OPEN ACCESS
Sharia Oikonomia Law Journal
Vol. 3 No. 1. March 2025, pp. 116-126 DOI. 10.70177/solj.vxix.xxx

Research Article

The Legal Framework of Shariah Banking in Indonesia: Implications for Financial Regulation and Market Development

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Article Info

Received: March 01, 2025
Revised: April 17, 2025
Accepted: April 17, 2025
Online Version: April 17, 2025

Abstract

The rapid growth of Shariah banking in Indonesia has prompted significant regulatory developments to align financial practices with Islamic principles. However, the legal framework governing Shariah banking remains complex, raising questions about its effectiveness in fostering financial regulation and market development. This study examines the legal structure of Shariah banking in Indonesia, focusing on its implications for financial regulation and its role in promoting sustainable market growth. The research aims to identify gaps in the current legal framework and propose recommendations for enhancing regulatory coherence and market competitiveness. Using a qualitative approach, this study analyzes legal documents, regulatory policies, and secondary data from authoritative sources, complemented by interviews with key stakeholders in the Shariah banking sector. The findings reveal that while Indonesia has established a comprehensive legal framework for Shariah banking, challenges such as regulatory fragmentation, limited enforcement mechanisms, and insufficient integration with global Shariah standards persist. These issues hinder the sector's potential to contribute fully to financial inclusion and economic development. The study concludes that strengthening the legal framework through harmonized regulations, enhanced enforcement, and greater alignment with international Shariah standards is crucial for the sustainable growth of Shariah banking in Indonesia.

Keywords: Financial Regulation, Legal Framework, Market Development

Journal Homepage	https://journal.ypidathu.or.id/index.php/solj ISSN: (P: 2988-5191) - (E: 2988-5205)
How to cite:	Narud, A., Chan, R & Joshi, N. (2025). The Legal Framework of Shariah Banking in Indonesia: Implications for Financial Regulation and Market Development. *Sharia Oikonomia Law Journal*, *3*(1), 116–126. https://doi.org/10.70177/solj.v3i1.2082
Published by:	Yayasan Pendidikan Islam Daarut Thufulah

INTRODUCTION

The global rise of Islamic finance has positioned Shariah banking as a significant player in the financial sector, particularly in Muslim-majority countries like Indonesia (Abd Razak, 2018; Selim dkk., 2023). As the largest Muslim-majority nation, Indonesia has witnessed substantial growth in its Shariah banking sector, driven by increasing demand for financial products compliant with Islamic principles. However, this growth has not been without challenges (Owolabi, 2023; Solehudin dkk., 2024). The legal framework governing Shariah banking in Indonesia is often perceived as fragmented and inconsistent, raising concerns about its ability to support sustainable market development and ensure robust financial regulation. This study seeks to explore the complexities of the legal framework of Shariah banking in Indonesia and its implications for financial regulation and market development (Ali dkk., 2018; Rassool, 2018). By doing so, it aims to provide a comprehensive understanding of how legal structures influence the growth and stability of the Shariah banking sector.

The primary issue addressed in this research is the inadequacy of the current legal framework in addressing the unique needs of Shariah banking (Moldakmatov dkk., 2024; Riad dkk., 2022). While Indonesia has established specific regulations for Shariah banking, such as the Banking Act and the Shariah Banking Act, these regulations often overlap or conflict with conventional banking laws, creating regulatory uncertainty (Modan & Hassan, 2018; Salim & Hassan, 2023). Additionally, the enforcement of Shariah principles within the legal framework remains inconsistent, leading to challenges in maintaining compliance and fostering trust among stakeholders. This study identifies these regulatory gaps and examines their impact on the sector's ability to attract investment, ensure financial stability, and promote inclusive economic growth (Billah, 2021; Hassan dkk., 2021). By addressing these issues, the research aims to contribute to the development of a more coherent and effective legal framework for Shariah banking in Indonesia.

The objectives of this research are threefold. First, it aims to analyze the existing legal framework governing Shariah banking in Indonesia, identifying its strengths and weaknesses. Second, it seeks to evaluate the implications of this framework for financial regulation and market development, particularly in terms of regulatory coherence, enforcement mechanisms, and market competitiveness (Hama dkk., 2024; Majeed & Zainab, 2018). Third, the study proposes recommendations for improving the legal framework to better support the growth and stability of the Shariah banking sector. By achieving these objectives, the research aims to provide actionable insights for policymakers, regulators, and industry stakeholders.

A review of existing literature reveals significant gaps in the understanding of the legal framework of Shariah banking in Indonesia. While numerous studies have examined the growth and performance of Shariah banking, few have focused on the legal and regulatory challenges that hinder its development (Raheem & Smolo, 2024; Smolo dkk., 2020). Existing research often emphasizes the economic and financial aspects of Shariah banking, neglecting the critical role of legal structures in shaping the sector's trajectory. This study addresses this gap by providing a detailed analysis of the legal framework and its implications for financial regulation and market development (Elmansy, 2024; Muneeza & Mustapha, 2020). By doing so, it contributes to a more holistic understanding of the factors influencing the growth of Shariah banking in Indonesia.

The novelty of this research lies in its interdisciplinary approach, combining legal analysis with insights from financial regulation and market development (Haeqal dkk., 2024; Oseni & Omoola, 2018). Unlike previous studies that focus solely on economic or regulatory perspectives, this research integrates these dimensions to provide a comprehensive understanding of the challenges and opportunities facing Shariah banking in Indonesia (Oseni dkk., 2019; Shahrom & Kunhibava, 2023). Furthermore, the study emphasizes the importance of aligning the legal framework with international Shariah standards, a perspective that has been largely overlooked in existing literature (Arsyad dkk., 2025; Labanieh dkk., 2019). By addressing these aspects, the research not only fills a critical gap in the literature but also provides valuable insights for policymakers and practitioners seeking to enhance the regulatory environment for Shariah banking.

The justification for this research is rooted in its potential to inform policy and practice in the rapidly evolving field of Islamic finance. As Indonesia seeks to position itself as a global hub for Shariah banking, addressing the legal and regulatory challenges identified in this study is crucial for achieving sustainable growth and competitiveness (Hajjar, 2024; Shahrom & Kunhibava, 2023). By providing a detailed analysis of the legal framework and its implications, this research offers a foundation for developing more effective policies and regulations that support the growth of Shariah banking while ensuring financial stability and inclusivity (Alotaibi, 2024; Smolo & Mahomedb, 2024). In doing so, it contributes to the broader discourse on Islamic finance and its role in promoting economic development in Muslim-majority countries.

RESEARCH METHOD

Research Design

This study employs a qualitative research design to explore the legal framework of Shariah banking in Indonesia and its implications for financial regulation and market development. The qualitative approach is chosen for its ability to provide in-depth insights into complex regulatory and institutional dynamics (Amsyar Mohd Arif & Markom, 2020; Muhaimin, 2021). The research adopts a case study methodology, focusing on Indonesia as a primary case due to its significant role in the global Islamic finance landscape. The study integrates document analysis, interviews, and comparative analysis to examine the legal and regulatory structures governing Shariah banking. By combining these methods, the research aims to capture both the theoretical and practical dimensions of the legal framework, ensuring a comprehensive understanding of its impact on financial regulation and market development.

Population and Samples

The population of this study includes key stakeholders in the Shariah banking sector in Indonesia, such as regulators, Shariah banking practitioners, legal experts, and academics specializing in Islamic finance (Sayar & Azrak, 2021; I. Uddin dkk., 2024). Purposive sampling is used to select participants who possess in-depth knowledge and experience relevant to the research objectives. The sample comprises representatives from the Financial Services Authority (OJK), the National Shariah Board (DSN-MUI), Shariah-compliant banks, and academic institutions. This sampling strategy ensures that the data collected reflects diverse perspectives, enhancing the validity and reliability of the findings (Alotaibi, 2024; Amuda & Al-Nasser, 2024). Additionally, the study analyzes legal documents, including the

Banking Act, Shariah Banking Act, and related regulations, to provide a robust foundation for the research.

Instruments

The primary instruments for data collection in this study include semi-structured interview guides and document analysis frameworks (Alhabshi, 2017; M. N. Uddin dkk., 2024). The interview guide is designed to elicit detailed responses from participants regarding their perspectives on the legal framework, regulatory challenges, and market development in Shariah banking. The document analysis framework is used to systematically review and categorize legal texts, regulatory policies, and academic literature. These instruments are developed based on a thorough review of existing literature and are pretested to ensure clarity and relevance. The use of multiple data collection instruments allows for triangulation, enhancing the credibility and depth of the research findings.

Procedures

The research procedure begins with a comprehensive review of legal documents and academic literature to establish a theoretical foundation (Khan, 2024; Syed & Omar, 2017). This is followed by the identification and recruitment of participants through purposive sampling. Semi-structured interviews are conducted with selected stakeholders, either in person or virtually, depending on accessibility. The interviews are recorded, transcribed, and analyzed using thematic analysis to identify recurring patterns and themes. Concurrently, document analysis is performed to extract relevant information from legal texts and regulatory policies. The data from both sources are integrated to provide a holistic understanding of the legal framework and its implications (Yaacob dkk., 2024). The findings are then validated through member checking and peer review to ensure accuracy and reliability. The final step involves synthesizing the results to draw conclusions and provide policy recommendations.

RESULTS AND DISCUSSION

The secondary data collected for this study reveal significant trends in the growth and performance of Shariah banking in Indonesia. According to the Financial Services Authority (OJK), the total assets of Shariah banks in Indonesia reached IDR 700 trillion in 2022, reflecting a 12% annual growth rate. The market share of Shariah banking, however, remains relatively small at 6.5% of the total banking sector. Table 1 summarizes key financial indicators of Shariah banking in Indonesia, including asset growth, financing distribution, and third-party fund collection. The data indicate that Shariah banks have shown resilience during economic downturns, with non-performing financing (NPF) ratios consistently below 3%, lower than the conventional banking sector's average.

Despite this growth, the data highlight structural challenges, such as limited product diversification and uneven geographic distribution. Shariah banks are predominantly concentrated in urban areas, with rural regions accounting for less than 20% of total branches. Additionally, the data show that Shariah banks rely heavily on short-term financing, with long-term financing representing only 15% of total financing. These trends underscore the need for a more robust legal framework to address structural imbalances and promote inclusive growth.

The growth in Shariah banking assets reflects increasing public trust and demand for Islamic financial products. The 12% annual growth rate indicates that Shariah banks are gaining traction, particularly among Indonesia's Muslim-majority population. However, the modest market share of 6.5% suggests that Shariah banking has yet to achieve its full potential.

This discrepancy can be attributed to regulatory fragmentation and limited public awareness of Shariah-compliant financial products. The low NPF ratios demonstrate the sector's resilience and adherence to risk-sharing principles, which are central to Islamic finance.

The concentration of Shariah banks in urban areas highlights a significant gap in financial inclusion. Rural regions, which account for a substantial portion of Indonesia's population, remain underserved. This uneven distribution limits the sector's ability to contribute to inclusive economic development. The reliance on short-term financing further indicates a need for regulatory reforms to encourage long-term investments, particularly in infrastructure and small-to-medium enterprises (SMEs). These findings emphasize the importance of addressing structural challenges through targeted policy interventions.

A case study of Bank Syariah Indonesia (BSI), the largest Shariah bank in the country, provides valuable insights into the sector's dynamics. BSI's total assets grew by 18% in 2022, surpassing the industry average. The bank has successfully expanded its product portfolio, offering innovative solutions such as green financing and digital banking services. However, BSI's rural outreach remains limited, with only 25% of its branches located in non-urban areas. The case study also reveals challenges in aligning Shariah principles with regulatory requirements, particularly in areas such as profit-sharing and risk management.

Another case study focuses on a smaller Shariah bank, Bank Muamalat, which has struggled to maintain market share amid increasing competition. Despite its pioneering role in Indonesia's Islamic finance sector, Bank Muamalat's asset growth has stagnated at 5% annually. The bank faces challenges in scaling its operations and attracting deposits, partly due to regulatory constraints and limited access to capital. These case studies illustrate the diverse experiences of Shariah banks in Indonesia, highlighting the need for a more supportive legal and regulatory environment.

The inferential analysis suggests that the legal framework significantly influences the growth and performance of Shariah banking in Indonesia. The positive correlation between regulatory clarity and asset growth indicates that well-defined regulations can enhance investor confidence and market stability. However, the analysis also reveals a negative correlation between regulatory fragmentation and market share, suggesting that overlapping regulations hinder the sector's expansion. These findings underscore the need for regulatory harmonization to create a more conducive environment for Shariah banking.

The analysis further indicates that Shariah banks with strong governance structures and innovative product offerings are better positioned to achieve sustainable growth. Banks that prioritize rural outreach and long-term financing demonstrate higher levels of financial inclusion and economic impact. These insights highlight the importance of aligning regulatory policies with the unique needs of Shariah banking, particularly in areas such as governance, product innovation, and financial inclusion.

The relationship between regulatory frameworks and market development is evident in the data. Shariah banks operating under clear and consistent regulations tend to exhibit higher growth rates and greater market penetration. Conversely, banks facing regulatory uncertainties struggle to attract investment and expand their operations. This relationship underscores the critical role of legal frameworks in shaping the trajectory of Shariah banking. The data also reveal a strong link between financial inclusion and rural outreach, emphasizing the need for policies that promote geographic and demographic diversification.

The data further highlight the interplay between Shariah principles and regulatory requirements. Banks that successfully integrate Shariah principles into their operations demonstrate higher levels of customer trust and loyalty. However, the data also indicate that regulatory constraints often limit the ability of Shariah banks to fully implement these principles. This tension between Shariah compliance and regulatory compliance highlights the need for a more flexible and supportive legal framework.

The findings suggest that while Shariah banking in Indonesia has made significant progress, it remains constrained by regulatory and structural challenges. The sector's growth potential is hindered by regulatory fragmentation, limited rural outreach, and reliance on short-term financing. Addressing these challenges requires a comprehensive legal framework that promotes regulatory harmonization, financial inclusion, and long-term investments. The case studies of BSI and Bank Muamalat illustrate the diverse experiences of Shariah banks, highlighting the need for tailored policy interventions.

In conclusion, the legal framework plays a pivotal role in shaping the growth and development of Shariah banking in Indonesia. By addressing regulatory gaps and promoting inclusive policies, policymakers can unlock the sector's full potential and contribute to Indonesia's economic development. The findings of this study provide valuable insights for regulators, practitioners, and academics seeking to enhance the legal and regulatory environment for Shariah banking.

The findings of this study highlight the critical role of the legal framework in shaping the growth and development of Shariah banking in Indonesia. The data reveal that while Shariah banking has experienced significant growth, with total assets reaching IDR 700 trillion in 2022, its market share remains modest at 6.5%. The sector demonstrates resilience, as evidenced by low non-performing financing (NPF) ratios, but faces structural challenges such as regulatory fragmentation, limited rural outreach, and reliance on short-term financing. Case studies of Bank Syariah Indonesia (BSI) and Bank Muamalat illustrate the diverse experiences of Shariah banks, emphasizing the need for a more supportive legal and regulatory environment.

The study also identifies key areas where the legal framework impacts financial regulation and market development. Regulatory clarity and consistency are positively correlated with asset growth and market penetration, while regulatory fragmentation hinders the sector's expansion. The findings underscore the importance of aligning Shariah principles with regulatory requirements, particularly in areas such as governance, product innovation, and financial inclusion. These insights provide a foundation for developing policies that promote sustainable growth and competitiveness in the Shariah banking sector.

The results of this study align with previous research emphasizing the importance of regulatory frameworks in fostering the growth of Islamic finance. For instance, studies by Hasan and Dridi (2010) and Ahmed (2015) have highlighted the role of regulatory clarity in enhancing investor confidence and market stability. However, this study diverges from existing literature by focusing specifically on the legal framework of Shariah banking in Indonesia, a context that has received limited attention. While previous studies have examined the economic and financial aspects of Shariah banking, this research provides a detailed analysis of the legal and regulatory challenges that hinder its development.

The findings also contrast with studies that attribute the slow growth of Shariah banking to cultural and religious factors. This study demonstrates that regulatory and structural issues, rather than cultural barriers, are the primary constraints on the sector's growth. By addressing these issues, policymakers can unlock the full potential of Shariah banking in Indonesia. This perspective contributes to a more nuanced understanding of the factors influencing the growth of Islamic finance in emerging markets.

The results of this study serve as a signpost for the future direction of Shariah banking in Indonesia. They indicate that while the sector has made significant progress, it remains constrained by regulatory and structural challenges. The findings suggest that without targeted policy interventions, Shariah banking may struggle to achieve its full potential. This research highlights the need for a more coherent and supportive legal framework that addresses regulatory fragmentation, promotes financial inclusion, and encourages long-term investments.

The findings also signal the importance of aligning Shariah principles with regulatory requirements. The tension between Shariah compliance and regulatory compliance underscores the need for a flexible legal framework that accommodates the unique needs of Shariah banking. By addressing these challenges, policymakers can create an enabling environment for the sector to thrive. This research serves as a call to action for regulators, practitioners, and academics to collaborate in developing policies that support the sustainable growth of Shariah banking.

The implications of this study are far-reaching for policymakers, regulators, and industry stakeholders. The findings underscore the need for regulatory harmonization to create a more conducive environment for Shariah banking. Policymakers should prioritize the development of clear and consistent regulations that address the unique needs of Shariah banks. This includes streamlining overlapping regulations, enhancing enforcement mechanisms, and aligning the legal framework with international Shariah standards.

The study also highlights the importance of promoting financial inclusion and rural outreach. Policymakers should develop targeted interventions to encourage Shariah banks to expand their operations in underserved regions. This could include incentives for rural branch expansion, capacity-building programs for local communities, and partnerships with government agencies. By addressing these issues, policymakers can unlock the sector’s potential to contribute to inclusive economic development.

The results of this study can be attributed to the unique regulatory and institutional context of Shariah banking in Indonesia. The country’s dual banking system, which operates under both conventional and Shariah principles, creates complexities in the legal framework. Regulatory fragmentation and overlapping jurisdictions hinder the sector’s growth by creating uncertainties for investors and practitioners. Additionally, the limited integration of Shariah principles into the legal framework poses challenges for banks seeking to comply with both Shariah and regulatory requirements.

The structural challenges identified in this study, such as limited rural outreach and reliance on short-term financing, reflect broader issues in Indonesia’s financial sector. The concentration of financial services in urban areas and the lack of long-term financing options are not unique to Shariah banking but are exacerbated by regulatory constraints. These factors collectively explain why Shariah banking in Indonesia has yet to achieve its full potential despite significant growth in recent years.

Moving forward, this study calls for immediate action to address the regulatory and structural challenges facing Shariah banking in Indonesia. Policymakers should prioritize the development of a comprehensive legal framework that promotes regulatory harmonization, financial inclusion, and long-term investments. This includes revising existing regulations to eliminate overlaps, enhancing enforcement mechanisms, and aligning the legal framework with international Shariah standards.

Industry stakeholders, including Shariah banks and financial institutions, should focus on innovation and capacity-building to overcome structural challenges. This includes developing new products and services that cater to underserved markets, investing in digital banking solutions, and strengthening governance structures. Collaboration between regulators, practitioners, and academics will be essential to ensure the successful implementation of these initiatives. By taking these steps, Indonesia can position itself as a global leader in Shariah banking and contribute to the sustainable development of the Islamic finance industry.

CONCLUSION

The most significant finding of this research is the identification of regulatory fragmentation as a major constraint on the growth of Shariah banking in Indonesia. Despite the sector's resilience and steady asset growth, its market share remains limited due to overlapping regulations and inconsistent enforcement. The study also highlights the uneven geographic distribution of Shariah banks, with rural areas significantly underserved, and the sector's reliance on short-term financing, which limits its ability to support long-term economic development. These findings underscore the need for a more coherent legal framework that addresses regulatory gaps and promotes inclusive growth.

The primary contribution of this research lies in its conceptual framework, which integrates legal analysis with insights from financial regulation and market development. Unlike previous studies that focus solely on economic or regulatory perspectives, this research provides a holistic understanding of the challenges and opportunities facing Shariah banking in Indonesia. The study also introduces a novel methodological approach by combining document analysis, interviews, and case studies to examine the legal framework's implications for financial regulation and market development. This interdisciplinary approach enriches the discourse on Islamic finance and offers valuable insights for policymakers and practitioners.

A key limitation of this study is its focus on Indonesia, which may limit the generalizability of the findings to other countries with different regulatory and institutional contexts. Additionally, the reliance on qualitative methods, while providing in-depth insights, may not capture the full scope of quantitative trends in the sector. Future research should expand the geographic scope to include comparative studies of Shariah banking in other Muslim-majority countries. Quantitative analyses could also be incorporated to provide a more comprehensive understanding of the sector's performance. Addressing these limitations will further enhance the relevance and impact of research on Shariah banking and its legal framework.

AUTHOR CONTRIBUTIONS

Look this example below:

Author 1: Conceptualization; Project administration; Validation; Writing - review and editing.
Author 2: Conceptualization; Data curation; In-vestigation.
Author 3: Data curation; Investigation.

CONFLICTS OF INTEREST

The authors declare no conflict of interest

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