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Research Article

Transforming Conventional Banking Contracts to Sharia-Compliant Systems in Aceh: Legal and Operational Challenges

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Abstract

This study examines the transformation of conventional banking contracts into Sharia-compliant agreements following Qanun Aceh No. 11 of 2018. Aceh's financial institutions are required to transition to Islamic financial systems, employing Sharia-based mechanisms such as subrogation, *qardh*, and *hiwalah* to restructure contracts. Through document analysis and case studies, this research identifies both operational adjustments and legal challenges in implementing these changes. Results show that while existing methods facilitate the conversion process, further refinement is necessary to meet Sharia principles fully. This highlights the need for enhanced frameworks to support sustainable Islamic banking in Aceh.

Keywords: Islamic Banking Conversion; Sharia Compliance; Subrogation

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Introduction

Islamic economic principles diverge considerably from those in conventional economics. While conventional economics contends that human desires are limitless and natural resources scarce, necessitating the discipline of economics to optimize the use of limited inputs for maximum outputs (Arifin, 2000, p. 97), Islamic economics takes a distinctly different approach. Islamic economics is integrated within the comprehensive Islamic framework, encompassing *aqidah* (faith), shariah (law), and *akhlaq* (morality) (Ali, 1993, p. 32). According to Islamic economic doctrine, natural resources are seen as plentiful, granted by Allah for humanity's responsible use. It asserts that human needs are limited, essentially covering only essential daily requirements.

In response to societal advancements, financial institutions have developed a variety of products to cater to diverse public needs, including products facilitating financial transactions. In Indonesia, financial institutions are categorized as either Conventional

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Financial Institutions or Islamic Financial Institutions, with the latter further divided into Islamic Banks and non-bank Islamic Financial Institutions.

A fundamental distinction between Islamic and conventional banking is the prohibition of *riba* (interest) and *gharar* (uncertainty) in Islamic finance. Conventional economics primarily operates on the self-interest principle, whereas Islamic Financial Institutions (IFIs) calculate returns based on fund utilization rather than charging interest (Antonio, 2001, p. 12).

The establishment of Bank Muamalat Indonesia, the first Islamic bank in Indonesia, on May 1, 1992, marked a pivotal moment. Following this, Law No. 7 of 1992 on Banking was introduced, implementing a profit-sharing model. In 1998, Law No. 10 of 1998, amending the 1992 law, further expanded Islamic banking opportunities in Indonesia (Antonio, 2001). The enactment of Law No. 21 of 2008 on Islamic Banking aimed to strengthen the legal foundation for Islamic banks, accelerating their development. According to Article 1, point 12 of Law No. 21, banking activities must comply with Islamic principles under the authority of a fatwa-issuing Islamic law body, requiring that all Islamic bank transactions align with these principles and adhere to Islamic law.

Aceh differs from other Indonesian regions by implementing Qanun, a form of regional regulation equivalent to bylaws. Qanun Aceh is granted this status under Law No. 11 of 2006, which, in alignment with the 1945 Constitution, recognizes the authority of autonomous regional governance (Anggriani, 2011). Consequently, governance in Aceh is further regulated through Qanun.

Qanun Aceh No. 11 of 2018 mandates that all financial institutions in Aceh, both banks and non-banks, operate under Islamic principles. Aceh stands as Indonesia's only province enforcing the transition of conventional banks to Islamic banks (Utamy & Hasan, 2020). This policy has been positively received in Aceh, given the province's predominantly Muslim population and its commitment to comprehensive Islamic law.

The enactment of Qanun for Islamic Financial Institutions necessitates that all conventional banks in Aceh convert to Islamic systems, requiring customers of conventional banks to transfer their accounts accordingly. The conversion of conventional banks to Islamic banks entails a formal legal transformation, empowering banks to offer sharia-compliant services and obligating them to comply with banking regulations (Sholihin, 2013). This conversion process involves core banking operations, including fund collection, storage, and distribution through sharia-based financial transactions. After conversion, Islamic banking operations utilize a Profit and Loss Sharing (PLS) model, although risk factors in financing under *mudharabah* and *musyarakah* contracts lead to a lower prevalence than debt-based schemes (Rahayu, 2013). Debt-based schemes, such as *murabahah*, pose challenges to

Islamic economic justice principles and remain associated with *riba*, which is prohibited.

In conventional banking, products like credit financing typically involve interest, which is strictly forbidden in Islamic finance. Instead, Islamic banks apply a profit-sharing principle. To comply with sharia, conventional banks in Aceh must transition to alternative methods that meet customers' needs within Islamic guidelines. This research analyzes the contractual consequences of converting from conventional to Islamic banking practices.

Methods

This research employs a normative juridical approach, concentrating on a normative legal analysis of the regulations governing the conversion of conventional banking to Islamic banking in Aceh. Primary legal sources include Qanun Aceh No. 11 of 2018 on Islamic Financial Institutions, relevant banking laws, and pertinent fatwas from the DSN-MUI (National Sharia Council of the Indonesian Ulema Council). Secondary sources encompass academic journals and regulatory documentation that explore the principles distinguishing conventional from Islamic banking. The analysis focuses on legal provisions, Sharia principles in banking, and contract conversion procedures aligned with Sharia compliance, particularly examining mechanisms such as subrogation, *qardh*, and *hiwalah*.

Results and Discussion

Conversion of Conventional Credit Contracts to Islamic Financing Contracts

Following the enactment of Qanun Aceh No. 11 of 2018 regarding Sharia Financial Institutions in Aceh, all conventional banks are legally obligated to adopt Sharia-compliant principles in their operations. This legislative change significantly impacts customers who previously held agreements with conventional banks (Fariani, Riyaldi, & Furda, 2021). Credit agreements between customers and conventional banks are now subject to review, given that conventional banking practices are no longer permitted in Aceh. To address this, conventional banks have adopted a subrogation mechanism, enabling the conversion of conventional credit agreements into Sharia-compliant contracts. Under this process, conventional banks transfer their creditor rights to Islamic banks, which then assume the role of creditors and manage the outstanding balances of customers' credit.

The use of subrogation in Islamic banking across Aceh has become prevalent due to the shift to a fully Sharia-compliant financial system. This regulatory transition has required conventional banks to reassign their credit portfolios to Islamic banks through subrogation, wherein Islamic banks step in as new creditors by settling the existing customer debts. Consequently, all prior credit obligations with conventional

banks are nullified, with customers now operating under new agreements with Islamic banks (Andriani & Zulfitri, 2021).

The subrogation process for customers in Islamic banks can be illustrated as follows:

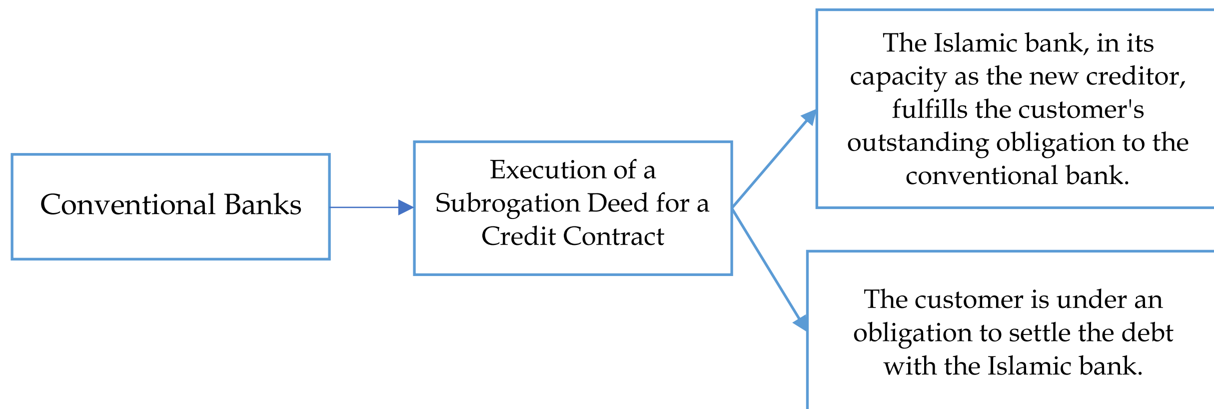

Figure 1. Schematic of the subrogation process for customers

Figure 1 presents the subrogation process, wherein a conventional bank executes a subrogation deed, transferring the creditor's rights and responsibilities to an Islamic bank upon the full or partial settlement of a customer's loan. As a result, the customer's debt obligation is reassigned to the Islamic bank. However, an in-depth examination of Figure 1 highlights a significant limitation in the conventional method of transforming credit agreements into Sharia-compliant financing contracts through subrogation. This practice conflicts with Islamic legal principles on debt transfer, as it frequently overlooks the transaction's fundamental economic essence, potentially sustaining non-compliant financial instruments.

Additionally, this approach breaches the principles outlined in Fatwa DSN-MUI No. 31/DSN-MUI/VI/2002 on Debt Transfer, which suggests various acceptable methods for transferring debts from conventional banks. The Fatwa underscores the need to restructure the underlying economic substance into a Sharia-compliant framework—a goal that a straightforward subrogation often does not fulfill. The Fatwa provides specific guidelines to prevent usury, as follows:

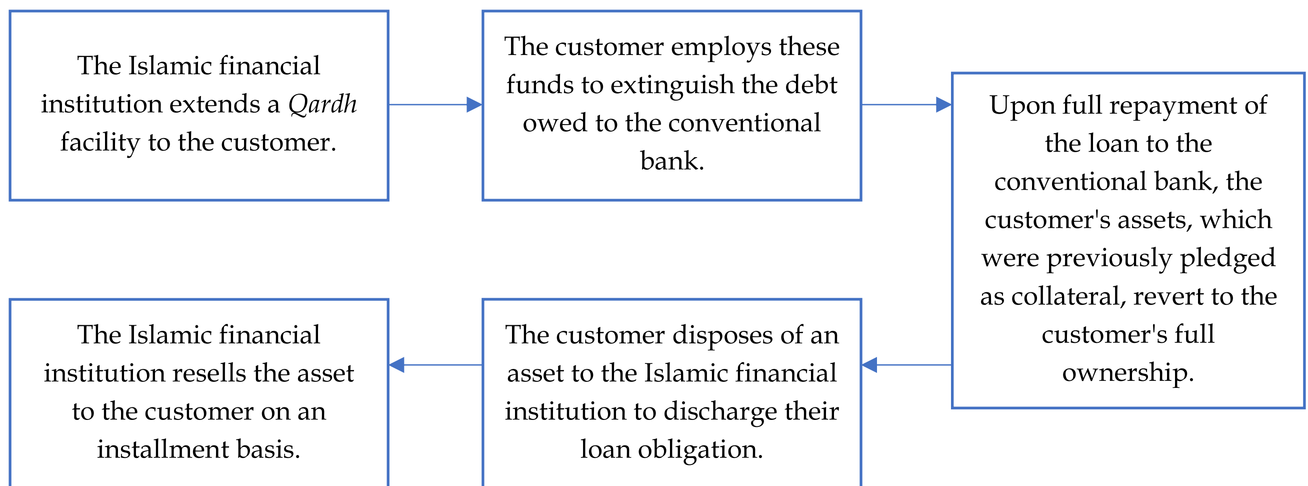

Figure 2. Guidelines for alternative debt transfer from conventional banks

In the ideal scenario, an Islamic financial institution should provide a *Qardh* (interest-free loan) to the customer before fulfilling any outstanding obligations with the conventional bank. A *Qardh* represents a gratuitous loan, entailing the transfer of funds without an expectation of return. Within classical Islamic jurisprudence, *Qardh* is classified as a mutually beneficial agreement rather than a commercial transaction (Sabiq, 1987). The core principle of *Qardh* is the provision of funds without any expectation of interest, aligning with Islamic law, which prohibits the lender from seeking a return, though borrowers may voluntarily offer a token of appreciation (Ichsan, 2016). Through the *Qardh* contract, customers can effectively repay debts owed to conventional banks.

According to both the Civil Code and Fatwa DSN-MUI No. 104/DSN-MUI/X/2016, subrogation is designed to assist third parties unable to immediately repay their debts. This principle aligns with Islamic teachings, as demonstrated in a saying of the Prophet Muhammad: "Whoever eases the hardship of someone in difficulty, Allah will ease their hardship in this world and the Hereafter" (Narrated by Ibn Majah via Abu Hurairah). This concept of mutual aid is central to Islamic teachings and extends to financial matters, as evidenced by the conversion of conventional loans into Sharia-compliant financing to facilitate accessibility, especially in Aceh Province. The requirement for Islamic banks to repay customers' outstanding loans to conventional banks primarily stems from the Qanun on Islamic Financial Institutions, which mandates Sharia-compliant transactions across Aceh's financial landscape (Aguswandi, 2021). This conversion is not necessarily driven by customers' inability to repay but rather by the provincial mandate for financial alignment with Sharia principles.

The principle behind Islamic banks settling conventional loans can offer public benefits, whether initiated by the customer or mandated by government regulation. However, the current practice of such transitions often diverges from the authentic principles of *hiwalah* as outlined in Islamic law. *Hiwalah* refers to the transfer of a debt

from one party to another, shifting the financial burden from the debtor to another party willing to assume it, at the same nominal value (Ichsan, 2016). Under Sharia principles, a proper *hiwalah* transaction involves transferring a debt from one debtor to a third party who agrees to assume it (al-Sharbini, n.d.).

Ideally, Sharia-compliant *hiwalah* practices suggest that Islamic banks should provide a *qardh* (interest-free loan) to the customer before settling their debt with a conventional bank, allowing the customer to fully own the asset. Subsequently, the customer may sell the asset to the Islamic bank, formalizing a *murabahah* (markup) contract for installment payments.

In take-over financing, Islamic banks typically categorize conventional bank debts into two forms: those comprising principal plus interest, and those with principal only. For principal plus interest debts, Islamic banks may offer *qardh* financing. *Qardh* allocation, including for settling interest-based debts, follows the *qardh* contract. Conversely, for principal-only debts, Islamic banks provide *hiwalah* (debt assignment) services, as *hiwalah* cannot be applied to interest-bearing debts. Consequently, Islamic banks categorize customer financing into take-over or non-take-over financing (Karim, 2008, p. 248).

In the take-over process, an Islamic bank assumes the customer's debt from the conventional bank, acting as the customer's representative to settle the loan balance and collect the necessary documentation, ensuring full ownership of the asset by the customer (Karim, 2008).

The legal foundation for debt transfer (takeover) as a Sharia banking service lies in Law No. 10 of 1998 (amendment to Law No. 7 of 1992 on Banking). With Law No. 21 of 2008 on Sharia Banking, the practice of *hiwalah* gained a firmer legal basis. Article 19 of the Sharia Banking Law includes the acquisition of debt based on *hiwalah* or other contracts adhering to Sharia principles.

According to Fatwa DSN-MUI No. 19/DSN-MUI/IV/2001 on *Al-Qardh*, "*Qardh* customers may voluntarily provide additional contributions to Islamic Financial Institutions if it is not stipulated in the contract." As a financing product, *Qardh* is primarily intended for ultra-micro enterprises without capital, and does not generate profit for the Islamic Financial Institution beyond the borrower's goodwill (Ichsan, 2016). *Qardh* funding may come from capital funds, zakat, *infaq*, or waqf, depending on its intended purpose.

The DSN-MUI, established by the Indonesian Ulema Council (MUI) in 1998, oversees Sharia finance issues in Indonesia, confirmed by MUI Executive Decree No. Kep-754/MUI/II/1999.

Fatwa DSN-MUI No. 12/DSN-MUI/IV/2000 on *Hawalah* addresses situations where debtors are unable to directly repay debts, allowing debt transfer to a third party,

termed *hawalah*. This contract specifies the debt transfer from one debtor to another willing party who assumes repayment responsibility.

General conditions outlined in Fatwa DSN-MUI No. 12/DSN-MUI/IV/2000 on *Hawalah* require the agreement of all involved parties: the *muhil* (the debtor-creditor), *muhal/muhtal* (creditor to the *muhil*), and *muhal 'alaih* (party obligated to repay the muhtal). The contract also includes the debt (*muhal bih*) and a statement of consent (*ijab-qabul*) for validity. The *hawalah* agreement must be documented formally, requiring consent from all parties.

Disputes between customers and banks may be addressed through non-litigation methods, such as mediation or arbitration managed by BASYARNAS (National Sharia Arbitration Board), as per Sharia Banking Law Article 52, Paragraph 2, Law No. 21 of 2008.

Alternatively, disputes are resolved in the Religious Court, as stipulated by Law No. 3 of 2006 on Religious Courts, which holds jurisdiction over Islamic economic matters. Thus, customers may bring forth complaints regarding credit transfers from conventional to Islamic banks in the Religious Court under Law No. 3 of 2006, which governs Islamic economic matters.

Legal Status and Obligations of Debtors in the Transfer of Credit Agreements to Sharia Banking Contracts

The transfer of debt, commonly referred to as "takeover" in banking, involves assuming responsibility for an existing credit, often by a third party stepping into a control position within a company or other financial entity (Naja, 2019). In the context of transferring a conventional credit contract to an Islamic banking contract, this shift imposes legal consequences for all involved parties. Legal consequences refer to any impacts arising from legal actions performed by legal subjects with regard to specific legal objects, or due to certain events recognized by law as legally binding outcomes. Essentially, legal consequences materialize when a legal action is conducted between two legal entities (Sjahdeini, 2014). Similarly, the transfer of a credit agreement to a sharia contract affects both the customer and the sharia bank, as both parties mutually agree to execute a subrogation contract based on the initial credit agreement.

In banking, the term "credit takeover" signifies an arrangement where a third party provides a loan to a debtor to settle the debtor's obligation to the original creditor, thereby establishing a new credit agreement with the debtor and assuming the former debtor's position (Naja, 2019). This transaction is akin to subrogation, as outlined in Article 1400 of the Indonesian Civil Code, defining subrogation as the transfer of a creditor's rights to a third party who repays the creditor. This process can occur either through mutual agreement or under legal mandates. In credit transfers, subrogation arises when a third party, either directly or indirectly through the debtor, reimburses the creditor (Subekti & Tjitrosudibio, 2004).

The shift from a conventional credit contract to an Islamic banking contract creates legal consequences for the customer, conventional bank, and Islamic bank. The customer, who initially has a credit relationship with the conventional bank, is directly affected by this transition. The conventional bank, which initiates the transfer of the customer's credit to an Islamic bank under a subrogation contract, also bears legal responsibility. As the third party in this context, the Islamic bank replaces the original creditor and assumes responsibility for the customer's outstanding obligations. Once the Islamic bank pays off the customer's debt to the conventional bank, the customer's obligations shift from the conventional bank to Islamic bank (Naja, 2019).

As a result of this transfer, several rights accrue to the customer. First, the right to establish a new agreement with the Islamic bank. Following subrogation, the customer's obligation to repay shifts to the Islamic bank, permitting the establishment of a new contract addressing financing terms agreed upon by both parties. This contract may require involvement from a notary, as stipulated by Law No. 22 of 2014, which mandates the role of notaries in drafting authentic deeds, including those in Sharia transactions. Financing contracts often overseen by notaries include *musyarakah* (joint venture financing), *mudharabah* (profit-sharing where one party provides capital and the other manages it), *ijarah* (leasing), and *murabahah* (cost-plus financing). Notaries must adhere to legal standards and understand Islamic principles when drafting Islamic banking contracts, even though no specific regulatory framework exists for Islamic contracts. Therefore, notaries typically rely on positive law to ensure the deed's authenticity under existing laws (Maulana, 2020).

A second entitlement granted to the customer is the right to receive services from the sharia bank during the debt repayment period. This relationship, based on mutual benefit, allows the bank to profit through shared returns from financing transactions, while the customer gains access to funds to support business activities. Mutual interests encourage both parties to uphold their roles and responsibilities, with banks providing services that enhance customer satisfaction and promote smoother transactions (Yusmad, 2018).

Furthermore, the customer benefits from having any collateral freed from conventional bank control after the Islamic bank settles the customer's debt. Conventional banks generally require collateral, which serves as security in case the customer defaults. Islamic banks also require collateral, but the responsibility for repayment shifts to the Islamic bank once it settles the customer's debt. This enables the customer to reclaim collateral from the conventional bank and repledge it to the Islamic bank, as needed (Maulana, 2020).

Another legal effect of subrogation is the end of a credit relationship with the original creditor due to a new creditor's payment. Subrogation effectively shifts the creditor's position from the original creditor to the new creditor, i.e., the Islamic bank, as they

assume responsibility for the debt repayment. Payment by the new creditor (the Islamic bank) nullifies the previous obligation between the customer and the original creditor, establishing a new legal relationship between the customer and the Islamic bank (Z., 2013).

The conversion from a conventional banking system to a Sharia-based system brings comprehensive changes, including the reclassification of assets previously held by the conventional bank. This shift transfers all obligations from the conventional bank to the Islamic bank, which assumes responsibility for the customer's previous obligations to the conventional bank. Post-transfer, the customer's responsibilities transfer fully to the Islamic bank, and repayment must be made to the Islamic bank, which has now assumed all former obligations.

Alongside these rights, the customer also has responsibilities toward the new creditor, including repayment of all financing obligations. The customer must honor the original debt agreement with the conventional bank, fulfilling the terms and conditions agreed upon prior to the transfer. Unlike subrogation practices under the Civil Code, which merely continue existing agreements, sharia-based subrogation often necessitates new contractual terms, including monitoring requirements, insurance, and payment terms. These conditions are implemented under Sharia subrogation, reflecting both parties' commitment to a new, binding agreement.

Conclusion

The transition of conventional banking to a Sharia-compliant framework in Aceh, mandated by Qanun Aceh No. 11 of 2018, has reshaped financial operations to align with Islamic principles. Through mechanisms like subrogation and *qardh*, conventional debts are restructured to prevent *riba* and ensure compliance with Sharia law. However, some challenges persist, notably the alignment of economic substance with Islamic legal principles. Addressing these challenges requires more robust frameworks to ensure the authenticity and sustainability of Sharia-compliant financial conversions.

Conflict of Interest

The authors declare no conflict of interest.

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