International Journal of Information System and Innovation Management

Volume 2 Issue 1 June 2024
Page : 9-15

The Innovation of Market Structure and Sharia Governance Model of Islamic Financial Institutions

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Submitted: 3 May 2024, Accepted: 20 June 2024, Published: 10 July 2024

ABSTRACT
Market structure significantly affects price manipulation and economic efficiency. From an Islamic perspective, market structures should allow freedom but remain bound by rules that uphold responsibility and justice. Among the four primary market forms—perfect competition, monopoly, oligopoly, and monopolistic competition—the perfect competition market is deemed most ideal as it fosters balanced and efficient economic activity, aligning with Islamic principles of fairness. Sharia governance is crucial for ensuring that Islamic financial institutions (IFIs) adhere to Islamic laws, avoiding prohibited practices like riba and maintaining the halal nature of profits. This research, using descriptive analysis, examines the market structure in Islam and the Sharia governance model of Islamic Financial Institutions (LKS) within Indonesia's legal framework. The study, through literature reviews and legal document analysis, finds that Indonesian regulations comprehensively address Sharia governance, outlining aspects such as regulation, organizational structure, processes, and functions, thereby ensuring adherence to Sharia principles and promoting ethical financial practices.
Keywords : *Sharia Economy, Market Structure, Sharia Governance*

1. Introduction

In the Qur'an, Surah Ali Imran verse 130 states, "O you who believe, do not consume usury, doubled and multiplied, but fear Allah that you may be successful." This verse commands believers to abstain from usury (riba), which in Islamic jurisprudence (Usul al-Fiqh) translates to a directive to cease engaging in usurious practices. The fundamental legal ruling on prohibitions is that they are forbidden.

A market is a place where goods or services are offered for sale by sellers to buyers. In a market, interactions occur between sellers and buyers, where prices are set based on the forces of demand and supply. Markets can be traditional, located in specific places, modern, situated inside buildings, or online, operating through the internet. The interaction process between demand and supply for a particular good or service, according to economic theory, fulfills the conditions to be called a market, which in turn can determine the equilibrium price (market price) and the quantity traded. Thus, any process that brings together demand (buyers) and supply (sellers) will form an agreed price between buyers and sellers.

Markets encompass various aspects, such as market history, market structure, types of markets, and factors affecting the market, such as government policies, technology, and consumer behavior. Markets are crucial in economic and business analysis as they help in planning marketing strategies, making investment decisions, and understanding the overall dynamics of the economy (Bougatef, 2021).

As the country with the largest Muslim population globally, Indonesia has a significant number of Muslims who may object to transacting or dealing with banking institutions that operate on a usury-based system. Initiated by the Indonesian Ulema Council (MUI), the first sharia-compliant bank, Bank Muamalat Indonesia, was established on November 1, 1991, aiming to provide solutions for Indonesian Muslims to avoid usurious practices (Kasri, 2010). This initiative received a positive response from the government, which supported it with the issuance of Law Number 7 of 1992, accommodating sharia principles in banking practices (Bakar & Yusoff, 2016).

The development of the Islamic financial industry, especially in the banking sector in Indonesia, requires a governance system that ensures the achievement of the objectives of Islamic Financial Institutions (IFIs). The governance system of IFIs differs from that of conventional banks due to the requirement to ensure sharia compliance in all products, instruments, operations, practices, and management of Islamic banking (Mollah & Zaman, 2015).

Sharia governance is a unique and specialized concept of governance for companies or financial institutions offering products and services in accordance with sharia principles. It complements existing good corporate governance systems, with its main function being to review sharia compliance of all company activities both before the transaction (ex-ante) and after the transaction (ex-post) (Grassa, 2013). To carry out this function, the sharia governance system must have three main components: the sharia board (DPS), sharia compliance opinion, and sharia review process. In practice, the sharia governance model of Islamic financial institutions varies across countries due to differences in the legal frameworks regulating them (Hasan & Dridi, 2011).

Previous studies have explored various aspects of sharia governance and market structures in Islamic finance. For example, Grassa (2013) examined the ethical perspective of sharia governance systems in Islamic financial institutions, highlighting the importance of ethical compliance in financial activities. Mollah and Zaman (2015) compared the sharia supervision, corporate governance, and performance of conventional versus Islamic banks, indicating differences in governance structures and their impact on performance. Hasan and Dridi (2011) conducted a comparative study on the effects of the global financial crisis on Islamic and conventional banks, demonstrating that Islamic banks were more resilient due to their adherence to sharia principles.

Alam and Nizam (2020) provided an overview of the sharia governance framework for Islamic banks, emphasizing the need for a robust governance structure to ensure compliance with Islamic principles. Furthermore, El-Hawary, Grais, and Iqbal (2007) discussed the diversity in the regulation of Islamic financial institutions, pointing out the varying governance practices across different jurisdictions. Farook and Farooq (2019) investigated the socio-economic development role of awqaf in Iran and Pakistan, showing the potential of Islamic financial instruments in contributing to social welfare.

Chazi and Syed (2010) analyzed the risk exposure of Islamic banks during the global financial crisis, finding that Islamic banks exhibited lower risk due to their adherence to sharia principles. Magalhaes and Al-Saad (2013) explored corporate governance in Islamic financial institutions, focusing on the issues surrounding unrestricted investment account holders. Srairi (2009) examined the cost and profit efficiency of conventional and Islamic banks in GCC countries, revealing the competitive edge of Islamic banks in certain financial metrics.

Despite extensive research on sharia governance and Islamic banking, there is a noticeable gap in the literature regarding the specific market structure and sharia governance model in the Indonesian context. Most studies have focused on general principles or comparisons with conventional banking systems without delving into the unique legal and regulatory framework of Indonesia.

This research aims to fill the gap by providing a comprehensive analysis of the market structure and sharia governance model of Islamic Financial Institutions in Indonesia. By focusing on the Indonesian legal framework, this study will offer insights into how sharia governance is implemented in practice and its impact on the market dynamics within the country's Islamic financial sector. This research will contribute to the existing literature by highlighting the distinctive features of Indonesia's approach to sharia governance and its implications for the broader Islamic finance industry.

2. Literature Review

Definition of Market Structure

A market is a place or process where demand (buyers) and supply (sellers) of a particular good/service interact to set an equilibrium price (market price) and quantity traded. Every process that brings together buyers and sellers will result in an agreed price between them. Market structure refers to the classification of producers into various market forms based on characteristics such as the type of product produced, the number of companies in the industry, the ease of exit or entry into the industry, and the role of advertising in industrial activities. Generally, market structures are distinguished based on the number of sellers and buyers.

1. **Perfect Competition**: This market structure features a large number of small firms competing against each other with no significant market power, producing an optimal level of output as no single firm can influence the market price (Dzahabiyah & Umiyati, 2020).
2. **Monopoly Market**: A market structure where a single firm controls the entire market, often resulting in reduced output to raise prices and earn more profits (Hamza, 2013).
3. **Oligopoly**: A market structure dominated by a small number of firms that generate limited competition and may collude to use their collective market power to raise prices and earn more profits (Bougatef, 2021).
4. **Monopolistic Competition**: A market structure where many small firms compete against each other, selling similar but slightly differentiated products, giving them a certain degree of market power (Dzahabiyah & Umiyati, 2020).

Types of Market Structures

1. **Perfect Competition**: Features a large number of firms that maximize profits, with free entry and exit, selling homogeneous goods with no consumer preferences. An example in Indonesia is the rice market.
2. **Monopoly Market**: Characterized by a single firm that maximizes profits, sets prices, and faces high barriers to entry and exit. Examples in Indonesia include PLN, PT Pertamina, and KAI.
3. **Oligopoly**: Dominated by a few firms that may collude or compete, with barriers to entry and differentiated or homogeneous products. An example is the telecommunications industry in Indonesia (Telkomsel, Smartfren, Indosat Ooredoo).
4. **Monopolistic Competition**: Features many firms selling differentiated products, allowing them some control over prices. Examples include fast-food chains like McDonald's, Burger King, and KFC in Indonesia.

The Role of Market Structure in Islam

In Islamic teachings, the market is placed in a proportional position, contrasting with capitalism and extreme socialism. The market is one of various distribution mechanisms taught by Islamic law. Islamic market mechanisms, as described by Ibn Taymiyyah, include free entry and exit, sufficient market information, elimination of monopolistic elements, and product standardization to prevent fraud and counterfeit goods (Mukaromah & Wijaya, 2020).

1. **Perfect Competition Market in Islamic View**: Emphasizes fair pricing and free market entry and exit, as demonstrated during the time of Caliph Umar bin Khattab RA (Mukaromah & Wijaya, 2020).
2. **Market Monopoly in Islamic View**: While monopoly is not inherently prohibited in Islamic economics, the practice of 'ikhtikar' (selling fewer goods to raise prices) is prohibited (Bougatef, 2021).
3. **Oligopoly Market in Islamic View**: Oligopolies are permitted as long as they do not engage in collusion or other unethical practices that contradict Islamic principles (Bougatef, 2021).

4. **Monopolistic Competition in Islamic View**: This market structure is acceptable as long as it does not involve collusion or exploitation. Islamic teachings offer sharia-based moral rules to protect market participants' interests (Dzahabiyah & Umiyati, 2020).

Shariah Governance Model of LKS in Indonesia

Shariah governance is a unique structure in LKS (Islamic Financial Institutions) that ensures all operations comply with shariah principles. This governance system fosters trust among stakeholders and the public, avoids shariah risk, and maintains the credibility and efficiency of Islamic banks (Hamza, 2013).

1. **Regulatory Framework**: The shariah governance model varies across jurisdictions, with some countries involving authorities heavily while others allow industry self-regulation (Hasan, 2011).
2. **Shariah Supervisory Board (DPS)**: In Indonesia, the governance system involves the DSN-MUI at the macro level and DPS at the company level, ensuring compliance with shariah principles (Hasan, 2011).
3. **Shariah Review Process**: Indonesia uses a moderate approach, allowing DSN-MUI members to serve as DPS members, which differs from Malaysia's stricter separation to avoid conflicts of interest (Bougatef, 2021).
4. **Shariah Supervisory Functions**: DPS in Indonesia functions mainly in advisory and supervision roles, with internal shariah units assisting in compliance audits (Hamza, 2013).

In conclusion, the study of market structure and sharia governance in Indonesia highlights the unique integration of Islamic principles in economic activities and the regulatory frameworks ensuring sharia compliance. The analysis of different market structures from an Islamic perspective and the examination of sharia governance models provide valuable insights for improving the efficiency and ethical standards of Islamic financial institutions.

3. Research Methods

In this research, the method employed is descriptive analysis, which involves gathering and analyzing data to characterize the phenomena under study. The focus is on examining the market structure in Islam and the Sharia governance model of Islamic Financial Institutions (LKS) in the context of Indonesia's legal framework. Data is collected through multiple channels: a literature review encompassing academic books and peer-reviewed journal articles that provide foundational and current insights into market structures and Sharia governance; internet browsing of official websites and online databases for reports and statistical data; and the analysis of legal documents and institutional reports for relevant regulatory and operational information.

The analysis of this data is conducted descriptively to detail the market structures within Islamic economic theory and to evaluate the Sharia governance frameworks of LKS in Indonesia, including the roles of Sharia supervisory boards and regulatory bodies. The research follows a structured framework: beginning with problem identification and setting research objectives; conducting a comprehensive literature review; collecting data from various sources; performing descriptive analysis to interpret the data; and then presenting and discussing the findings. Finally, the research concludes with summarizing key insights and offering recommendations for future research and practice. This systematic approach ensures a thorough exploration of the subject matter.

4. Results and Discussions

Result

Market Structure means the classification of producers into several market forms based on characteristics such as the type of product produced, the number of companies in the industry, the ease of exit or entry into the industry and the role of advertising in industrial activities. In general, market structure is distinguished based on the number of sellers and buyers.
There are 4 types of market structure, namely:

- Perfect Competition Market: The market structure is dominated by a large number of producers who sell homogeneous products.
- Monopoly Market: A market structure where only one producer sells a unique product.
- Oligopoly Market: A market structure controlled by several producers selling homogeneous or differentiated products.
- Monopolistic Market: Market structure controlled by many producers selling homogeneous or differentiated products.

According to the Islamic view of the four market forms above, the most ideal is the perfect competition market because it is considered to encourage the wheels of the economy efficiently, because there is balanced competition so as to form healthy competition.

Sharia governance or also known as governance carried out in sharia, the function or importance of Sharia Governance in all countries that apply it is the same, namely to keep profits / profits / profits from all Islamic Financial Institutions from the ribawi system and various other non-halal ways. This is to maintain the purity of all profits so that their halalness is guaranteed. The position of Sharia Governance in Islamic Financial Institutions throughout the world is vital and inviolable, without Sharia Governance, Financial Institutions will not be able to carry out Sharia Compliance properly, and name their Institution as one of the Islamic Financial Institutions.

Based on the study of legal documents related to the practice of shariah governance in Indonesia based on the aspects of regulation, organizational structure, process, and function of shariah governance, it is found that in general the regulations (laws and regulations) on Islamic banking and finance have regulated the shariah governance system for Islamic financial institutions in Indonesia.

Discussion

In discussing market structures and Sharia governance, several insights emerge from the literature. Market structures, which include perfect competition, monopoly, oligopoly, and monopolistic competition, are categorized based on factors such as the number of sellers, product types, and market entry barriers. The ideal market structure from an Islamic perspective is perfect competition, as it promotes balanced competition and efficient economic functioning. This view is supported by the research of Azad and Ibrahim (2019), who find that competitive market environments enhance the efficiency and effectiveness of Islamic financial institutions (IFIs) in emerging markets, including Malaysia (Azad & Ibrahim, 2019).

The significance of Sharia governance in ensuring the adherence to Islamic principles is critical. Alam and Nizam (2020) provide an overview of Sharia governance frameworks for Islamic banks, emphasizing its role in preventing non-halal earnings and maintaining the integrity of financial practices (Alam & Nizam, 2020). Effective Sharia governance is vital for the credibility and operation of Islamic financial institutions, as it guarantees that profits are derived from permissible activities and that the institution remains compliant with Sharia principles. Bakar and Yusoff (2016) further corroborate this by highlighting the effectiveness of Sharia governance mechanisms in Malaysian financial institutions, which are essential for maintaining Sharia compliance and ethical standards (Bakar & Yusoff, 2016).

The regulatory landscape in Indonesia, as outlined in the study of legal documents, shows that the country has established comprehensive regulations to guide Sharia governance within its Islamic financial sector. This regulatory framework ensures that Islamic financial institutions adhere to Sharia laws and maintain operational integrity (Grassa, 2013). The effectiveness of these regulations is crucial for upholding the principles of fairness and transparency in financial practices, reflecting the broader goal of Islamic economic theory to promote ethical business conduct and market efficiency (El-Hawary, Grais, & Iqbal, 2007).

5. Conclusion

Market Structure is defined as the classification of producers into several market forms based on characteristics such as the type of product produced, the number of companies in the industry, the ease of exit or entry into the industry, and the role of advertising in industrial activities. The market structure is distinguished based on the number of sellers and buyers. Different sources provide various definitions and understandings of market structure, emphasizing factors such as company behavior, market conditions, and the number and size of firms in the market.

The forms of market structure include perfect competition, monopolistic competition, monopoly, and oligopoly. Perfect competition occurs when there are many sellers and buyers trading homogeneous goods, while monopolistic competition involves many sellers offering differentiated products. A monopoly market has only one seller, and an oligopoly market consists of several sellers. The number of sellers and the nature of goods are key factors in determining market structure, with competition levels varying based on these factors.

In Islamic teachings, the market is viewed as a mechanism for distribution in the economy, with principles emphasizing free competition and fairness. The ideal market structure in Islam is one that promotes balanced competition and efficiency, such as perfect competition. Sharia governance plays a crucial role in ensuring that Islamic financial institutions operate in compliance with Islamic principles, avoiding non-halal practices and maintaining the purity of profits.

The market structure in Indonesia is regulated through laws and regulations governing Islamic banking and finance, with a focus on sharia governance to ensure compliance with Islamic principles. The Sharia Supervisory Board oversees the implementation of sharia governance at both macro and micro levels, with fatwas issued by the highest authority being binding. The process of sharia governance in Indonesia follows a moderate approach, allowing members of the Sharia Supervisory Board to also serve at the company level, while the functions of the board are advisory and supervisory in nature.

Overall, the study of market structure and Sharia governance in Indonesia highlights the importance of regulatory frameworks, organizational structures, processes, and functions in ensuring compliance with Islamic principles in financial institutions. The role of Sharia governance is essential in maintaining the integrity and halalness of profits in Islamic financial institutions, contributing to a fair and ethical market environment.

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