

THE INFLUENCE OF ISLAMIC LAW AND ECONOMIC PRINCIPLES ON BANKING INDUSTRY IN INDONESIA

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ABSTRACT

The purpose of this study is to explore the influence of Islamic law and economics principles on the Indonesian banking industry in accordance with the continuous growth of Sharia law. This is a normative legal research comprising the statute and conceptual approaches. Secondary data were obtained from primary, secondary, and tertiary legal materials, such as books, journals, and other relevant sources. The results showed a gradual transformation in Islamic banking based on Sharia law and economics principles to achieve its current structure in Indonesia. It also provides insights towards a better future by establishing Islamic banks for the Muslim market based on the facets of their economic life on the Qur'an and Al-Sunnah. The rapid growth of the economy makes it necessary for the government to implement new laws guiding Islamic-based financial institutions. This research also indicated the gaps and highlighted the areas needed to improve Indonesian law for banks to achieve an adequate Sharia-based banking governance system. Further studies need to be conducted using other sources of data.

Keywords: Banking Industry, Islamic Banking, Islamic Law, Islamic Banking Principles, Indonesian Banking Industry, Muslim Financial Market.

JEL Classification: B26, K22, M21

INTRODUCTION

Indonesia is a country with the largest Muslim population, and the highest developer of Sharia economic assets using various Islamic concepts (Ningsih & Disemadi, 2019). Most of the issues regarding Islamic economics are found in the Qur'an and Hadith. According to Sodiq (2015), sharia economic assets are essential as a social science discipline. Soerjono Soekanto stated that law is a rule recognized by the Indonesian value system, for a sustainable society (Disemadi & Roisah, 2019). Therefore, Islamic law is inseparable from the Indonesian society comprising a large number of Muslims. According to Schaik, Islamic banking is a trusted place for people willing to invest fairly into a profit-sharing system in accordance with sharia principles (Hejazziey, 2016).

Muslims belief Islam was founded on comprehensive and universal Shari'a laws, which incorporates all aspects of life, both muamalah, and worship. Furthermore, Muamalah is attributed with numerous meanings, one of which is in the economic and banking fields (Karim, 2010). Therefore, the name Islamic banking was coined from the concept of Islamic economics

in the financial sector (Sutedi, 2009), which prohibits maysir (gambling), usury practices, and gharar (obscurity) while implementing the principles of fairness and halal business activities in accordance with the Sharia (Sutedi, 2009).

Islamic banking was regulated in Law number 7 of 1992, and amended in Law number 10 of 1998. According to Disemadi (2019), public enthusiasm for the growth of Islamic economic practices is high in Indonesia, especially with the establishment of Islamic financial institutions (LKS) such as Bait at Tamwil, and BPR Syariah. In its development, Islamic banking implementation is based on Sharia principles and economic laws that served as the main drivers behind the profit and loss system as opposed to the interest-based system.

LITERATURE REVIEW

According to preliminary studies, there is no difference in the objectives and principles between the Islamic economic system and others. All economic systems work to achieve the same goal and meet the basic social needs of humans (1). Furthermore, every economic system works according to (2) the same principle, which ensures society produces the needed goods at the lowest possible cost. However, in Islam, the implementation of the practice is different with various limitations due to its associated philosophy and life principles, which are based on Islamic jurisprudence (Ali, 1988). The basic principles set by Islam regarding trade and commerce reflects on the values of honesty, trust, and sincerity. Honesty in business is a supreme value of ethics. A hadith of the Prophet Muhammad stated that after death, honest traders are sent to be together with the Prophets, shiddiqin, and shaheed (martyrs) after death. Honesty in the business world is needs to be practiced and prioritized by every business actor. This is one of the reasons all elements of deception, such as competition, which is conducted in a dishonest way (cheating) is rejected in business. Apparently, the principle is not only virtuous according to Islam; rather it is an ideal image that reflects human business activities (Triyanta, 2012). Islamic principles indicate that people have the right to economic activities, and must be freed from the exploitation of others (Fahmi, 2013).

Islam firmly forbids every Muslim from sabotaging others, "*and do not commit abuse on earth...*". In addition, the Prophet Muhammad has also reminded us, "*O! People fear injustice because, on the resurrection day, the unjust is sent into the dark.*" In Islamic economics, business and ethics need to be seen as a single entity. This is because business is worldly affairs and is also considered an integral part of future investment. Therefore, when business orientation and investment efforts in this life and the hereafter are intended as worship, it symbolizes obedience to God. Hence, businesses are mandated to be in line with moral principles based on the Islamic faith. Business actors need to be punctual, recognize weaknesses and shortcomings, constantly improve the quality of goods or services regularly, and not cheat or lie. Furthermore, they are required to have an awareness of moral ethics.

Furthermore, business actors that are careless and do not maintain ethics are likely to find it difficult running their businesses adequately, which tends to threaten their social relationship, with consumers (Widodo, 2016). For Muslims, the moral issue plays an essential role and has persistently become a guideline obtained from the holy Quran, Hadith, and Ijtihad, which needs

to be implemented into human life (Friends, 2018). Therefore, the purpose of this study is to enable humans carry out the best economic activities without straying to non-Islamic teaching (Saib, 2004). According to Santoso (2018), Muslims do not forget that the law's main purpose is order and justice, which is also a means of renewal in society. Therefore, in this study, it is also necessary to present the concept of justice according to Islam. The Arabic dictionary defined justice as an honest state, while dishonesty or unworthy is considered unjust. The idea of right and wrong is implied in the term *adl* or just. It is often used in a broader sense to include values and religion (Santoso, 2012). This means that business competition carried out unfairly and dishonestly, inhibits competition, and violates religious provisions, which is against Islamic beliefs.

The obligation to carry out business activities lawfully while prohibiting fraud is applicable to every business actor. This is because they are humans created by God and accountable for their actions, regardless of their social and economic status in society. The basic principles set in Islam on trading are honesty, trustworthiness, and sincerity (Sugianto et al., 2020). However, in the Islamic economy, the most important thing is the desire to achieve social benefits. Furthermore, studies have not been conducted regarding the opinion related to the practice of economic activity. According to Mannan (1993) people capable of obstructing achievements for economic growth are non-Islams.

This section provided a detailed overview of the Islamic Economic system, which is integrated with Indonesian legal position and influence of Islamic law on society.

Historically, Islamic economic law has never been applied significantly. An instance is the symbols of trade transactions in several traditional markets, which seem thick with the jurisprudence schools known to the public (Sodiq, 2015). Indonesia comprises known legal systems, such as the Customary Law, the Islamic Legal System, the Colonial Legal System, and the National Legal System. Until the 14th century, the each archipelago region adhered to the customary law. However, with the entry of Islam, many regional customs permeated the elements into customary laws. This is also associated with the migration of the Portuguese, British, and Dutch in the 17th century. In addition, the industrial products of immigrants are also influenced by the local community with their religious teachings; hence the customary law in Indonesia was permeated by the teachings of Protestant and Catholic Christians (Apriani & Suriaatmadja, 2020). In 1998, the GBHN (Outlines of State Policy) implemented a unified law throughout the archipelago by introducing the Indonesian National Law System, based on the 1945 Pancasila Constitution (Najicha & Hermawan, 2019). On the other hand, the relevance of Islamic economic law has increased since the advent of the Islamic banking system based on profit and loss philosophy.

Sharia economic law shows that Islam has become a source of national, western, and customary laws. However, this does not mean that it has to be formal in its exclusive form, rather it needs to serve the already applicable laws in everyday life (Dimiyati, 2007). Therefore, the source of law needs to be interpreted as material.

It is agreed that Islam regulates all aspects of social life with a set of legal norms for Muslims. The Qur'an contains many general provisions to guide human behavior (Hadi, 2016). The formation of national law, which is based on sharia teachings, cannot be released in the

context of national legal politics, rather in the practice of Islamic teachings (kaffah). According to Iswanto (2014) Islamic legal legislation is placed in the context of the needs of the Muslim community. Therefore, the law is carried out consistently because it is considered a practice of Islamic teachings that are kaffah.

Economic activities need to be carried out in Indonesia to obtain justice for Muslims and non-Muslims in accordance with Sharia principles. The Indonesian state (national law) is only applicable to Indonesians. This law was built after the country's independence as a substitute for colonial rule. According to Yudisthira et al. (2015), national law is based on the Pancasila and the 1945 Constitution. The presence of Islamic economic law in the Indonesian legal system needs the wider community to show fairness and equity guarding the welfare of the people and the Unitary State (Maksum, 2016).

As previously described, the position of Islamic economic law is stronger when connected with the philosophy and constitution of the country, namely Pancasila and the 1945 Constitution (Mughits, 2008). Indonesia has a Pancasila ideology, which aims to meet the people's welfare without conflicting rules. In addition to the ideology, the 1945 Constitution is always guarded by dignity. Sharia economic, legal system does not violate the Pancasila, especially "*The Precepts of God Almighty*." This is in addition to the preamble part, which includes the sentence "... *By realizing social justice for all Indonesian people*," as well as part of its contents, especially those contained in Chapter XI (Religion) Article 29 paragraphs (1) and (2), and Chapter XIV Articles 33 and 34 which regulate the national economy and Indonesian social welfare.

KHES is a form of unification of sharia economic law in Indonesia. When not properly compiled, the religious court judge decides the sharia economic case by referring to the Fiqha books spread in various schools. This is because there is no positive legal reference associated with unification. Hence, there is a disparity in decisions between courts and judges (Iswanto, 2014). The study of economics, in general, is associated with the attitude of human behavior towards production, distribution, consumption of commodity goods and services. In this respect, the study of Islamic economics laws is similar to secular economics, which is bound by Islamic values, such as halal-haram.

This section sheds light on the integration of Islamic economic principles in Indonesia. Subsequent section of this study analysis the Islamic economy and banking sector of Indonesia from a holistic view.

Islamic economics is the science of people that believe in the values of Islam. It studies social individuals and humans with the obligation to worship God. The basic values of Islam control Islamic Economics in its application, based on the commands of the Qur'an and Hadith (Pardiansyah, 2017). Generally, the existence of Islamic economics amid society is in line with the banking industry. According to Bangsawan (2017), the timely demand of Islamic economics is its historical obligation to be reborn and grown into an alternative banking system. The main motive is grounded on the notion of profit sharing for the associated risks rather than operating on a predefined ratio. Similarly, Sudarsono reported that "*Islamic bank is one of the state financial institutions that provide credit to other banking services in the payments and circulation of money that operate based on religious or Sharia principles*" (Mervyn, 2007).

Therefore, the key target for the development of Islamic Banks is not only mere enhancement of economic welfare. Rather it also includes the achievement of socio-economic justice, high economic growth rates, the distribution of reasonable income and wealth among the citizens, extension of employment opportunities, stability in the value of money, and mobilization of savings and investments for economic development (Khan, 2011).

The financial transactions based on the teachings of Islam are another imperative feature of the Islamic Banking Principles. According to Hermansyah (2013), the main principle of Islamic banks for all parties is the provision of benefits to the broader community. Therefore, Islamic banks applied the provisions by refraining from usury and implementing the principle of profit-sharing and buying and selling (Pardiansyah, 2017). The inclusion of Islamic elements (sharia economics) in Indonesian economic law's ideals means that it has a strong and formal foundation. Formally the existence of Sharia has a strong foundation on the argument and context of the country, while Islamic economics has a constitutional basis (Wajdi, 2016). Islamic law has long been placed in Indonesia in the context of its validity, both normatively sociologically and formally juridical (Hirsanuddin, 2008).

The Islamic banking industry in Indonesia is widely known and applied by the public (Rama & Makhilani, 2014). The existence of Islamic economics is marked by the mushrooming of Islamic-based financial institutions, such as Islamic Banking, Islamic Capital Market, Non-Bank Financial Industry (IKNB) Sharia, etc. The economy of Muslims, which is historically related to Islamic Banking, was prevalent during the time of the Prophet Muhammad (Arifin, 2015). These muamalah activities include receiving deposits, lending money for consumption and business purposes, as well as sending money in accordance with sharia-compliant agreements (Bangsawan, 2017). Theoretically, the concept of Islamic Bank first appeared in the 1940s, with the idea of banking based on profit sharing. Meanwhile, the development of modern Islamic banking was internationally initiated by Egypt with the submission of a study proposal on the establishment of Trade and Development. This proposal aimed to establish a Federation of Islamic Banks at the Foreign Minister's Organization of the Islamic Conference Organization (OIC) Conference in Karachi, Pakistan in December 1970.

Subsequent effort to establish Islamic and conventional banks was experienced in many countries, including Indonesia (Al-Arif, 2013). The initiative to establish an Islamic bank in Indonesia started in 1980 through discussions on its use as a pillar of Islamic economics. In 1990, the Indonesian Ulama Council (MUI) held a Cisarua bank and banking interest workshop in Bogor, West Java. This workshop led to establishing the first Islamic bank, known as PT Bank Muamalat Indonesia (BMI), on November 1, 1991. Since May 1, 1992, BMI has been officially operating with an initial capital of Rp. 106,126,382,000. There are some similarities between Islamic and conventional banks, especially on the technical side of money receipts, transfer mechanisms, computer technology, etc (Sodiq, 2015). According to Arifin (2015), the basic difference between these two banks is in terms of the legal aspects, organizational structure, businesses financed, and the work environment. The development of the Islamic banking system in Indonesia has made a lot of progress, both in institutional structure, supporting infrastructure, regulatory instruments, supervision systems, public awareness, and literacy in Islamic financial services.

In 2002, Bank Indonesia issued a Blueprint for the Development of Islamic Banking, such as the Indonesian Banking Architecture (API) and the Indonesian Financial System Architecture (ASKI). This is in addition to the international best practices formulated by Islamic financial institutions, such as the IFSB (Islamic Financial Services Board) (Fathurrahman, 2014). In the formulation of these policies, various aspects were comprehensively considered, including the actual condition of the national sharia banking industry and related instruments. The development trend of the national sharia banking industry is materialized and inseparable from a more macro-financial system framework (Al-Arif, 2013). Table 1 shows the ten Islamic sharia banks operating in Indonesia.

| Islamic Commercial Banks | Abbreviations |
|---------------------------------|----------------------|
| Bank of Sharia Mandiri | BSM |
| Bank of Muamalat Indonesia | BMI |
| Bank of Maga Sharia | BMS |
| Bank of BNI Sharia | BNIS |
| Bank of BRI Sharia | BRIS |
| Bank of BJB Sharia | BJBS |
| Bank of Sharia Bukopin | BSB |
| Bank of Victoria Sharia Bukopin | BVS |
| Bank of Panin Sharia | BPS |
| Bank of BCA Sharia | BCAS |

Since the establishment of Bank Muamalat two decades ago, Islamic finance has increased tremendously in Indonesia. Its development has produced various achievements, with an increasing number of products and services that support the development of Sharia (Bangsawan, 2017). Islamic banking has special characteristics, with products and transaction mechanisms based on principles of Islamic Economic Law (Baidowi, 2016). Furthermore, the existence of finance based on Islamic principles led to the development of Sharia Capital Markets and other Finances (Iswanto, 2013).

In Indonesia, the existence of Islamic banks is in line with conventional banks, with the economy based on Islamic principles as a whole in its structure, substance, and culture. The economy based on Islamic principles in terms of structure is seen in regulatory or enforcement institutions such as the Religious Courts, MUI National Sharia Council, OJK, Sharia Financial Institutions, etc. The substance shows that the regulatory example of the Sharia banking law in terms of culture, namely the implementation of Islamic economic principles in society in the form of the operation of sharia banks, etc.

The above section introduced the Indonesian Islamic banking setting and its importance to the economy.

Generalization of the Main Statements

This is the first contextual study examining the economic Influence of Islamic Law and

Economics Principals in the Indonesian Banking Industry. Therefore, due to the significance of this study on the Islamic banking system, the following were determined:

1. The existence of Islamic economic principles and laws in the Indonesian National Legal system.
2. Determine Islamic Economics Principals that influences the Banking Industry regulations and practices in Indonesia.
3. Determine Islamic Laws that influence the Banking Industry regulations in Indonesia.
4. Integrate Islamic Economic Principals, laws, and the Indonesian National legal system to cut out the current structure of Indonesian banking laws and regulations.

METHODS

This research applied the normative legal method using the statute and conceptual approaches. Secondary data were collected from primary, secondary, and tertiary legal materials, such as legislation, books, journals, etc. The data obtained were analyzed using qualitative analysis. The legal data sources from 1992 were used because the emergence of Islamic Banking in Indonesia started that year. Data were systematically selected from 1992 to 2020 using key words method. Only relevant data on Islamic Laws and regulations, Islamic Economic Principals, and Islamic Banking industry regulations were collected from all available secondary sources. A similar data search technique was adopted on the internet using keyword searches such as "*Islamic Laws in Indonesia*," "*Islamic Economics Principals*," "*Islamic Economic Principals in Indonesia*," "*Islamic Banking regulations in Indonesia*," "*Islamic Banking laws in Indonesia*." The collected data were gathered separately for each variable, and content analysis was performed to extract the references used in this research and draw some useful conclusions.

DISCUSSION

The important rules and regulations by the Indonesian government to monitor and govern the banking sector are influenced by Islamic economic principles. According to the information presented in the literature review on Islamic banking, the government also presented the following important laws.

According to Law no. 7 of 1992 the Islamic bank is located in commercial and rural areas. Banks based on Islamic rules are allowed to perform their activities like a conventional bank. However, the Islamic/sharia bank term is not used in this law. It further describes that commercial banks have the ability to finance customers for profit sharing and maximization purposes in accordance with government rules (Khatimah, 2007). Law no. 10 of 2008 was formulated to improve and explain this analysis. According to Sharia, articles 1 and 6, Islamic banks have to perform all their business operations like a commercial financial institution. These principles are a rule or set of rules containing an agreement between parties that provide guidelines for people to perform their business activities based on the Islamic rules. Furthermore, these activities are based on various investment methods, such as profit sharing, wealth contribution, the principle of selling and buying products, lease giving activity, and changing ownership from one person to another according to leased product principles (Wahab, 2016).

Asides law 7 of 1992 and law 10 of 2008, the other two important laws include i) law no. 23 of 2003, which aims to protect the presence of Islamic banks. For instance, it protects Islamic banking by providing all possible facilities to Bank Indonesia and by making sure it formulate all its rules according to Islamic principles. The other is ii) law no 21 of 2008, which differentiated the Islamic and conventional banks formulated when Islamic banking progressed rapidly. This law also strengthens the Mudaraba, Wadi'ah, Masyarakat. There is no doubt that Islamic banking has a place in Indonesia, as it has been adjusted and recognized by financial institutions. However, the activities of the Islamic banks are overseen by Bank Indonesia, the country's central bank (Pardiansyah, 2017). Moreover, some other rules are also formulated by this bank in managing Sharia financial institutions in Indonesia. The first is regulation no. 9/19 / PBI / 2007, which is supposed to implement the sharia-related laws in performing all financial activities such as providing finance to customer, fundraising, capital sharing, etc. The other regulation is 6/24 / PBI / 2004, whose task is to make sure commercial banks perform activities according to the Sharia laws.

The main objective for controlling and administering Islamic banks is to achieve proper management by maintaining capital adequacy, liquidity, asset, profit-making, and all other activities relevant to Islam and Sharia principles. Moreover, Islamic banks need to provide all facts and details of their activities to the Bank Indonesia on mutually agreed terms and conditions (Khatimah, 2007). Furthermore, Islamic banks needs to assign a public accountant office for scrutiny, as stated in Article 52 (2) (1). Bank Indonesia holds the rights to take steps against the continuity of the Islamic Banks, assuming their business activities are not in accordance with the set rules and regulations. The critical decisions taken by experts in such circumstances are as follows.

1. The application of general meeting restrictions of Shareholders, directors, commissioners, etc.
2. Increasing shareholders capitals.
3. Requesting the Shareholders to ensure the people have a place in the board of bank Sharia
4. Ensuring that the Islamic bank manages its activities by eliminating the distributed (paid) funds and overviewing loss.
5. Requesting for the merger of two Islamic banks.
6. When people agree to possess the responsibilities of an Islamic bank, they are requested to take over its affairs completely.
7. Sharing the responsibilities of Islamic Bank completely or partially with other parties.
8. Asking Sharia banks to shift the assets and responsibilities of Islamic bank to conventional banks.

There is a continuous increase in Islamic banks similar to conventional banks, which is in line with article 33 of the 1945 National constitution. According to this article, Islamic banking is based on the principle of kinship. Therefore, the main motive needs to enhance the employment rate for people to generate income. The bank needs to also play its role in making people rich. Furthermore, Islamic banking needs to make its basis conferring upon ideas, namely intimacy, competence, integrity, and freedom. Awareness of environmental issues needs to be careful towards economic unity for economic growth (Beik, 2016). Additionally, Islamic banking is also established on multiple criteria. Firstly, it is appropriate for the Indonesian nation because it fulfills the community's needs and objectives, especially for citizens in small

businesses. Secondly, it focuses on individual-level progress by prioritizing each person. Thirdly, it also helps people to acquire financial stability, such as those in the lower-income group. Fourthly, Islamic banks also create a balance between this life and hereafter (ukhrawi).

Asides these outlined points; an Islamic bank needs to follow some rules. One of which is to resolve bank related disputes with the help of Religious courts according to Islamic laws. However, when the parties involved wish to use other methods to resolve their dispute they are mandated to follow the Islamic Principles (Wahab, 2016). The main purpose of resolving disputes using Islamic laws is to better Indonesia, which also attracts financiers from other countries.

This study provided several important policy insights for government in general and banking sector practitioners. For instance, it shows that Islamic banking industry is in Muslim and non-Muslim societies. This study also showed the process used to integrate Islamic laws, economic principles, and banking industry practices into the Indonesian Islamic Banking Industry context. This integration shows that Islamic laws are not specific to Muslims alone, rather they are based on universal ethical and moral standards that are acceptable and promoted among other non-Muslim societies. Incorporating Islamic laws in banking rules and regulations brings honesty, fairness, and trust between stakeholders and the society. Policymakers tend to seek deep insights from Islamic banking customers and management by establishing a feedback or reconciliation mechanism to address the contradictory laws and regulations in the banking industry. Future research needs to be carried out on this unique aspect to highlight the strategies used by various Muslims and non-Muslim countries in integrating Islamic laws and economic principles while regulating Islamic banks. Furthermore, research needs to be carried out to determine the perceptions of Islamic banking customers on the integration of its laws and economic principles and ways used to carry out businesses.

CONCLUSION

In conclusion, the basic drive behind the establishment of the Islamic banks is an urge for Muslims to base all facets of their economic life on the Qur'an and Al-Sunnah. Generally, the existence of Islamic economics in the Indonesia is in accordance with the demands of society. Therefore, in conclusion, a total of 199 Indonesian banks are established on Islamic laws. Among these, 12 banks are commercial, 22 functions as Sharia business units, while the remaining 165 operate as Sharia rural banks. Moreover, the existence of Islamic economics is marked by the mushrooming of Islamic-based financial institutions, such as Banks. Furthermore, Islamic economics is based on the Al-Qur'an and Al-Sunnah or Ulama fatwas, which are then used as the basis of the associated law built on religious principles oriented to the world and hereafter. Therefore, in conclusion, Islamic economic law is parallel with the conventional banking system. It originates from its laws and economic principles to make it more reliable in the teachings of the Quran and Sunnah. In summary, the concept of Islamic banking is also synchronized with the country's law no. 10 of 1998 and law no. 7 of 1992. Similarly, the importance of Islamic banking is multifold because it is currently the leading part of the growing economy. Sharia banks came into existence to lead people according to Islamic laws and

economic principles mentioned in the Quran and Sunnah in order to achieve long-term goals. This study provided answers to several questions related to the integration and influence of Islamic economic principles on the Islamic banking Industry. It also opened several new avenues for future research growth in this stream of literature.

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