*International Journal of Economics and Business Administration*
*Volume VIII, Issue 1, 2020*

*pp. 285- 291*

# Freedom of Contracts and Dispute Settlement Between Conventional Banking and Sharia Banking

*Submitted 21/12/19, 1st revision 25/01/20, 2nd revision 20/02/20, accepted 13/03/20*

Budiharto[1], Edy Sismarwoto[2]

***Abstract:***

***Purpose:*** *This study aims to investigate the freedom of contract in conventional and sharia banking interpreted as an event of signing a credit agreement that raises the rights and obligations of the parties.*
***Design/methodology/approach:*** *The research design was qualitative, and the method was conducted by using a normative juridical method on a philosophical approach.*
***Findings:*** *The results showed that based on some lawsuit cases, in the conventional banking agreement, the customer submits the law to the credit rules made by the banking system. In Islamic banking agreements, the bank and the customers resolve the dispute to the existing agreement schemes in the sharia economic legal system. The results also reveal the construction of values contained in the principle of freedom of contract in each banking agreement.*
***Practical implications:*** *This paper can be used by management and legal experts to identifying the differences in principle of freedom of contract in conventional and sharia banking as a measure of justice in civil agreements in business law.*
***Originality:*** *This paper originally highlight that differences in principles and mechanisms for contracting affect procedures in dispute resolution.*

***Keywords:*** *Contract, sharia economy, conventional banking, dispute settlement.*

***JEL code:*** *K20.*

***Paper type:*** *Research article.*

[1]*Universitas Diponegoro, Semarang, Indonesia, email: budiharto@live.undip.ac.id*
[2]*Universitas Diponegoro, Semarang, Indonesia, email: edysismarwoto.undip@gmail.com*

## 1. Introduction

Business law construction stands on the foundation of the so-called legal principle sourced from the philosophical values. In doing so, business law in Indonesia stands on the principles of law that originate from the social values, which was now inherently contained in national philosophy of Pancasila. The principle of freedom of contract in business law becomes a measure of justice in civil agreements, due to the consensus of the parties in entering into an agreement.

However, in essence justice in the consensus of banking agreements based on the principle of contracting is questionable. In some cases, in its reality the position of the bank is higher than that of its customers in making agreements. The principle of freedom of contract in Indonesia adopted from Western law and Islamic law normatively is set forth in the regulation of civil law. Article 1338 paragraph (1) of the Civil Code states that all legally created contracts/agreements apply as a law to those who make them. In this article, the role of individuals becomes crucial for understanding the value of the principle of freedom of contract which must also fulfill the principle of consensuality. This principle is used in conventional banking contracts and Islamic banking. The Civil Code positions as the legal source in legislation, this provision applies generally to all laws and regulations, including Islamic contracts applied by Indonesia Islamic banking. This needs efforts to harmonize legal values as there are different characteristics between Civil Code and Islamic Law (Hamidah *et al.*, 2017; Priyono *et al.*, 2019). In Islamic Law, freedom of contract must have a religious value, where the parties who contract voluntarily as the principle of consensuality submit themselves to the sharia contract which is a system of rules specifics. Every sharia contract has special rules governed by the characteristics of Islamic values which generally have restrictions of no fraud, no interest, and no gambling (Guillén and Tschoegl, 2002; Chong and Liu, 2009; Permana, 2017; Setyawati *et al.*, 2017).

The rapid growth of the Islamic banking industry has opened a contract system based on Islamic law, as a new discourse and alternative economic system (Ismal, 2013; Imam and Kpodar, 2013; El Qorchi, 2005). Moreover, the system of contract and dispute settlement mechanisms in this industry was also extensively studied (Wulandari *et al.*, 2016; Wahyudi, 2019; Harahap and Hasanah, 2018; Ningsih and Disemadi, 2019; Triana, 2017). The development of Islamic banking in Indonesia has become an interesting study from both an economic and legal perspective. From an economic standpoint this development shows the role of the sharia banking industry in the national economy and banking industry (Hidayat, 2019; Mahboud, 2017).

However, unlike countries that officially adopt Islam as a source of constitutional law, such as in the Middle East, and in Southeast Asia like Malaysia and Brunei Darussalam, Indonesia clearly determines that Islam is not an official religion. The Indonesian legal system is more influenced by the Civil Law system. Thus, there are legal issues relating to the adoption of Islamic values in certain legal mechanisms,

such as religious courts, family law, and Islamic economics. As a result, the development of sharia-based industries has led to efforts to harmonize and incorporate the value of Islamic law as a reference for legal formation. This study henceforth aims to investigate the nature of the difference between the conventional banking contract and the sharia banking contract in banking transactions in the Indonesian legal system.

## 2. Freedom of Contracts as the Manifestation of National Legal Philosophy

As a national philosophy, values contained in Pancasila such as Godhood, justice, and humanity affect the substance and structure of national legal arrangements, including in economic fields. In the context of the legal principle of freedom of contract, Indonesia adopted the legal values from civil law system. Legal contract in this regard was similar with that in Western civil law as well as in new adoption of freedom of contract in Islamic economy, though some noticeable differences posed along with the difference in principle and supporting mechanisms. The main difference is in the source of its value, in form of the philosophy that underlies the birth of the principle.

The principle of freedom of contract in Western law stems from the capitalistic and liberal philosophical viewpoint (Bagus, 2000). As a theory, materialism is deemed as a monistic ontology (Smith, 2009). In other words, materialism is a view of life that seeks to base everything that belongs to human life in the material universe, leaving aside everything that transcends the senses. As Indonesia does not explicitly adhere to the economic ideology of materialism and liberalism, normative references in forming a legal framework are values in the national philosophy of Pancasila, including in the principle of freedom of contract.

From a philosophical point of view, the principle of freedom of contract aims to achieve justice for the parties. The main objective of the principle of freedom of contract is to achieve justice where the parties are equal in the law and the agreement. Therefore, its application should also be based on these philosophical values. Indonesia has a national philosophy called Pancasila with the values in being sourced from customary and religious values. The meaning of a principle in law in Indonesia should refer to that value. Pancasila in Indonesia legal system is the main source affecting the substance of laws and regulations (Prawiranegara, 1984).

Justice in Pancasila has a level of meaning from the level of meta-ethical values to practical values. The meta-ethical value is hidden in the meaning of the first precepts: Godhead, which is the basic character of the Indonesian people in interpreting justice, that is the understanding that humans are God's creatures who must submit, obey, follow God's rules. This value becomes meta-ethical as it is in the subconscious of every Indonesian human being. Justice in this level manifests itself as an attitude of mutual help, mutual assistance, respect, tolerance and peace for fellow human beings. The precept of just and civilized humanity emphasizes morality to be fair and civilized in human relations, including banking agreements. This value is a derivation of the religious values that exist in the precepts of the Pancasila principle more clearer goals

in terms of human attitudes. Justice in this precept is the attitude of humans who humanize humans in a just and civilized manner. Its nature is universally recognized. In Indonesian context, state law is a derivation of philosophical values contained in Pancasila which is an agreement between religious people. The principle of freedom of contract in Indonesia must manifest the national philosophical values. Humans, are subjects as well as objects of justice caused by social life that forms the state for the common good in the form of value networks and system. For its sake, human beings and legal structure in Indonesia are guided by the values of humanity that are just and civilized. The purpose of justice is for the common interest in the life of the state, manifested in the moral attitude of obeying the rule of law including in banking agreements (Subroto, 2015).

### 3. Freedom of Contract in Banking System from Legal Perspectives

In Islamic Law, contract terminologically comes form the Arab language of al-aqd, which means recorded agreement (Ishola *et al.*, 2016; Hassan, 2002). In the Encyclopedia of Islamic Law, this word implies on the practicality of consensualism (Aziz, 2006). In Indonesian Civil Code, agreement and engagement are terms that are well known in describing the achievement of an agreement between parties to bind themselves to one another. In addressing the legal consequences of the agreement to bind themselves, it turns out that the notion of an agreement does not always have the same meaning as an engagement. At the engagement, each party has the legal right to demand the performance of the achievements of each party who has agreed to be bound, while the agreement does not affirm the legal rights possessed by each party who promised if one of the parties defaults (Simanjuntak, 2011).

The results showed that the contract in conventional banking is interpreted as the event of the signing of a credit agreement that raises the rights and obligations of the parties. In Islamic banking, the contract is interpreted as the agreement which becomes the model of the agreement that must be signed with the consent letter between the customer and the bank (Lewis, 2001). The difference between a conventional bank contract and an Islamic bank is that in a conventional bank, all banking products are carried out with a credit agreement or a debt service agreement that requires additional loan repayments as interest or usury. The additional debt repayment is attributed to the loan amount that must be paid in addition to the principal loan.

All conventional banking products, both loans and savings or financing, are given an additional interest or valued as bank loans to customers. In Islamic bank contracts, the debt agreement scheme is always avoided, using the murabaha (buying and selling) scheme, or mudaraba (profit sharing) scheme. Because the addition to debt repayment in form of usury is strictly prohibited in Islamic Law, banking profits are thus derived from product transactions. The Islamic bank replaces the loan receivable contract with a sale and purchase scheme or cooperation with profit sharing so that the benefits of the bank become legal according to Islamic Law as it does not contain usury.

Another thing that makes a difference is the legal consequences in the event of a default or dispute. In a legal suit in Indonesia between a conventional bank and its customers, the prosecution is made by the bank for the payment of principal and interest as interest in a credit agreement is also a debt that must be paid as a result of the agreement. In the end, there was a decision to reconstruct the debt payment including the interest. The sharia also acknowledges in the case of default, where the bank's claim is made against the obligations that have been agreed with the sharia agreement. This risk should be considered by the bank when the contract occurs. Based on article 49 of Law No. 3 of 2006, the lawsuit is the authority of the religious court with judges examining the sharia legal problem. A legal case in the field of sharia economics must adhere to the resolution of the dispute by considering the principles of sharia economics in compliant with shariah principle.

### 4. Mechanisms and Binding Capacity of Banking Contracts

The principle in the settlement of Islamic banking disputes is to return to the agreed contract agreement. Hence, the binding capacity of the contract to the parties is like binding the law or pacta sunt servanda (for discussion about this legal norm, see Wehberg, 1959; Kunz, 1945; Sharp, 1941). The main task of the examining judge in resolving this dispute, is to first ensure the validity of a contract, by conducting a contract quality test based on sharia law principles and modern law. The main object that is used as a source of law in prosecuting this case is an agreement or contract that has been established between the litigants. Before considering further, the examining judge needs to first consider the validity of the contract. Therefore, after testing the quality of the contract, further task is to ensuring the bank's internal efforts and negotiations to restore the contract. In the process, if there is still no settlement, and if proven defendant as a customer has broken a promise/default and proven detrimental to the plaintiff as the creditor/bank, all negligence committed by the defendant against the plaintiff must be calculated as negligence that contains a real loss for the bank.

Freedom of contract leads to the binding capacity of a contract as if it were a law by using legal principle of ‘pacta sunt servanda’. However, the two kinds of dispute resolution between conventional and sharia banking made different mechanism and legal consequences due to different value bases in interpreting the principle of freedom of contract (Arbouna, 2007). In conventional banking, the value foundation used is by charging interest in credit system. In such credit system, the bank never loses because interest on loans is debt that must be borne by the debtor. Therefore, the freedom of contract in conventional banking places the customer as the party who submits himself to the rules made by banks. In sharia banking, the transaction system used is a system that has been regulated in sharia in the form of a scheme with sharia principles (Bakar, 2003).

Hence, bank profits are obtained through an agreed price margin agreement within the agreed time period based on the existing sharia rules system. Both parties of the bank and the customer, submit themselves to the transaction system that has been regulated

by sharia principles (Venardos and Rashid, 2010). Both of them only agree on the rules as their agreement. This distinguishes the mechanisms of freedom of contract with conventional banks and Islamic banks.

## 5. Conclusion

A contract in banking is interpreted as an event of the signing of a credit agreement that raises the rights and obligations of the parties. The principle of freedom of contract becomes a measure of justice in civil agreements, due to the consensus of the parties. The agreement is considered fair because it has been mutually agreed upon. In the event of a dispute, the settlement is returned to the contents of the agreement. Differences in principles and mechanisms for contracting affect procedures in dispute resolution. As the rapid growth in the Islamic banking industry, the principles and procedures of the contract become a separate subject, comparatively different from that of conventional banks. There are also noticeable differences between conventional and sharia banking in legal submission of the parties in their respective agreements. The fundamental difference in the principle of freedom of contract in conventional banking and Islamic banking agreements lies with the legal submission of the parties in entering into the agreement.

In a conventional banking agreement, the customer submits the law to the credit rules made by the banking system. In Islamic banking agreements, both the bank and the customers submit a legal submission to the existing agreement scheme in the sharia economic legal system. By using the national philosophical ethics as specified in Pancasila, the implementation of freedom of contract is realized through the interpretation of the fair and civilized humanitarian precepts, which sees the agreement as the moral encouragement of the parties in making the business contracts.

## References:

Arbouna, M.B. 2007. The combination of contracts in Shariah: A possible mechanism for product development in Islamic banking and finance. Thunderbird International Business Review, 49(3), 341-369.

Aziz, D.A. 2006. Encyclopedia of Islamic Law. Jakarta, Ichtiar Baru Van Hoeve.

Bagus, L. 2000. Dictionary of Philosophy. Jakarta, Gramedia Pustaka Utama.

Bakar, M.D. 2003. Contracts in Islamic commercial and their application in modern Islamic financial system. Iqtisad Journal of Islamic Economics, 1-42.

Chong, B.S., Liu, M.H. 2009. Islamic banking: interest-free or interest-based? Pacific-Basin finance journal, 17(1), 125-144.

El Qorchi, M. 2005. Islamic finance gears up. Finance and Development, 42(4), 46.

Guillén, M.F., Tschoegl, A.E. 2002. Banking on gambling: Banks and lottery-linked deposit accounts. Journal of Financial Services Research, 21(3), 219-231.

Hamidah, S., Bakri, M., Budiono, A.R., Winarno, B. 2017. The Harmonization of Islamic Law and Civil Code in the Murabahah Contract: A Case in Indonesia. JL Pol'y & Globalization, 58, 112.

Harahap, M.Y., Hasanah, U. 2018. The concept of a regulation of collateral under the

mudharabah financing contract according to the Law No. 21 of 2008 on sharia banking in Indonesia. In Law and Justice in a Globalized World, Vol. 127, No. 132,. 127-132. Routledge in association with GSE Research.

Hassan, H. 2002. Contracts in Islamic law: the principles of commutative justice and liberality. Journal of Islamic Studies, 13(3), 257-297.

Imam, P., Kpodar, K. 2013. Islamic banking: how has it expanded? Emerging Markets Finance and Trade, 49(6), 112-137.

Ishola, A.S., Azeez, Y.A., Ali, N.M. 2016. Al 'aqd Al sahih: The Legal Basis for Determining the Validity of Islamic Financial Transactions. International Journal of Economics and Financial Issues, 6(3S), 140-143.

Ismal, R. 2013. Islamic banking in Indonesia: New perspectives on monetary and financial issues. John Wiley & Sons.

Kunz, J.L. 1945. The meaning and the range of the norm pacta sunt servanda. American Journal of International Law, 39(2), 180-197.

Lewis, M.K. 2001. Islam and accounting. In Accounting forum, Vol. 25, No. 2, 103-127. Blackwell Publishers Ltd.

Mahboud, R. 2017. Main Determinants of Financial Reporting Quality in the Lebanese Banking Sector. European Research Studies Journal, 20(4B), 706-726.

Ningsih, A.S., Disemadi, H.S. 2019. Breach of contract: an Indonesian experience in akad credit of sharia banking. Ijtihad: Journal of Islamic Law and Humanitarian Discourse, 19(1), 89-102.

Permana, D. 2017. Toward the Best Model of Strategy Implementation in Indonesian Islamic Banking from the Lens of Strategic Clarity. European Research Studies Journal, 20(4B), 3-15.

Prawiranegara, S. 1984. Pancasila as the sole foundation. Indonesia, (38), 74-83.

Priyono, E.A., Budiharto, B., Wulandari, A.H. 2019. Regulations for e-commerce agreement according to ict act and title iii of indonesian civil code. Diponegoro Law Review, 4(1), 359-371.

Setyawati, I., Suroso, S., Suryanto, T., Nurjannah, S.D. 2017. Does Financial Performance of Islamic Banking is better? Panel Data Estimation. European Research Studies Journal, 20(2A), 592-606.

Sharp, M.P. 1941. Pacta Sunt Servanda. Columbia Law Review, 41(5), 783-798.

Simanjuntak, R. 2011. Contract Law and Business Contract Design Techniques Kontan Pub.

Smith, M.E. 2009 Against dualism: Marxism and the necessity of dialectical monism. Science and Society, 73(3), 356-385.

Subroto, W.T. 2015. Revitalization of Pancasila Economic System in the Globalization Era. International Journal of Economics and Financial Issues, 5(4), 860-867.

Triana, N. 2017. Reconstructing Sharia Economic Dispute Resolution Based on Indonesian Muslim Society Culture. Ijtimā'iyya: Journal of Muslim Society Research, 2(1), 107-128.

Venardos, A.M., Rashid, A.Z.A. 2010. An introduction to the laws and practices of islamic trusts and the distribution of a trust upon maturity. In Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System, 145-166.

Wahyudi, F. 2019. The quo vadis of bankruptcy settlement and pkpu laws on sharia banking. Journal of Law and Justice, 8(1), 1-20.

Wehberg, H. 1959. Pacta sunt servanda. American Journal of International Law, 53(4).

Wulandari, P., Putri, N.I.S., Kassim, S., Sulung, L.A. 2016. Contract agreement model for murabahah financing in Indonesia Islamic banking. International Journal of Islamic and Middle Eastern Finance and Management.