has faced several issues regarding the its legal aspects. Most of the rules on Islamic Banking transaction is not regulated in Islamic Bank Law. For instance, Law No. 10 Year 1998 of Banking is not comprehensive and only covers Islamic banking's fundamental elements, thus excluding important aspects of Islamic financial transactions. In further development, the Law No. 21 Year 2008 of Islamic Banking, which is a more comprehensive law, is enacted. However, the definition of product is limited as defined in this law. The rigid definition of Islamic Banking contract causes the limitation in product development progress in Islamic Bank. Usually, when an Islamic institution wants to create a new product or contract that does not exist yet, they ask for Fatwa (legal opinion) from National Sharia Board (Dewan Syariah Nasional, DSN) MUI. However, the National Shariah Board’s fatwa can only be fully implemented and binding the Islamic Financial Institution when adopted into the regulation. This is because DSN MUI is neither a state entity nor a government institution. Moreover, although Islamic Bank can ask for the fatwa from Shariah National Board for the new product, the fatwa from Shariah National Board cannot be against the Islamic Banking Law as the higher regulation, and not as powerful and binding as the Islamic Banking Law.

2.4.2. Lack of standardization contract

The unique nature of Islamic law may create uncertainty in Islamic Banking contract. While the Common law jurisprudence was developed by way of precedent and the Civil law by

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36 Djojosugito, “Relative Suitability of Civil and Common Law Regimes for Islamic Banking.”
41 Ibid.
way of codification, the Islamic jurisprudence was developed by way of Islamic scholars. Thus, due to various interpretations about fiqh (mahzab) of Muslim scholars on Islamic Economics industry, it may create legal uncertainty. Additionally, sometimes the regulation in conventional law cannot fully accommodate the shariah-compliance requirement. The legal uncertainty may arise due to the inability of national law to fully accommodate Islamic law. The uncertainty may result in different interpretations of some transactions that may not be in line with Shariah's intention.

Moreover, the absence of recognizable and standardized contract in Islamic Banking instrument can make the integrity and legality of the whole operations of Islamic Banking can be questionable. In addition, contracts without particular standards may cause Islamic Banking to get a risk due to the contracts' unenforceable. Thus, some transactions might be deemed illegal by law even though Shariah allows such transactions. In addition, no codified Islamic Banking framework caused the legal uncertainty in dispute resolution, because the contract is open to interpretation.

Therefore, it can be concluded that Islamic Bank has risks related to the Islamic contract and its enforcement power. Since there is no particular guidance for Islamic banking contracts, Islamic banks create the product and contracts according to their understanding of the Sharī’ah, the local laws, and their needs and concerns.

2.4.3. Lack of Court Systems to Resolve Islamic Banking problem

The unavailability of the court that can resolve the Islamic contracts' enforcement also increases legal risk in Islamic contracts. While shari’ah law is supposed to be governing law to resolve the dispute on Islamic Banking, the courts in most jurisdictions use Western commercial law. In addition, according to Djojosugito, Judges in non-Shariah court are not capable of delivering judgments related to Shariah since they are rarely receive proper training in Shariah. Thus, it is possible that the Judge’s decision not reflect the Shariah principles.

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42 Ahmed, “Islamic Law, Adaptability And Financial Development.”
43 Djojosugito, “Relative Suitability of Civil and Common Law Regimes for Islamic Banking.”
44 Ibid.
45 Ahmed, “Islamic Law, Adaptability And Financial Development.”
47 Ahmed, “Islamic Law, Adaptability And Financial Development.”
If there is a conflict between the shariah law and national law, there is at least the possibility that a defaulting party can try to evade his responsibilities by claiming non-compliance with Shari’ah. Moreover, the absence of any state involvement makes it more difficult to impose Islamic Banking transactions and contracts in the case of disputes. Therefore, this may cause the parties in transaction avoid using Islamic law in contracts to hinder the legal uncertainty in Islamic contract law.

Fortunately, in Indonesia, there are specific court that in charge for the dispute on Islamic Financial Institution, namely Religious Court. Article 49 of Law Number 3 of 2006 on Religious Court and Article 55 verse (1) of Law Number 21 of 2008 give the absolute authority to the Religious Court to handle the case on Islamic Economic dispute. However, the implementation of this clause still lack in practice. Not all judges in Religious Court mastering the topics of Islamic Contract Law. For instance, Harahab (2008) research shows that Judges of Religious Courts in DI Yogyakarta is not ready to solve Islamic Economic cases due to the lack of human research that capable in that field.

2.4.4. Issues on the Product Development Process in Islamic Bank

Before issued an Islamic product or contract, the compliance department on Islamic Financial Institution needs to understand the implications of the laws and regulations of the country on the Islamic mode used in a product. From an external factor, there is a legal and regulatory requirement that affects Islamic products. As a part of the corporate governance system, Shariah governance affected by the existing regulation in operation country. However, sometimes the disparity of laws/regulations at the national level and the Islamic law used at the product level can create situations in which the latter is not compatible with the former. In such cases, the modes in the potential set that do not conform to national laws and statutes cannot be used in developing products. Therefore, to overcome such external constraints, sometimes the Islamic Financial Institution need to modify the products to compliance with the laws and

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48 Ibid.
50 Ahmed, “Islamic Law, Adaptability And Financial Development.”
regulations in operating countries.\textsuperscript{53} This can cause the Islamic spirits on Islamic Banking products sacrificed due to the strict rules on the country.\textsuperscript{54} Thus, before issuing the Islamic Banking product, the firm needs to understand the implications of the country's laws and regulations on the Islamic mode used in a product.

2.5. Shariah Governance as Mitigation Strategy to Overcome Legal Risk and Sharia Risk

A regulatory framework for banking is essential to provide a favorable environment for industrial growth and development, as well as overall financial sector stability. This is particularly relevant for Islamic Banking, where there are various types of investments that are complex and must comply with sharia regulations and continuous innovation and the implications of the risks involved. The availability of appropriate regulations will contribute to improved guidance and supervision, increased effectiveness of monetary and credit policies, and system stability and safety nets.\textsuperscript{55} Currently, national Islamic Banking is required to apply international banking regulatory standards to participate at the international level. However, regulations that are too strict and comprehensive can backfire. Over-regulation can increase compliance costs and hinder innovation and creativity. The trade-off between stability and efficiency should receive adequate attention, considering the Islamic Banking industry is still small and in dire need of significant growth.\textsuperscript{56}

Furthermore, to address problem that discussed in previous section, Islamic Bank needs to optimize the role of Good Corporate Governance, more specifically, Sharia Governance. Good Corporate Governance is the system which is necessary to maintain the sustainability of the business.\textsuperscript{57} Meanwhile, shariah governance is a complement to the existing good corporate governance system. Its main function is to ensure sharia compliance of all Islamic Institution

\textsuperscript{53} Ahmed, “Islamic Banking and Shari’ah Compliance : A Product Development Perspective.”


\textsuperscript{56} Ibid.

activities, both before the transaction (ex-ante) and after the transaction (ex-post).\textsuperscript{58} This governance system is needed by Islamic Financial Institution in order to foster trust from stakeholders and the public in general, and to assure that all practices and activities carried out in this institution are in accordance with sharia. Additionally, proper sharia governance system is also needed to avoid the occurrence of Sharia risk.\textsuperscript{59}

The sharia governance model is different from each country. This occurs due to differences in regulatory frameworks that govern the sharia governance system in each jurisdiction.\textsuperscript{60} Ahmed identified four types of Shari’ah governance regime, namely legal construction, robust Shari’ah governance, passive Shari’ah governance, and market-driven.\textsuperscript{61} In the legally constructed regime, shari’ah framework is determined by regulation, yet no Shari’ah Board at national or organisational levels. In robust Shari’ah governance, the country has a regulation to support the Islamic Banking industry and an active Shari’ah governance system both at national and organisational levels. A country with a passive Shari’ah governance regime has Islamic Banking regulations, yet the Shari’ah governance at national level is passive. However, they have active Sharia Supervisory Body at organisational level. In market-driven regime, there are no specific regulatory framework or national body for Islamic banks. Shari’ah governance system is self-regulated by Islamic banks.\textsuperscript{62}

The problems of shariah implementation in Islamic Banking usually occurs in in countries without regulatory oversight (that either has the passive Shari’ah governance or market-driven regimes). Therefore, a framework for Sharia governance in the form of laws/regulations which is also supported by a national Sharia oversight mechanism is essential. The Sharia governance framework will protect the interests of the sharia industry. Therefore, shariah governance as regulatory framework in both organizational and institutional level is important for product development in Islamic Banking. Suitable regulatory framework for Islamic Banking will ease the creation of Shari’ah compliant products and minimize the risks arising from Shari’ah principles in banking operations.\textsuperscript{63}

\textsuperscript{59} Ibid.
\textsuperscript{60} Ibid.
\textsuperscript{61} Ibid.
\textsuperscript{62} Ahmed, “Risk Management Assessment Systems: An Application To Islamic Banks.”
\textsuperscript{63} Ibid.
\textsuperscript{63} Ahmed, “Islamic Banking and Shari’ah Compliance : A Product Development Perspective.”
At the national level, the regulatory framework's role is essential to ensure that Islamic banks activities comply with the Shari'ah principle. Moreover, the dilution of Shari'ah principles is most likely to occur in countries without Shari'ah regulatory framework, as in the country with passive Shari'ah governance or market-driven regimes. In organizational level, there is the possibility of friction between Shari’ah compliance and economic incentive. The National Sharia Board have duty to handling issues related to Shari’a/fiqh fatwas, harmonizing Shari’ah interpretations, and ensuring banking institution compliance with Shari’ah principles. In addition, the National Sharia Board can also reduce legal risks by carrying out its role in providing fatwas to banking products according to sharia. Thus, this role will build trust and trust among stakeholders and ensure the industry's long-term sustainability and growth.

Furthermore, in institutional level, Shari’ah Supervisory Board (SSB), which comprises Islamic scholars, has an essential role in safeguarding the Shari’ah aspects in product and the operation of Islamic bank. This SSB consists of Shariah advisors who are employed by financial institutions and act as internal supervisory bodies within the organization, thereby increasing the institution's credibility, and strengthening their Islamic credentials. Particularly in Islamic product, SSB is responsible as a gatekeeper to assuring the compliance of product with the Shari’ah principles and objective before its releases to the consumer. The role of SSB is essentials in Shariah Governance approving Shari’ah-compliant products and avoiding pseudo-Islamic products, thus avoid the products that have potential to create legal risk or sharia risk.

Indonesia already has the robust Shari’ah governance regime. Indonesia has specific Act which is regulates Islamic Banking, namely Law Number 21 of 2008 on Islamic Banking. In addition, Indonesia also have National Shari’ah Board (Dewan Sharia Nasional) as an independent body. All new products coming to the market must be approved by this national Shari’ah body. National Sharia Board (Dewan Syariah Nasional/DPS) MUI have several function such as create Fatwa (legal opinion) on Sharia Economic and give recommendation for Sharia Supervisory Body (Dewan Pengawas Syariah/DPS) to be appointed on Islamic Economic

64 Ahmed, “Risk Management Assessment Systems: An Application To Islamic Banks.”
65 Ahmed, “Islamic Banking and Shari’ah Compliance: A Product Development Perspective.”
66 Ahmed, “Islamic Law, Adaptability And Financial Development.”
Based on reports from DPS at each Islamic financial institution, DSN MUI can give a warning if the institution in question deviates from the established guidelines. If the Islamic institution does not obey the warning, DSN MUI can submit a recommendation to an authorized institution, such as Bank Indonesia and the Ministry of Finance, to impose sanctions.

Moreover, one of the distinguished characteristic of Islamic Banking institution obliged them to have Sharia Supervisory Body in each institution. In Indonesia, DPS as Sharia Supervisory Body is in charge of supervising all bank activities to always in accordance with sharia principles. In other words, DPS is responsible for the products and services offered to the public to comply with Sharia principles. Bank Indonesia further stipulated that DPS membership must obtain a recommendation from the DSN established by the Indonesian Ulema Council. In the sharia governance system, the Sharia Supervisory Body plays an important role in the process of supervision, monitoring, auditing, and providing opinions on Sharia compliance to financial institutions or companies that offer sharia products and services. Especially, the role of SSB is important in pre-transaction (ex-ante) process by issue legal opinion on creation of Islamic Banking product. Thus, they have role to prevent the sharia risk and legal risk.

Therefore, there is some strategy to mitigate legal risk and shariah risk by using Shariah Governance in internal and external of Islamic Banking operations:

a. From internal of Islamic Bank, the legal risk must be prevented by preparing proper document, complying with regulation, and legal risk audit that involves lawyer. Moreover, Ahmed (2006) suggested that in country without Islamic courts, the parties should include choice-of-law and dispute settlement clauses in the Islamic contracts. There are two possibility option in such case. First, by using Sharia as the applicable law since the legitimacy of Islamic financial contracts must be based on Sharia principles. For this reason, the contract must include a clause which states that if there is a dispute, Islamic law will be used. The second approach is by using choice of law national law to resolve disputes. In this approach, clause of dispute resolution must be

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68 Barlanti and Dewi, “Should National Shariah Board Be Restructured to Sustain the Development Economic Shariah in Indonesia.”
69 Sigit dan Totok Budisantoso Triandaru, Bank Dan Lembaga Keuangan Lain (Jakarta: Penerbit Salemba Empat, 2006).
71 Rama, “Analisis Kerangka Regulasi Model Syariah Governance Lembaga Keuangan Syariah Di Indonesia.”
arranged to be resolved through an arbitration body. These options should be used to reduce legal risk. Meanwhile, to reduce the sharia risk, the role of Sharia Supervisory Body is essential to filter non sharia-compliance contracts or products.

b. From external factors, the government must provide a regulatory regime that facilitates dispute resolution. In addition, to support the growth of the Islamic financial industry, there needs to be an Islamic dispute resolution institution or court that understands the form of a contract so that it can be interpreted and enforced accordingly. For example, Indonesia already has a Sharia Court as a separate court to resolve sharia disputes. Since it is difficult to expect changes in the entire court system, the solution is to call in legal experts who understand the issues of Islamic economics. In addition, this industry requires a codification of law covering all activities of Islamic Banking. This can be done through standardization of Sharia rules, with harmonization between several Sharia scholars. With the codification, judges have specific guidelines for resolving disputes in court.

3. Conclusion

Islamic Banking is expected to fulfil the compliance with the shariah rules as its distinguish character. However, there is a possibility of conflict between the legal and Sharia rule rules in Islamic Bank implementation, which will cause either legal risk or shariah risk. Both risks is crucial because it has severe impact, which may damaging reputation and can create systemic risk which harms the whole the industry. The role of Shariah Supervisory Body is essential to ensure the product is fully comply with both legal principle and shariah principle. However, Shari’ah governance at the organizational level is not sufficient to manage and mitigate overall Shari’ah risk. Establishment of a complementary Shari’ah supervision mechanism at the regulatory level is also required to accomplish the broader Shari’ah requirements of the industry, minimize the reputation and legal risks, thus ensure the stability of the sector.

The strategy to mitigate legal risk and shariah risk in Islamic banking operations can use internal and external approaches. From internal, the legal risk is prevented by involving a lawyer

72 Ahmed, “Islamic Law, Adaptability And Financial Development.”
73 Ibid.
to ensure product compliance with the regulation. Meanwhile, the role of the Sharia Supervisory Body is essential to filter non-sharia-compliance contracts or products.

From external factors, the government must provide a regulation that facilitates dispute resolution. Islamic dispute resolution institutions or courts should understand the sharia aspect of the contract. In addition, codification of Islamic Banking law also necessary for judges as the guidelines for dispute resolution in court.

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