

## The Effectiveness of the Supervisory Role of the Sharia Supervisory Board in Minimizing the Risk of Non-Compliance of Islamic Banking in Carrying Out Financial Performance

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### ABSTRACT

This study aims to analyze the effectiveness of the role of the Sharia Supervisory Board (DPS) in minimizing risks to Islamic financial institutions in Indonesia. This study is motivated by the importance of the sharia supervision function in maintaining integrity, compliance, and public trust, although normatively the duties of the DPS have been regulated in Law No. 21 of 2008 and various OJK regulations, but its effectiveness still faces challenges, especially related to the risk of sharia non-compliance and reputational risks. Using a non-doctrinal research design with a legislative and conceptual approach as well as descriptive-analytical methods, primary data was obtained through interviews with DPS members and the management of Islamic financial institutions. The results of the study show that the effectiveness of DPS supervision is influenced by the independence and institutional position of DPS, the competence of DPS members in fiqh muamalah and modern financial practices, as well as the support of an integrated sharia risk management and internal audit system. This study concludes that DPS that functions optimally is able to minimize sharia, reputation, and legal risks and increase the level of institutional compliance with sharia principles.

## **INTRODUCTION**

Islamic banking as part of the Islamic financial system has experienced rapid development in terms of the number of institutions, assets, and service products since the last few decades. This growth is not only driven by increasing public demand for financial services in accordance with sharia principles, but also supported by regulations, product innovation, and technological integration. However, along with this expansion, challenges related to sharia compliance and good governance have become crucial. Non-compliance with Sharia principles not only causes reputational problems, but also has the potential to create operational, legal, and market risks that can negatively impact the financial performance of Islamic banks and customer trust.

In this context, the Sharia Supervisory Board (DPS) plays a central role as the guardian of sharia principles in every Islamic banking activity. The Sharia Supervisory Board is responsible for issuing fatwas, approving products, supervising the implementation of sharia principles in operational practices, and ensuring that all bank products and business contracts are in accordance with sharia regulations. The role of the Sharia Supervisory Board includes preventive measures such as reviewing products and procedures before launching as well as corrective actions such as recommendations for improvements to findings of non-compliance. Therefore, the effectiveness of the Sharia Supervisory Board is a key factor in minimizing the risk of non-compliance that can erode the financial performance of Islamic banks.

Sharia non-compliance can arise from a variety of sources, including inappropriate product designs, weaknesses in internal oversight, inadequate staff understanding of sharia principles, and competitive pressures that encourage aggressive business practices that may ignore sharia rules. In addition, the complexity of modern financial products such as sukuk, conditional financing structures, and customized derivative instruments requires a deep understanding and proper interpretation of sharia. Without effective sharia supervision, the implementation of these products can deviate from the essence of sharia, causing potential reputational and financial losses.

The role of the Sharia Supervisory Board is not only normative but also strategic. Normatively, the Sharia Supervisory Board provides fatwas and operational guidelines. Strategically, the Sharia Supervisory Board helps management direct product innovation within a safe and sustainable Sharia framework, so that banks can grow without sacrificing compliance. The effectiveness of the Sharia Supervisory Board can be measured through several indicators, including the quality of fatwas, frequency and quality of supervision, integration and recommendations of the Sharia Supervisory Board into bank policies and procedures, and management's responsiveness to the findings of the Sharia Supervisory Board. This measurement is important because an active and competent Sharia Supervisory Board is able to prevent high-risk practices and increase public and investor confidence, which in turn contributes to the stability and financial performance of banks.

However, in practice, several studies and empirical observations show that there are challenges that affect the effectiveness of the Sharia Supervisory

Board. These challenges include: (1) the independence of the Sharia Supervisory Board from management or shareholder intervention, especially when the Sharia Supervisory Board consists of members who also have economic relationships or other positions in the institution; (2) the technical and sharia capabilities of the members of the Sharia Supervisory Board which are sometimes inadequate to assess complex financial products; (3) suboptimal coordination between the Sharia Supervisory Board and other internal supervisory functions (e.g., compliance, internal audit); (4) weaknesses in the reporting mechanism and follow-up on the recommendations of the Sharia Supervisory Board; and (5) variations in sharia standards and interpretations between countries or even between institutions, which cause inconsistencies in implementation. Inefficiencies in these aspects have the potential to reduce the ability of Sharia Supervisory Boards to detect and address non-compliance early.

In terms of regulation, banking authorities and financial supervisory institutions in many jurisdictions have issued guidelines that regulate the functions, authorities, and work procedures of the Sharia Supervisory Board to strengthen sharia governance. These regulations usually encourage the Sharia Supervisory Board to be independent, have members with sharia and financial competence, and implement transparent audit and reporting mechanisms. However, the implementation of regulations in the field often encounters obstacles, such as limited resources, organizational cultural resistance, and differences in interpretation of sharia standards. Therefore, an empirical evaluation of the effectiveness of these regulations on practices at the institutional level needs to be carried out to find out the extent to which the Sharia Supervisory Board is really able to minimize the risk of non-compliance.

The financial performance of Islamic banks is greatly influenced by the quality of Islamic supervision. Non-compliance that is not addressed immediately may lead to transaction cancellation, restitution obligations to customers, or fines that affect the bank's assets and profits. In addition, public perception of sharia compliance affects the level of loyalty and growth of the customer base, two factors that are the main pillars of the bank's revenue and capital stability. Thus, the effectiveness of the Sharia Supervisory Board not only contributes to the fulfillment of religious and ethical obligations, but also has a real economic impact through risk mitigation that has an impact on short-term and long-term financial performance.

In the framework of measuring the effectiveness of the Sharia Supervisory Board, it is important to pay attention to quantitative and qualitative dimensions. Quantitatively, indicators can include the frequency of non-compliance findings, correction costs, the financial impact of sharia findings, and the ratio of the influence of the Sharia Supervisory Board's recommendations on operational policies. Qualitatively, relevant aspects include the reputation of the institution, customer satisfaction with sharia commitments, the quality of communication between the Sharia Supervisory Board and management, and the consistency of the enforcement of sharia principles. Empirical research that correlates these indicators with financial performance outcomes (e.g., ROA, ROE, SHARIA NPF,

asset growth) can provide evidence of how effective the Sharia Supervisory Board is in minimizing the risk of non-compliance with financial impacts.

Furthermore, the development of financial technology (fintech) and the digitalization of banking services add a new dimension to sharia supervision. Digital services such as sharia peer to peer financing, digital waqf, or online platform-based investment products require an adaptive sharia vertical mechanism. The Sharia Supervisory Board is required to update the assessment methodology and expand its competencies in order to be able to evaluate compliance risks in the digital ecosystem. This also raises the need for more intense collaboration between the Sharia Supervisory Board, the information technology team, and the compliance unit to design effective internal controls.

Finally, strengthening the role of the Sharia Supervisory Board to minimize the risk of non-compliance requires a comprehensive approach that involves; improving the competence of Sharia Supervisory Board members through education and certification, strengthening independence and protection from internal pressures, integration of Sharia Supervisory Boards in broader corporate governance, improving reporting transparency and follow-up mechanisms, and clear and consistent regulatory support. These measures are expected not only to reduce the frequency and impact of non-compliance but also to increase public trust in Islamic banking institutions so as to contribute positively to sustainable financial performance.

From the above background description, several legal issues can be formulated, including:

1. What is the role of the Sharia Supervisory Board (DPS) in supervising sharia compliance in Islamic banking?
2. How effective is the supervision of the Sharia Supervisory Board in minimizing the risk of non-compliance with Sharia principles in the financial activities of Islamic banks?

## LITERATURE REVIEW

### *The Concept of Sharia Supervision*

According to Antonio (2001), sharia supervision is an effort to ensure that all activities of Islamic financial institutions run in accordance with Islamic sharia principles, including products, services, and financial transactions. The Sharia Supervisory Board (DPS) has the responsibility to provide advice, supervision, and recommendations on operational activities so as not to deviate from sharia provisions.

### *Position and Duties of the Shariah Supervisory Board*

Based on Law Number 21 of 2008 concerning Sharia Banking and OJK Regulation Number 8/POJK.03/2014, DPS is an independent organ that must exist in every Islamic financial institution. Its main duties include: providing advice and suggestions to the board of directors related to sharia compliance, assessing and ensuring products and business activities in accordance with DSN-MUI fatwa, reviewing and providing recommendations on sharia compliance reports. DPS performance is one of the main indicators in assessing the sharia compliance level.

### ***Effectiveness of Risk Management Fund Supervision***

According to Hameed, the effectiveness of sharia supervision is measured through the level of consistency in the application of sharia principles in all lines of activity. This effectiveness is also closely related to Good Corporate Governance (GCG). In the context of risk management, DPS acts as a preventive control mechanism to identify, assess and minimize potential sharia risks such as: Risk of product non-conformity with DSN-MUI fatwa, Reputational risk due to violation of sharia principles, Legal risk due to non-conformity of contract contracts. The effective role of DPS can increase public trust in Islamic financial institutions while strengthening national Islamic financial stability.

### **METHODOLOGY**

research is an empirical or non-doctrinal (socio-legal) legal research. The approaches used are a legislative approach and a conceptual approach. The purpose of the research is to understand and analyze in depth the effectiveness of the role of the Sharia Supervisory Board (DPS) in minimizing risks to Islamic financial institutions, both from the regulatory and implementation aspects in the field. This approach allows researchers to comprehensively describe how the DPS monitoring mechanism is carried out and identify the constraints and factors that affect its effectiveness.

This study uses two main types of data, namely primary data and secondary data. The data collection techniques used include: semi-structured interviews to obtain direct views and experiences from DPS regarding the effectiveness of supervision and the obstacles faced. The Documentation Study is carried out by examining official documents of Islamic financial institutions, such as annual reports, sharia compliance reports and sharia audit results. The data analysis technique is carried out qualitatively through the stages of data reduction, data presentation, and conclusion drawn.

### **RESEARCH RESULT AND DISCUSSION**

#### ***The Role of the Sharia Supervisory Board (DPS) in Supervising Sharia Compliance in Sharia Banking***

The Sharia Supervisory Board is one of the important elements in the governance structure of Islamic banking in Indonesia. Its presence is not only an institutional formality, but has a strategic function in keeping every bank's operational activity in accordance with sharia principles. DPS is tasked with providing advice, recommendations, and internal fatwas to bank management so that all products, services, and business activities do not conflict with the provisions of Islamic law.

In the context of supervision, DPS performs a controlling function through two main mechanisms, namely preventive supervision and repressive supervision. Preventive supervision is carried out before a product or policy is implemented, for example by providing a review of the draft financing contract, investment products, and standard operating procedures (SOPs). Meanwhile, repressive supervision is carried out after implementation, through sharia

compliance audits, financial statement audits, and assessments of the implementation of sharia contracts in the field.

The effectiveness of this role is highly dependent on the independence and competence of the DPS. DPS must have a deep understanding of muamalah fiqh, Islamic economics, as well as technical knowledge of the modern financial system. Without this capacity, the supervision carried out has the potential to be only administrative, not substantive. In addition, the support of the management and the board of directors is also an important factor, as the DPS recommendations must be translated into real policies implemented by the bank.

Thus, the role of the DPS in supervising sharia compliance is not only to check the conformity of documents with the DSN-MUI fatwa, but also to include efforts to build a culture of sharia compliance in all organizational lines. The success of DPS can be measured by the extent to which Islamic banks are able to avoid the practices of gharar (ambiguity), riba (interest) and maysir (speculation), while maintaining moral integrity and public trust in Islamic financial institutions.

The role of DPS is not only limited to ensuring that the bank's operational activities deviate from sharia principles, but also functions as a guardian of the integrity of the Islamic financial system. In a broader context, DPS is tasked with building a governance framework based on sharia values that includes the principles of trust, justice, transparency, and moral responsibility. This means that the supervision carried out by the DPS is not only oriented towards fulfilling formal legal aspects, but also aims to maintain maqashid al-sharia, namely the protection of religion (hifz al-din), property (hifz al-mal), and social justice in economic activities.

In the management of modern Islamic banking, DPS has a strategic position equivalent to other main organs such as the Board of Commissioners and the Board of Directors. Based on the provisions of the Financial Services Authority (OJK) Number 8/POJK.03/2014 concerning the Sharia Supervisory Board, DPS must be placed independently in order to carry out objective supervision. Thus, the role of DPS is an integral part of sharia-based GOOD Corporate Governance (GCG).

The implementation of GCG in Islamic banks requires DPS to: 1). Become a filter for business ethics, so that every management policy is not only economically beneficial, positive law, and sharia values; 2). Becoming a catalyst for integration between economic interests, positive law, and sharia values; 3). Be a counterweight to corporate decisions, so that profit orientation does not get rid of the principles of Islamic morality. This role is very important because the Islamic financial system is not just an economic alternative, but a value system that puts morality and justice at the center of business activities.

Sharia compliance is the main foundation for the sustainability of Islamic banks. DPS is responsible for ensuring that every business process from fundraising, financing, to investment is carried out in accordance with the DSN-MUI fatwa. Supervision is carried out in layers, starting from document assessment to observation of practice in the field. To maintain the effectiveness of supervision, DPS usually uses three approaches: 1). Normative approach, namely ensuring

that all products and contracts are in accordance with the provisions of fiqh muamalah; 2). Systemic approach, namely assessing how the bank's organizational structure and internal system are able to support sharia compliance; 3). Evaluative approach, which is to assess the effectiveness of the application of sharia principles in the results and impact of bank activities. With this approach, DPS can map potential deviations from the early stages, so that violations of sharia principles can be prevented before causing losses or violations of the law.

Institutionally, DPS has a vertical relationship with the National Sharia Council of the Indonesian Ulema Council (DSN-MUI) and a horizontal relationship with the Financial Services Authority (OJK). DPS acts as an extension of DSN-MUI at the financial institution level. Every decision or recommendation of the DPS must refer to the DSN-MUI fatwa, while the results of the DPS supervision are evaluation material for the OJK in assessing the level of compliance of the institution with sharia principles.

The synergy between DPS, DSN-MUI, and OJK is important to ensure the uniformity of sharia standards, avoid different interpretations between institutions, and maintain public trust in the Islamic banking system. However, in practice, coordination obstacles are still found such as communication delays or differences in fatwa interpretation. Therefore, a digital-based integrated reporting system is needed that allows DPS to report the results of its supervision in real time to DSN-MUI and OJK.

In carrying out its duties, DPS faces challenges that are not only technical, but also structural and cultural. Structurally, DPS often has limited formal authority to follow up on violations findings. DPS recommendations are often advisory, not binding, so their implementation depends on the bank's management policy. In addition, the workload of DPS that usually handles more than one financial institution causes suboptimal supervision.

Meanwhile, from a cultural perspective, there is still a gap in understanding between profit-oriented bank management and sharia-compliant-oriented DPS. This leads to the emergence of conflicts of interest when business policies are considered more financially profitable but have the potential to violate sharia principles. To overcome this obstacle, DPS must be able to position itself as a strategic partner of management, not just a passive supervisor. DPS also needs to strengthen its role through a consultative supervision approach, which is to provide direction and practical solutions so that business activities remain sharia-compliant without hindering the bank's productivity.

For the role of DPS to run effectively, it is necessary to increase the capacity and professionalism of DPS members. They must master two scientific dimensions at once: 1). The science of muamalah jurisprudence to understand the basic principles of sharia; 2). Modern economics and finance in order to be able to assess banking products technically and rationally.

In addition, DPS also needs to have high communication skills, risk analysis, and professional ethics. Institutions such as the MUI Institute and the OJK Institute have begun to develop DPS certification programs as a step to strengthen this professionalism. In the long-term context, the role of DPS will not

only be limited to the supervision of financial institutions, but will also be the vanguard in the innovation of competitive, ethical, and sustainable Islamic financial products.

*The Effectiveness of Sharia Supervisory Board Supervision in Minimizing the Risk of Non-Compliance with Sharia Principles in Sharia Bank Financial Activities*

The effectiveness of the supervision of the Sharia Supervisory Board is the main indicator of the success of the implementation of sharia principles in Islamic banking institutions. In practice, this effectiveness is not only measured by how often DPS conducts supervision, but also by how much impact the supervision has in reducing the level of non-compliance risk that can harm banks morally, legally, and financially.

Non-compliance with sharia principles can have various serious consequences, such as loss of customer trust, sanctions from sharia authorities (DSN-MUI or OJK), and damage to the reputation of the financial institution. Therefore, DPS plays a role as a guardian of sharia integrity (shariah guardian) which ensures that all financing, investment, and transaction activities are carried out in the halal corridor.

The effectiveness of DPS supervision in this context can be seen from three main aspects: 1). Structural aspects, namely the extent to which DPS is given formal authority and independence in decision-making; 2). Functional aspects, namely how the supervision mechanism is carried out systematically through internal sharia audits, routine reporting, and follow-up on findings of non-compliance; 3). Outcome aspect, namely the extent to which DPS supervision is able to reduce violations of sharia principles in financing, investment, and fund management practices.

In addition, the effectiveness of DPS is also influenced by synergy with the Sharia Compliance Officer (SCO) and Sharia Internal Auditor (SIA) units, which are an extension of DPS in the field. Good collaboration between these three components creates a layered surveillance system that is able to detect potential violations early.

Thus, the effectiveness of DPS supervision is not only seen from the existence of annual reports or sharia audit results, but from how far the supervision system is able to prevent and minimize the risk of non-compliance before it occurs, as well as ensure that the bank's financial performance continues to run according to the principles of justice, transparency, and blessing as the main goal of the Islamic economy.

The effectiveness of DPS supervision is the main key in ensuring that all financial activities in Islamic banking institutions run in accordance with sharia principles. In the modern Islamic banking system, the risk of non-compliance with sharia principles not only has an impact on the reputation of the institution, but can also affect financial stability, public trust, and moral legitimacy of the Islamic financial system itself.

DPS as a sharia supervisory institution has a mandate to not only detect, but also prevent, correct, and follow up on any potential sharia violations in the bank's operational practices. Thus, the effectiveness of DPS is not measured by

how many reports are made, but the extent to which the supervision is able to produce actual compliance in all aspects of the bank's activities.

Effectiveness in the context of sharia supervision can be interpreted as the level of success of DPS in achieving the objectives of supervision, namely ensuring that all bank activities are free from elements of *riba*, *gharar*, and *maysir*, and in accordance with *maqashid al-sharia*. According to the theory of organizational effectiveness, supervision is said to be effective if: 1). The goals that have been set can be achieved optimally; 2). The implementation process is in accordance with the set standards, and; 3). The impact provides positive results on organizational performance.

in this context, the effectiveness of DPS can be measured through three main indicators: 1). Structural compliance, namely the conformity of the bank's internal policies to DSN-MUI regulations and fatwas; 2). Operational compliance, namely the extent to which investment and transaction financing practices are carried out in accordance with sharia principles; 3). Cultural compliance, which is the formation of a work culture based on Islamic values in all lines of the bank's organization. The effectiveness of DPS will be high if the three forms of compliance run in harmony, because sharia compliance is not only an administrative issue, but also a moral and spiritual awareness in doing business.

The risk of sharia compliance risk is the risk of violation of sharia principles set by DSN-MUI and authority regulations. This risk can appear in various forms, including: 1). Errors in the implementation of the contract, such as the use of *murabahah* contracts for activities that contain usury; 2). Investment incompatibility, for example the placement of funds in conventional interest-based financial instruments; 3). Inconsistencies in business processes, such as manipulation of profit-sharing reports that are detrimental to customers.

Any such violation has serious consequences, both legally and morally. From a legal perspective, banks can be sanctioned by the OJK or DSN-MUI. From a moral point of view, banks have lost public trust, which is the main asset in the Islamic financial system. In this context, the effectiveness of DPS is the first line of defense against the potential risk of sharia non-compliance. Through the mechanism of sharia audit, product evaluation, and compliance assessment, DPS ensures that every financial activity does not deviate from Islamic principles.

The effectiveness of DPS supervision is determined not only by the quality of individual supervisors, but also by institutional and systemic factors. Some of the main factors that affect the effectiveness of DPS are: 1). Independence and integrity of DPS, Independence is the main foundation for DPS to carry out its duties objectively. DPS that are too close to the bank's management are prone to conflicts of interest. Moral integrity is also key, as DPS must be able to resist pressures that can compromise sharia principles; 2). Competence and scientific capacity, DPS members must have a comprehensive understanding, both in the aspect of *fiqh muamalah* and in the technical aspects of modern banking. Without adequate knowledge, DPS finds it difficult to assess complex financial products such as *sukuk*, sharia derivatives, or large corporate financing; 3). Managerial support and compliance infrastructure, the effectiveness of DPS will increase if

the bank's management provides sufficient support, such as data access, sharia internal audit team, and system-based compliance technology. Without this support, the DPS functions only as a symbol, not a substantive supervisor; 4). Regulations and coordination of external supervisory institutions, clear OJK and DSN-MUI policies regarding the duties and authorities of DPS also have a great influence. Strong coordination between supervisory agencies ensures that there are national standards in assessing sharia compliance between banks.

Ideally, DPS is expected to be able to minimize all forms of non-compliance risk through a structured and continuous monitoring system. But in reality, the effectiveness of DPS is often not optimal. Several studies show that some DPS in Indonesia do not have adequate time and resources to carry out active supervision, because some DPS members also concurrently hold positions in other institutions.

In addition, most of the supervision carried out by DPS is still post-audit, which is carried out after the activity occurs, not real time supervision that can prevent violations from an early stage. This creates a gap for the potential for sharia non-compliance without being detected quickly. These limitations indicate that the effectiveness of DPS has not been fully achieved. Therefore, there needs to be a transformation of the supervisory system from the conventional model to digital and risk-based sharia supervision, where DPS can use sharia compliance indicators as a tool to measure bank performance in real time.

The effectiveness of DPS supervision has a direct correlation with the financial stability and reputation of Islamic banks. Effective supervision is able to foster public trust, attract investors, and increase customer loyalty. On the contrary, weak supervision can degrade the image of the Islamic finance industry as a whole. In addition, the effectiveness of DPS also affects the bank's financial performance. Banks that consistently implement sharia compliance tend to have healthier financing portfolios, lower credit risk levels, and more harmonious relationships with customers. This shows that sharia compliance is not only a religious value, but also a risk management and business sustainability strategy. In other words, the effectiveness of DPS is not only to maintain the sanctity of sharia law, but also to support the sustainability of the banking institution itself.

To strengthen the effectiveness of DPS in minimizing the risk of sharia non-compliance, several strategic steps can be taken, including: 1). Implementation of integrated sharia audit, where internal and external audit results are digitally linked so that DPS can monitor compliance at all times; 2). Improving the professionalism of DPS, through mandatory training and certification by DSN-MUI and OJK; 3). Implementation of a public reporting system, so that the public can assess the transparency and performance of bank sharia compliance; 4). Collaboration between DPS and institutions, to establish a coordination forum and share best practices in sharia supervision; 5). Empowerment of sharia compliance units in each bank branch to practically expand the scope of DPS supervision. These measures will encourage DPS to function more actively, responsively, and relevant to the dynamics of the modern financial industry.

## CONCLUSIONS AND RECOMMENDATIONS

From the above descriptions, it can be concluded as follows:

1. Overall, the role of the Sharia Supervisory Board in supervising sharia compliance in Islamic banking includes normative, structural, and moral dimensions. DPS is not only the supervision of sharia law, but also a guide for financial institutions to continue operating within the framework of maqashid al-sharia. Strengthening independence, professionalism, and institutional synergy is the key so that DPS can function optimally in creating credible, transparent, and fair Islamic banking.
2. The effectiveness of DPS supervision in minimizing central risks in maintaining the moral, legal, and operational legitimacy of Islamic banks. This effectiveness requires a combination of personal integrity, a strong supervisory system, adequate regulatory support, and an embedded culture of compliance in the organization. An effective DPS not only acts as a guardian of sharia law, but also as an architect of trust that ensures that Islamic banking operates according to Islamic values, is fair to all parties, and makes a real contribution to the welfare of the people.

## ADVANCED RESEARCH

Future research can be expanded by examining the institutional dynamics and regulatory ecosystem that shape the effectiveness of the Sharia Supervisory Board, particularly through comparative studies across different Islamic financial institutions or countries with mature Islamic finance frameworks. Advanced studies may also incorporate mixed-method or longitudinal approaches to evaluate how DPS independence, competency development, and risk-management integration evolve over time and influence the mitigation of sharia non-compliance risks. In addition, exploring the impact of digital transformation—such as AI-driven sharia audit tools, automated compliance monitoring, and fintech-based Islamic products—could provide deeper insights into how technological innovations enhance or challenge DPS performance. This would allow for a more comprehensive understanding of how DPS can adapt, strengthen legitimacy, and maintain public trust in an increasingly complex and technology-driven financial environment.

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