

# Sharia Supervisory Board Religious Compliance in the Islamic Banks: An Interpretive Approach

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**Abstract:** The concept of SSB religious compliance comes from a Sharia (Islamic teaching) law as foundation rules and principles in the Islamic banks. The concept of SSB religious compliance is shaped by the role of religious, normative and moral values. The objective of this paper is to explore how SSB articulates the notion of religious compliance in the context of Sharia compliance process in the Islamic banks. This paper is a conceptual based on previous researches to adopt in examining how SSB constructs the meaning of religious compliance in Islamic banks. This paper is deemed to provide the richest from a literature review and analysis using an interpretive approach to describe the meaning of SSB religious compliance in the Islamic banks. This paper demonstrates that SSB constructs the meaning of religious compliance in appearance and in fact through the social interactions at three levels: micro or personal self-reflexivity through ethical reasoning and image of individual SSB; institutional or organizational culture through a range of business activities and reputation; and macro or regulators and governance structure. This paper contributes to the Islamic banking literature by providing understandings into the construction of the meaning of SSB religious compliance from an interpretive approach.

## 1 INTRODUCTION

The concept of sharia supervisory board (SSB) religious compliance develops out from a religious imperative within Islamic banking and finance industry (IBF) in keeping with the principles and teaching of Islam. The religious imperative stresses the preservation of ethically based credentials and other exploitative and speculative based activities and promotion of risk sharing, innovation, entrepreneurship in the IBF business and operations (Warde, 2010; Diwany, 2010; Archer & Karim, 2007). The religious compliance in the IBF is deeply dependent on the views of SSB members. However, most of the theological exegeses are based on personal judgment, creating a risk of certifier bias (Hayat, *et al.*, 2013).

In a border research perspective, the concept of SSB religious compliance is shaped by the role of religious, normative and moral values. Some previous research explores the compliance behavior related to the notion of power, control in an institutional setting. For example, three top-rank journals in accounting

and finance are Accounting Organizations & Society (AOS), Journal of Business Ethics (JBE), and Accounting Auditing & Accountability Journal (AAAJ). Some researches review the concept of compliance, for example, Denyer (2009) and Dixon-Woods, *et al.* (2006) discuss the different perspectives of compliance within complex organizational systems and its environments.

Further, Sutinen & Kuperan (1999) also study the intrinsic and extrinsic motivation of compliance behavior, such as detention of enforcement system, illegal gains and its related sanctions, social influence and legitimacy objectives, and internal and external moral development and personal values. In determining compliance, the form of pure and social power or normative power is more useful and also can represent through ritual, symbol, esteem, and prestige (Etzioni, 1961). Weber, *et al.* (1946) put forward that the concept of compliance base on the conformity to legitimate order, charismatic devotion, and obedience. Weber's form came from the personal religious need and the perceived ideal interest within the social order. Parsons (1968) provided that the

concept of compliance includes common sentiments, a model of action or social relationship and the integrity of the value pattern.

Despite the growth in the religious compliance literature on the context of SSB, there has been little effort to understand how the “meaning” of SSB religious compliance in the Islamic banks. SSB religious compliance is constructed in a context of Islamic banks that has its roots for the assurance of religious compliance for the Sharia compliance process. Rahman (2011) exposed that SSB religious compliance has brought a more focus on the need for religious compliance to strengthen Islamic bank’s credibility. Nevertheless, Shafii, *et al.* (2013) and Yahya & Mahzan (2012) noted that religious compliance also could be understood from a legal insight. This reviews focused on the underperformance of formal monitoring of religious compliance.

Some critics in the early development stage of the religious compliance practices in Islamic banks, such as Hayat, *et al.* (2013) and Pitluck (2012) make a comparison of Islamic finance in the different form of investment alternative. They concerned Islamic banks practices as ambiguous in much of the translation of the Sharia law as the divine law. It described the conflict with societal expectations of Islamic banks ethicality and philanthropic motivation. Maurer (2003) described the powerful and emotionally unsettling in the negotiate and compromise ability in the Islamic banks between alternative religious and dominant values in a strange blend of a capitalist and moral economy.

Therefore, this paper attempt to address the gap in the literature by investigating how the meaning of SSB religious compliance is constructed in the context of Sharia compliance in Islamic banks using the interpretative approach. This paper explores how SSB articulates the notion of religious compliance in the context of Sharia compliance process in the Islamic banks.

Since this paper are concerned with an understanding and explain the social world primarily from the point of view of the actors directly involved in the social process (Burrell & Morgan, 1979). Using an interpretive approach to study the phenomenon, as it offers the prospect of reflecting some of the complexity and richness of Sharia compliance process in the Islamic banks within which religious compliance is being practised.

The remainder of the paper is organized as follows. Next section, this paper explains the theoretical framework SSB religious compliance and Sharia compliance process in the Islamic banks. The

following section describes the methodology, followed by discussion. The last section presents the conclusions

## 2 THEORETICAL FRAMEWORK

The Sharia supervisory board (SSB) is part of the key organ on Sharia governance to comply with the Sharia rules and law in the Islamic banks. Nathan & Ribiere (2007) exposed that the existence of the SSB is very crucial to ensure the integrity and credibility of Islamic banks. SSB is the independent body, which has a responsibility to direct, review and supervise all the banking activities and products to comply with the Sharia rules and principles. Although SSB is a vital resource in Islamic banks, SSB is derived from different resources of the board of director (BoD). Choudhury & Hoque (2005) and Daoud (1996) explained that SSB authorities base on religious, legal and systematic resources. The main obligation of SSB is to ensure that Islamic bank conducts their business activities in compliance with Sharia rules and principles (Algaoud & Lewis, 1997).

SSB as individuals, groups, and sub-groups through their interaction in the Sharia compliance process, construct meanings based on their understanding, experience and interpretation of their surroundings and actions at every level in the Sharia compliance process. Therefore, an interpretative approach provides a framework to investigate how the meaning of SSB religious compliance is formed in the Islamic banks and its implications on the Sharia compliance process.

Interpretative or natural approaches mainly focus on people’s perceptions of reality and individual meanings (Hopper and Powell, 1985). The overall objective of the interpretive approach can be classified with meaning and understanding from the result of processes of interpreting. For example, the grasping and comprehending of the meaning that is felt, intended, and/or expressed by actors (Denzin, 2001).

An interpretive approach focuses on the details and processes from actors’ interpretation of the meaning of their own and others actions (Schwandt, 2000). Most of the interpretive researchers combine around the effort to explicate the ways people in specific social settings come to understand, account for, and manage their daily life to build understandings. Therefore, there are three main central concepts in an interpretive approach, interpretation, meaning, and understanding (Denzin, 2001).

The purpose of an interpretive approach is not always to find one truth. It gave the social construction from reality that might be many truths to construct (Shotter, 1993). Every understanding has negotiated meanings, and, as such, it is open to reconstruction (Schwandt, 2000). Therefore, Blumer (1969) proposed the three concepts in an interpretive approach, including social interactions, joint action and differential degree of power. Social interactions can be defined as learning conditions to fit with others who share the same world interpret as a collective voice or by adjusting one's manner to fit with accepted norms. For example, SSB often has their own pre-conceived judgments concerning the Sharia compliance process in the Islamic banks. When SSB encounters a new situation or rule, SSB must redefine their opinion based on interactions with others, such as BoD, Sharia compliance officers, internal auditors, etc.

Furthermore, Blumer (1969) explained that joint action relates to the collective manner of diverse participation in the negotiation process when a new situation arises. For instance, among SSB members experience the negotiation process, can take joint action to accept or reject new rules or recommended practices. The differential degree of power also forms the meaning within the structure and organizations held by various actors. It may not only influence but also change the meanings of the phenomenon. For example, the change in meanings and actions attributes the higher level of negotiation powers held by some actors relative to others in the negotiation process, e.g. authority, intellect, etc.

The concept of compliance shapes from the role of religious, normative and moral values (Smith, 1790). Drawing from the previous studies, this paper adopts the notion of SSB religious compliance to be articulated within the set of characteristics that reflect a particular social reality. At the macro level or regulatory level, factors such as ideational realm of cultures such as general values and norms, philosophy, religious beliefs, and ethical principles, would set the limitations within which actors cooperate and develop their actions. Within an institutional or at the meso level, the interaction between SSB members and the bank's management may be influenced by the organizational culture. At the micro level or personal, self –reflexivity will support individuals to interpret the meanings and to see themselves from the perspectives of others.

### 3 METHODOLOGY

This paper is conceptual in nature. Based on previous researches to adopt in examining how SSB constructs the meaning of religious compliance in Islamic banks. This study explores how SSB articulates the notion of religious compliance in the context of Sharia compliance process in the Islamic banks based on an interpretive approach. The discussion and conclusions of this paper as a concept for describing the meaning of SSB religious compliance in the Islamic banks using an interpretive approach.

Thus, the methodologically, this paper is deemed to provide the richest from a literature review and analysis. A theoretical and extensively study of literature to bring out the objective of presenting the SSB religious compliance observes to the following principles:

- Study behaviour, the range and variety of meanings of religious compliance, and
- The actor's definition of the situation of reality and their relation to behaviour need.

### 4 DISCUSSION

#### *Macro or regulatory constructs of SSB religious compliance*

The Islamic bank develops from a religious imperative to provide alternative financial services in keeping with the principles and teaching of Islam. Diwany (2010) and Archer & Karim (2007) suggested that the religious imperative demands are to preserve of ethically based credentials, which include the bank on *Usury* (interest) and other exploitative and speculative based activities and promotion of risk sharing, innovation, entrepreneurship.

Further, the Islamic bank's compliance is heavily reliant on the views of Sharia boards (Sharia supervisory boards/SSB). However, most of the theological exegeses are based on personal judgment, creating a risk certifier bias (Hayat, *et al.*, 2013; Dranove & Jin, 2010). As an in-house Sharia board of the Islamic banks, their decision will have to refer to the national Sharia institution, and at the same time, certain prominent individual Sharia board members might have a powerful impact on higher level Sharia rulings (*Fatwa*). Their decision of interpretation from Islamic law as a source of guidance for Islamic banks, for example, is a strategy for responding to existential uncertainty (Clack, 2008).

Government and regulatory bodies have committed to developing formal regulations for an Islamic bank. A number of governance's standard and guidelines are issued on the international level, i.e., the Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). Several central banks, such as Bank Negara Malaysia (BNM), Bank Indonesia (BI), Central Bank of Bahrain (CBB), and State Bank of Pakistan (SBP), have also published governance guidelines for Islamic banks to raise the confidence of the users of financial statements in the information covered in them.

In regards to the Islamic bank industry as the social phenomenon, there are some issues in Islamic banks that relate the picture of religious compliance. Islamic banks as the fairly new and unfamiliar industry for regulators have been operating in a weaker government oversight and non-transparent environment. For example, the collapse of Ihlas Finance House (IFH) of Turkey in 2001 showed about the weaknesses of corporate governance in practice. It describes that a failure for the implementation of religious compliance, which entails negative repercussion for trustworthiness and sustainability of an Islamic financial institution (Sultan, 2007; Jang, 2003).

Thus, most of the regulators arrange their governance structure by the addition of SSB to distinguish from conventional governance structures. The addition of SSB in the governance structure is required to encourage transparency and disclosure in decision-making and religious compliance in Islamic banks. The regulator adds SSB as an in-house religious advisor to ensure that Islamic bank's business practices and products comply with Islamic law, and also to mitigate the institution's exposure to fiduciary and reputational risk related to religious compliance in Islamic law (Algaoud & Lewis, 1999).

Linking back to Islamic banks, Sharia rules and principles are intended to stabilize the structure of compliance behavior. However, regulators have left religious compliance under the Islamic bank as institutional for many reasons. As the result, the level of enforcement of religious compliance in Islamic banks is endogenous. In a sense, Islamic banks reflexivity in religious compliance behavior lies within a continuum of an expected cost linked to institutional legitimacy and pressures, and the extent of the accepted level of non-compliance. Giddens (1986) emphasized that human action occurs as continues the flow of conduct, as does cognition. So, the religious compliance in Islamic banks is

composed of an aggregate of their actors and institutional, reasons and motives.

In short, regulators set Sharia rules and principles, which based on the *Quran* and *Sunnah* (an illustration of the lifestyle, daily religious practices, acts and behaviors of the Prophet Muhammad) as religious compliance in the Islamic banks. Sharia rules and principles provide a set of rights and obligations that enable Islamic banks to gain credibility and integrity as an ethical and religious compliance based financial services provider (Diwany, *et al.*, 2010).

The main sources for Islamic bank as religious compliance codes are the *Quran* and *Sunnah*. The *Quran* and *Sunnah* as the main guidance in Islam divided three foundations for the religious compliance codes, namely *Aqidah* (the code of faith), *Sharia* (the code of practice), and *Akhlaq* (the code of ethics). *Aqidah* defines the principles of faith and belief in Islam. *Akhlaq* governs the Islamic ethical and moral code at a personal level. Further, *Sharia* treats as a being synonymous with the law and governs all forms of practical action, such as ethics and the religious compliance approach to faith are directly connected. It involves both the law that governs man's worship of God, which pertains to *Ibadah* (devotional matters) and the law that relates to man's acts in terms of political, economic and social domains of behavior (*Mu'amalat*). *Sharia* is considered enforceable in both these areas (Diwany, *et al.*, 2010).

As a result, the regulators have left religious compliance under the Islamic bank as institutional for many reasons. However, regulators construct the religious compliance base on the *Quran* and *Sunnah*. Through the *Quran* and *Sunnah* as the elements in the macro environment is making it easier to take joint actions to bring about changes, SSB construct their meanings of religious compliance accordingly. Then, interactions also occur at the institutional level between SSB, and this affects their construction of the meaning of religious compliance, as discussed next.

#### ***Meso or institutional constructs of SSB religious compliance***

The ambiguities in Islamic banks are evident and unresolved even at the regulatory level, have subsequently drifted down into the institutional level. The unresolved ambiguity combined with the low exogenous pressure could create a grey area. It leaves some rooms between the rules and Islamic banks as institutional understanding and interpretation, and a gap to construct the meaning of SSB religious compliance, which has drifted down into institutional levels.



In the governance structure in Islamic banks, regulators require banks to employ a Sharia Compliance Officer (SCO) as an independent, extended structure of the SSB. Some critics from scholarly works highlighted that the Islamic banks heavy dependent on the views of SSB as in-house Sharia scholars in the seal of approval of compliance (Hayat, *et al.*, 2013; Dranove & Jin, 2010). In the course of interpretation of the theological exegeses are based on personal judgment and could lead a risk of certifier bias (Unal, 2011, Rammal & Parker, 2010).

In regards to the construction of the meaning for SSB religious compliance as the social phenomenon of this paper, there are issues in Islamic banks, which provide a picture of religious compliance. The SSB activities are the key to corporate governance in Islamic banks to ensure the constant surveillance and check-and-balance over the Islamic bank's products and operations (Al Nashmi, 2002). Hasan (2008) and Rahim (2008) stated that the roles and functions in Islamic banks are directing, reviewing and supervising all activities, products, and services of the Islamic banks to ensure they are in compliance with Sharia law.

Sharia law as a base of religious compliance in Islamic banks has the ultimate objective to bring about human prosperity. Linking back to Islamic banks as a financial institution based on the Sharia law, hence advancing society's well-being, eventually becomes part of the organizational objective. In this case, the SSB religious compliance from the institutional perspective is merely a tool for checking the fulfilment of Sharia legal requirements (Muneeza & Hassan, 2013).

SSB religious compliance can be an assurance program, if properly in place, and becomes a compliance defiance system. SSB religious compliance brings about the reference to a restructuring program to stabilize the dynamic of religious compliance attitude, which in the end guides the Islamic banks to comply with Sharia law. However, some criticisms for Islamic banks showed that the doubts in the interpretation of religious compliance principles, and a lack of monitoring of Sharia compliance (Rahman, 2011; Kasim, *et al.*, 2009).

The focus on SSB is controlled demands and expectations to ensure religious compliance are being met in Islamic banks environment. But a lack of consensus on Sharia compliance criteria in this industry is trapped within the battle of defining religious compliance parameter. Islamic banks as financial institutions have been trapped into legally

based religious compliance whilst seeking to build moral commitment to the Sharia principles and rules with the religious compliance law. This is represented through the differences of interpretation of Sharia as religious compliance in different jurisdiction and Islamic banks as financial institutions (Hameed, 2009; Aggarwal & Yousef, 2000).

In other words, the meaning of SSB religious compliance in Islamic banks is flourishing with the academic work to the industry focus on legitimating legal compliance to the religious order (Yahya & Mahzan, 2012; Muhamad, Edil bin Abd. Sukor, & Shihabuddin, 2009). Islamic banks as a financial institution with the Sharia law become alerted to legitimating the ethical aspect and morality in their operations and products since an ethical lapse could damage organizational reputation. Power (1999) put an argument that the rise of religious compliance has roots in political demands for accountability and control, and the assurance of religious compliance becomes subject to formal scrutiny.

Although the meaning of SSB religious compliance in appearance is associated with the interpretation of Sharia law within Islamic banks as financial institutions, SSB also needs to interpret their actions based on their personal values, and this is discussed next.

#### ***Micro or actors constructs of SSB religious compliance***

Self-reflexivity becomes an important variable in enabling individuals, through their social interactions to build a perspective or opinion of a particular concept (Hudaib & Haniffa, 2009). Alford & Friedland (1985) emphasized that individual behavior can never be adequately explained by individual interest, perceptions, and motivations, nor can individual behavior or social interaction theories explain organizational or societal processes.

In the case of Islamic banks, they face two highly institutionalized environments, the regulatory environment with its own authoritative, and the endogenous religious rules and governance environment that need to be satisfied to be qualified as a Sharia-compliant financial institution. SSB as the in-house scholars have a crucial role to assure the Sharia law as the values basis in the Islamic bank's products and operation. SSB is an independent body in Islamic bank's governance structure, which designs to perform religious compliance law translation and interpretation. SSB also have a responsibility to assure the implementation of religious compliance principles in the Islamic bank's products and operation (Kasim, *et al.*, 2009).

SSB certifies the Sharia-compliant aspect for every product, transactions, and agreements of the Islamic bank by issuing a Sharia legal opinion called *Fatwa*. The role and function of SSB as the in-house religious scholar is central to internalization of Sharia compliance principles for the overall aspects of the Islamic bank's products and operations. SSB has a crucial responsibility to assure the implementation of the pronounces Sharia rules and principles for religious compliance and SSB must be separated with the Sharia compliance officer as an internal religious compliance to review all banking activities in day-to-day operation (Besar, *et al.*, 2009).

In the Sharia compliance process, SSB is described as a traditional controller in order to develop credible images that rationalize what they are doing. SSB tacit knowledge plays an important role in every decision on Sharia compliance approval for each product and operation in Islamic banks. In this case, the construction of SSB religious compliance comes from their tacit knowledge and power as the individual religious scholar controls and balances the ambiguous religious rules to meet the business demand.

Further, there is a heavy reliance on the tacit knowledge of SSB as the individual scholar to perform the meaning of religious compliance and also as the rules maker, the rules-fine runes, the rules refine and the rules auditor. At the individual level, SSB has an ambiguity to interpret the religious compliance, when a single individual handles the Sharia governance main functions. So, the construction of SSB religious compliance is very much related to personal style, power, personal religious views, and independency (Archer & Karim, 2007).

The above rhetoric shows that a gap between Sharia rules and implementation might create rules ambiguity in relation with the SSB religious compliance, and this becomes wider when the rules maker is also the rules auditor. The issue is the lack of direction of religious compliance principles makes inconsistency and the absence of operational principles enables actors and institutions to exploit the inherent openness of rules interpretation, and shape the religious compliance according to their preferred direction (Al Nashmi, 2002).

SSB religious compliance behavior describes a dynamic process reflecting the trade-off between two poles of Sharia law and business logic and the rationalization of power and resource allocation (Daoud, 1996). From the Islamic perspective, Sharia as a law is considered enforceable for devotional or *Ibadah* (ritual matters), and in any political, social,

economic and commercial activities (*Mu'amalat*) (Hameed, 2009).

In SSB assurance program, a religious compliance defense system brings a reference to a rectification program to stabilize the dynamic of religious compliance attitude, which in the end guides Islamic banks to be congruent with its ideals.

## 5 CONCLUSIONS

This paper provides understandings and interpretations of the meaning of SSB religious compliance in the context of Islamic banks. The constructions and interpretations are drawn from the richest from a literature review and analysis.

The contextual analysis in this paper at the macro level or regulator level indicates the meanings of the concept of SSB religious compliance to a large extent are being associated with Sharia rules and principles, which based on the *Quran* and *Sunnah*. Government and regulatory bodies have committed to developing formal regulations for an Islamic bank. On an international level, a number of governances' standard and guidelines are issued, such as the Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).

Sharia rules and principles are intended to stabilize the structure of compliance behavior. However, regulators have left religious compliance under the Islamic bank as institutional for many reasons. As the result, the level of enforcement of religious compliance in Islamic banks is endogenous. As a result, the SSB religious compliance in Islamic banks is constructed of an aggregate of their actors and institutional, reasons and motives.

Similarly, lack of meaning of SSB religious compliance might lead frustrating for some SSB. In the same vein, lack of religious compliance means that SSB needs to deal with pressures of bias and discrimination in maintaining SSB religious compliance. The business and economic objectives by Islamic banks could force the meaning of SSB religious compliance to the disturbance and might lead to the image of Sharia compliance process within Islamic banks.

At the meso or institutional level, the Sharia law largely influences the meaning of SSB religious compliance as the mandatory regulations and rules in the Islamic banks. Linking back to Islamic banks as a financial institution based on the Sharia law, hence advancing society's wellbeing, eventually becomes part of the organizational purpose. SSB religious

compliance can be an assurance program, if properly in place, and becomes a compliance defiance system. SSB religious compliance brings about the reference to a restructuring program to stabilize the dynamic of religious compliance attitude, which in the end guides the Islamic banks to comply with Sharia law.

Further, the meaning of SSB religious compliance in Islamic banks is flourishing with the academic work to the industry focus on legitimating legal compliance to the religious order (Najeeb & Ibrahim, 2013; Yahya & Mahzan, 2012). The Sharia law becomes alerted to legitimating the ethical aspect and morality in the Islamic bank's operations and products since an ethical lapse could damage organizational reputation.

At the micro level, the SSB religious compliance is often related to the personal reputation and understanding of the local environment and religious norms rather than the organizations and general ethics. Understanding the nature of SSB as a symbol in the Islamic banks, it can help to understand the concept of SSB religious compliance and the need for adaptation of such concept to be in line with Sharia law.

From the various interpretation of the construction of the meanings of SSB religious compliance in Islamic banks, it can be determined that SSB as a personal actor has a crucial role to assure the Sharia law as the values basis in the Islamic bank's products and operation. SSB is an independent body in Islamic bank's governance structure, which designs to perform religious compliance law translation and interpretation.

SSB is described as a traditional controller in order to develop credible images that rationalize what they are doing. SSB own a tacit knowledge to manage every decision on Sharia compliance approval for each product and operation in Islamic banks. In Islamic banks, the construction of SSB religious compliance comes from their tacit knowledge and power as the individual religious scholar controls and balances the ambiguous religious rules to meet the business demand. The concern for constructing the meaning of SSB religious compliance comes from the adoption of Sharia law values, expression, a reflection of societal needs, competent judgments, and an independent and influential from the professional body.

The limitation of this paper is this paper only focuses on understanding the construction of the meanings of SSB religious compliance base on interactions at macro, institutional and personal level. This paper does not distinguish how different social, cultural, firm and personal factors, which can

influence the perceptions on the SSB religious compliance when faced with specific situations of conflict. As a result, it would be interesting for future study to explore this aspect.

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