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COLLATERAL IN ISLAMIC BANKING: EVIDENCE FROM PARTNERSHIP-BASED FINANCING PRACTICES IN INDONESIA AND MALAYSIA

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Abstract. This paper discusses the importance of revisiting Sharia principles collateral to partnership-based financing in Islamic banking in Indonesia and Malaysia. This paper aims to show how banks often abuse collateral practices in partnership-based financing. Furthermore, this paper specifically aims to provide recommendations for redefining the meaning of collateral in the Indonesian legal system. To achieve this aim, this paper focuses on identifying current legal regulations, reviewing partnership-based financing practices, and assessing the experiences of several countries in adapting to developments in the banking world, particularly those related to partnership-based financing. This study used a juridical normative method with a conceptual and regulatory approach. The results indicate that Indonesia faces a mismatch between national law collateral requirements and Sharia principles in the context of partnership-based financing in banking. Currently, Indonesia does not have strict Sharia provisions prohibiting the use of collateral to generate profits, although authorized institutions have legitimized it. This contrasts with European practice, which has developed a partnership-based financing model that emphasizes contractual consensus among the parties rather than rigid legal regulation. Malaysia strictly prohibits the use of collateral for capital recovery or profit. The findings of this study could serve as a starting point for Sharia-compliant collateral law reform in Indonesia.

Keywords: Collateral, Islamic Bank, Partnership-based Financing, Indonesia, Malaysia.

Introduction

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In traditional banking, when a bank extends funding, commonly referred to as credit, it must consider guarantees. A guarantee provides legal assurance for debt repayment and protects all parties engaged in the financing. When the customer is unable to repay the debt or loan within the credit agreement's term, the bank may utilise the guarantee through an enforcement mechanism to settle the customer's debt in compliance with relevant legislation (Ali et al., 2018). In Islamic banking partnership financing, a guarantee is a crucial component that ensures customers operate their businesses appropriately and in compliance with the agreement. A guarantee is not intended to secure the customer's debt repayment, but rather to ensure compliance with the established agreement. Consequently, if the customer incurs solely economic losses, does not violate the agreement, and the losses are not attributable to negligence, the guarantee does not allow confiscation of property to recoup capital or the total funding extended by the bank (Fauzi et al., 2023).

Guarantee practices in Islamic banking are inherently linked to prudential banking principles, which Islamic banks undertake to safeguard against customer default risk (Hidayati et al., 2018). Nonetheless, critical questions emerge concerning the uniformity of guarantee utilisation in financing that adheres to the fundamental tenets of partnership agreements (e.g., *musharakah* and *mudharabah* financing), wherein partnership-based financing in Islamic banking is not debt-oriented and underscores the principles of trust, justice, and equitable risk sharing among the involved parties (Naim et al., 2016).

In fact, Islamic banking institutions in Indonesia and Malaysia frequently require guarantees for partnership financing that are akin to the norms observed in conventional credit agreements (Saifurrahman & Kassim, 2022; Sapuan, 2016). In Indonesia, collateral in Islamic partnership-based financing is frequently seized by banks if the customer's firm underperforms, irrespective of whether this is attributable to the customer's irresponsibility (Iksan & Yuspin, 2022). This mechanism undoubtedly presents essential difficulties that require re-evaluation. Certain academics contend that the utilisation of guarantees in Islamic partnership finance is a response to the global and national regulatory frameworks on the risk-mitigation requirements of financial institutions (Fauzi et al., 2023; Issoufou & Abdullah, 2019). This practice illustrates a conflict between the ideal tenets of Sharia in partnership-based financing, which prioritise trust and equitable risk-sharing, and credit financing, which focuses on risk mitigation through guarantees.

This study originates from the tension between Sharia principles and the realities of banking regulation and practices. It aims to review the regulation and practice of guarantees and collateral in Islamic banking in Indonesia and Malaysia, and to examine partnership financing practices in several European countries for a comparative perspective. In addition, this research seeks to reconstruct the legal definition of collateral within Indonesian law. Conducted as normative juridical research, the study applies conceptual and statutory approaches, complemented by a limited comparative analysis. It focuses on developing a clearer and more coherent legal framework for collateral in partnership-based financing that is consistent with Sharia principles and contemporary banking practice. During the preparation of this work, the authors used AI-assisted technology for langauge editing and literature review support in order to improve grammar and spelling of the manuscript, as well as to summarize key findings. After using this tool, the authors reviewed and edited the content as needed and take full responsibility for the publication's content, declaring adherence to the highest standards of scientific integrity.

1. Partnership-based financing in an Islamic bank

Partnership-based Sharia financing cannot be equated with conventional credit because it relies on *musharakah* and *mudharabah* contracts rooted in Natural Uncertainty Contracts (NUC). These arrangements inherently lack guaranteed returns and emphasize trust, fairness, and shared risks and rewards, reflecting the realities of productive economic activity in Islamic finance (Ichsan, 2016). Such financing is often described as investment-based or *amanah* in nature, in which parties are not held liable for losses or depreciation absent misconduct

(Adekoya, 2022; Islam & Ahmad, 2022). In NUC, the parties do not merely assume opposing risks, but instead share both risks and returns. In Indonesia, partnership-based Islamic financing is governed under the legal framework for Islamic banking, which recognizes *mudharabah* and *musharakah* as core contractual models. The key distinctions between these contracts lie in their capital contributions, profit distributions, and loss allocations. Malaysia follows a similar approach, as reflected in Bank Negara Malaysia's (BNM) Sharia Standards, which outline comparable principles for risk-sharing and partnership-based financing (Yustiardhi et al., 2020).

These models, as outlined in both national sharia guidelines, emphasize shared participation in productive activities. In both arrangements, profits are distributed according to an agreed profit-sharing ratio. Loss allocation, however, differs: *Musharakah* requires each party to bear losses proportionate to their capital contributions, while mudharabah places the financial loss on the capital provider, provided the manager has not engaged in negligence or misconduct (Adekoya, 2022). The legal relationship in partnership-based financing is horizontal and collaborative, positioning the bank and the customer as equal partners pursuing a common commercial objective (Fauzi et al., 2023).

Conventional credit financing is structured as a debt relationship in which the borrower must repay the principal plus interest. It establishes a hierarchical lender–debtor relationship without any profit-and-loss-sharing mechanism, and repayment obligations remain even if the business fails. It contrasts sharply with the risk-sharing logic of partnership-based Islamic financing, which distributes business outcomes between the parties rather than shifting all risk to the customer (Lestaria & Qoyum, 2021). Misunderstanding this distinction can lead to distortions in the implementation of Islamic financing practices (Amar & Alaoui, 2023). This is exemplified by many contemporary Islamic banking practices, which often impose stringent guarantees and collateral requirements, even in partnership-based financing. Since it violates the principles of trust, risk sharing, and profit-loss sharing, Islamic law does not allow the use of collateral to mitigate business risks in partnership-based financing or investment agreements, from a fiqh perspective (Lestaria & Qoyum, 2021).

In partnership-based financing, the preservation of wealth (*hifz al-mal*) serves as a central foundation, requiring fair capital management, proportional profit-sharing, and balanced risk distribution. It is supported by *hifz al-nafs* and *hifz al-din*, which demand integrity and the avoidance of harmful or unethical practices. Accordingly, financing decisions, supervision, and the use of collateral must reflect justice and moral responsibility. (Akram Laldin & Furqani, 2013). The scheme also embodies *hifz al-'aql* and *hifz al-nasl* through prudent risk assessment and sustainable capital management. When properly implemented, partnership financing promotes long-term economic welfare and social stability in line with the broader objectives of *maqasid al-shariah* (Ismail, 2019). The link between partnership financing and risk-sharing theory strengthens the position of the former within the framework of *maqasid al-shariah*. Risk-sharing theory asserts that economic stability can only be achieved if risks and profits are shared proportionally to each party's contribution, rather than being transferred entirely to one party as in debt-based financing (Farooq, 2007). From a shariah perspective, this risk-sharing mechanism is a concrete manifestation of *hifz al-mal*, as it prevents exploitation and ensures that each party bears the consequences of the business in a fair manner. Furthermore, risk sharing creates healthy market discipline through the skin-in-the-game mechanism, thereby encouraging more cautious, rational (*hifz al-'aql*), and long-term-oriented (*hifz al-nasl*) business behavior. Thus, the principle of risk sharing is not only a technical feature of partnership contracts but also an integral part of achieving Sharia objectives, including creating justice, sustainability, and economic benefit.

Islamic banks in Indonesia often treat partnership-based financing as equivalent to credit financing, as evidenced by contracts that emphasise guarantees and collateral to secure debt. This practice not only undermines the trust in partnership agreements, but also diverges from the fundamental nature of partnership-based financing (Mursid, 2019; Rahmanti, 2013). It is indeed crucial to adjust to modern banking practices; however, this must

be accomplished without diluting the fundamental character of Sharia financing agreements into mere imitations of conventional practices.

2. Understanding the concept of collateral in bank financing

Collateral is an asset pledged by a borrower to a lender to secure a loan or other credit, with the understanding that the lender can seize and sell the asset if the borrower defaults (Rusen, 2007). Collateral in banking is a popular risk measurement technique; it serves as security in the event of default or negligence. (Issoufou & Abdullah, 2019; Rahman et al., 2016). In Indonesia, guarantees are broadly classified into general guarantees that attach by operation of law, and specific guarantees created through agreement. The latter may take the form of personal guarantees or asset-based collateral, each governed by different regulatory instruments (Fitriani, 2017; Sriani et al., 2023). Malaysia adopts a similar structure by distinguishing between personal guarantees and real security, which may involve charges, assignments, mortgages, pledges, or liens, depending on the nature of the asset and the governing statute. Despite variations in terminology and regulatory sources, both systems share comparable characteristics.

In Indonesian banking law, collateral is commonly referred to as *agunan*. Collateral is a more specific form of guarantee that serves as additional security required by banks before extending credit or Islamic financing. Both the Banking Law and the Islamic Banking Law adopt similar approaches: collateral is viewed as supplementary security. The primary guarantee must be the bank's confidence in the debtor's creditworthiness. Both the Banking Law and the Islamic Banking Law reflect this by requiring banks to assess a customer's ability and willingness to repay before granting financing.

Bank Indonesia bases financing limits on creditworthiness, with collateral serving only as supplementary support. However, the guarantee framework remains ambiguous: the Banking Law does not explicitly require additional guarantees, though its explanatory notes imply their importance. In contrast, the Islamic Banking Law clearly distinguishes between primary guarantees and allows supplementary guarantees (Fitriani, 2017). This approach is consistent with the Civil Code, which regards a debtor's assets as general security while recognizing specific collateral that grants preferential rights. Although the Banking Law does not expressly mandate additional guarantees, its explanatory provisions and security doctrine imply their significance. The Islamic Banking Law makes this clearer by expressly recognizing primary guarantees (creditworthiness) and allowing supplementary collateral.

In practice, collateral is an important tool for banks to mitigate financing risks, especially when considering the main characteristics of conventional credit systems. These are based on the principle of risk transfer, whereby most of the business risk is transferred to the debtor, and the creditor has the right to execute the collateral (Adamu, 2018). Therefore, the function of collateral is appropriate when applied in a conventional credit system. However, the authors argue that this principle is inappropriate when applied to partnership-based Islamic financing, as the characteristics of partnership financing in Islamic banking are not debt-based but rather cooperation and investment (Fadhli et al., 2021).

In Indonesia's Sharia system, the concept of *rahn* evolved to define collateral as property pledged for a debt, as outlined in DSN-MUI *fatwas*. Later guidance even allows collateral to accompany partnership-based financing (Sriani et al., 2023). This permissibility does not arise from a desire to adopt the logic of conventional credit fully, but rather as an effort to avoid moral hazard and ensure the achievement of justice and the welfare of the parties in a partnership relationship. Collateral may be enforced if the customer does something that is not permitted or should not be done; fails to do something that is permitted or should be done; or violates the terms and conditions (that do not contradict Sharia) agreed upon by the contracting parties.

In Malaysia, collateral is treated as an essential risk-mitigation tool across both conventional and Islamic financing, regulated primarily by the FSA and IFSA, and further detailed in BNM's policies (Balarabe et al., 2022). While the statutes do not define collateral, they require banks to maintain strong internal controls to manage credit risk, including the use of collateral. BNM's credit-risk guidelines reinforce this by requiring banks to assess a borrower's creditworthiness as the primary source of repayment and to treat collateral only as secondary support, subject to periodic review (Koh et al., 2022). This approach reflects Malaysia's prudential regulatory framework, ensuring that collateral strengthens, not replaces, sound credit analysis.

Under the IFSA, Islamic banks must ensure that all activities, including the use of collateral, comply with Sharia principles (Aslan et al., 2024). The law obliges banks to assess a customer's character, capacity, and collateral as part of prudent financing. BNM reinforces this through its Shariah Standards on *Rahn* (Yunda et al., 2024), which permit the use of collateral in Islamic financing, and through the Shariah Governance Framework, which mandates internal Shariah oversight to ensure proper implementation.

Neither the FSA nor the IFSA mandates that all financing be collateralized, but both require sound credit risk management, with collateral recognized as one possible mitigation tool. BNM's credit-risk guidelines further require banks to reassess collateral values periodically. In Islamic finance, BNM's Shariah Standards on Rahn clarify that collateral should not guarantee capital or profit in partnership contracts such as *mudharabah* and *musharakah*. However, it may be used when losses arise from a customer's negligence or breach, allowing the bank to recover such non-economic losses. Thus, collateral in Malaysian Islamic banking functions not as a return-guarantee mechanism but as a safeguard against moral hazard (Lestari et al., 2024).

3. Practices of collateral in partnership-based financing

3.1. Practices in Europe

Sharia financing, especially partnership-based financing such as *musharakah* and *mudharabah*, is not a common practice in European countries. Their financial systems are built on modern legal traditions that differ greatly from Islamic economic principles. When European financial institutions introduced Sharia-based products, they faced the challenge of aligning strict collateral requirements with Islamic principles. Countries such as the United Kingdom, Spain, Germany, and France developed legal adaptations to reconcile banking developments with core Sharia principles.

First, the United Kingdom accommodates partnership-based Islamic finance by utilizing the flexibility of its common law trust system. Under this mechanism, banks may hold legal title to an asset, such as property, in *musharakah mutanaqisah*, while customers retain the beneficial interest. This structure ensures that the asset functions as a safeguard against negligence without transforming it into collateral that guarantees capital or profit. Execution is permitted only in cases of contractual breach, such as non-payment or asset misuse, thereby maintaining the bank's exposure to business risk in line with Shariah requirements. Consequently, the trust mechanism enables banks to meet prudential regulatory standards while preserving the risk-sharing nature of Islamic partnership financing (Belouafi & Chachi, 2014).

Second, Spain regulates partnership-like financing through *Préstamos Participativos*, an instrument whose profit-linked structure resembles *mudharabah*. However, Spanish law classifies this instrument as "quasi-equity," positioning it below ordinary creditors in insolvency proceedings. This legal status restricts the use of physical collateral, since secured guarantees would contradict the nature of capital that must legally bear commercial risk. As a result, Spanish financial institutions rely instead on personal guarantees (*avales*) from business owners (C & Rodríguez-Monroy, 2015). These limitations mean that participatory financing in Spain

is typically extended only to highly reputable, financially sound enterprises, thereby reducing accessibility for smaller firms.

Third, in Germany, Islamic finance is often structured through *a Stille Gesellschaft (silent partnership), which grants profit-sharing rights without conferring active managerial involvement* (Baig et al., 2024). German regulatory rules stipulate that if a bank secures the arrangement with physical collateral, the relationship may be reclassified as a conventional *Darlehen* (loan), thereby eliminating the partnership's legal and tax advantages. To avoid such reclassification, German banks refrain from using asset-based collateral and instead rely on contractual protections, such as negative covenants, which prohibit borrowers from taking actions that increase risk, including increasing indebtedness.

Fourth, France offers one of the most adaptable civil-law frameworks for Islamic finance through the *fiducie* mechanism, introduced in the 2007 legal reform to mirror trust-like functions. Through *fiducie-sûreté*, an asset may be temporarily transferred to a fiduciary to serve as security. In Islamic finance applications, this mechanism ensures that assets are enforceable only in cases of negligence, contractual violation, or managerial misconduct, not as a guarantee of capital or commercial returns. French regulators accept *fiducie*s for Islamic finance structures because they clearly distinguish between commercial risk, which must be shared in accordance with Shariah, and moral-hazard risk, which may be mitigated through security arrangements. It makes France one of the most responsive European civil-law jurisdictions in accommodating Islamic partnership financing (Baig et al., 2024).

3.2. Practices in Indonesia

Partnership-based financing in Indonesia is grounded in applying profit-sharing principles to eliminate practices such as usury (*riba*), uncertainty (*gharar*), oppression (*zalim*), and gambling (*maisyir*), thereby aligning with the values of Islamic economics. According to the values and principles of Islamic economics, the use of collateral in Islamic financing is not mandatory, especially in partnership-based financing (Fitriyanti et al., 2023). Several studies have noted that the purpose of such financing is to provide an alternative option for those who do not have collateral, as well as to facilitate trust and Islamic values among a predominantly Muslim population. However, in practice, Islamic banks find it challenging to implement financing without collateral (Fadhli et al., 2021). We believe that banks request collateral because, at present, customers' moral integrity cannot be reliably assessed.

Furthermore, to ensure that customers take responsibility for the financing they apply for, collateral instruments are crucial to ensure that customers operate their businesses with diligence and seriousness (Lestari et al., 2024). Another consideration is that banks possess clear regulatory authority to request collateral. Thus, Indonesian law frames collateral as a legitimate prudential tool that supports, rather than replaces, creditworthiness analysis. Banks must have confidence in their customers (as primary guarantees) and assess the 5C analysis principles, including the application of collateral (as an additional guarantee), before providing financing facilities (Hidayatullah & Fadillah, 2022). Islamic banks are therefore required to ensure that a customer can meet their obligations before disbursing financing. Viewed together, these provisions show that collateral protects both the bank from losses arising from customer negligence, and the public whose funds underpin the financing.

DSN-MUI *fatwas* on *musharakah* and *mudharabah* state that collateral is not required, but banks may request it to prevent misconduct. Collateral is merely optional and functions as a prudential safeguard, not as security for repayment. Its role is accessory and justified only when the bank identifies potential moral hazard or heightened customer risk. In practice, however, Islamic banks often treat collateral as a mandatory condition, which diminishes the partnership-based nature of these financing contracts (Asmirawati & Sumarlin, 2018).

Collateral assets are governed by general property law, distinguishing between movable and immovable property. Ownership grants the right to use an asset and to encumber it as security, and any pledged asset must be registered to ensure legal certainty and third-party awareness (Fauzi & Wulandari, 2023). This concept serves as the foundation for establishing security institutions intended to protect creditors' interests without depriving the debtor of ownership of the collateralized property, while ensuring that collateral strengthens trust in the provision of financing.

Only documents proving ownership are submitted as collateral to the Bank, not the physical object itself. Customers can still use the collateral in their daily lives. These documents are secured by the Bank as protection for the funds invested (Mahila et al., 2024). Upon completion of the contract and agreement, the collateral will automatically be returned to the customer. If, during the financing agreement period, the customer is unable to fulfil their obligations, the Bank will investigate the cause of the failure. However, the Bank often retains (and may even foreclose on) the customer's collateral regardless of the reasons for the partnership's failure.

In Islamic banking in Indonesia, *mudharabah* financing is typically used for ongoing businesses, where the bank provides all capital and the customer manages the business. Profits are shared based on an agreed ratio, while losses are borne by the bank unless caused by the customer's negligence. *Musharakah* financing is more common for investment purposes. Both the bank and the customer contribute capital to a productive venture, and the bank's ownership share is gradually transferred to the customer through instalments. Compared to *mudharabah*, *musharakah* offers greater flexibility, as it allows the bank to participate in supervision and decision-making, reducing moral hazard risk.

The partnership-based financing process can be summarized as follows: the customer applies by submitting the required forms, identity and business documents, financial statements, and collateral details. The bank then assesses eligibility, commonly using the 5C analysis, which involves verifying documents, evaluating repayment capacity, and appraising the collateral. If approved, the bank issues a Financing Approval Letter (SP3) and prepares the financing contract. Both parties sign the financing and collateral agreements, typically before a notary or authorized bank officer, with the collateral serving as an accessory agreement. Upon completion of the documentation, funds are disbursed in accordance with the agreed terms. The customer must use the funds appropriately and report business progress, while the bank monitors performance. Repayment of principal and profit-sharing is carried out in line with the agreed schedule.

The authors have reviewed several partnership-based financing contracts at Islamic banks. In several examples of *mudharabah* and *musharakah* financing contracts, we found that the general contract structure includes the agreement heading, the parties' identity and comparison, the agreement's subject matter, and a dispute resolution clause. The main clauses of the agreement, which regulate matters such as profit-sharing ratio and collateral, are mostly determined unilaterally by the bank rather than through mutual agreement between the parties. In practice, Islamic banks in Indonesia often require collateral from the outset of the financing agreement, thereby altering the essence of partnership financing to resemble the risk-transfer mechanism found in conventional credit (Saifurrahman & Kassim, 2022).

The authors conclude that partnership financing practices, such as *musharakah* and *mudharabah*, are in accordance with the laws (Civil Code, Banking Law, Sharia Banking Law, DSN-MUI Fatwa on Musharakah, Mudharabah, and Rahn). However, when examining the implementation of collateral and financing contracts, some aspects require improvement, particularly the application of mandatory collateral without regard to execution provisions in accordance with the DSN-MUI *Fatwa* on Financing, accompanied by *Rahn*. In practice, Islamic banks still rely on collateral-based methods of execution used in conventional credit financing, which are inconsistent with Islamic law (Saifurrahman & Kassim, 2022).

3.3. Practices in Malaysia

Within the framework of Islamic banking law in Malaysia, the use of collateral in Islamic financing is regulated by the provisions of IFSA and reinforced by the Shariah Standards on *Mudharabah*, *Musharakah*, and *Rahn*, which are binding on all Islamic financial institutions. According to certain provisions of the Shariah Standards, the use of collateral (*rahn*) in partnership and investment financing agreements is permitted solely as a risk-mitigation mechanism against moral hazard. Collateral may be used as security (and enforced) in the event of losses resulting from negligence, fraud, or breach of contract. Nevertheless, it must not be used to guarantee the return of capital or specific profits, as this would contradict the principle of profit-and-loss sharing, which is the core of partnership agreements (Lawal, 2016).
The Islamic banking system in Malaysia applies a prudential approach to mitigate financing risks. Before entering into any financing agreement, banks are required to conduct a feasibility assessment of prospective customers. This approach aligns with the standards issued by the Islamic Financial Services Board (IFSB), which serve as regulatory benchmarks for the Islamic banking sector. Consistent with the general risk management principles outlined in the IFSA framework, Islamic banks evaluate key aspects of the applicant, such as character, capacity, capital, conditions, and collateral, to ensure that the financing decision is sound and compliant with Sharia-driven prudential requirements (Hidayati et al., 2018).

If the customer's requirements meet the criteria, a financing contract is drawn up according to the selected type, based on a *musharakah* or *mudharabah* agreement. The financing agreement contains the main points of the agreement between the parties, accompanied by a dictum/explanation of the collateral provided. The structure of a financing agreement in Malaysia generally follows the standard format, including the parties' identities, rights and obligations, the purpose of the financing, security clauses, a letter of offer, a facility agreement, security documents, and other relevant items as required by the parties (Lung, 2013).

In Malaysia, there is no categorization of property as collateral (Hidayati et al., 2018). The practice of explicitly transferring legal documents proving ownership of collateral is not recognized in Malaysian *rahn* regulations because there is no clear distinction between the objects of collateral. The concept of *rahn* applies to all physical objects that can be directly controlled or held by the collateral recipient, except for the 1965 State Land Act, which distinguishes between the mechanisms of pledge and lien (where only the title deed is transferred to the pledgee). The obligation to pledge collateral only applies to land; it does not apply to other assets such as land liens (which are merely notifications), collateral in the form of vehicles, machinery, and other movable property, where the sustainability of the collateral is sufficiently protected by *takaful* (insurance) (Hidayati et al., 2018).

Thus, in the use of collateral in banking, there is no specific provision for creating a security deed. Malaysia does not require the separation of security deeds from financing contracts, unlike Indonesia, which does (Hidayati et al., 2018). The mechanism also differs from Indonesia, because collateral is sufficiently secured by clearly stating it in a financing contract clause, without the need for a separate security deed executed before a notary, as required in Indonesia (Marwiyyah et al., 2025). The main agreement containing the collateral clause has legal standing in proving the security during enforcement, even without a separate security deed.

3.4. Common law and civil law system

Laws regarding collateral in Islamic banking are intended to balance the Sharia principles of trust and profit-and-loss sharing with the demands of prudential banking to maintain banking stability (Jatmiko et al., 2023; Sutomo, 2021). Although Indonesia and Malaysia share similar substantive goals, their regulatory frameworks differ. Indonesia’s rules on collateral are dispersed across various laws, making them more rigid and sometimes inconsistent. Malaysia, while lacking specific collateral legislation, provides more concise and uniform provisions, with regulations issued by BNM binding as positive law for both conventional and Islamic banking.

Meanwhile, in Indonesia, the DSN-MUI's provisions on collateral for Sharia-based contracts do not have the same legally binding force as in Malaysia.

In Malaysia, authorities such as BNM act not only as technical regulators but also as lawmakers in the context of Sharia banking, issuing Shariah Standards and Guidelines that are directly binding on Sharia financial institutions. These provisions have the same legal force as regulations because, under the IFSA, provisions issued by BNM are recognized as official sources of law (Zainudin, 2024). In Indonesia, however, the position of DSN-MUI *fatwas* is quasi-regulatory: they must be referred to by Islamic banks or the Financial Services Authority (OJK), but they are not direct sources of law. A *fatwa* of the Indonesian Ulema Council (MUI) only has a legal effect when it is used as a basis for consideration in legislation. However, from a normative perspective, MUI *fatwas* do not yet meet the criteria for legal regulations under the Formation of Legal Regulations Law. In practice, the role of the MUI is still categorised as a form of public participation in the regulatory process, as stipulated in the Formation of Legal Regulations Law (Widiyono, 2024). Consequently, MUI *fatwas* have been limited in their capacity to serve as legal instruments, lacking the definitive written norms and legal sanctions that characterise formal legal frameworks. As a result, DSN-MUI *fatwas* do not have the same legal standing as BNM provisions.

The authors believe that these differences have practical consequences. The Civil Law approach in Indonesia provides certainty and a systematic legal framework, as banks and customers have detailed legal guidelines. However, this can sometimes lead to disharmony between legal regulations. Meanwhile, the Common Law approach in Malaysia establishes relatively concise legal standards. Still, it offers flexibility and high authority to adapt interpretations to practical needs, making the law more responsive to the development of Islamic economics.

3.5. Dual banking systems and their consequences

Indonesia and Malaysia both adopt a dual banking system that accommodates conventional and Islamic banks operating in parallel within a single national legal framework. In this context, Islamic banks are subject to Sharia principles and standards. Still, in terms of institutions, licensing, supervision, and risk mitigation of Islamic banks remain under the national banking legal framework that also governs conventional banks. This dual banking model is designed to ensure a level playing field between the two types of banks and the stability of the national financial system (Syarifuddin, 2022).

The existence of a dual banking system causes a conflict between Sharia principles and conventional prudential banking principles. For example, in practice, the collateral instruments used by Islamic banks in Indonesia and Malaysia actually originate from the conventional legal system, which also forms the legal basis for conventional banks (Seff & Hidayatullah, 2020). As a result, Islamic banks are still legally required to provide additional guarantees (in the form of collateral) to comply with generally accepted prudential principles. This results in a “mixed” legal framework for guarantees, where Sharia rules are incorporated into the conventional legal framework for regulating securities.

We believe that this mixing is not accidental, but part of a policy design to maintain financial system integration as a consequence of the dual banking system. Islamic banks are part of the national financial system and must therefore comply with a uniform risk mitigation framework and prudential standards. Conventional legal instruments serve as a means for Islamic banks to meet the prudential banking requirements set by financial authorities, even though the substance of their Sharia contracts differs. Legal instruments from the national legal system remain in place to provide creditors with legal protection and to promote stability in the banking system.

Comparison of Partnership-based Financing in Indonesia and Malaysia		
Key Aspects	**Indonesia**	**Malaysia**
Binding Legal Foundation	Banking Law, Islamic Banking Law, Civil Code	IFSA, Shariah Standards by BNM
Key Settings	The regulatory framework does not expressly prohibit the use of collateral to safeguard capital or facilitate profit recovery in partnership-based financing.	There are binding regulations that prohibit the use of collateral as a guarantor of return of capital or profits in partnership-based financing.
Collateral in Partnership-based Financing	Collateral is normatively supplementary, serving as a prudential safeguard rather than repayment security.	Normatively, collateral functions to ensure customer accountability in cases of negligence, error, or breach of contract.
Types of Collateral	Movable and Immovable Property.	There is no formal categorization of collateral types within Malaysia's regulatory framework.
National Sharia Supervisory	DSN–MUI *fatwas* must be legitimized by the Financial Services Authority (OJK) in order to be legally binding.	Regulations issued by BNM are directly binding on all Islamic financial institutions.
Internal Sharia Banking Board/Committee	The Sharia Supervisory Board (DPS) has a limited role and lacks the authority to intervene in contractual arrangements.	The Shariah Committee has the binding authority to direct, admonish, and mandate revisions to contracts.
Practical Outcome	Collateral remains mandatory across numerous Islamic banks, reflecting incomplete compliance with partnership-based financing standards.	Compliance among Islamic banks is generally robust, with practices aligned with partnership-based financing requirements.

Table 1: Comparison of Partnership-based Financing in Indonesia and Malaysia (Source: authors' research).

4. Reconstructing the concept of collateral in Islamic partnership-based financing in Indonesia

One of the main problems in Indonesia's Islamic banking framework is the disharmony between the concept of collateral in national law and the nature of partnership-based financing. Indonesian law generally treats collateral as a means of repayment for obligations. Although this approach appears across different statutory instruments (such as the Civil Code, Fiduciary Law, and Mortgage Rights Law), the underlying assumption remains that security is asset-based and tied to individual liability. This conceptualization does not fully align with Islamic partnership contracts, which share risk and responsibility and do not always rely on asset-backed guarantees. It creates legal ambiguity for Islamic banks in structuring collateral that is both Sharia-compliant and enforceable under national law.

The resulting definition of collateral is considered inappropriate when applied to the Islamic banking system, particularly in relation to collateral in partnership-based financing. This type of financing is not a matter of debt or borrowing (Harahap & Hasanah, 2017). The structure of the guarantee, as described above, becomes problematic because partnership financing is not based on a debt contract but on a cooperation and investment contract that embodies the principle of profit-and-loss sharing. There is no debt to repay; instead, the parties share the business results and bear the risks of loss in proportion to their respective agreements. Therefore, to create harmony with the principles of collateral in partnership-based financing, it is necessary to refine the definition and function of collateral from a partnership financing perspective. This improvement can begin by distinguishing the definitions of collateral for conventional and Islamic financing in sectoral regulations (Fauzi & Wulandari, 2023). These regulations will then be applied to all Islamic financial institutions.

A specific provision on Sharia guarantees and collateral is necessary to address fragmentation across banking law, the Civil Code, the Fiduciary Law, the Mortgage Law, and Sharia *fatwas*, which creates legal uncertainty. Therefore, this study proposes refining the legal definition of "guarantee" or "collateral" in Islamic financing as follows:

Current definition of collateral in the Indonesian legal system	Redefinition of collateral in partnership-based financing provisions
A collateral is an object used as payment for a debt (see the Civil Code, Banking Law, Islamic Banking Law, Fiduciary Law, Mortgage Law, and the *Fatwa* of the DSN-MUI on *Rahn* and *Rahn Tasjily*).	Collateral in Sharia financing is an instrument (object) pledged to safeguard the trust, confidence, and compliance of customers with the agreements made to achieve financing objectives.

Table 2: Redefinition of collateral in partnership-based financing (Source: authors′ research).

This redefinition does not eliminate the distinctive characteristics of collateral as security, as it recognizes the existence of concrete objects that can be used to protect banks. This redefines the primary function of collateral as a manifestation of the trust and sincerity of the parties in fulfilling their agreements, not merely as a means of debt repayment. This approach also reflects the values of justice and equality that underpin muamalah relationships and maqashid al-sharia, while strengthening legal certainty for business actors and Islamic financial institutions. As such, this definition plays a strategic role as a harmonious bridge between national legal norms, Sharia principles, and modern financial practices in Islamic banking.

Malaysia's Standards on *Rahn* clearly restrict the use of collateral in *mudharabah* and *musharakah*, prohibiting it from guaranteeing the return of capital or profits, and allowing it only to address negligence or breach of contract. Indonesia, however, lacks an equivalent rule, creating space for Islamic banks to rely on collateral in ways that resemble conventional credit practices focused on repayment certainty rather than risk-sharing. Although DSN-MUI *fatwas* permit collateral in partnership financing, their broad wording leaves room for varied interpretations (Mursid, 2019). To preserve the integrity of Sharia principles and prevent a drift toward conventional credit logic, Indonesia would benefit from clearer norms, similar to Malaysia's, that ensure collateral serves solely as protection against misconduct, not as a tool to secure capital or profit guarantees.

Malaysia underscores the importance of clear, binding rules that explicitly prohibit collateral from serving as a guarantee of capital or profit in partnership-based financing. Such clarity is essential to preserve the core Sharia principles of trust and risk-sharing, and to prevent Islamic banks from treating collateral as a primary requirement, an approach suited only to debt-based products. Unlike banking practices in several European countries, Malaysia′s rules demonstrate a pragmatic approach that balances practical needs and contextual realities. Sharia financing is designed to operate in compliance with both core Sharia principles and national banking regulations. Although these adjustments are not always formally codified in statutory law, they are commonly structured through contractual arrangements agreed upon by the parties.

For Indonesia, this experience suggests the need to adopt similar approaches at the statutory or contractual level. If limitations on collateral remain only in *fatwas* or internal guidelines, interpretations will vary, and the risk of practices drifting away from Sharia principles remains high (Pujianti, 2022). Establishing firm rules would ensure that collateral is used solely as supplementary protection against misconduct, not as an absolute condition for financing (Adamu, 2018). It strengthens legal certainty while promoting the creation of a truly fair Islamic financing system. As a result, harmony between positive law, Sharia principles, and the practices of financial institutions can be achieved, while strengthening legal certainty and consumer protection in the Islamic financial sector.

Conclusion

Islamic finance in Europe addresses the issue of collateral not through detailed statutory regulation but through contractual consensus between the parties. In countries such as the United Kingdom, France, Germany, and Spain, this flexibility provides an advantage, as specific written provisions do not rigidly bind the parties and may enable the design of financing models that adapt Sharia principles to contemporary banking developments. Malaysia has specifically regulated guarantees in bank financing through dedicated provisions, and explicitly prohibits the use of collateral to return capital or profits. However, consistent with its legal system, these regulations are not formulated in an overly rigid manner, allowing some flexibility in practice. By contrast, the regulatory framework in Indonesia plays a more central and formal role. Indonesia faces a disharmony between the concept of collateral in national law and the nature of partnership-based financing. Currently, Indonesia does not have such strict Sharia collateral provisions, including a prohibition on using collateral to generate profits.

As implemented, Malaysia includes the securing of collateral directly in the financing contract clauses without requiring a separate collateral agreement. In contrast, in Indonesia, collateral must be secured in a separate deed executed before a notary. In light of its legal system and the implementation of a dual banking system, Indonesia has the opportunity to reconstruct guarantee law in partnership-based Islamic financing by redefining the concept of guarantee. This reform should include formulating a specific definition and its consequences by regulating Sharia guarantees, particularly by prohibiting the use of collateral to secure the return of capital or predetermined profits. At the same time, binding legislation should clearly state that collateral serves only as supplementary security and cannot be an absolute or primary requirement in partnership-based financing.

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