

**THE ROLE OF SHARIA SUPERVISORY BOARD IN THE
SHARIA COMPLIANCE PROCESS IN INDONESIA**

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**FACULTY OF BUSINESS AND ACCOUNTANCY
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KUALA LUMPUR**

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THE SHARIA COMPLIANCE PROCESS IN INDONESIA**

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ABSTRACT

The Islamic banking industry has growth remarkable over the past few years. Nowadays, Islamic banks operate in nearly all-Muslim countries and many non-Muslim countries. The most important aspect in an Islamic bank is the Sharia compliance process. The Sharia Supervisory Board (SSB) is established to ensure an Islamic bank complies with the Sharia requirements. SSB as an independent board certifies and becomes an internal part of the Sharia governance framework in an Islamic bank to assure that all products, transactions, and operations in the bank comply with the requirements of Sharia.

Sharia compliance process is one of the important tools in the Sharia governance framework within an Islamic bank. Several authors suggest that Sharia compliance process gives a crucial impact for an Islamic bank's operation and business. The presence of the SSB as one of the Board of Directors (BoDs) committee in an Islamic bank differentiates the governance structure of an Islamic bank from a conventional bank. In this context, the issues on the roles of SSB in the Sharia compliance process are critical, since Sharia compliance is the bedrock and identity of an Islamic bank.

The purpose of this study is to provide an in-depth understanding on the roles of SSB in assuring compliance with the Sharia requirements via the Sharia compliance process. Specifically, this study focuses on the role of the SSB as an independent body in an Islamic bank in facilitating the Sharia compliance process.

The behavioural theory of board and professionalism are utilised to develop themes in understanding the role of the SSB in the Sharia compliance process. There are three dimensions from the behavioural theory of board that explain the ability of the SSB to perform its roles in the Sharia compliance process, known as effort norms, cognitive

conflict, and the use of skills and knowledge. The theory of professionalism explains about the roles of the SSB contributes from the perspective of the professional power and the sustaining ideology.

This study is conducted using a qualitative method adopting semi-structured interviews with open-ended questions. This study extends the existing literature by providing empirical evidence on the sharia compliance process as one of the important governance mechanism within an Islamic banking industry in Indonesia. Due to the limited empirical research in the field of Islamic accounting, especially in Indonesia, this study contributes towards filling this gap.

This study presents two perspectives to develop the concept for evaluating the roles of the SSB in the Sharia compliance process in an Islamic bank. One, the findings point that; the roles of the SSB from the professionalism perspective are to advice, to regulate, to supervise and to audit. The *Quran* and *Sunnah* become the SSB's sustaining ideology to perform their roles in ensuring Sharia compliance in Indonesian Islamic banks. Two, from the perspective of the behavioural theory of board this study reveals that the roles of the SSB are to regulate, to control, to monitor and to provide the required services to facilitate the Sharia compliance process. It is hopes that the findings from this study can contribute towards enhancing the roles of the SSB in the Sharia compliance process in Indonesian Islamic banks. Among others, in improving the process of nurturing the sharia talents, in developing the operational standards and ethical standard for the SSB, and in improving the level of independence among members of the SSB.

ABSTRAK

Industri perbankan Islam mempunyai pertumbuhan luar biasa sejak beberapa tahun kebelakangan ini. Pada masa kini, bank-bank Islam beroperasi di negara hampir semua negara Islam dan di banyak negara bukan Islam. Aspek yang paling penting dalam sebuah bank Islam adalah proses pematuhan Syariah. Lembaga Pengawas Syariah (SSB) ditubuhkan untuk memastikan bank Islam mematuhi kehendak syariah. SSB sebagai sebuah badan bebas yang memperakui dan menjadi bahagian dalaman rangka kerja tadbir urus Syariah dalam sesuatu bank Islam supaya memberi jaminan bahawa semua produk, transaksi, dan operasi di bank itu mematuhi kehendak Syariah. Tujuan kajian ini adalah untuk menyelidik pemahaman yang mendalam dan menerokai peranan SSB dalam memastikan undang-undang Syariah, dan juga peranan SSB dalam proses pematuhan Syariah. Di samping itu, kajian ini memberi tumpuan di dua objektif utama ialah peranan SSB sebagai badan bebas di dalam pertubuhan bank-bank Islam, dan peranan SSB ke dalam proses pematuhan Syariah mengikut undang-undang Syariah.

Proses pematuhan Syariah adalah salah satu alat yang penting dalam rangka kerja tadbir urus Syariah dalam sebuah bank Islam. Beberapa penulis mencadangkan bahawa proses pematuhan Syariah memberi kesan yang penting untuk operasi bank Islam dan perniagaan. Kehadiran SSB sebagai salah satu Lembaga jawatankuasa (BODs) serta pengarah di sebuah bank Islam dalam membezakan struktur tadbir urus sesuatu bank Islam dari bank konvensional. Dalam konteks ini, isu-isu mengenai peranan SSB dalam proses pematuhan Syariah adalah kritikal, kerana pematuhan Syariah merupakan asas dan identiti sesuatu bank Islam.

Tujuan kajian ini adalah untuk memberi kefahaman yang mendalam mengenai peranan SSB dalam memastikan pematuhan kepada keperluan Syariah melalui proses pematuhan

Syariah. Secara khusus, kajian ini memberi tumpuan kepada peranan SSB sebagai sebuah badan bebas dalam bank Islam dalam memudahkan proses pematuhan Syariah.

Theory behavioural of board dan *professionalism* akan digunakan sebagai pembangunan tema dalam memahami peranan SSB dalam proses pematuhan Syariah. Terdapat tiga dimensi daripada *theory behavioural of board* yang menerangkan keupayaan SSB untuk melaksanakannya peranan dalam proses pematuhan Syariah, yang dikenali sebagai norma usaha (*effort norms*), konflik kognitif (*cognitive conflict*), dan penggunaan kemahiran dan pengetahuan (*the use of skill and knowledge*). Teori *professionalism* menjelaskan tentang peranan SSB menyumbang dari perspektif kuasa professional (*the professional power*) dan ideologi mampan (*sustaining ideology*).

Kajian ini dijalankan dengan menggunakan kaedah kualitatif menggunakan temu bual separa berstruktur (*semi structured*) dengan soalan-soalan terbuka. Kajian ini meliputi kesusasteraan yang sedia ada dengan menyediakan bukti empirikal mengenai proses pematuhan syariah sebagai salah satu mekanisme tadbir urus yang penting dalam industri perbankan Islam di Indonesia. Oleh kerana penyelidikan empirikal yang terhad dalam bidang perakaunan Islam, terutamanya di Indonesia, kajian ini menyumbang ke arah mengisi jurang ini.

Kajian ini membentangkan dua perspektif untuk membangunkan konsep bagi menilai peranan SSB dalam proses pematuhan Syariah dalam bank Islam. Satu, penemuan menunjukkan bahawa; peranan SSB dari perspektif *professionalism* adalah nasihat, untuk mengawal selia, untuk menyelia dan audit. Al-Quran dan Sunnah menjadi ideologi mampan SSB untuk melaksanakan peranan mereka bagi memastikan pematuhan Syariah di bank-bank Islam Indonesia. Dua, dari perspektif *theory behavioural of board* kajian ini mendedahkan bahawa peranan SSB adalah untuk mengawal selia, untuk mengawal, memantau dan menyediakan perkhidmatan yang diperlukan untuk memudahkan proses

pematuhan Syariah. Ia adalah harapan bahawa penemuan daripada kajian ini dapat menyumbang kepada peningkatan peranan SSB dalam proses pemuatan Syariah di bank-bank Islam Indonesia. Antara lain, dalam meningkatkan proses memupuk bakat syariah, dalam membangunkan standard operasi dan etika bagi SSB dan memperbaiki tahap kemerdekaan (*indepency*) di kalangan ahli-ahli SSB.

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“Indeed, along with hardship there is always ease. Then, which of the favours of your Lord will you deny? Allah will forgive my imperfect way”

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GLOSSARY OF ARABIC TERMS

<i>Akad</i>	Islamic traditional contract or often referred to Islamic principles as an instrument to replace the conventional system.
<i>Al-aqd</i>	Meaning as an obligation. Islamic financial products have to fully determined by the legality of permissibly (<i>halal</i>) and prohibition (<i>haram</i>) of actions.
<i>Al-ghunm Bi'l-ghurm or Al-kharj Bi'l-daman</i>	No part of the benefits without taking part in risk or to any benefit should be a real economic cost of the real economy.
<i>Al-Wadiah</i>	The old concept of <i>Amanah</i> , where one person hands over his or her assets to other person for the aim of safekeeping.
<i>Amanah</i>	Fulfilling or upholding trusts.
<i>Dzalim</i>	Injustice or unfair.
<i>Fiqh Al-Muamalat</i>	Islamic commercial jurisprudence or the rules of transacting in a Sharia compliant manner or the rulings governing commercial transactions between the parties involved.
<i>Fatwa</i>	Any religious decision made by mufti (Islamic scholar who is an interpreter or expounder of Islamic law).
<i>Gharar</i>	Uncertainty.
<i>Halal</i>	Legal of permissibly in Islam law
<i>Haram</i>	Something, which is forbidden to the people who are not in a state of purity who are not initiated into sacred knowledge or sinful action.
<i>Hiwalah</i>	Transfer of debt from the debtor to another person who is obliged to bear.
<i>Ijarah</i>	A financing contract with a sale contract of the right to use an asset for period of time.
<i>Infraq</i>	Issuing something for god or bad interest.
<i>Istisna'</i>	A financing contract for a commodity that can be managed before it comes into existence.

<i>Ju'ala</i>	A fee-based contract, which is can be applied for representation a specified service as opposed to the manufacturing of a product.
<i>Kafalah</i>	A financial guarantee whereby the bank gives a pledge to accreditor on behalf of the debtor to cover payments or any other personal liabilities.
<i>Maisyir</i>	Gambling.
<i>Maqasid</i>	Sharia objectives or purposes or parameter which means Sharia principles must be understood from an angle form purposes and objectives of Islamic law.
<i>Muakil</i>	The designator in <i>Wakalah</i> contract.
<i>Mudharat</i>	Losses for society.
<i>Mudharabah</i>	A form of joint capital and effort partnership with Proportionate profit and loss sharing.
<i>Mudarib</i>	Management expertise or entrepreneur as agent.
<i>Musharakah</i>	Equal position as partners and capital providers.
<i>Musyarakah fi Sahm Aash- Syarikah</i>	Equity participation
<i>Murabahah</i>	Non-PLS financing contract, which is used in sale transaction within Islamic banks and mostly used for trading and asset financing.
<i>Muamalat</i>	Social domain.
<i>Qard Hasan</i> <i>Al</i>	Benevolent loans or soft loans.
<i>Quran</i>	The Holy Book of the Muslims consisting of the revelations made by <i>ALLAH</i> to the Prophet Muhammad.
<i>Rab-Al-Mal</i>	The owner of capital.
<i>Rahn</i>	Holding one of the borrower's properties as collateral for a loan received.
<i>Riba</i>	An increase or additional to the premium that must be paid by borrowers to the lenders along with the principal as condition for the loan or for an extension to its maturity.
<i>Shadaqah</i>	Issuing treasure in the way of <i>Allah</i> , as proof of the honesty or truth of personal faith.

<i>Shahibul Maal</i> or <i>Rabbul Maal</i>	The customer depositors in <i>Mudarabah</i> contract
<i>Salam</i>	A non-PLS financing product with a form of forward agreement, where delivery happens at a future time in exchange for spot payment.
<i>Sharf</i>	Buying and selling currencies with other currencies.
<i>Shura</i>	The divine guidance in the <i>Quran</i> and <i>Sunni</i> and represents all aspects of the Islamic faith.
<i>Sunnah</i>	The most important source of Islam faith after the <i>Quran</i> and refers essentially to the Prophet Muhammad.
<i>Ujr</i>	Wages or commission.
<i>Ulama</i>	The body of scholars who are authorities on Muslim religion and law.
<i>Usury</i>	The ban of interest.
<i>Waaf</i>	Assets entrusted to an individual or organization for a specific charitable purpose.
<i>Wadi'ah</i>	Customer deposit, which must be preserved and restored at any time the customer wants.
<i>Wadi'ah Yad Amanah</i>	Safe deposit box.
<i>Wakalah</i>	A fee-based product, which is resulted from the bank acts as the agent of a customer to trade and to issue a letter of credit facility.
<i>Wakil</i>	An agent in the <i>Wakalah</i> contract.
<i>Zaqah/Zakat</i>	Religious obligation on the Muslim to pay predetermined percentage of the value of their annual savings, commodities, or properties to the Islamic state, mainly for the benefit of the poor and the needy.

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
AIG	American International Group
BAPEPAM	Badan Pengawas Pasar Modal (Indonesian capital market supervisory)
BCBS	Basel Committee on Banking Supervision
BCCI	Bank of credit and commerce international
BI	Bank Indonesia (Central Bank of Indonesia)
BoD	Board of Director
BUS	Bank Umum Syariah (Islamic commercial bank)
CSR	Corporate Social Responsibility
DSN	Dewan Syariah Nasional (Indonesian National Sharia Board)
GCC	Gulf Cooperation Council
GCG	Good Corporate Governance
IAH	Investment Account Holder
IAIB	International Association of Islamic Banks
IAS	International Accounting Standards
IFIs	Islamic Financial Institutions
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IFSB	Islamic Financial Services Board
IILM	International Islamic Liquidity Management Corporation
ISAU	Internal Sharia audit unit
ISCU	Internal Sharia compliance unit
ISRU	Internal Sharia review unit/department
MUI	Majelis Ulama Indonesia (the Indonesian <i>Ulama</i> council)
NPL	Non-Performing Loan
OECD	Organization for Economic Cooperation and Development
OJK	Otoritas Jasa Keuangan (Indonesian Financial Services Authority)
PBI	Peraturan Bank Indonesia (Indonesian central bank regulation)
PLS	Profit and Loss Sharing
ROE	Return on Equity
RUPS	Rapat Umum Pemegang Saham (General Meeting of Shareholders)
SFSB	Sharia Financial Supervisory Board
SSB	Sharia Supervisory Board
SSC	Sharia Supervisory Committee
UEA	United Arab Emirate
UUS	Unit Usaha Syariah (Islamic business unit)
LC	Letter of Credit
IDB	Islamic Development Bank
BCCI	Bank of Credit and Commerce International
GCG	Good Corporate Governance
CG	Corporate Governance
RI	Republic of Indonesia

CHAPTER 1: INTRODUCTION

1.1. Overview

The financial crisis that occurred in 2008 was described as the worst crisis since the Wall Street Crash and the Great Depression in the 1920s and 1930s (Turner, 2009). This financial crisis greatly affected various sectors, such as: capital markets, money markets and financial institutions. The global financial crisis in 2008 became one of the important historical events for the collapse of several major companies, such as the US giant investment bank Lehman Brothers and the big insurance company American International Group (AIG).

The 2008 financial crisis started from the United States in mid-2007 due to the credit crisis, or better known as subprime mortgages (Cheffins, 2009). This mortgage crisis has later led to the financial sector crisis. The main factor of financial crisis was caused by deregulation in the financial sector. The biggest possibility is that banks are involved in hedge fund trading in the form of derivatives. Ultimately, the bank as a financial institution innovates on the mortgage market by using mortgage-backed securities and loan guarantees-based bonds. This crisis is also caused by the rapid rise in house prices in the US. The increasing house price is due to the increasing value of the liquidity from the cash flows and the development of the subprime mortgage market, which is driven by the huge demand and the value of the housing.

The financial crisis in 2008 caused central banks and policy-makers around the world to deliberate several questions. According to Zamorski & Lee (2015) there are several problems that contribute to the financial crisis in 2008, namely, (1) weak supervision of the banking industry, (2) the ineffective role of supervisors in the banking industry, (3) supervision control has not been maximized, thus fail to identify problems

in the banking industry, and (4) insufficient use of macro prudential policies in controlling systematic risks. All of the above-mentioned factors show that there are some failures in managing risks as well as weak corporate governance.

As a result of this crisis, there are doubt on the role of conventional financial institutions in contributing towards efficient economy globally. According to Conyon, *et al.* (2011) the downfalls of conventional financial institutions are due to the following factors; (1) liquidity crisis, (2) sovereign crisis, (3) massive asset sales resulting in decline in asset prices, (4) declining value of banking assets, (5) solvency issues, and (6) ethics and disclosure issues.

The downfall occurred in conventional financial institutions because (1) their system of interest creates the money supply which is not back by the real economic activities, (2) the occurrence of financial transaction when there is no accessibility of funds, (4) the sale of assets where the asset is not yet available, and (5) transferring risk to borrowers (Krugman, 2009). The collapse of conventional financial institutions due to the financial crisis of 2008 did not give significant effect to sharia financial institutions.

The 2008 financial crisis trigger economist globally to search for possible alternatives to the conventional financial institution system due to the failure and collapse of various conventional financial institutions. The attention has been focused on Islamic banking and finance as an alternative model to the problematic conventional financial institution system. Derbel, *et al.* (2011) and Moody's Investors Services (2008) stress that Islamic financial institutions (IFIs) are more stable than conventional financial institutions. Karwowski (2009) argue that IFIs are more stable in the crisis period can benefit both the Muslim and non-Muslim as Islamic financial transactions are based on the sharing of profit and risk, focus on sustainable financing which are supported by real assets/and economics activities (Hassan & Kayed, 2010).

When discussing the impact caused by the 2008 financial crisis on IFIs, it is important to consider the three points, namely, supervision, the mode of transaction used, and the performance of the bank at the time of crisis and after the crisis. In terms of the transaction mode, various sharia contracts are adopted in structuring the deposits, financing and investments products. From the perspective of the supervisory policies, it was the unique method adopted in the control and risk-taking behaviour by IFIs that could lead to failure or success (Lewis, 2010).

The Islamic finance industry is becoming an important element of the financial system in an increasing number of jurisdictions. According to the Islamic Financial Services Board (IFSB) (2015) and Muhamad & Alwi (2015), the Islamic finance industry is currently estimated at US\$ 1.88 trillion to US\$ 2.1 trillion with the expectation that the market size would reach US\$ 3.4 trillion by the end of 2018. Bahrain, Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirate (UEA) and Turkey have the highest market growth. They are the driving force of the Islamic finance industry. This industry is not only limited to Muslim customers. Non-Muslim are increasingly involved as the major stakeholders in the operational structure of this rapidly growing financial system. This could be so because of its non-interest-based transactions. There are many factors behind the demand for Sharia-compliant financial products and transactions.

The interest-free Islamic finance system has established itself as a legitimate alternative to the traditional interest-based finance system. IFIs operate using Sharia principles in their financial transactions and operations. IFIs work within this limitation and have introduced various financial products and services, which are compliance with the Sharia law (Choudhury & Harahap, 2008; Choudhury & Hoque, 2006). IFIs operate based on trust. Rather than to attain pure financial outcomes, IFIs have the alternative performance objectives for safeguarding reputation, credibility and legitimacy. Further, IFIs are anticipated not to cause moral hazard and create any agency problem. It is due to

the existence of ethical or cooperative financial solutions to be extended to the society at large and are not subject to any particular ethical group (Nawaz & Haniffa, 2017). To ensure that products and services comply with the Sharia principles, IFIs are guided by an internal control body known as the Sharia Supervisory Board (SSB). These boards are established by IFIs to ensure that all products, transactions, operations and businesses are in compliance with the Sharia law. As a result, these boards play a crucial role in ensuring that the Islamic finance system maintains its fundamental principle and do not violate any requirement of the Sharia law.

IFIs are required to have an additional layer of corporate governance, known as Sharia governance as these institutions are required to comply with the Sharia law. Therefore, the establishment of the SSB is regarded as an extra layer of governance in the corporate governance structure in IFIs. SSB is as independent bodies of knowledgeable scholars, and it is part of the internal arrangement in the institutions forming part of its governance structure (Graiss & Pellegrini, 2006c).

SSB is entrusted to play crucial roles in ensuring a good Sharia governance mechanism is effectively implemented (Hasan 2009) and work as an internal control (Garas, 2012), a supervisor and an advisor (Andriana & Muhamad, 2015; Hamza, 2013) due to the requirement of IFIs to comply with the Sharia law. The failure of SSB in performing their role effectively will affect public confidence in IFIs and exposing them with the credibility risk. The dynamic and good Sharia governance is the very essence in the development of IFIs sector. Good Sharia governance assures the dynamicity of IFIs growth (Alnasser & Muhammed, 2012).

The focus of this thesis is to examine the roles of SSB in the Sharia compliance process. In particular, this study investigates the roles of SSB in Indonesian Islamic banks. The main focuses of the study are: First, to ascertain an in-depth understanding on the roles of SSB in Islamic banks. Second, to examine and analyse the roles of SSB in the

Sharia compliance process in Islamic banks.

This chapter presents an overview of the thesis. The next section describes the background to the study. Section 1.3 discusses the problem statement, followed by research objectives in Section 1.4. A brief account of research questions in Section 1.5 and Section 1.6 explains the research methodology of this study. Section 1.7 highlights the motivation for and contribution of this research. The organization of this thesis is presented in the final section.

1.2. Background of the Study

The collapse of reputable corporate and financial institutions in the 2008 financial crisis like Enron, Parmalat, WorldCom and Baring Bank, to mention a few during the last two decades exposed the deficiencies of such companies (Adeyemi & Adenugba, 2011; Okpara, 2011). Evidence gathered revealed that poor corporate governance resulted in those failures. The problems included poor management, fraud, violation of rules by management and board members, poor asset and liability management, poor regulations and poor supervision, among others (Babalola, 2010). As a result of the economic crisis in 1997, IFIs, including Islamic banks developed an alternative finance option to conventional financial services (Muhamad & Alwi, 2015; Muhamad, *et al.*, 2012). These IFIs came with the religious imperative to provide alternative financial services in accordance with the principles and teachings of Islam. The religious imperative demands the preservation of ethically-based credentials that include the ban on interest (*Usury*) and other exploitative and speculative activities and transactions, promotion of risk-sharing method, and managing innovation, entrepreneurship, and business using Islamic principles (Warde, 2010; Iqbal & Mirakhor, 2007).

All segments of the Islamic banking industry continue to record a moderate

growth rate. This industry has become an important factor in an increasing number of jurisdictions in the financial system. This increasing growth has also put the Islamic banking industry at a significant position. The Islamic banking industry has also developed as a religious alternative which provides financial services in accordance with Islamic principles (Archer & Karim, 2007). The financial infrastructure included standard setting and regulatory institutions saddled with the development of the Islamic financial industry. The Sharia standard setting and regulatory institutions were derived from principles rooted in the Sharia. Contrary to pre-existing secular financial systems, Islamic banks do not distinguish between religious and other aspects of life, including transactions falling under the political, economic, or social domain (*Muamalat*) (Hussain, *et al.*, 2015).

The Islamic banking industry is now well established in the global banking industry. Its growth has also been consistent for the past decades. The global financial crisis cast a doubt on the performance of conventional banking; hence, Islamic banks have continuously getting more attention (Beck, *et al.*, 2010). Islamic banks have to comply with the Sharia law (Mohammed, 2005). The fast growth and increasing acceptance of Islamic banks globally have successfully improved the offerings of Islamic financial products and services that are meeting the needs of both Muslim and non-Muslim customers (Muhamad, *et al.*, 2011; Muhamad, *et al.*, 2009).

The long-standing argument about corporate failures is not limited to conventional business and economics. The governance system in Islam is based on the principles of individual and societal rights; however, some recent examples presented the failures of these institutions in practice. Among these are some recent cases like *Nakheel Sukuk*¹ (Muhamad, *et al.*, 2011), Ihlal Finance House (Dusuki, 2007) and Dubai Islamic Bank

¹ The Islamic equivalent of a bond but created to comply with the principles of Sharia law, which bans paying or receiving interest (Muhamad, Melewar, and Syed Alwi, 2011; AAOIFI, 2010).

(The Peninsula, 2009). It portrayed the failure of effective governance in IFIs which raise doubt and concerns on whether IFIs are actually compliance with the Sharia principles.

Take an example of the case of *Nakheel Sukuk*, which is listed on the Dubai International Financial Exchange. These bonds are issued using a mortgage lease in the form of *Ijarah* and the proceeds of the lease are used for coupon payments to the *Sukuk* holders. In 2009, there was a delay in payments for an amount due for almost USD4 billion. As a result of this incident, this *Sukuk* has to be restructured, which cause concern and chaos among the *Sukuk* holders (Salah, 2010).

The second case involving the Dubai Islamic bank where a fraud involving almost USD501 million grant. As a result, seven bank employees including two executives were dismissed disrespectfully from their position. In this case, there is a fabrication of documents and fabricating of transactions in the provision of funds for large amounts of financing (Hasan, 2010). These examples describe the issues or problems that occur due to the weakness of Sharia governance mechanism, especially on the effectiveness of supervision in IFIs. It also shows that Sharia governance mechanism, which involves the monitoring IFIs' activities accordance to the Sharia law is not functioning well and effective.

The IFIs and Islamic banks operate alongside the conventional financial sector. This IFIs are also exposed to and experience the same systematic risk and volatilities as their conventional counterpart (IFSB, 2015). However, conventional and Islamic financial institutions needed different forms of corporate governance mechanisms. According to Basel Committee on Banking Supervision (2006), corporate governance (CG) is an important tool for banking systems to stimulate the notion of fairness, transparency and accountability among their stakeholders. Given the importance of good CG, this would result in a better performance of the banking sector.

Some challenges for the development of Islamic banks create a particular type of

organisation culture, which might give some potentially conflicting forces. For example, the need to establish a commercially viable enterprise capable of competing with conventional banks operating on a standard capitalist model. However, the Islamic banks must comply with the Sharia law and the establishment of institutional structures that determine this compliance to customers and outsiders. Muslim customers are willing to sacrifice some return in exchange for the confidence that their investments comply with the Sharia principles, but it cannot be assumed that any significant sacrifice of return, or security can be accepted by the majority of customers over a long period (Maali & Napier, 2010).

The Islamic banking industry is a financial industry that has a number of characteristics that underpin the need for strong Sharia governance. Islamic banks have their own degree of regulation and supervision, which places an utmost importance on ethical values. However, Islamic banks are also exposed to similar corporate governance failures as conventional banks. Islamic banks do not have immunity against financial crisis. It is argued that it is not always easy to practise the ethical values of Islamic law (Muhamad, *et al.*, 2011). Ethical identity became the trademark for Islamic banks since this philosophy is very important in the Sharia (Haniffa & Hudaib, 2007).

The main difference of IFIs as compared to conventional financial institutions is the requirement to have in place a SSB that consists of a number of Sharia scholars to oversee and advise IFIs on matters relating to the Sharia law (Ghayad, 2008; Grais & Pellegrini, 2006c). SSB functions as an internal control body and supervises Islamic banks to enhance their credibility in the eyes of its customers, clients and shareholders.

As religious organisations, Islamic banks have an orientation to follow a strict moral constraints that shape the precise context of the economic operations. These constraints are also expected to enhance the organisational morality. The well-defined moral guidelines or structures in these organisations will affect members to embrace the

morally responsible behaviour. Further, the religious values in Islamic banks can extend the moral accountability of their actors, such as, board of directors, SSB members, and managers. SSB as an additional governance mechanism has to ensure that Islamic banks as a religious organisation operate to comply with the Sharia law. SSB as an extra layer in the Islamic bank's governance structure is expected to additionally limit opportunities for financial misstatements and consequently moderate the higher agency cost (Abdelsalam, *et al.*, 2016).

Furthermore, SSB performs certain functions like directing, reviewing and supervising all activities, products and services of Islamic banks to ensure compliance with the Sharia law (AAOIFI, 2010). The role of the SSB is similar to that of an auditor. There is a similar approach between the auditor and SSB's activities. For example, SSB has to present verification on the Islamic banks' operation and system at the end of the year (Ghayad, 2008; Warde, 2000; Karim, 1990). Islamic banks have an obligation to compensate this board but SSB is expected to retain their independence (Karim, 1990).

On the other hand, some observers also criticize about the effectiveness of SSB's roles. For instance, the consistency in the application and interpretation of the Sharia law (Abbas, 2008; Karim, 1990). Since Islamic banks employ their own SSB members, there are concern on the failure to uniformly comply with the Sharia law and this presents a risk to the integrity, credibility and reputation of Islamic banks. This situation can influence SSB decision-making and consistency in Sharia interpretation. The non-compliance in the Islamic banks' activities, products and transactions can lead to a passive role of the SSB in the Sharia governance structure (Hamza, 2013).

Further, Sharia non-compliance risks may result from this situation and the asset values of Islamic banks will be affected. The direct effects of the Sharia non-compliance are the fund withdrawals from the investment account holder (IAH) and cancellation of investment contracts. This concern can cause a decline in profits and the performance of

Islamic banks. The Sharia non-compliance risks can influence public confidence and expose the Islamic banks to incredibility risk (Hamza, 2013; Muhamad, *et al.*, 2009).

SSB has an obligation to ensure that products, transactions and services offered to consumers and investors comply with the Sharia law. The lack of an active role by SSB results in the ineffectiveness of the Sharia governance system in Islamic banks (Muhamad, *et al.*, 2011). Muhamad, *et al.* (2009) also emphasized that religion and religiosity are the basic need that motivates consumers and investors to select this financial service, and thus, the management should emphasize these two points.

It is argued that SSB has vital position and functions which should make them directly involved in the Sharia governance process with the Board of Director (BoD) and managers. Islamic banks as a religious organization brings together social norms that suppress opportunistic behaviours (Abdelsalam, *et al.*, 2016). Grais & Pellegrini (2006c) opined that SSB has an important and multi-dimensional role; on the other hand, the SSB also faces some pressure to preserve Islamic banks reputation and image in relation to the financial services offered. Garas (2012) revealed that this situation might create a conflict of interest, which would lead to a doubtful situation regarding the SSB's integrity and credibility. This matter can impact potential profits and the performance of current projects and products in Islamic banks.

The increasing and growing importance of the Sharia compliance process in the Islamic banking system in the current economy is considered as part of the current Islamic resurgence. Islamic banks are running their business in many parts of the world, especially in the Middle East and Asia (Karim, 1996). Nowadays, most Islamic banks are less than 20 years old, but they are considered as an emerging power in international finance (Warde, 2000). Islamic banks in Indonesia also have grown significantly after the Asian financial crisis in 1997-1998 (Juoro, 2008). The Islamic banking industry is considered as the most established Islamic business organization (Zaher & Hassan, 2001). The

development of Islamic banks also has led Islamic banks to enhance the effectiveness of the SSB's roles as a key player in the Sharia mechanism (Abdullah, *et al.*, 2013).

Therefore, the research on the roles of SSB in Indonesia are taken to represent what is actually disclosed (or the actual) in practice. This study examines the effectiveness of the SSB's roles from the perspective to understand and to evaluate in depth the roles of SSB in the Sharia compliance process. This study is based on the premise that the Sharia compliance process is an important element in the Islamic banking industry. Indeed, the SSB as an important key actor in the Sharia compliance process is considered as an important organ in the overall governance structure.

1.3. Problem Statement

The recent failures and collapse of IFIs, such as *Nakheel Sukuk* (Muhamad, *et al.*, 2011), Ihlal Finance House (Dusuki, 2007) and Dubai Islamic Bank (The Peninsula, 2009) show that IFIs are not immune from the failure. It also raised an issue on the ineffectiveness roles of the SSB in IFIs. According to Greuning and Iqbal (2008) the unique feature of Islamic bank, which is compliance with the Sharia law necessitate the establishment of CG structures and processes that provide assurance all transactions and products comply with the Sharia law. SSB, operating either within the Islamic bank itself or through external institutions, has an obligation to ensure conformity with the Sharia law. SSB must ensure and monitor the compliance of the whole banking operations with the Sharia law.

SSB is an independent body of jurists that specializes in *Fiqh Al-Muamalat*.² SSB members may include an expert from other professions in the field of IFIs with the

² *Fiqh Al-Muamalat* is Islamic commercial jurisprudence or the rules of transacting in a Sharia compliant manner or the rulings governing commercial transactions between the parties involved (AAOIFI, 2010).

knowledge of *Fiqh Al-Muamalat*. SSB is entrusted with the obligation to direct, review, and supervise activities, products, services and transactions of IFIs to comply with the Sharia laws and principles. The *Fatwa*³ and pronouncements issued by the SSB are binding on IFIs (AAOIFI, 2010). The main role of SSB is to ensure all activities, products, services and transactions of Islamic banks are in compliance with the Sharia law. Therefore, the SSB is important as the Sharia compliance gatekeeper in the Sharia governance structure (Grais & Pellegrini, 2006c). Abdullah, *et al.* (2014) stated that SSB has an obligation as Sharia advisors to ensure Islamic banks' comply with the Sharia law. SSB tasks are much more comprehensive as compared to BoDs in conventional banks. SSB members are compelled to master knowledge and skill in the Sharia law, banking activities and systems.

SSB as a key organ of the Sharia governance structure presents rules, policies and regulation to Islamic banks according to the Sharia law. The approach that has been used by Islamic banks in achieving good Sharia governance is always aligning all business activities to the sharia law and Islamic moral guidelines (Rahman, 1998). According to Sharia governance, stakeholders' interests are not only financial but also include ethics and moral values. The stakeholders also expect IFIs to comply with the Islamic law (Iqbal & Mirakhor, 2004). Supervision of ethical characters to transactions, services and product development is not sufficient, the behaviour of directors and the frameworks of the organization are also very important, and all these should be monitored by the Sharia boards (Racha, 2008).

SSB members are individuals who have good reputations in the society because of their broad knowledge and important roles they play in the society. Islamic banks urgently need individuals who are experts in the Islamic commercial law and are able to

³ *Fatwa* is any religious decision made by mufti (Islamic scholar who is an interpreter or expounder of Islamic law) (AAOIFI, 2010).

apply Sharia principles and rules to modern practices, such as in the banking sector (Grais & Pellegrini 2006c; Ghayad, 2008; Hameed, 2009).

The unique requirement of Islamic banks to comply with the Sharia law has resulted in greater attention to Sharia governance, resulting in three operational situations. The first is that Islamic banks have to comply with the Sharia law and also conform to banking regulations (Archer, *et al.*, 1998). Most depositors and investor are extremely concerned about the compliance of Islamic banks with the Sharia law. The compliance of Islamic banks with the Sharia law has a significant impact on the fund they put in those banks. The SSB is expected to assure depositors and investors that all the business activities and operations in the bank are in accordance with Sharia rules since most depositors are prepared to withdraw their fund if the bank fail to comply with the Sharia law.

The second situation is that there are no fixed rules about IAH (investment account holder) in Islamic banks. According to Chapra & Ahmed (2002) and Nienhaus (2007), these account holders could be involved in conflicts that occur within agencies because the investment account products are structures based on the profit loss sharing contract (PLS)⁴ like shareholders. This conflict initiates the agency cost and increases the legal liabilities for managers in Islamic banks (Abdelsalam, *et al.*, 2016; Belal, *et al.*, 2015). Furthermore, SSB guarantees the protection of the account holders' interest by ensuring that all banks activities comply with the Sharia principles and rules. As for the third situation, Claessens (2006) emphasized that most Islamic banks operate in emerging markets, where the institutional environment have a big influence. The influence of ownership concentration, family control, monitoring costs, lack of market discipline and

⁴ Profit loss sharing (PLS) is the method utilized in Islamic banking to comply with the prohibition of interest (Van Greuning and Iqbal, 2007).

asymmetric information still appear in such markets. Hence, these conditions making the role of the SSB as more important in ensuring good governance in Islamic banks.

Other factors that has led to greater attention on Sharia governance according to Abbas (2008) and Karim (1990) are due to the lack of consistency in the application and interpretation of the Sharia law. There is some concern that SSB might not fully comply with the Sharia rules and principles since they are employed by Islamic banks. Other factor that may results in differences among Islamic banks is the different interpretation of the Sharia law by jurists in various Muslim countries. In addition, Abbas (2008) also mentioned that there is a shortage of qualified and experienced SSB members as the Islamic banking industry has grown remarkable resulting in Islamic banks employing less qualified scholars which raised doubt on their competency level to effectively discharged their duty in ensuring Islamic banks are fully compliance with the Sharia law.

Together, the above-mentioned factors and criticisms regarding the roles of SSB has raised doubt and concern on the effectiveness of the Sharia governance mechanism in IFIs. The roles of SSB in the Sharia compliance process remains unexplored due to the lack of information about the actual practices of how SSB members discharge their responsibilities in assuring Sharia compliance. More research in this area would help the Islamic banking industry and researchers to have a better understanding of the role of the SSB in ensuring Sharia compliance. This study provided an understanding of the current roles of SSB in the Sharia compliance processes in practice. This study also drew some crucial conclusions about SSB's role; hence, Islamic banks can have a better understanding of how to protect the interest of their stakeholders by assuring the Sharia compliance of products, services and operations.

Further, some observers also highlighted the difference of Sharia opinion on supervision in Islamic banks. The differences of Sharia opinion influence the Sharia decision-making process (Clack, 2008). There is a shortage of individuals qualified for

the roles of the SSB. As a consequence, Islamic banks have some issues of trust and transparency. Some people criticize the lack of Islamic elements in Sharia financial products and services that led to erosion in the Sharia values in the structuring of Islamic banking products and services. Increasingly, society demands Islamic banks to balance up their financial activities, putting importance on both the religious and commercial objectives.

SSB as an internal Sharia governance mechanism has a direct involvement to monitor the Islamic banks' activities and products in accordance with the Sharia law (Waemustafa & Abdullah, 2015). According to Alnasser & Muhammed (2012) the main reason of the establishment of SSB in the Sharia governance mechanism is to ensure that activities, transactions and products are in compliance with the Sharia law. Sharia non-compliance will result in the bank losing confidence from stakeholders. The *Fatwa* and SSB supervise the application of different aspects of Sharia in the bank. It also ensures that all the transactions and products comply with the Sharia law. The board is further sanctioned with the right of contradicting (*Fatwa*) any violating procedures, if found.

Karim (1990) stressed that SSB has an obligation to supervise and monitor IFIs in the Sharia compliance process. However, he raised concern on the independence of the SSB members as they are internal adviser, and their independence will give impact on the credibility of Islamic banks. Rammal & Parker (2010), Safieddine (2009) and Warde (2010) focus also study on the issues of governance in Islamic banks. The finding of these studies showed that there is evidence of lack of monitoring in the Sharia compliance process. Criticisms on the practices of moral credential may place Islamic banks to face a risk of being challenged on religious ground. This risk can affect the reputation of Islamic banks.

Critics from Hayat, *et al.* (2013) and Dranove & Jin (2010) identified that the Islamic bank's heavy reliance on the advice of SSB in the sharia compliance process. It

may lead to a risk of certifier bias as most of the theological exegeses based on personal judgement occur in the course of interpretation of the Sharia law. The SSB's tacit knowledge, comprehensive understanding, independence, competence and effectiveness in examining the complexity of financial instruments become the main factors and challenges in interpreting and deciding on the approval of contracts and products (Hayat, *et al.*, 2013; Ünal, 2011; Ramal & Parker, 2010; Shanmugam & Zahari, 2009).

Present literature supports Islamic banks as the provider of Sharia financial products and services should have in place an efficient Sharia compliance process to ensure their overall operation are in compliance with the Sharia law. It is suggested that Sharia compliance process has a crucial influence on the products and services. Hence, this main objective of this study is to ascertain an in-depth understanding on the roles of SSB in the Sharia compliance process at Islamic banks in Indonesia since the review of the extant literature established that there is no other study has empirically demonstrated this observation.

1.4. Research Objectives

The extant literature suggested that SSB operates either as an internal body or outsource to external institutions to ensure the business' activities, operations and transactions are in line with the Sharia law. Most literature focused on Sharia compliance as a central requirement. This study emphasizes the SSB members as an individual actor within the Sharia compliance process. In this case, the study examines the SSB as an independent body, as an extra layer in the Sharia governance structure within Islamic banks. Each member of SSB has an obligation to ensure products and financial instruments that are in compliance with the Sharia law.

The compliance process becomes the most important process to determine smooth and successful banking operations (Basel Committee on Banking Supervision, 2006). In the Islamic banking industry, any action for non-compliance activities and operations would lead to serious damage as it would deliberately expose banks to compliance risks. Shanmugam (2005) stated that the Sharia compliance process form part of the crucial element in the Sharia governance structure within the Islamic banking environment. Islamic banks are governed under the Sharia law, which forms an important law in governing the banking transactions and operations. As part of Sharia governance structure, the roles of the SSB is automatically becomes a central key for the Sharia compliance process. Its roles are pertinent in ensuring that a comprehensive and rigorous compliance process is in place and effectively implemented.

Therefore, the main research objective of this study is to ascertain an in-depth understanding of the roles of SSB in the Sharia compliance process at Islamic banks. In particular, this study examines the definition and the effectiveness of the roles of SSB in ensuring compliance with the Sharia law. Thus, various issues relating to the Sharia compliance process in Islamic banks are examined to ascertain the perception of the SSB. The extant literature provides limited knowledge on the effective roles of the SSB in Islamic banks.

Consequently, the specific aims of this study are to:

1. Understand the definition of the effective roles of SSB in the Sharia governance.
2. Examines the effectiveness of SSB roles in the Sharia compliance process.
3. Determine issues and problems facing by SSB in performing their effective roles in the Sharia compliance process.

1.5. Research Questions

Previous studies in Islamic banks asserted that the SSB should fulfil their roles in the Sharia governance structure. The SSB is similar to the BoD, but it has the obligation of ensuring the compliance with the Sharia law (Garas, 2012; Karim, 1990). As discussed earlier, the focus of this study is on the roles of SSB in the Sharia compliance process, it is a relatively new issue and remains largely unexplored. The lack of research has contributed to the inconsistencies perception on the Sharia compliance process, which contribute towards ineffective Sharia governance in the Islamic banking industry. The SSB effectiveness in the Sharia compliance process relates to how the SSB members fulfil their roles in the Sharia compliance process.

Given the limited literature on the roles of the SSB in the Sharia compliance process, in particular in the Indonesia context, this study explores the experiences and perceptions of key individuals, i.e. the SSB members, who were involved in the Sharia compliance process. This study provides an in-depth insight onto the roles of the SSB in the Sharia compliance process. The experiences of the SSB members is important in this process. A qualitative approach was used to gain a better understanding of the key actors' experiences in the Sharia compliance process. Kazmi (2003) emphasized that *dig the gold* approach is an effective method to use focusing on matters related to human behavioural issues in the organization. The qualitative method with *dig the gold* approach could help to develop and disseminate ideas on the findings obtain in this study.

Therefore, the essential purpose of this study is to gain an in depth understanding on the roles of the SSB in the Sharia compliance process in Indonesian Islamic banks. Thus, the main research question is,

What are the roles of the SSB in the Sharia compliance process?

The proposed research question represents a two-part study that are interrelated. This is an exploratory research to ascertain the definition of the effective roles of the SSB and to gain an in depth understanding on why the roles of SSB are very crucial in the Sharia compliance process. The specific research questions for this study are:

Sub-question 1: *What is the definition of an effective roles of the SSB?*

Sub-question 2: *How are the roles of the SSB in the Sharia compliance process been carried out?*

1.6. Research Process

This study adopts a qualitative approach. A case study is conducted to provide answers to pertinent questions about the roles of SSB in the Sharia compliance process. Patton (2002) opined that a qualitative research can explain phenomena in a real-world setting without any manipulation. The case study analysis utilising a qualitative approach is implemented in this study.

Some issues were considered for the case study design. These include: (a) *Why* and *how* the SSB operate, the definition and identification of their effectiveness in the Sharia compliance process in Islamic banks in Indonesia; (b) The analysis of this phenomenon in the Sharia compliance process in Indonesian Islamic banks, and (c) the determination of issues that are found in the practice. This case study is an exploratory in nature.

The data for this research was collected in the Indonesian Islamic banks. Due to the main focus of this study, which is to examine the roles of the SSB in the Sharia compliance process, therefore, semi-structured interviews are conducted with the SSB members of Islamic banks in Indonesia. A semi-structured interview is constructed to identify and examine the behaviours and relationships involved in a case study (Clack,

2008). The important points and patterns emerging, discontinuing and re-emerging are acknowledged across the whole period of the study through the processes of noting, memo writing, subsequent analysis, coding and analysing of both accumulated process and reflective notes (Hammersley & Atkinson, 1995). These themes and patterns are developed inductively from the analysis of interviews and documentations. These methods were used to identify the relationships between the concepts, and influences that impact the process and the apparent outcomes of the SSB roles.

1.7. Motivation and Contribution of the Study

In line with previous studies, this study divided the concept of motivation and contribution into two: theoretical and practical contribution. This study provided an opportunity to enhance both the theoretical and practical perspectives of the Sharia compliance process in Islamic banks. The purpose was to provide an in-depth description of the motivation and contribution of this case study.

1.7.1. Theoretical Contribution

This topic is relatively new in the Islamic bank literature and has increasingly getting attention from scholars and researchers. The issues and problems that lead to failures and collapse of various IFIs, especially in the banking industry, have intensified interest in this research area. Most researches on corporate boards focus on conventional institutions (Dalton et al., 1999), (Boyd, 1994) and (Zahra & Pearce, 1989). Due to the basic need for risk minimization, a good and efficient Sharia governance structure is considered crucial for Islamic banks. As one of the essential key participants in Islamic banks, the SSB has become the central organ of the Sharia governance structure, which is responsible to provide assurance on matters relating to the Sharia compliance. As a

result, the study of the roles of SSB practices has a profound influence on this topic. This study investigated the importance of SSB roles in Islamic banks. This study contributed to the existing knowledge by providing an in depth understanding of SSB roles, in particular, the professionalism perspective. This perspective concentrated on how professionalism as a societal structure influences the SSB roles in Islamic banks (Birkett & Evans, 2005; Macdonald, 1995; Abbot, 1988).

As an organization, Islamic bank has a different principle from conventional bank. Therefore, different social environments influence the behaviour in a conventional system. Finkelstein and Mooney (2003) suggested that the examination of the board be carried out to understand the decision-making process. In addition, the recognition of the SSB as a guardian and gatekeeper in Islamic banks plays a very important role in the Sharia compliance process. This approach assisted this research to understand the roles of the SSB and how they respond to the Sharia compliance process. This can be explained by the fact that this approach treats organizations as unitary actors developing strategic responses to pressures (Greenwood & Hinings, 1996) and the choice process between conformity and resistance used by the SSB in the Sharia compliance process in Islamic banks (Oliver, 1991).

This study explored the roles of the SSB through the professionalism and behavioural of board processes. Given the importance of the SSB roles in the Sharia compliance process, this study is important for many reasons. From a theoretical perspective, this study contributes to the development of Sharia governance through an increased understanding of the SSB roles in the Sharia compliance process, an area that has been acknowledged as lacking in the Sharia governance literature. Thus, this study filled a gap for the need of research into the roles of the SSB (Birkett & Evans, 2005) and calls for a greater focus on the individual aspects of the SSB behaviour (Sonnenfeld, 2002 and Pettigrew & McNulty, 1998). The knowledge gained from this study will form a basis

for future studies into the roles of the SSB. Additionally, this study will inform future researchers about the impact of the SSB in the Sharia compliance process. This study explored the roles of the SSB in the Sharia compliance process by using behavioural theory of boards (Van Ees, *et al.*, 2009; Huse, 2007).

Further, this study developed an intuitive concept to facilitate the understanding of the Sharia compliance process, and the dynamic of the Sharia compliance process from the SSB perspectives across the Islamic banking industry. Due to the lack of consensus on the SSB roles in the Sharia compliance process, the Islamic financial industry is trapped in a battle of defining critical religious restrictions. Islamic banks are stuck between the legal roles of the SSB in the Sharia compliance process. The SSB seeks to build a moral commitment to comply with the Sharia law. As a result, the topic of the role of the SSB in the Sharia compliance process is flourishing within existing academic research as a consequence of the industry's focus on legitimizing compliances to the religious law (Al Haiti, 2009; Al Nashmi, 2002; Bakar, 2002; Abu Ghudda, 2001). Hence, more in-depth studies are needed to examine the roles of the SSB in the Sharia compliance process. A better understanding of the definition, concept, interpretation and implementation of the Sharia law at regulatory, institutional and individual levels in the Islamic banking industry is clearly essential.

The main foundation of a financial system in Islam is the Sharia compliance process. Islamic banks are compelled to follow a set of institutional arrangements to manage the Sharia compliance aspects of business operations and transactions. Many previous researches focus on risk ratio and risk management (Mohd-Sanusi, *et al.*, 2015), corporate social responsibility (Raman & Bukair, 2013), exposure draft of the Sharia audit framework (Rahman, 2011), and Sharia non-compliance risk (Shafii, *et al.*, 2010). Due to the limited research on the Sharia compliance process within Islamic banks, especially in the SSB roles, Islamic banks have innovatively established the Sharia compliance

process mechanism as part of the obligation to meet stakeholders' demand. This research emphasized the internal dynamic within Islamic banks by focusing on the roles of the SSB in the Sharia compliance process. Although, various researches were conducted on Sharia compliance process, among others, Hassan (2011), Muhamad (2011), Grais & Pellegrini (2006c), Maali, *et al.* (2003), Bakar (2002), Rahman (1998) and Karim (1990); they mostly cantered on the exploratory aspect of the Sharia compliance process. Empirical research is scarce, in particular, update data, practical evidence and micro perspective analysis on the SSB roles in the Sharia compliance process.

Finally, information from previous researches on the decision-making processes and perceptions surrounding the activities of the corporate boards in particular organizational contexts are limited (Filatotchev & Boyd, 2009). Brown *et al.* (2011) determined some difficulties in the measurement of the quality of corporate boards because researchers had problems in the econometric analysis of the data when trying to explain the causes and the effects of policy decisions. Brown *et al.*'s research also identified the lack of clarity on the boundaries in the structure of databases. Most of the databases from the corporate boards were only compiled annually, some of which have remained unchanged for long periods of time and it does not provide an accurate picture of the process of corporate boards' decision-making. Therefore, Kazmi (2003) addressed the *dig the gold* approach, which uses the qualitative method based on the philosophical foundation and comprehensive approaches. This research used the *dig the gold* approach in an interview with the SSB members to determine their roles in the Sharia compliance process within Islamic banks on the perspectives they represented the board members. As a result, this study can capture the definition and the effectiveness of the roles of the SSB members in the actual practice relates to the Sharia compliance process.

1.7.2. Practical Contribution

This research contributes empirical evidence utilising primary data. Until recently, the SSB members are generally reluctant to provide access to data on their roles in the Sharia compliance process. It has to a certain extent dampened research in these areas. Attracting the targeted interviewees to participate in this study shows that the SSB members are willing to contribute to scholarly research in the Sharia governance issues in the Indonesian Islamic banks. In the view of the SSB roles and compliance process, there may be a need for the government and other institutions in Indonesia to consider the possible need to look beyond the current Sharia governance framework.

This research takes the Indonesian Islamic banking industry as a case study because the Indonesian banking industry developed a new banking system for new instruments, transactions' system, policies, and governance applications. The empirical findings from this research can be used to strengthen the existing Sharia governance system and framework in Indonesia. The findings established in this research can significant contribute to the Indonesia banking industry in addressing issues and challenges in the Sharia compliance process aspects, which are related to the roles of the SSB (Grais & Pellegrini, 2006c) in the Sharia governance framework in Indonesia. In addition, this study proposes a Sharia compliance framework for the purpose of enhancing the Sharia governance process in the Indonesian Islamic banks.

This study provides an opportunity to Islamic banks to improve the effectiveness of the SSB by understanding the SSB's roles in the Sharia compliance process. The recent cases like *Nakheel Sukuk* (Muhamad, *et al.*, 2011), Ihlas Finance House (Dusuki, 2007) and Dubai Islamic Bank (The Peninsula, 2009) have heightened the need for the SSB to improve their performance in relinquishing their roles. The SSB as an extra layer of the Sharia governance need to understand the Sharia compliance process; hence, enabling them to discharge their roles more effectively. Thus, understanding the determinants of

the SSB roles is pertinent as SSB members are engaged in various important roles. More importantly, this study explored the most important roles of the SSB in ensuring that activities, transactions and products comply with the Sharia law.

There are various issues about the effectiveness of the roles of the SSB. Competency is the main challenges in ensuring the effective role of the SSB in the Sharia compliance process. Since the Sharia scholars are appointed to sit on the SSB have great responsibilities, it is very important that high calibre scholars are selected. There is currently a shortage of appropriately qualified scholars to provide rigorous challenge and oversight on bank's products and services (Garas, 2012). In addition, the independence issue is also a challenge in the governance structure of Islamic banks in Indonesia. Due to the shortage of scholars, many members of SSBs in Indonesian Islamic banks hold position in more than one Islamic bank and have access to exclusive information. Based on Bank of Indonesia (BI) regulation number 11/33 / PBI / 2009 concerning the aspect of SSB's transparency. SSB members are required to disclose dual positions as members of SSB in other IFIs in the report on the implementation of corporate governance (Bank Indonesia, 2009). Acting as a SSB member in more than one Islamic bank can create the possibility of serious conflict of interest (Garas, 2012). Due to the shortage of the qualified scholars, this study also examines the needs to establish a pool of Sharia talent by providing the needed training and education.

1.8. Organization of Chapters

This thesis is divided into eight chapters comprises of literature review, the conceptual framework for the SSB, research methodology adopted in the study, the presentation of results and findings of the study, discussion and conclusions. These chapters are organized as follows:

CHAPTER ONE: INTRODUCTION

This chapter provides an overview of the research. It provides the background of the study, problem statement of the research, research objectives and questions, research process as well as the motivation and contribution of the research. The chapter also provides the organization of the thesis.

CHAPTER TWO: ISLAMIC BANKING INSTITUTIONS

The objective of Chapter Two is to outline the underlying context, the nature and historical development of Islamic banking institutions, as well as the basic principles that underline the operations of Islamic banks. The chapter presents the historical background of the Islamic banking industry in Indonesia and the regulation that supports Islamic banks in Indonesia. An overview and brief discussion of the Sharia financial products and services in Islamic banks are presented in this chapter as well as those that are offered in the Indonesian Islamic banks. This chapter discusses the operations of Islamic banks in Indonesia, which can be categorised into fund collection, fund distribution, services, and social activities.

CHAPTER THREE: THE SHARIA GOVERNANCE IN ISLAMIC BANKS

This chapter provides an overall understanding of the Sharia governance in Islamic banks. The corporate governance model for Islamic banks, specifically, the Sharia governance model in Islamic banks is designed based on the followings; the Sharia principles and law of property rights and contracts, the unique requirements of products and services as well as operations of Islamic banks, i.e. compliance with the Sharia law, and also the protection of stakeholders' rights. Stakeholders in an Islamic bank include the management, shareholders, employees, suppliers, depositors and also the society at large. This chapter discusses the nature of the Sharia governance in Islamic banks, Sharia compliance process

as an important element of the Sharia governance, and also the Sharia governance structure and process in the Indonesian Islamic banks.

CHAPTER FOUR: SHARIA SUPERVISORY BOARDS

This chapter describes the development of the Islamic banking industry in Indonesia and the basic framework that underlies its practice. It also provides an overview of the profile of SSBs in Indonesian Islamic banks. The development of the Islamic banking industry in Indonesia after the economic crisis in 1997-1998 is presented whereby a restructuring of the financial system has been conducted by the Indonesian government (Siregar & Ilyas, 2000). Islamic banks are expected to play a greater role and becoming an important catalyst in the Indonesian economy post restructuring exercise. The CG practices for Islamic banks are regulated by the regulation No. 11/33/PBI/2009 (PBI 2009) from the Indonesian Central Bank (BI). PBI 2009 is issued as a guideline for the CG effectiveness in the Indonesian Islamic banks to achieve a healthy and strong foundation for the accomplishment the *Maqasid* of Sharia (Abdullah, 2000; Bank Indonesia, 2009). In the Indonesian Islamic banks, the SSB is regarded as an extension of the National Sharia Boards (Dewan Syariah Nasional/DSN). The DSN ensures Fatwa presented by the SSB are in accordance with Sharia principles (Bank Indonesia, 2004).

CHAPTER FIVE: THEORITICAL FOUNDATION OF THE RESEARCH

This chapter discusses the relevant theoretical perspective underpinning this research. In this chapter, the theoretical framework for the interpretation of data gathered in this study are identified. The theories of professionalism (Birkett & Evans, 2005) and board process (Finkelstein & Mooney, 2003) are discussed. As the focus of the study is on the SSB roles in the compliance process, which is regarded as one of an important governance processes, the behavioural theory of board (since the roles of the SSB is similar to the BoD) and professionalism are utilised for the interpretation of data collected via in depth interviews. The three attributes, known as effort norms, cognitive conflicts and the use of

skills and knowledge as illustrated by Forbes & Milliken (1999) are applied to explain the ability of the SSB in performing their roles. In addition, the professional power and sustaining ideology as advocated by Birkett & Evans (2005) under the professionalism theory is adopted to describe the roles of the SSB.

CHAPTER SIX: RESEARCH METHODOLOGY

This chapter presents discussion on the research philosophy, research method, unit of analysis, Islamic banks selected for the case studies, and conceptual framework of the research. This chapter outlines and discusses the key aspects of the research design, research strategy, and the empirical techniques applied based on the philosophical assumptions underpinning in this study. The ontological and epistemological biases are examined in this chapter. This chapter also discusses the rationales for using the interview method. This chapter presents the unique challenges of the SSB as an extra layer in the Sharia governance structure in Islamic banks. Discussion on the rationale of adopting the case study approach, selected samples, interview guide, data collection procedures, data analysis, validity and reliability, and ethical consideration are all presented in this chapter.

CHAPTER SEVEN: FINDINGS AND DISCUSSION

Chapter Seven presents the result the study. It discusses the overall findings obtained from in depth interviews conducted with the selected SSB members. The semi-structured interview with open-ended questions is utilised in this study to enable the researcher to acquire related information on the Sharia compliance process from the selected participants. The analysed data provide an insight into the roles of the SSB in the Sharia-compliance process. The result and findings emerged from the data analysis are interpreted based on the two theoretical perspectives identified in Chapter 5.

CHAPTER EIGHT: SUMMARY AND CONCLUSION

Chapter Eight presents the conclusion of the thesis. This chapter presents a summary of the main findings and drawn the importance of these findings. The chapter highlights the potential theoretical and practical implication on the roles of the SSB in the Sharia compliance process in an attempt to strengthen the overall Sharia governance process in the Indonesian Islamic banks. An improved Sharia governance framework was proposed to include an additional unit known as the Sharia Research Unit as well as to consider appointing professional from legal, banking and accounting background to also sit on the SSB of Islamic banks. The establishment of the Sharia Research Unit is expected to provide robustness in the Sharia deliberations and discussion for the final decision making in matters pertaining the Sharia law. The appointment of members from other professional background will add diversity to the SSB membership and is expected to provide a holistic view in analysing arising issues. The limitations and recommendation for future research are also discussed at the end of this chapter.

For the purpose of clarity, Figure 1.1 summarizes the arrangement of the chapters in this study.

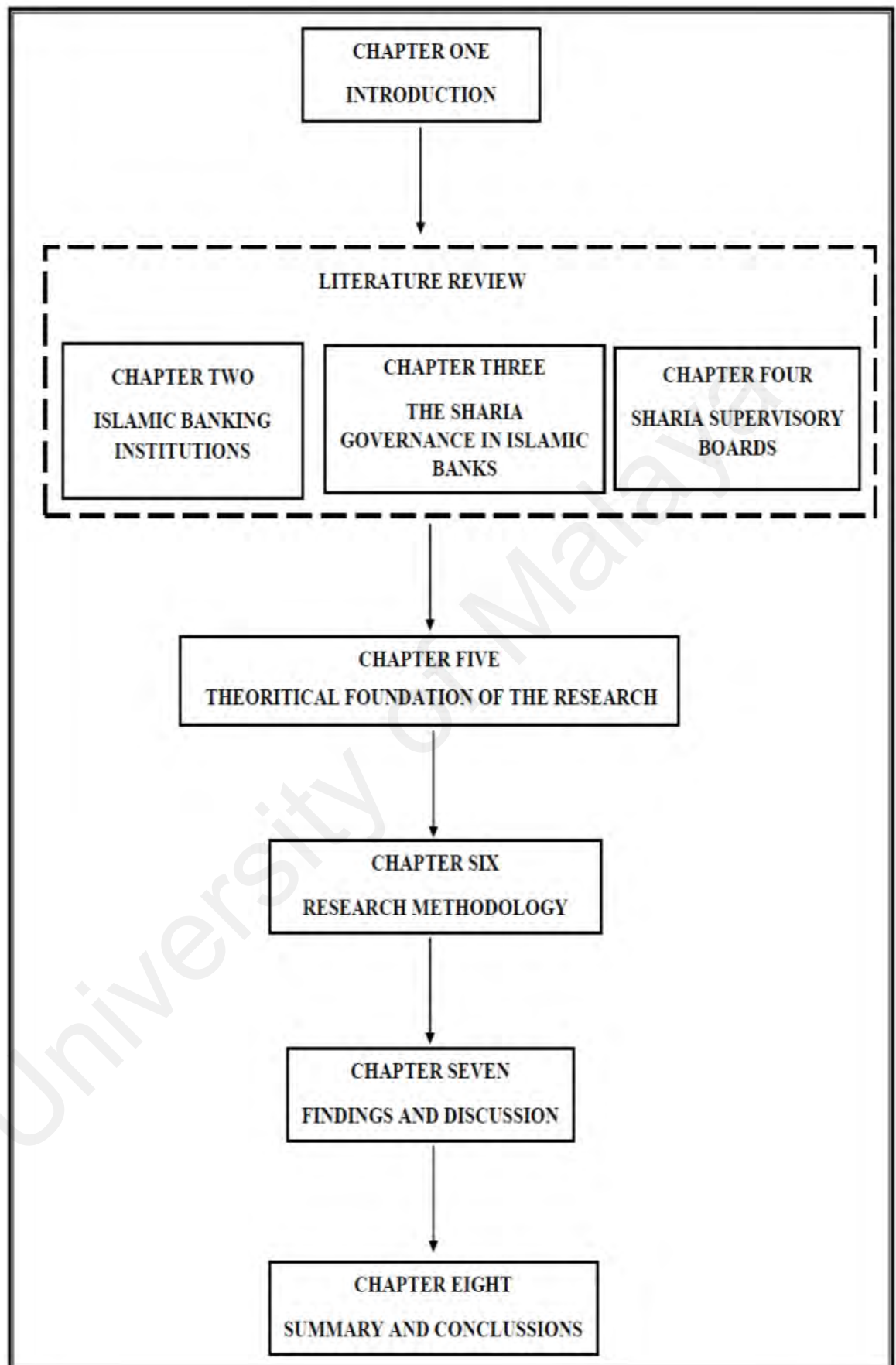


Figure 1.1: Overview of the Study

CHAPTER 2: ISLAMIC BANKING INSTITUTIONS

2.1. Introduction

This chapter describes the objectives of the historical development of Islamic banks. Then, the basic underlying context of Islamic banking institutions, and its principles, and the Sharia principles of the products and services are highlighted in this chapter. In addition, this chapter also explores the operational practices, products and services in Indonesian Islamic banks.

2.2. The Historical Development of Islamic Banks

Islamic banks were established with the main objective to fulfil the Sharia needs of the Muslim society in carrying out business and financial activities. Islamic banks are regulated by Islamic ethics and morality. It is prohibited for the financial instruments and activities to incorporate interest-based transactions (Iqbal & Molyneux, 2005). Greif (1989) stated that *Maghribi* traders practised a form of joint capital and effort partnership with proportionate profit and loss sharing (PLS/*Mudharabah*) in the medieval era known as *Commenda*. *Maghribi* traders built the partnership-based financial model to encourage entrepreneurship. It also empowered the active partners to have equal positions as partners and capital providers (*Musharakah*). This business approach implied that the risks were equally distributed for all participants and provide an ideal economy for entrepreneurship.

Initially, the practice of this business technique was in the form of trade and investment in the Muslim world where it began from the 10th century onwards. During the early stages of Islam, Muslims succeeded in setting up trades without involving interest. This is evident from the wide use of the partnership and profit-sharing investment tools in the 12th and 13th centuries in the Mediterranean (Iqbal & Molyneux, 2005). Meloy

(2003), in his book, stated that Ahmad ibn ‘Ali al-Maqrizi (1364-1442), a scholar in religious sciences with a specialization in writing, argued that the management of monetary affairs should be in accordance with the practices of Muslim societies in the past.

Al-Maqrizi put forward the issues of the economic crisis that occurred due to ‘political corruption, the increasing prices of land and the circulation of copper money’; all these affected ‘the distribution of income and wealth between social classes’. He proposed a scheme to reform the monetary sector in Egypt (1250-1517), adopting similar financial activities similar to modern banking practices but in line with the Sharia law. He suggested that the practice of joint capital effort partnerships (*Mudharabah*), in addition to *Zakat (Zakah)* and *Waqf* would play the main role in the public financial system (Diwany, 2010; Sabra, 2000). However, during the economic growth and rapid development of banks in the West, the practice of interest became widespread. The conventional financial system spread to Muslim countries through trading and colonization. Hence, Muslim countries started to apply it in their banking systems (Iqbal & Molyneux, 2005; Thani, *et al.*, 2003).

The need to ban interests on banking activities initiated the establishment of interest-free principles in the Mit Ghamr Local Savings Bank and Nile Delta of Egypt (Haron & Shanmugam, 1997). These institutions accepted little amounts of savings from rural sectors depositors and no interests were paid. Then, the entrepreneurs also introduced the concept of profit sharing. However, the political turmoil in 1967 ensured the operation of this institution was taken over by the National Bank of Egypt and the Central bank; hence, interest-based operations were once again encouraged by financial institutions. At the same time, there was a significant decrease in the number of depositors. There is an effort to counter this situation with a new government policy to carry out the Sharia compliant transaction set up by the Nasser Social Bank in 1971. This

innovation captured the attention of the private sector. Subsequently, a businessman from Saudi Arabia, Sheikh Saleh Kamel, founded the Dallah AlBaraka Group of Islamic banks (Wilson, 2002).

The Islamic banking institution transformed into a modern financial institution in 1971 when Dallah AlBaraka and Dar al Mal al Islami banking group were founded; they Islamised western banking without changing the existing business model and institutional framework (Diwany, 2010). Dr. Sami Hassan Homoud, a pioneer of modern Islamic banking and founder of Jordan Islamic Bank discovered the *Murabahah* instrument that represents sale with mark-up in advanced Islamic banking instrument (Iqbal & Mirakhor, 2007). This financial instrument was incarnated from a sale contract, which was dedicated to the entrepreneurs' needs for capital expansion to develop their business.

The Islamic Development Bank was developed in 1975 with its headquarters in Jeddah, Kingdom of Saudi Arabia (KSA). The Islamic Development Bank was established to fund projects in its member countries and to bring about economic and social progress in line with Sharia principles (Iqbal & Molyneux, 2005; Wilson, 2002; Haron & Shanmugam, 1997). In the same year, Dubai Islamic bank was launched as the first commercial Islamic bank. Various financial products were set up with Sharia compliance principles to lead the development of Islamic banks worldwide. During the increase of oil prices in the Gulf countries, a lot of multinational banks proposed Islamic financial products or set-up Islamic windows. From 1975 to 1990, Pakistan, Iran and Sudan gradually renewed their financial system to incorporate an interest-free financial alternative (Iqbal & Molyneux, 2005; Haron & Shanmugam, 1997).

From 1970 to 1990, Pakistan took the first step in implementing a financial system with Sharia principles. Then, the legal framework was amended to allow the operation of Sharia-compliant profit-sharing finance companies in 1980, and this also allowed the banks to give financial support through the Islamic financial instruments. Iran also

developed a new banking law to replace conventional banking with the interest-free banking system in 1983. In 1984, Sudan introduced Sharia principles into their entire banking system. Thani, *et al.* (2003) stated that due to the rapid growth of financing in the world, the needs for financial infrastructure including standards-setting and regulatory institutions are very urgent as guidance for the Islamic financial industry, although standardization of Islamic financial products across different countries remains a challenge. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has operated in Bahrain since 1991, making Bahrain a significant centre for international Islamic financial market in the Middle East. Subsequently, in 2002, Malaysia established the Islamic Financial Services Board (IFSB), which serves to supervise, and regulatory standards and guidelines. Recently, in an event in 2010, Malaysia started to issue short-term Sharia-compliant financial instruments through the Malaysia-based International Islamic Liquidity Management Corporation (IILM) for facilitating cross-border Islamic liquidity management.

2.3. The Basic Principles of Islamic Banks

Islamic banking is a banking system governed and guided by the Sharia law (Chalu, 2014; Adebayo & Hassan, 2013; Garas, 2012; Algaoud & Lewis, 2001). The Islamic financial industry is established based on the prohibition of paying interest (*Usury*) on money borrowed, and the prohibition of investment in businesses categorized as unlawful (i.e. businesses that are associated with the production of food/drink, media and others forbidden in Islamic law), these cannot be guaranteed by the conventional banking system. Islamic banks also mean banks operate with the Islamic principles, which refer to the guidance of the *Quran* and *Sunnah*. There are four religious' prescriptions in Islamic banks and identify as *Mudarabah*, *Musharakah*, purchase of ordinary shares or

industrial enterprises and any investment on profit and loss sharing basis, and *Qard Al-Hasanah* (Chalu, 2014; Algaoud & Lewis, 2001).

Islamic banks hold holy principles, which distinguish them from conventional banks. This holy law guides the Islamic banks to comply with the fundamental rules to avoid interest-based activities, excessively uncertain business, taking profits without effort or accepting liability, promoting equally distributed risks and obligations, and trading of forbidden objects, such as pig products and productions, sale and distribution of alcohol, gambling business and so on (Khir, *et al.*, 2008). Chapra (2000) added that the concept engages the stakeholders' membership (*Shura*) in the relationships of the corporation either directly or via representatives. The concept of *Shura* in the government context represents the existence of Sharia Supervisory Committee/Board (SSC/SSB) for interpreting and monitoring the implementation of Sharia compliance in banking operations and businesses.

2.3.1. Prohibition of Interest (*Riba*)

First principle in the Islamic banks is the prohibition of interest (*Riba*). In Islam, *Riba* is an increase or excess to the premium that must be paid by borrowers to lenders along with the principal as a condition for the loan or for an extension to its maturity (Ahmad & Hassan, 2007). This feature is very important because Islamic banks are bound by the non-*Riba* system based on the holy *Quran* (Olson & Zoubi, 2008; Algaoud & Lewis, 2001). The *Quran* describes receiving and paying interest on all transactions as *Haram*¹ and have some penalties for those who engage in such activities (Zamir, 2007; Algaoud & Lewis, 2001). For financial transaction forms, the implementation of the

¹ *Haram* is something, which is forbidden to the people who are not in a state of purity who are not initiated into sacred knowledge or sinful action.

prohibition of *Riba* is part of the Islamic vision of the moral economy and those who neglect the ban on *Riba* are at war with God².

In Islam, *Riba* is strictly prohibited on loan given. Instead, Islam encourages giving of *Qard Al Hasan*³ to the needy. Taking interest on loan given is a great sin in the Sharia. In parallel, Sharia also encourages people to carry out business activities by investing their surplus money. The profit that is earned from the business is *Halal* (not *Riba*). As a result, Muslims can invest extra money in the business to earn a profit (Jalil & Rahman, 2010; Ghannadian & Goswami, 2004). The conventional banking system follows the unequal distribution of capital. However, it can be a great advantage if the interest-based financial intermediation is replaced by the profit and loss sharing (PLS) system (Chapra, 2000). Siddiqi (2004) suggested some reasons for prohibiting *Riba*, are: *Riba* damages the society, *Riba* implies fraud on other people's property, *Riba* leads to a negative growth, *Riba* demeans and reduces human personality, and *Riba* is unfair.

Some activities that are categorized as *Riba* are: banks accumulating funds and money to their own advantages, interest also supports the concept of shifting the cost to the next person, distributing the treasures only for those who can afford, the latter is a public undertaking, disempowering economic stability and investment policies, and creating a gap that cannot be filled. Therefore, the fundamental difference between conventional banks and Islamic banks is the philosophy adopted. Islamic banks do not implement the system of interest in all activities whereas conventional banks do just the opposite. There is a big difference in the products developed by Islamic banks, they avoid the interest rate system. The system developed by Islamic banks encourages buying and selling as well as partnership in the form of profit sharing. Basically, all kinds of commercial transactions in Islamic banks are allowed if they do not contain elements of

² The *Quran* sections (*Al-Baqarah* 2: 275-279; *Al-Imran* 3: 130; *An-Nissa* 4:161 and *Ar-Rum* 30:39).

³ *Qard Al Hasan* is full assurance loans or loans that do not involve benefits or additional terms at the time of loan repayment.

interest (*Riba*). The incorporation of *Riba* in Islamic banks can have a snowball effect leading to its adoption by other financial institutions (Zamir, 2007).

There are some criticisms for *Riba*, such as the unjustified and unjust property rights (Saeed, 1996). The arguments based on Islamic scriptures contend the prohibition of *Riba* based on a wrongful interpretation of the Sharia text. For example, nowadays debt does not necessarily relate to poverty, but for commercial borrowing to produce goods and services or for purchasing a durable good (loans for investments). The critics argued that in financial management of banks, interests are an important component of the bank's survival. For instance, Olson and Zoubi (2008) revealed that some studies suggest charging a fixed rate in advance in the profit-sharing arrangement, this is similar to the principle of risk-sharing. This concept of interest is replaced by the concept of profit and loss sharing.

Riba exists on both sides of the balance sheet in the context of modern banking. The liability side summarizes *Riba* in the deposit mobilization operation; whereas, in the asset side, *Riba* comes from the application for funds from the banks. For example, when a bank collects deposits from customers and assures them of a positive fixed rate of return dependent on deposit periods, that is *Riba*. *Riba* also occurs when a bank offers a loan to a customer and imposes a certain percentage of interest on the principal, such an arrangement is *Riba* (Sultan, 2006). The capital structure of an Islamic financial institution has to preclude that *Riba* bearing financing in Islamic finance. *Riba* must be avoided in all the following transactions: preference shares, debentures, *Riba* leasing transactions, amount payable, amount receivable and bonds. The interest-bearing instruments can be replaced by profit and loss sharing instruments, such as *Mudharabah*, *Musharakah* and *Murabahah*. The development of Sharia financial products can lead to different types of innovative practices deviant of Sharia principles.

2.3.2. Profit and Loss Sharing (PLS) Concept

The second religious principle in Islamic banking is PLS concept. Ahmad & Hassan (2007) stated that Islam enjoins a support system for Muslims to invest their money and become partners to share their profits and risks instead of becoming creditors. As a result, there is an implication for those who provide capital and those receiving capital to share the risk from the business. The solution for the prohibition of *Riba* is risk sharing and this is considered close to social ethics, justice and equity. Risk sharing can also be considered a support investment system that benefits the society as a whole.

Prohibition of interest in Sharia consequently means the abolishment of interests. The PLS concept is a viable alternative to the interest system which does not reflect justice (injustice/*Dzalim*). The interest system presents a discrimination against risk and profit sharing for economic actors (Sadeq, 1992). The principles of Islamic finance are built on the basis of the prohibition of *Riba*, *Gharar* and lawful business guidance, but business risk are equally shared, and economic transactions are based on the consideration of a sense of fairness. PLS means to increase gains or losses due to an economic activity/business existing together. The PLS presents no fixed profit-sharing ratio, profit and loss are shared based on the real productivity of the product.

PLS is a system which encourages the provision of capital in an entrepreneurship role. Capital and entrepreneurship have become integral units that should be considered in determining production factors. According to Sharia, money can be acquired only by real productivity. Interest on principal is not generated by productivity. In PLS, the agreement is the proportion of revenue sharing (called a sharing ratio) in percentage terms over a possible outcome from real productivity. The nominal value for the result is obviously unacceptable and is only known determined after results are achieved from the utilization of actual funds. The agreeing parties determine the profit-sharing ratio. The proportion ratio is a decided based on the contribution of each party (share and

partnership) and the prospect of profitability (expected return) as well as the level of risk (expected risk) (Hendrie, 2003).

2.3.3. *Zakat*

The third religious principle in Islamic banking is *Zakat*. One of the uniqueness of Islamic bank is how an Islamic bank can affect the social sector. Islamic banks do not live and thrive only for profit, but to provide an assistance to the people. *Zakat* is one tool for Islamic banks to use their profit for a social benefit. Although, there are still differences of opinion on whether an institution is obliged to pay *Zakat*. However, charity appears in the form of social control of human behaviour and being more sensitive to others. Islamic Banks as formal and legal institutions play an enormous social role through the *Zakat* mechanism. *Zakat* is a metaphor mandated in an Islamic bank. These metaphors have a consequence on business organization, it is no longer oriented to profit (profit-oriented) or oriented to the shareholder (stakeholder-oriented) but remains oriented towards charity (*Zakat*-oriented). With the orientation of *Zakat*, the company strives to achieve a higher number of pay-out. Thus, the net profit is no longer dependent on the size of the company, on the contrary zakat can be a measure of the company's performance (Chalu, 2014).

Furthermore, Qardhawi (2000) stated that *Zakah* serves as a means to dispose of money in a spiritual way. Islam orders Muslims to follow the terms and condition of *Zakat*. The payment of *Zakat* is an obligation which serves as a commitment and contribution from Islamic banks. *Zakat* is an important tool for the redistribution of income. Economic development occurs as a result of the contribution of *Zakat*. Islamic banks are based on religious philosophy. This activity is a religious requirement. *Zakat* payment acts as a means for Islamic banks to mobilize their investable funds for

productive use. If there is less money circulation, it can lead to lower production, high unemployment, and reduced incomes (Rosly, 2010).

Then, Anas & Mounira (2009) and Farook & Lanis (2005) also highlighted that the most important objectives of the Islamic banks are to maximize the social utility of public interest. The benefit of the public must dominate private benefit. Any difficulties perceived must be prevented via cooperation. This socio-economic objective should also lead to a focus on equality and fairness in the allocation of wealth among needy society members and the distribution of public resources to the poor and needy. The distribution of *Zakat* must, therefore, be fair and unbiased to the beneficiaries and the allocation of donations and charity is highly encouraged.

2.3.4. The Existence of Sharia Supervisory Board (SSB)

Finally, the fourth religious principle in Islamic banks is the existence of the SSB. According to AAOIFI (2010), SSB is an independent body that consists of specialist jurists in *Fiqh Al-Muamalat* (Islamic jurisprudence). SSB is entrusted with the obligation to direct, review and supervise the activities of Islamic banks in order to comply with Sharia rules and principles. SSB must issue *Fatwa* and rulings, which shall be compulsory on the Islamic banks. The members of SSB consist of at least three members and are appointed by using the recommendation from the Board of Director (BoD). SSB members have to prepare a report about the Sharia compliant of all contracts, transactions, and products. SSB must state all the allocation of profit and charging of losses related to investment accounts, all these require the approval of the SSB. The BoD with the shareholders' authorization sets the remuneration of the SSB.

The primary role of the SSB is to form an independent opinion on Sharia compliance and report it in their review report (Nienhaus, 2007). However, SSB positions

lead to further conflicts of interest due to competition between Islamic banks (Wilson, 2009a; Grais & Pellegrini, 2006c). Therefore, optimizing the role of the SSB can be done by proper socialization among Islamic banks itself. The roles of the SSB are important to the general public in assuring Sharia compliance in Islamic banks. It is important that the community becomes an element to control the role of SSB in Islamic banks. If the dissemination of the role of Sharia supervision in economic development is achieved, then the same consciousness is expected to be achieved between SSB and the wider community in supervising the operation of Islamic banks to comply with Sharia principles and to encourage the development of both.

SSB as in-house religious advisers in the each IFIs, which covers five main areas: certifying financial instruments and products, verifying the compliance with *Fatwa*, calculating and paying *Zakat*, disposing of non-compliance earnings, and advising on the distribution of income or expenses among shareholders and investment account holders (Grais and Pellegrini, 2006). According to IFSB (2009) SSB is one of the most important governance mechanisms in IFIs, which has an obligation to assure the integrity and credibility of the institutions. According to the Act of the Republic of Indonesia number 21 of 2008, the SSB has an important task to give advice and recommendation to the BoD and to supervise the transactions and operations in accordance to the Sharia law.

Further, the primary role of SSB is to supervise the implementation of *Fatwa* on the bank's operations and products, so it does not deviate from the Sharia rules. Ideally, SSBs cannot be separated from Islamic banks, though; its role is to serve as an evaluation body. This is because it recognizes the separation between business and religion in Islam. This related to the opinion of Karim (1990) that the SSB is an independent body, and it has roles contrary to that of auditors. Externally, SSB members are employed and paid by the bank. Since the SSB is an independent body, which issues *Fatwa*, and it presents

its report to shareholders, the remuneration of SSB members by the bank remains a debate.

2.4. The Sharia Financial Products and Services in Islamic Banks

Sharia law and principles serve as the guidance for the permissibility of any commercial activity in Islamic banks. The guidance of the *Quran* and *Sunnah* characterized as the Islamic commercial law guides the interactions, transactions, and exchanges between individuals, which are facilitated through formal and informal contracts within the society (Diwany, 2010; Iqbal & Mirakhor, 2007). Through a contract, the purpose and the obligations for each party are instructed. A contract is considered lawful and permissible under the Sharia law as long as it avoids the involvement of *Riba* in the transactions and *Gharar*. Due to this objective, the contract facilitates various forms of economic activities, ranging from sales and purchases of goods, exchanges, arrangement of credit and financing, collateral and guarantee, as well as empowering the public through investments and creation of opportunities. A permissible contract must consist of transactional, financing and social welfare contracts.

Essentially, Islamic banking and financial instruments are different from their conventional counterparts. Some of the functions of these Islamic financial instruments are quite similar to conventional financial instruments, but the whole mechanism is completely different. The services provided by Islamic banks are similar to those of conventional banks, but the objectives and purposes are different. Chapra (1985) stated that the basic objectives of Islamic banks are to support the economic well-being to encourage full employment and a high rate of economic growth, socio-economic justice, an equal distribution of wealth, stability in the value of money, and the mobilisation and investment of savings for economic development; all parties involved and therefore get a profit-sharing return.

Furthermore, Uzair (1955) emphasized two central fundamental principles for the Islamic banking model. First, return on capital cannot be fixed in advance but must be an equal allocation of profits or returns. Second, capital not including labour is liable to the financial risks of the venture. Table 2.1 describes the four categories and contracts in Islamic commercial law. These contracts are a basic requirement for products and services offered by Islamic banks nowadays. As Hanif (2000) concluded, Islamic banking methods are quite similar to the modern conventional banking system.

Table 2.1. Contracts Under Islamic Commercial

<i>Type</i>	<i>Contract/Instruments</i>	<i>Specifications</i>
Transactional	Sale (<i>Bay'</i>)	Spot, on Deferred basis, Promise to pay
	Exchange (<i>Sarf</i>)	Spot Money exchange
	Sale of Right to use/Usufruct (<i>Ijarah/Isthisna</i>)	Leasing/Manufacturing financing
Financing	Trade Financing (<i>Murabahah</i>)	Sales with agreed margin asset financing
	Asset-Backed (<i>Ijarah/Isthisna</i>)	Leasing/Manufacturing financing
	Equity Partnership (<i>Musharakah</i>)	Co-ownership or Diminishing partnership
Intermediation	Partnership: Equity Partnership (<i>Musharakah</i>)	Co-ownership or Diminishing partnership
	Joint Capital Effort Partnership (<i>Mudharabah</i>)	Trustee finance contract
	Fee Based Services: Guarantee (<i>Kafalah</i>)	Guarantee service (e.g. Letter of Credit)
	Fee-Based Service (<i>Ju'alah</i>)	Compensation based/agency service
	Custody (<i>Amanah</i>)	Safe keeping (e.g. Safe Deposit Box)
	Representation (<i>Wakalah</i>)	Trading representation
	Insurance (<i>Takaful</i>)	Insurance based on <i>mudharabah</i> , <i>murabahah</i> , <i>musharakah</i> and <i>waqf</i>
Social Welfare	Gratuitous Loan (<i>Qardhul Hassan</i>)	Loan for community service
	Trust/Endowment (<i>Waqf</i>)	Asset transfer for community service

Source: (Diwany, 2010; Iqbal & Mirakhor, 2007)

2.4.1. Funding Products

All banking systems, whether Islamic or conventional, corporate or retail have to accept some sort of funds from investors. The public use banks as financial intermediaries. These banks also have their own capital and equity apart from the deposits of their customers. Most Islamic banks rely on deposits as the major source of funding apart from their own capital and equity. Khan and Mirakhor (1989) categorized deposits into two: Deposits are risk-free and have no returns; investments carry a risk and it has a variable return. Islamic banks operate four types of account based on Sharia principles.

First is the current savings: This is an account for depositors, where funds are deposited safe keeping, and no returns are paid by Islamic banks on them. These deposits are risk-free, and considered as a trust and are deposited on the basis of *Al-Wadiah*⁴ principle of the Sharia law. Islamic banks as a trustee can use the fund from depositors for short transactions on the bank's obligations, not for any investment. The banks must pay back these deposits when requested by account holders.

The second type of account is called a savings account. This account is for deposits, which are accepted by the Islamic banks like any other conventional bank. The difference in the case of Islamic banks is that there is no fixed or pre-determined rate of interest paid annually to the account holders by the bank. The difference between saving and the current account is their management and the acceptance of deposits based on various principles (Algaoud & Lewis, 2001).

The third type of account is the investment account. This account is primarily for the purpose of earning returns or profits. Basically, these accounts are not concerned with the safekeeping of the fund and use them only for transaction purposes. These accounts are run on the principle of *Mudharabah al-Mutlaqa*, where the account holders have to

⁴ *Al-Wadiah* is the old concept of *Amanah*, where one-person hands over his or her assets to other person for the aim of safekeeping (Qaed, 2014)

accept certain circumstances, such as: higher fixed minimum of funds, a longer duration, a liability for the loss of some part or all of the funds in case any loss occurs to the investment project. Islamic banks act like entrepreneurs in these accounts on behalf of the account holders. The account holders can withdraw their deposits if an agreed advance notice is given to the bank.

The fourth type is a special investment account. These deposits are operated under the principle of *Mudharabah* and engaged larger investors and institutions. The difference between an investment account and a special investment account is that the former is used in any investment venture and the latter is used in specific projects or investments carried out by the bank. The maturity period and the allocation of return or profit are negotiated for each special investment account (Algaoud & Lewis, 2001).

2.4.2. Financing Products

As for financial instruments, the financial model in Islamic banks is based on Sharia principles and must ban interest on transactions. The modes of financing in Islamic banks are called sharing models and are based on the principle of PLS. This study also distinguished the term “loan” which refers to a benevolent loan (*Qard Al Hasan*), a form of financial assistance to the needy and poor to be repaid free of interest, and other instruments of Islamic finance, which are not referred to as “loan” but rather as financing models falling under three classifications: PLS, non-PLS, and fee-based products (Hussain, Shahmoradi, & Turk, 2015).

2.4.2.1. PLS Financing Products

PLS financing complies with Sharia principles. Compared with non-PLS financing, PLS have core principles of equity and participation of the member, as well as

a similar structure to economic activities which promote an equitable distribution of income, leading to more efficient allocation of resources. PLS financing is divided into two types:

The first type of PLS financing is *Musharakah*, which is a contract with profit and loss sharing partnership and it is the most genuine form of Sharia financing (Song & Oosthuizen, 2014). This contract is a partnership where there are two or more partners providing capital for financing a project, such as owning a real estate or movable assets, it could be on a permanent or diminishing basis. The second type is *Mudarabah*. This financing is PLS financing contract where one party supplies the capital funding as the financier of the project, the other party provides effort and management expertise (*Mudarib*) with a view to generating a return. The distribution of profits is determined by mutual agreement but losses, if any, are accepted entirely by the financier, except if this results from the *Mudarib*'s carelessness, misconduct, or violation of the contract term. (Hussain, Shahmoradi, & Turk, 2015).

2.4.2.2. Non-PLS Financing Products

Non-PLS contracts are the most common in practice. These contracts are mostly used to finance consumers and corporate credit, asset rental, and manufacturing credit. In this study, there are four types of financing instruments.

First, non-PLS financing contract is *Murabahah*. This contract is a popular Sharia-compliant sale transaction in Islamic banks and it is mostly used for trading and asset financing⁵. The profit or expected returns on *Murabahah* are usually associated with interest payment on traditional loans, creating a similarity between *Murabahah* sales and

⁵ These Sharia compliant contracts are similar to traditional financial products based on mark-up sales and leasing products (Hussain, Shahmoradi, & Turk, 2015).

asset-backed loans. However, *Murabahah* is a postponed payment form of sale transaction where the purpose is to support the acquisition of goods and not to exchange money for more money (or monetary equivalents) over a period of time. In contrast to traditional loans, after the *Murabahah* contract is signed, the amount being financed cannot be increased for late payment or default, nor can a penalty be executed, except the buyer has deliberately refused to make a payment. These financing contracts also assure the seller, eliminating the risks of delivering defective goods (Hussain, Shahmoradi, & Turk, 2015; Algaoud & Lewis, 2001).

Next, the second type of financing contract is *Ijarah*, which is a contract which permits the use of an asset for a period of time. It must be a lease type of contract, whereby the lease manages the leased asset during the period. The lease pays an amount periodically to use the asset. The leaser can reclaim the asset in case of non-payment. The leaser is responsible for the maintenance of the asset in case of damage; however, damages can result from the lessee's negligence. There is an element of risk in making *Ijarah* payment, this makes it permissible.

The third type of non-PLS financing contract is *Salam*. This financing product is a form of future agreement, where delivery happens at a future time in exchange for prior payment. This transaction is carried out originally to conquer the financial need of poor farmers when they cannot repay their loans until some periods after the initial investment is made. A crucial condition for the validity of this contract is the payment of the price in full at the time of initiating the contract, or else the outcome is a debt-against-debt sale that is forbidden under Sharia principles. The subject matter, price, quantity, and date and place of delivery must be specified in the contract. If the seller cannot produce the goods or obtain them elsewhere, the buyer can take back the paid funds with no increase, or wait until the goods become available. Then, if one of the parties cannot fulfil the contract, the bank can get back the initial investment, and must accept the loss. For reducing exposure

to credit risk, the bank can ask for a financial guarantee, mortgage, advance payment, or third-party guarantee.

Finally, the fourth type of financing model is *Istisna'*. This contract is a financing product for a commodity that can be managed before it comes into existence. The uniqueness of *Istisna'* is that nothing is exchanged on the spot or at the time of initiating contracting. It is the only forward contract where the obligations of both parties are in the future. *Istisna'* contract could be directly between the end user and the manufacturer, but it is typically a three-party contract, with the bank as an intermediary. Under the first *Istisna'* contract, the bank agrees to receive payments from the client on a long period schedule, whereas under the second contract, the bank as a buyer makes progressive instalment payments to the producer over a short-term period of time (Hussain, Shahmoradi, & Turk, 2015).

2.4.2.3. Fee-Based Products

Islamic banks also offer a wide spectrum of fee-based services using three types of contracts. The first contract is *Wakalah*. This fee-based product is generated when the bank acts as the agent of a customer to trade and to issue a letter of credit facility. The term *Wakalah* refers to a person/institution/organization who/which legally represents another person/institution/organisation. For this product, the bank acts on behalf of the client or financier which operates the trade as an agent (*Wakil*) and charges the client an agency fee. This contract is similar to *Mudharaba* but with significant differences, because in *Mudharaba*, the entrepreneur has a full control to use the money and get a share of the profit. In *Wakalah*, the agent must operate in accordance with the instructions of the designator (*Muakil*) and get a fee for this operation (Ayub, 2009).

Then, the second type of contract is *Kafalah*, which is a financial guarantee whereby the bank gives a pledge to a creditor on behalf of the debtor to cover payments or any other personal liabilities. This contract is commonly used in conjunction with other financing models or documentary credits. Finally, the third type of fee-based contract is *Ju'ala*. This contract is similar to the *Istisna'* because it is similar to the representative system which is a specified service as opposed to the manufacturing of a product. This contract offers a service for a pre-determined fee or commission. The client and the bank open this contract, where the client agrees to pay the bank some fee or commission for some specific services. This type of service can be advisory, asset management, consulting and professional services, and fund placement and trust services (Ayub, 2009; Hassan & Lewis, 2007).

2.5. The Islamic Banks in Indonesia

The economic crisis of 1997 -1999 was one of the major economic crises of the 20th century in East Asia. It was a huge financial problem – to the currency as well as the banking system. Previous studies explored the reasons for these economic crises - weak economic fundamentals and policy inconsistencies were major causes of the East Asian crisis of 1997-1999 (Krugman, 1998; Miskhin, 1991). Stiglitz (2002, 1999), Radelet & Sachs (1998), and Furman & Stiglitz (1998) believed that the root of the crisis was pure contamination and market irrationality of the banking system. The middle ground argument stated that both contamination and poor economic fundamentals caused the crisis, and it had a very bad effect on the economy (Djiwandono, 1999; Roubini, 1998). McLeod (1999) and Hill (1999) claimed that the main cause of the 1997 – 1999 crisis in East Asia was poor management and it led to a fragile political system and the system in place was quite ineffective to manage the problem.

The impact of the crisis was quite damaging. Indonesia also suffered considerably. The financial crisis of 1997-1998 caused the financial industry in Indonesia to collapse. The banking sector was the most seriously damaged by the crisis. Sixteen banks were liquidated, 51 banks were merged, and over 35,000 employees were laid off in Indonesia (Bank Indonesia, 2010c). The wider impact of the closures was unanticipated; measures were aimed at restoring confidence in the Indonesian banking system but, in fact, had the reverse effect. In the absence of clear guidelines on depositor compensation and opaque liquidation policies coupled with political uncertainties, the decision prompted a market panic and systematic bankrupt.

During the economic crisis, the Indonesian banking sector faced very serious problems because of the improper handling of the banking system. Rebuilding public trust in Indonesian banking after the crisis was not an easy task because most of the Indonesian banks failed to implement good corporate governance and to apply good risk management practices. The Indonesian government had to restore the solvency and stability of the banking system with a restructuring program by recapitalizing and restructuring some viable banks, and by freezing all operations or closing some troubled banks to prevent the financial system and the economy from further disruption. During the post-crisis period, the Indonesian Central Bank (BI) introduced various banking regulations that focused on changes in the internal mechanisms of the banking institutions in their respective economies. After the economic crisis of 1997-1998, the banking industry in Indonesia carried out a variety of restructuring in order to restore the financial health of the banking system and its function as an intermediary institution. Islamic banks emerged as healthy alternative institutions in financial services. Integrating religious principles with modern banking systems created a new phenomenon of Islamic banks which developed very progressively in Indonesia. The Islamic banking system has several strengths. Siregar &

Ilyas (2000) stated that the new concept in the banking system reduced the unproductive speculation and alleviated the problem of the crisis using Sharia principles.

Several factors supported the rapid growth of Islamic banks in Indonesia: (i) Population is a major factor. Indonesia has the world's largest Muslim population, and many Indonesian Muslim leaders do not believe in the commercial interest system in the conventional banks (Ismal, 2011; Venardos, 2005); (ii) Another factor is the endorsement from the banking regulators, parliament and government which played a part in the development of the Islamic financial institutions due to the overwhelming response from the public after the financial crisis of 1997-1998 (Ismal, 2011); and (iii) Loyalty of customers. Venardos (2005) stated that although Islamic banks in Indonesia have a small market, they have loyal customers. Hence, these factors presented an advantage for the IFIs to grow. Siregar & Ilyas (2000) argued that the development of Islamic banking in Indonesia was based on two thoughts. First thought is Islamic banks had an advantage in the market because of the Sharia principles of the Islamic banking system. This system assisted the mobilization of the funds in the financial market. Second, the Islamic banking system was included among the banking restructuring programs in the Indonesian banking system by the government.

After the banking crisis in 1997, the Indonesian banking industry was thrown into a challenging environment that which the country has still not fully recovered from. Some issues arose such as the high-interest rates that attracted deposits. However, banks were still hesitant to give out credits due to a high rate of non-performing loans (NPLs) and slow sector restructuring. In this situation, Islamic banks showed a reputable performance; such as a lower level of NPL and an increase of IAHs. The development of modern Islamic banks in Indonesia started in 1992 and was formally initiated in line with the Indonesian Government Banking Act 7. Starting in 1990, the Indonesian *Ulama* council (MUI) held their first symposium to form a task force and recommend the

establishment of Islamic banks to the government. Further, BI amended the Indonesian Government Banking Act 10 to overcome some challenges faced by Islamic banks in the early stage, such as no market instruments and no alternative for liquidity management. The Banking Act 10 was established to encourage network expansion and provide a wider opportunity and stronger legal foundation for Islamic banking industries in Indonesia (Venardos, 2005; Siregar & Ilyas, 2000).

The first commercial bank in Indonesia that operated based on the Islamic law is PT Bank Muamalat Indonesia, Tbk. According to the Indonesian Banking Law 7 of 1992 on banks, was explicitly regulated by the Sharia law and according to government Regulation No. 72 of 1992, it was established on profit-sharing principles. Thus, since 1992, the Indonesian banking industry has been familiar with the profit-sharing principle. However, Islamic banks in operation were not solely based on profit-sharing principles. An agreement contract can be implemented for the free interest bank in practice. *Aqd* (*Akad*) as an Islamic traditional contract is an instrument in Islamic principles, which replaces the conventional contract of interest (*Riba*), uncertainty (*Garar*), and gambling (*Maisyir*) which are elements that are prohibited by Islamic law (Venardos, 2005).

The growth of the Islamic banks in Indonesia was most rapid between the years 2005 to 2015. The number of Islamic commercial banks (BUS)⁶ increased from only 3 banks in 2005 to 12 banks in June 2015. The Islamic business units (Unit Usaha Syariah/UUS)⁷ increased from 19 business units in 2005 to 22 business units in June 2015. Even though there was a decrease from 2007 to June 2015. Furthermore, the Islamic rural banks⁸ also increased from 92 banks in 2005 to 161 banks in June 2015 (Otoritas Jasa

⁶ The Islamic commercial bank (BUS) is a Sharia bank providing services in the transaction of payments.

⁷ The Islamic business units (UUS) is a working unit of the conventional commercial bank head office functioning as head office of offices or units conducting business activities based on the Sharia principles, or working unit in a branch office of a bank located overseas conducting conventional business activities functioning as a head office of sub-Sharia (Islamic) branches and/or Sharia unit.

⁸ The Islamic rural bank is a Sharia bank, which do not provide services in the transaction of payment.

Keuangan, 2015). Even though this growth is remarkable, Indonesia joined the Islamic bank market fairly late compared to Malaysia, although Indonesia has the world's largest population of Muslims (Venardos, 2005) although, some young people and intellectuals tried to establish the Islamic financial institutions before this, they were not successful. The Sharia Bureau of BI worked to meet the demands for Islamic banking. The Indonesian Government accommodated the public demand of the new banking system by issuing Act No. 7 of 1992 about banking which clarified the Government Decree No. 72 of 1992 on banks applying the share-based principle.

BUS is an Islamic bank that provides services in payment commerce as referred to in Indonesian Banking Regulation No. 21 of 2008 concerning Banking Sharia. BUS conducts the business activities conventionally or by Sharia principles providing services and activities for payment transactions. BUS collects funds from the public in the form of deposits, which include: current accounts based on the principle *Wadi'ah*⁹, savings based on the principle of *Wadi'ah* or *Mudharabah*¹⁰, deposits based on the principle of *Mudharabah*, or other forms based on the principle *Wadi'ah* or *Mudharabah*. They channel these funds through: buying or selling based on the principles of *Murabahah*¹¹, *Istishna*¹², *Ijara*¹³, *Salam*¹⁴, and other transactions, financing for results based on the principle of *Mudarabah*, *Musharakah*¹⁵, and for other results, other financing based on

⁹ *Wadi'ah* is customer deposit, which must be preserved and restored at any time the customer wants.

¹⁰ *Mudharabah* is the form of cooperation between two or more parties where shareholders to entrust amount of capital to the manager (*Mudharib*) with an agreement at the beginning. This confirmation expresses the form of cooperation with one hundred percent of capital contributions from the owners of capital and expertise from the manager.

¹¹ *Murabahah* is buy-sell agreement between the bank and its customers. Islamic banks are required to buy goods and then sell it to the customer at cost plus an agreed profit margin between Islamic banks and customers.

¹² *Istishna* is the sales contract between the buyer and the manufacturer of goods. In this contract, the manufacturer of goods received orders from buyers.

¹³ *Ijara* is contract transfer of rights to the goods or services, through the payment of wages leasing, without being followed by the transfer of ownership (*ownership/Milkiyah*) on the goods themselves.

¹⁴ *Salam* is the contract of sale of goods between the owner of the goods and the buyer, which the buyer pays the goods to immediately suspend the delivery of goods and the owner of the goods in certain time.

¹⁵ *Musharakah* is the general form of business for which the results of two or more people donating their finance and business management in the proportion can be the same or not. Profits are shared according to the agreement between the partners, and the losses will be distributed according to the proportion of capital.

the principle *Hiwalah*¹⁶, *Rahn*¹⁷, *Qardh*¹⁸, buying, selling and/or guarantee on own risk securities issued by third parties on the basis of real transactions (underlying transaction) based on the principle of sale or *Hiwalah*, and buying government securities which are issued based on the Sharia principle.

BUS provides these services to: interchange the money for its own interest and/or customers based on the principle *Wakalah*¹⁹, receive payment on securities issued and or serve as a third party between the parties based on the principle of *Wakalah*, provide a place to store goods and valuable based on the principle of *Wadi'ah*, conduct custody activities, including administration for the benefit of another party based on a contract with the principles of *Wakalah*, provide customer funds to another customer in the form of securities that are not listed on the stock exchange based on the principle of *Ujr*²⁰, provide a letter of credit (LC) based on *Wakalah* principle, *Murabahah*, *Mudarabah*, *Musharakah*, and *Wadi'ah*, as well as facilitates bank guarantee based on the principle of *Kafalah*, and conducts transactions based on the *Ujr* principle, and serve as a trustee based on the principle *Wakalah*. BUS also performs other activities such as: foreign exchange operations based on the *Sharf*²¹ principle; equity based on the *Musharakah* principles and/or *Mudarabah*, they also perform equity transaction based on *Musharakah* and or *Mudharabah* to overcome the consequences of failed financing, they act as trustees of pension funds based on Islamic principles in accordance with the funds pension regulations. Islamic banks act as a treasury institution which receives funds from *Zakat*,

¹⁶ *Hiwalah* is transfer of debt from the debtor to another person who is obliged to bear.

¹⁷ *Rahn* is holding one of the borrower's properties as collateral for a loan received.

¹⁸ *Qardh* is a loan agreement (disbursements) to the customer and the customer is obligated to return the funds received for IFIs on the agreed time between customers and IFIs.

¹⁹ *Wakalah* is a transfer from one person to another for doing something about the things that can be represented.

²⁰ *Ujr* is wages or commission.

²¹ *Sharf* is buying and selling currencies with other currencies.

*Infdaq*²², *Shadaqah*²³, *Waqaf*²⁴, social grants or funds and distribute it to the beneficiaries in the form of compensation and/or loans (*Qardhul Hasan*). Finally, BUS performs other activities commonly performed by banks that have an approval from the National Sharia Council (DSN). The activities of the BUS are also supervised by the DSN (Bank Indonesia, 2009).

UUS is an opportunity for conventional banks to conduct banking activities based on Islamic principles. Some transactions in conventional banks are conducted based on Sharia principles, among others according to BI Regulation No. 11/10/PBI/2009 on Sharia and Law No. 21 of 2008 on Islamic banking (BI Regulation No.11/10/PBI/2009). UUS is the Sharia unit of conventional banks. Strategic steps can be taken by UUS in order to improve financial performance in the banking industry in Indonesia. Financial performance has a tremendous impact on customers' confidence. UUS should maintain a good financial performance in managing funds; financial statements are published to keep the shareholders in loop (Bank Indonesia, 2009).

Islamic rural bank is the bank that provides such activities as collecting funds from the public in *Wadiah* form or *Mudarabah* and savings based on the principle of *Wadi'ah* or *Mudarabah*, time deposits based on the principle of *Mudharabah* and other forms that use the principle of *Wadi'ah* or *Mudarabah*. Further, Islamic rural bank distributes funds by conducting transactions based on the principle *Wadi'ah*, *Istishna*, or *Salam*, transactions lease with the principle of *Ijara*, funding for results based on the principle of profit and or *Musharakah*, and finally, performing other activities that are not contrary to BI regulations and Islamic principles (Bank Indonesia, 2009).

²² *Infdaq* is issuing something for god or bad interest.

²³ *Shadaqah* is issuing treasure in the way of *Allah*, as proof of the honesty or truth of personal faith.

²⁴ *Waqaf* is handing off an ownership right to a person or nadzir (guard *Waqf*) either individually or in the form of the governing body provided that the results or benefits are used for things that are in accordance with Sharia.

Islamic banks in Indonesia has grown rapidly; however, improvement is still needed for its competitiveness in the market especially in term of economic benefits, like return on equity (ROE), service quality, efficiency and Sharia compliance assurance. Indonesian Islamic banks face some issues: such as service quality, product information inferior to those of conventional banks, and difficulties serving corporations due to their current size and legal lending limits. Islamic banks in Indonesia are also faced with the lack of a proactive approach by Islamic bankers to promote the Sharia products and services to corporate customers. The development of Islamic banks is also challenged by operational and macroeconomic management. The major problem is the low level of development of Islamic banks, such as lack of a clear concept of Islamic banking systems and its products, inadequate Islamic banks' infrastructure and lack of experts in the Islamic banking industry (Siregar & Ilyas, 2000).

Nowadays, the development of Islamic banks in Indonesia is growing very rapidly. The development of Islamic banking in the reform era was marked by the approval of Indonesian Banking Act 10 of 1988. These laws regulate the operations of Islamic banks. The law also provides guidance for conventional banks in opening Islamic branches or convert totally into Islamic banks. The development of Islamic banking in Indonesia cannot be separated from the conventional banking system in Indonesia. Islamic banking system is well regulated by Law No. 10 1998, Law No. 23, 1999, Law No. 9 2004 of BI, and most recently, Law No. 21 2008 was introduced to legislate Islamic banking activities of conventional banks (Abdullah, 2010; Siregar & Ilyas, 2000).

The banking legislation in Indonesia is responsible for the two systems: the conventional banking and the Islamic banking system. The development of Islamic banks by the BI is also regulated by Law No. 23 of 1999. The dual system of the Islamic bank in Indonesia can run the two systems, these systems run independently of each other (Abdullah, 2010). According to Arifin & Nasution (2015), the term dual system is still

based on PLS system and cannot accommodate all the non-compliant activities, products and services, Islamic banks have different characteristics from conventional banks.

The rapid growth of Islamic banks in Indonesia started from the issuance of Regulation No. 10 of 1998. Then, Amendment to Regulation No. 7 of 1992 provided regulations for the dual banking system through the establishment of the UUS. Islamic banking and conventional banking support the mobilization of public funds to improve financing in various sectors of the national economy. As a result, post-regulation led conventional banks to take part in providing Islamic services to its customers (Bank Indonesia, 2012).

BI regulations (PBI) specifically implements Regulation No. 21 of 2008 concerning Islamic banking (Bank Indonesia, 2012):

The following are the regulation of the PBI:

1. PBI No.10/16/PBI/2008 about Amendments to Regulation No. 9/19/PBI/2007 about the implementation of Sharia in funding, disbursement and Islamic banking services.
2. PBI No.10/17/PBI/2008 about Islamic banking and Islamic banks products.
3. PBI No. 10/18/PBI/2008 about financing structuring for Islamic banks.
4. PBI No.1/23/PBI/2008 about second Amendments to Regulation No.6/2/PBI/2004 about minimum statutory in Rupiah (Rp) and other foreign currencies for conventional bank conducting business based on Sharia principles and requirements.
5. PBI No. 10/24/PBI/2008 about second Amendments to Regulation No. 8/21/2006 about asset quality rating for conventional bank conducting business based on Sharia principles and requirements.
6. PBI No. 10/32/PBI/2008 about Islamic banking committee.

Recently, under Article 34 of Law No. 3 of 2004 on the Amendment of Act No. 23 of 1999 concerning BI, the government created an agency to mandate an independent

financial services sector, no later than the end of 2010. This institute is in charge of supervising and controlling the industry banking, insurance, pension funds, capital markets, venture capital, and finance companies, and other entities operating in the management of public funds. After this, Law No. 21 of 2011 on the independent financial services or Financial Services Authority (Otoritas Jasa Keuangan/OJK), was released, it was enacted on 22 November 2011. Then, regulation and supervision of the banking sector which was originally located at BI was transferred to OJK. The explanation of the Act mentioned that OJK is needed as an independent institution to regulate and supervise the financial service sector to be more comprehensive in order to achieve an effective coordination mechanism in addressing the problems that arise in the financial system as well as to ensure a stable financial system.

Table 2.2 shows the regulatory framework in Indonesian Islamic banks. The content of regulatory framework covers five themes, which are: Sharia governance infrastructure, function, responsibility and restriction of Sharia governance organs, additional guidelines, and implementation factors.

Table 2.2: Regulatory Framework in Indonesian Islamic Banks

Regulatory Framework	Sharia Governance					
Framework	Board of directors	Board of audit committee	Board of risk management committee	Nomination & remuneration committee	Internal audit	External audit
Functions	Responsibility, independence and competency of key organs	Guidelines for Sharia committee	Sharia supervisory available bank level and national board	Sharia audit function embedded in internal audit function	International Sharia review	Sharia risk management - general
Responsibility & restriction of Sharia governance organs	Limitation on SSB period of appointment – 1 period equal to BoD period	Restriction on SSB members – not an employee	Limitation on Sharia scholar's membership – max 2 banks & 2 non-competing institution	Training program for SSB members – national level	Ground for SSB disqualification	Resolution for conflict of Sharia rulings – national level
Additional guidelines	Special guidelines for auditing in Islamic bank	Guidelines for risk management - general	Sharia parameter reference			
Implementation factors	Binding power of governance – strong recommendation	Accounting standard – Indonesian standard accounting with IFRS convergence	Non-compliance report - general			

Source: (Bank Indonesia, 2009)

2.6. Sharia Financial Products and Services in Indonesian Islamic Banks

Broadly, business activities of Islamic banks in Indonesia can be divided into fund collection, fund distribution, services, and social activities (Ascarya & Yumanita, 2015). First, Fund collection: For this financial activity, Islamic banks in Indonesia mobilize saving investment for economic development in a fair way so that equal profits can be guaranteed for all sides. The objective for mobilization of funds is essential in Sharia activities due to the prohibition of accumulating savings and demanding that resources are used productively to achieve the socio-economic goals of Islam. In this case, Islamic banks do not follow the principle of interest (*Riba*), they comply with Islamic law, especially *Mudharabah* (profit sharing) and *Wadi'ah* (deposit). The overall source of funds of Islamic banks can be divided into:

- (a) Capital, which is large portions of the source of funds of Islamic banks come from the capital because Islamic banks run the Sharia system. Small ratios of capital to total funding sources proved not to be a good practice for banks. Islamic banks face challenges because of the problem of inadequate capital from the beginning. Equity participation is carried out based on *Musharakah fi Sahm Aash-Syarikah*.
- (b) Demand deposit account, where Islamic banks accept deposits from customers in the form of checking accounts (current account) for security and convenience using the principle of *Al-yad-dhamanah Wadi'ah* (short *Wadi'ah*) or the trust.
- (c) Saving account, which is deposits from customers in the form savings account for security and simplicity of use, but it is not quite flexible because the customer cannot withdraw funds by check. The principle used can be: *Wadi'ah* or deposit, *Qardh* or loan, and *Mudharabah* or profit sharing.
- (d) General investment account / Unrestricted investments is deposits (from one month upward) into the investment accounts (general investment account) with the principle of *Mudarabah Al-Muthlaqah*. Public investment is often referred to as unrestricted investment. Customer's investment account can be intended for profit rather than to secure their money.
- (e) Special investment account / Investment bound is a general investment accounts, Islamic banks also offer special investment accounts to customers who want to invest directly in the project that is implemented by the bank based on *Mudarabah Al-Muqayyadah* principle.
- (f) Sharia bond, where Islamic banks can also conduct mobilization of funds by issuing Sharia bonds. With Sharia bonds, banks obtain alternative sources of funding long-term (five years or more) that can be used for long-term financing. Sharia bonds can use some of the principles allowed by the Sharia, such as *Mudharabah* (profit sharing principle) and *Ijarah* (lease principle).

Then, Islamic banks in Indonesia also provide a wide range of financing forms. In funding distribution, Islamic banks grant five major forms, namely *Murabahah* and *Musharakah* (profit and loss sharing form), *Murabahah* and *Salam* (with the sale and purchase pattern) and *Ijarah* (lease with operational and financial form). In addition to the five forms of financing, there are various forms of financing, such as:

- (a) Profit sharing financing is the primary forms of Islamic bank and the most important element is an agreement based on profit and loss sharing. The principle is *Al-ghunm Bi'l-ghurm* or *Al-kharj Bi'l-daman*, which means no part benefits without taking part in the risk. There are some types of profit-sharing financing offer in the Indonesian Islamic banks: (1) *Mudharabah* financing is a form of profit-sharing financing in which a bank acts as the fund or capital owner, commonly called *Shahibul Maal* /*Rabbul Maal*, providing 100% capital for the business as a manager, commonly called *Mudharib*, to undertake productive activities with agreement that the profits generated will be shared; and (2) *Musharakah* financing is a form of profit-sharing financing, in which a bank as the fund/capital owner participates as business partners to finance others' investment efforts. Additional financing is given to business partners (individuals or groups), who own some of the financing for the investment.
- (b) Non-profit sharing financing is a part from the main shared financing principles, Islamic banks have other forms of financing with the principle of trading; operating leases, and services (fee-based services). This makes Islamic banks to not only serve as an investment banks, but also serves, among other things, as a trading company (merchant banks) and leasing company, so Islamic banks being are recognised as universal banks (multi-purpose banks). (1) *Murabahah* financing is a form of selling financing principle, which is basically a sales gain (margin), plus a certain cost. Payment can be in cash or deferred, paid in instalments. *Murabahah* in Islamic jurisprudence is a form of trading that has nothing to do with financing in the

beginning; (2) *Salam* is a form of sale with payment in advance and delivery of the goods at a later date (advanced payment or forward buying or future sales) with the price, specifications, quantity, quality, and the date and place of delivery clearly specified. Items are not yet available at the time of the transaction and must be produced in future, such as agricultural products and fungible products (goods that can be estimated and replaced appropriately by weight, size, and number) and so on. In practice, Islamic banks in Indonesia offer *Salam* (as sellers/*Muslam Ilaih*) by accepting orders for goods from customer (buyer/*Muslam*), then the bank (as the buyer/*Muslam*) orders for the goods requested by the customers from the manufacturer/seller (*Muslam Ilaih*) with payment in advance, with a delivery time agreed; (3) *Istishna* is one form of sale with reservation, which is similar to *Salam*. In practice, Islamic banks in Indonesia do *Istishna* (as the recipient of the order/*Shani* ') by accepting orders for goods from the customer (buyer/*Mustashni*'), then the bank (as buyer/*Mustashni*') orders for the goods demanded by the customers from the producer as seller (*Shani*') with payment in advance, instalment, or at the end, with an agreed delivery time together; (4) Lease (financial and operational lease) or *Ijarah* can be used as a form of financing. Initially, it is not being a form of financing but it is a business activity such as buying and selling; and (5) *Qardh* is a soft loan or it can be called charity loans. It is usually without reward for purchasing fungible goods (that is, goods that can be estimated according to weight, size, and quantity). Borrowers on their own part return more money as gratuity. Certain scholars let the lender to charge a service fee for procuring the loan. This is not interest but costs incurred by the loan grantor, such as for building, rental fees, salaries and equipment. Sharia law permits the lender to ask the borrower to pay operating costs beyond the principal, but these costs are not interest, commission or fees and it should not be made proportional to the amount of the loan.

- (c) For running transactions for profit, Islamic banks conduct some transactions that are not for profit called financial services. This transaction is included in services (fee-based income). Some forms of services are provided by Islamic banks for customers, such as financial services, agencies, and non-finance services. Included in the financial services are *Wadi'ah Yad Dhamanah* or deposit (in the form of demand deposits and savings), *Wakalah* (delegation of powers to the bank to represent the customer), *Kafalah* (guarantee given to ensure the fulfilment of an obligations), *Hiwalah* (redirects funds/debt of depositors/debtor to the receiver/creditors), *Rahn* (loans with collateral or pledge or mortgage), *Sharf* (selling and buying currency). Islamic banks can also act as an agent of investment in the form of *Muqayyadah* *Mudharabah* or bound investment when investors as customers provide investment restrictions. Banks only acts as agents or intermediaries to bring together investors and entrepreneurs. Additionally, Islamic banks also provide non-financial services, such as providing deposit services - *Wadi'ah Yad Amanah* (safe deposit box).
- (d) The type of businesses that can be financed by Islamic banks are different from those of conventional banks. Conventional banks can finance any business, whether the business is lawful or unlawful according to the Sharia law. Meanwhile, Islamic banks can only finance *Halal* businesses. Islamic banks must not finance *Haram* or non-Sharia businesses. For example, business or objects that contain unlawful elements, such as industrial processing of alcohol and pork, works that brings about *Mudharat* or losses for society, the businesses associated with sordid deeds/immorality, like nightclub business, businesses related to gambling, such as casinos, business associated with the illegal arms industry or oriented to the development of weapons of mass murder; and business that could harm the symbols of Islam, either directly or indirectly.

- (e) Besides profit-oriented activities, Islamic banks have to be orientated in social welfare. Therefore, Islamic banks always pay attention to the way it runs its business with regards to societal activities. Though it is important and it is a priority but it is not the only criteria for evaluating the performance of an Islamic bank because it must be in line with the objectives of social norms with the public interest in mind. In addition to attention to social welfare in any commercial venture, Islamic banks are also obliged to carry out corporate social activities. They should engage in the collation and distribution of *Zakat*, *Infaq*, and *Sadaqah* and provide soft loans without interests (*Qardhul Hasan*), as well as provide scholarships.

CHAPTER 3: THE SHARIA GOVERNANCE IN ISLAMIC BANKS

3.1. Introduction

Islamic banks are expected to carry out the objectives of maintaining ethical values. Islamic banks also practice CG values similar to conventional banks. However, it is argued that CG failures come from incidences of collusion of the BoD with their own management, such as audit failures and excessive risk-taking by management (Grais & Pellegrini, 2006c). There are at least three famous cases of financial distress relating to Islamic finance, which are, the collapse of the Bank of credit and commerce international (BCCI)¹ in 1991, The bankruptcy of Ihlas Finance House of Turkey in 2001, and the collapse of the Patni Cooperative Society of Surat, India in 2003. These cases showed the poor or ineffectiveness of CG practises, in addition a weak legal, regulatory and conflict resolution framework also influenced those failures.

It is crucial to improve the CG state of these institutions in order to maintain stakeholders' trust in the financial system of Islamic institutions. The failure to increase stakeholders' trust and confidence in these businesses will lead to negative reactions from stakeholders (Chapra & Ahmed, 2002). According to Bhatti & Bhatti (2009) and Hasan (2008), the CG model for Islamic banks or Sharia governance model in Islamic banks is based on: the sharia principles and law of property rights and contracts, the need to design the system to comply with the Sharia law, and the protection of the stakeholders' right that include management, shareholders, employees, suppliers, depositors and also the society is evident.

¹ The BCCI failures affected the other Islamic financial institutions distress, such as Faisal Islamic Bank of Egypt, Dubai Islamic Bank, the Khartoum based on Tadamon Islamic Bank, Qatar Islamic bank, and Kuwait Finance House, which invested in BCCI with the understanding that BCCI would invest their funds and commodities or goods (Grais & Pellegrini, 2006c).

3.2. The Sharia Governance in Islamic Banks

The Sharia governance framework of Islamic financial institutions including Islamic banks is distinguished from the traditional governance framework by the presence of Sharia supervisory boards/advisory boards. The Sharia board has a critical role in ensuring that all activities and operations comply with Sharia principles, whereas shareholders also play a crucial role as active members in the process of decision-making. Society as another stakeholder provides mutual corporations in protecting the interest as a whole and stimulating the social welfare function. All of these processes focus on fulfilling the ultimate objective of Sharia governance (Choudhury & Hoque, 2006).

Furthermore, it is very clear that in Islamic financial institutions, the core features are not merely limited to ensuring that actions of the management are kept in line with the needs of shareholders and stakeholders, but also to fulfil religious values and Sharia requirements based on the *Quran* and *Sunnah*. Hence, the essence of Sharia governance must be in line with the objectives (*Maqasid*) of Sharia that bring about better welfare in the society through upholding the principle of distributive justice for the organization and community. Looking at the objectives from a boarder perspective, the CG standards for conventional financial institutions can be paired with Sharia requirements, which can result in a CG framework that can be applied to Islamic financial institutions. However, there is a difference between Sharia governance and conventional CG. The addition of Sharia compliance and assurance is an important requirement for CG in Islamic financial institutions, and the role and function of Sharia committee or Sharia Supervisory Board in addition to this is considered a crucial aspect of Sharia governance.

In Islamic banks, there are two types of owners, which are the shareholders and the investment account holders, or depositors. According to Adeyemi & Adenugba (2011), the relationship between investment account holders and the banks is parallel in the collective investment scheme, where the participants or the investment account

holders have an authorisation for their fund manager to manage their investments in Islamic financial banks. For example, the depositor acts as the IAH and also as the owner of capital (*Rab-Al-Mal*) in a *Mudharabah* contract while Islamic bank acts as the agent (*Mudarib*). These two parties share the risks and rewards with the other party equally. Therefore, the depositors have legal rights to resist unexpected losses in the same way as shareholders.

The objective in IFIs always cover a broad range of purpose and aims, like efficiency and effectiveness of operations, safeguarding of assets, reliability and integrity of the reporting processes, and complying with the Sharia law and other rules and regulations in all policies, procedures, and contracts. It also includes all elements of risk management and internal control framework, which covers the internal control environment, all the elements of risk management framework, such as risk identification, risk assessment and response, information and communication, and monitoring. Grais & Pellegrini (2006c) defined ideal CG in Islamic financial institutions as a unique internalized stakeholders' value combined with the Sharia law. It also gives all shareholders the right to participate, with a strong fiduciary duty to both stakeholders and SSB for achieving the objective to comply with the Sharia law and providing excellent services to the society as a whole.

3.3. The Sharia Governance Standards and Guidelines for Islamic Banks

This section discusses the application of a selected international governance standards for the Sharia governance in Islamic banks, such as Organization for Economic Cooperation and Development (OECD) principles of CG (2004), Basel committee on Banking Supervision (2006) paper, AAOIFI standards, and IFSB guidelines.

First, Sharia governance standards and guidelines in a Sharia-compliant organization were set by the Organization for Economic Co-Operation and Development (OECD) in 2004. The OECD's principles of corporate governance (2004) were first published in 1999 and adopted by the 30-member countries of the OECD. This principle was amended in 2004 to ensure that was flexible enough in various legal, economic and cultural contexts (Jamali, *et al.*, 2008; Jesover & Kirkpatrick, 2005). This principle was created to support policies that would significantly improve the economic and social benefits of the society worldwide.

Second, the Basel Committee on Banking Supervision or BCBS (2006) paper explains the Sharia governance standards and guidelines for Islamic bank. This standard was also informed by the publication of the OECD's principles of corporate governance in 1999. The BCBS paper was then modified in 2006 following OECD's 2004, revision of the OECD principles. The purpose of BCBS paper is to give assistance for supervisory authority and banks to enhance the CG frameworks and implement uniform and reliable CG in practice (Bank for International Settlements, 2012).

Third, the role of Sharia governance standards is guided by the guidelines for accounting, auditing and governance of Islamic financial institutions (AAOIFI standards). The AAOIFI standard is formed to promulgate and harmonize accounting, auditing, ethics, and Sharia governance standards. The AAOIFI is currently based in Bahrain and acts as the standard setting and consulting body for harmonizing practices relevant to IFIs (Ahmed, 2010; Venardos, 2005; Thani, *et al.*, 2003). The purpose of AAOIFI standard is to establish accounting standards for Islamic financial institutions; however, AAOIFI does not have the power to impose the application of their standards on Islamic financial institutions worldwide. Islamic financial institutions have to comply with the laws of the country on which they are listed.

Furthermore, the role of AAOIFI is to convince central banks and supervisory authorities to implement this standard in their countries. Bahrain, Qatar, Lebanon, Jordan, Sudan and Syria have adopted and implemented the AAOIFI standards, but most Islamic banks in other countries still comply with International Accounting Standards (IAS) or International Financial Reporting Standards (IFRS). In this case, the IAS or IFRS only implements the AAOIFI standard for the areas where the accounting treatment of Islamic financial instruments is not covered. As noted, AAOIFI issues 26 accounting standards, five auditing standards, seven governance standards, two ethics standards, 35 Sharia standards and three standards for strengthening the role and functions of Sharia governance (AAOIFI, 2010).

Finally, the fourth standard and guideline body for Islamic banks is the International Financial Service Board (IFSB) which provides CG guidelines. The IFSB is based in Kuala Lumpur, Malaysia; with the purpose of setting standards for regulators and supervisory agencies dedicated to strengthening the infrastructure of IFIs. In the IFSB guidelines, stakeholders are the source of reference in order to determine the structure, process and best practices for IFIs. The OECD principles and the BCBS are the guiding principles of CG adopted by the IFSB. Also, they have taken the distinctive characteristics of Islamic banks into account. The IFSB also issues some prudential guidelines on the Sharia governance framework (IFSB, 2015; IFSB-10, 2009; IFSB, 2006).

3.4. The Sharia Compliance Process in the Sharia Governance

CG for Islamic banks is a fundamental measure that must be undertaken according to the internal management or industry guidelines. The role of internal control is to minimize risk rather than eliminate them. Internal control is one of the risk principles that should be managed. The internal control system is the portrait of a well-managed organization. An organization that fails in the application of good internal control system

is at a high risk of damage. The higher the risk, the higher the damage and it can be done to a company's goal.

Generally, an organization has three broad objectives in planning an effective system of internal control; the reliability of financial reporting, efficiency and the effectiveness of the operation, and compliance with the laws and regulations. A company also has five main components of internal control system: control environment, identification and evaluation of risks and control objectives, information and communication, control procedures and monitoring, and corrective action (Shafii & Salleh, 2010).

CG offers an effective framework for monitoring and assessing the Sharia compliance process. Trust in the Sharia Supervisory Committee of organizations is one of the main focuses of CG in Islamic banks. Nevertheless, Grais & Pellegrini (2006c) identified several disputes and encounters in term of the Sharia compliance process on corporate governance in Islamic banks. As such, Adawiah (2007) stated that there are 7 parts of Sharia compliance process that the governing body follow in the IFIs (figure 2.3). In addition, Rosly (2010) stated that there are four parameters to enhance the Sharia compliant position. The first parameter is the *Al-aqd*² approach. The second is the *Maqasid*³ parameter. The third parameter is accounting and financial reporting approach. The last parameter is the legal documentation of contract.

² *Al-aqd* has a meaning as an obligation. Islamic financial products have to fully determine by the legality of permissibly (*halal*) and prohibition (*haram*) of actions.

³ *Maqasid*³ parameter which means Sharia principles must be understood from an angle form purposes and objectives of Islamic law.

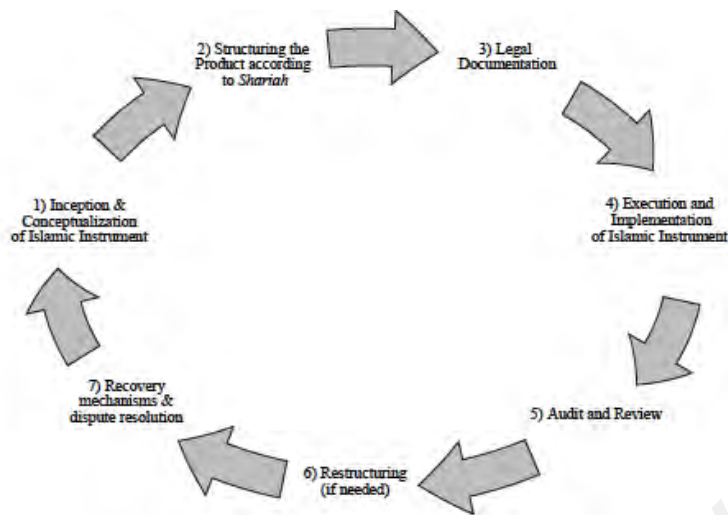


Figure 3.1: The Sharia Compliance Systematic Process in Islamic Bank

Figure 3.1 describes the Sharia compliance systematic process and it requires the involvement of numerous organs of governance. In this systematic process, the Sharia board plays a crucial role to assure the legitimacy of the products and services and it can be achieved by having comprehensive Sharia supervision and an efficient internal Sharia review unit. The Sharia supervisor acts as a liaison officer or coordinator to the Sharia governance process from product initiation to annual Sharia review.

The Sharia governance framework consists of the *ex-ante* and *ex-post* stages. The former is the issuance of Sharia rulings and dissemination of Sharia-related information and the latter is a periodic and annual internal Sharia review process. IFSB-16 explained that *ex-ante* should take place at the product design or development stage before products and services are offered to customers. This stage covers the relevant *ex-ante* processes, that is the issuance of Sharia pronouncements/resolutions and compliance checks before the product is offered to customers. IFSB-18 describes the *ex-post* stage. At this stage, the check is carried out on products or transactions offered. The *ex-post* stage involves good risk management and progressive verification of product viability by presenting

internal Sharia review and Sharia governance reports. This stage is very crucial due to the ability to monitor the consistency of its Sharia compliance and effectively manage any Sharia compliance risk that may arise over time (IFSB, 2006).

A research carried out by Hasan (2011) based on the practice of Sharia rule to identified the regulatory framework through the Sharia board structure, composition, role, function, independence, competence, disclosure and transparency. The study provides data on ways to improve the Sharia governing process and secure the interests of the stakeholder. It is advisable that Islamic banks have internal standard operating procedures for the Sharia governance process. It is also important that they present Sharia review reports. A proper reporting structure is required for the Sharia compliance process to maintain standard operating procedures. Islamic banks should ensure that council meetings are conducted at least four times a year and have standard operating procedures that must be obeyed. It is also important for the Sharia board to undertake self-evaluations and cross-evaluations. Islamic banks should have a sound risk management initiative by having tight external and internal controls, especially pertaining to Sharia compliance.

The objective of the Sharia governance system lies on the philosophical foundation of Sharia compliance. It involves some processes and procedures, which incurs costs and involvement of various organs of governance in Islamic banks. The Sharia compliance system is very important to promote moderation and justice in business transactions in Islamic banks. Therefore, the public image needs to be enhanced on the aspect of compliance in its practice of Sharia rules and principles are very crucial. The primary objectives of Islamic banks are not only to guarantee the shareholders' wealth alone but also to protect the confidence and trust of the public and society who rely on the services provided. In the absence of any assurance of Sharia compliance, the public would not be confident of the legitimacy and legality of the products of Islamic banks.

Consequently, enhancement of the Sharia compliance system, which consists of the *ex-ante* and *ex-post* stages, influence the credibility of Islamic banks (Wilson, 2009a).

The Sharia compliant requirements are unique to Islamic banking operations and activities. Muhamad (2011) pointed out that the requirements of Sharia compliance are one of the unique features of Islamic banking products, services and operations. Rahim (2008) stated that the Sharia compliant process has two stages. The first stage is the *ex-ante* stage where the product is subjected for reviewing in term of the Sharia law. All activities in this stage, such as the design of contracts and agreements and the execution and conclusion of products are performed by the IFIs to ensure that they comply with the Sharia law. The second stage is known as the *ex-post* stage, where the random samples review is completed to ensure that all transactions, services, and operations are in line with the Sharia law.

3.4.1. The Ex-Ante Process of Sharia Compliance

Two processes of the *ex-ante* stage of Sharia compliance that should be verified are: the conceptualization of the product, and the legal documentation procedures involved. This Sharia compliance process stage involves the issuance of Sharia decisions, product structuring or design processes backed by comprehensive Sharia research, scrutinizing of contracts and agreements as well as compliance checks before the product is offered to the customers.

This process includes the pre-product approval process that involves the issuance of Sharia decisions/pronouncements/resolutions, product structuring or design process and backed with comprehensive Sharia research, scrutinizing of contracts and agreements, and compliance checks before the products are launched and offered to the customers. This process involves the procedures for the product design.

According to Ahmed (2010) the SSB must supervise and control the launching of new products that are supported by different departments within the Islamic banks, such as finance department as the financial stability controller, treasury department as the asset and liability department, risk management department to manage and control risks, compliance department as the internal and external regulation's controller, legal department as the examiner of law compliance assurance, marketing and operating department as the products and services development and implementation, and Sharia department for assisting, developing and managing all activities to comply with the Sharia law.

The Sharia non-compliance issue might become a widespread problem in the development process due to the improper structuring of products, lack of internal research in understanding the Sharia concepts, and misrepresentation of the product at issuance or marketing stage. Islamic banks have to recognize that managing a Sharia-based institution is a continuous process, and it requires Islamic banks to have sufficient and applicable measures and controls in place, including risk-mitigating instruments that could address or mitigate Sharia noncompliance cases (Abdullah, *et al.*, 2014). Furthermore, Islamic banks are expected to refer all Sharia matters related to end product development design and process to the SSB. It includes explaining the process involved, documents used and other necessary information. The new products must be certified by the SSB and must be backed by relevant *Fiqh* literature, evidence and analysis. It involves the scrutinization of legal contracts and documents related to the products or transactions (IFSB, 2006).

The SSB must guide the responsibility distributions in this process, which covers idea generation and acceptance, converting the idea into a product, launching and commercialization in the market. The non-compliant conditions and requirements can cause product rejection and launch abortion. The failure of the Sharia compliance can reduce depositors' confidence, investment, and the company's reputation. The SSB must

interpret the Sharia rules and principles based on the discipline of *Fiqh Al-Muamalat* matter of the professional judgment. Thus, if consensus among SSB members cannot be achieved, a central authority like the national Sharia board or *Fatwa* council has the power to ensure pronouncements/resolutions. This stage requires an officer from the internal Sharia review unit/department (ISRU) to be part of the compliance team to monitor the day-to-day compliance to the Sharia pronouncements/resolutions at every level of the bank's operations and transactions.

3.4.2. The *Ex-Post* Process of Sharia Compliance

Islamic banks are required to run in a Sharia compliant manner. It should be in review reports that Islamic banks operate the Sharia law (Onagun & Mikail, 2013). In the *ex-post* process of Sharia compliance, the SSB must monitor the implementation of Sharia principles, identify the area of Sharia non-compliance risk, and propose relevant actions to management. SSB should be observed at the *ex-post* stage after the product has been offered to the customers and transactions have been carried out. Islamic banks have to ensure that the results of the *ex-post* stage are included in its internal Sharia review and Sharia governance reporting.

This process must be performed by the internal Sharia compliance or audit unit. Any case of the non-compliance must be recorded and reported in the Sharia governance report, which is published by the Islamic banks (Abdullah, *et al.*, 2014). IFSB (2006) states that the Sharia pronouncements/ resolutions issued by the SSB should be strictly followed. This stage requires the internal Sharia audit unit (ISAU) to support the roles of the SSB in the Sharia compliance process, where it must provide the requirements or recommendations for the management to address and to rectify any issues and matters of Sharia compliance.

The SSB must appropriately carry out an annual Sharia compliance review to verify the internal Sharia review. Onagun & Mikail (2013) stated the SSB has an obligation to issue Sharia pronouncements/resolutions and must take charge of this process and receive feedbacks and reports from ISRU. Thus, these tasks should be assigned to a competent external auditor or external Sharia firm. The external auditor carries out the Sharia compliance audit to produce a report, whether the Islamic banks comply with the Sharia requirements during the financial year. There are two types of reports produced by the external auditor: a general statement of compliance that should include a detailed account of the compliance work specifically addressed to the supervisory authority. The Sharia audit is conducted periodically. The external auditor has an obligation to provide an independent assessment and an objective assurance design to add value and improve the degree of compliance in relation to the Islamic bank's operations and activities.

3.5. The Sharia Governance in Indonesian Islamic Banks

The Islamic banking industry in Indonesia introduced an amendment to the Banking Act no. 7 of 1992 to allow banks to incorporate profit earnings by way of revenue sharing rather than by interest bearing (Venardos, 2005; Thani, *et al.*, 2003). The BI obliged banks to apply the revenue sharing concept to appoint SSB members. The company law that was endorsed in 1995 became the CG legal framework for limited liability companies in Indonesia. Further, the capital market supervisory (Badan Pengawas Pasar Modal/BAPEPAM) and Indonesian stock exchange also introduced the Sharia governance regulation in the Indonesian capital market to provide the basis for Sharia governance of publicly listed companies in Indonesia (World Bank, 2004).

The company law was introduced by the Dutch during the Indonesian colonization and subjected to the Commercial Code of 1987. The Dutch law affected the Indonesian

dual board system, where the board of commissioners supervised and advised the BoD concerning the management of the operations of the company. However, both the board of commissioners and the board of directors were responsible for the financial statements of the company (World Bank, 2004).

GCG is one of the important variables in the banking industry due to the ever-present risks and challenges. The implementation of GCG consistently strengthens the company's competitive position, maximizing the value of the company. Eventually, it strengthens the trust of shareholders and stakeholders, and the company can operate and grow sustainably in the long term. The national committee on the governance of Indonesian banks issued the Code of GCG, while BI introduced several regulations to support the CG structures of commercial banks and Islamic banks in Indonesia. According to Abdullah (2010), there are some of the regulations issued by BI:

1. Regulation No. 8/4/PBI/2006 about GCG implementation for commercial banks.
2. Regulation No. 9/12/DPNP concerning GCG for conventional banks.
3. The act of RI No. 11 of 2008 about Islamic banking.
4. Regulation No. 11/3/PBI/2009 concerning Sharia conventional banks.
5. Circular letter to all commercial banks conducting business based on Sharia principles in Indonesia and Sharia supervision, and presenting report guidelines to the Sharia supervisory board - No. 8/19/DPbS.

Islamic banks in Indonesia are fully committed to maintaining GCG at all levels of the organization with reference to various regulations. This was embodied in the list compiled by Abdullah (2010):

1. The performance of duties and responsibilities of the board of commissioners and BoD.
2. Implementation of the comprehensive legislation by the committee that controls the internal affairs of banks.

3. Implementation of the internal and external auditing regulations.
4. Implementation of risk management, including internal controlling system.
5. The provision of funds to related parties.
6. Strategic planning.
7. Transparency of the financial and non-financial aspects.

For optimizing the application of Sharia governance, Islamic banks in Indonesia built a reliable infrastructure, carried out internal restructuring leading to best practices, adjusted and renewed the system and procedures to support the effective implementation of Sharia governance. Islamic banks in Indonesia measure the level of compliance in the application of Sharia governance by using a self-assessment, where the results of the assessment are in the form of an index. For internal purposes, the assessment conducted quarterly and report to the BI, and the assessment is conducted on an annual basis (Bank Indonesia, 2009).

3.6. Policy, Mechanism and Organ Structures of the Sharia Governance in Indonesian Islamic Banks

Islamic banks in Indonesia must completely fulfil the various policies (soft-structure) on the implementation of Sharia governance. Islamic banks have to prepare a flexible structure for Sharia governance to fulfil their needs and refer to various provisions in place in Indonesia. Soft-structure of Sharia governance for Islamic banks contains (Bank Indonesia, 2009):

1. Sharia governance charter. This charter is expected to be a guide for the management in the implementation of Sharia governance according to the standards.
2. Code of conduct as a guide for all actors in the Islamic banking industry to act in accordance with the Sharia law, professionally, responsibly, reasonably,

appropriately, and be trustworthy in conducting business with customers, partners and in their relationships with co-workers.

3. Committee charter, including audit committee, remuneration and nomination committee, and risk monitoring committee.

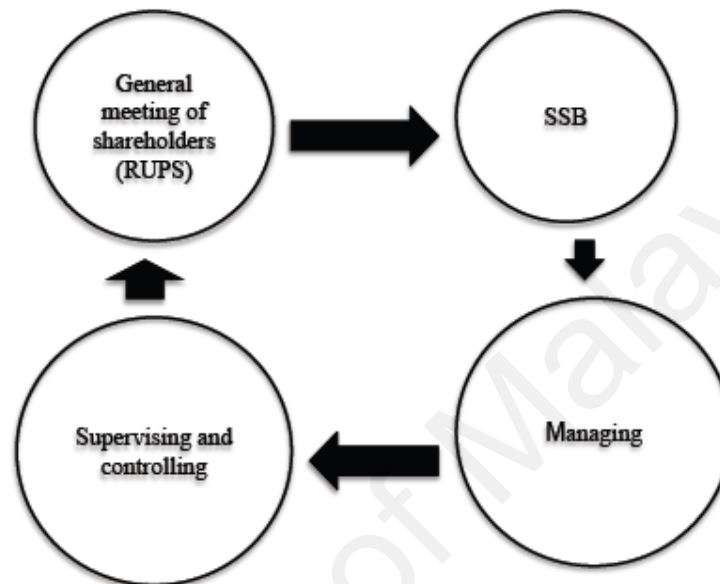


Figure 3.2: The Sharia Governance Mechanism in Indonesian Islamic Banks

Figure 3.2 shows the Sharia governance mechanism in Indonesian Islamic banks. This mechanism shows that RUPS have an important role in decision-making based on the company interest, based on the subject of the provisions' statutes and applicable laws and regulation. The BoD monitors the activities of Islamic banks as an organization, while the commissioners perform adequate supervision on the performance of corporate management. The SSB ensures that products and services of Islamic banks comply with the Sharia principles (Bank Indonesia, 2009).

Furthermore, the organ of Sharia governance includes RUPS, the board of commissioners, SSB, and director; they have the vital role implementing an effective Sharia governance. The soft-structure of Islamic banks should perform its functions in

accordance with the applicable provisions based on the principle that each structure in the organization is independent in carrying out its duties, functions and responsibilities only to the interests of the company (Bank Indonesia, 2009).

1. RUPS, which is the highest power in the company structure and holds all of the authority, which is not submitted to the board of commissioners or SSB. RUPS as a vital structure in the company is a forum of shareholders, which makes important decisions related to the capital investment in the company based on the provisions of the constitution and the laws and regulations. The decision is taken in the RUPS based on long-term company interest. RUPS and or shareholder do not intervene against the duties, functions and powers of the board of commissioners, SSB and directors; therefore, they are without prejudice to the authorities that carry out the RUPS in accordance with the articles of association and the laws and regulations. RUPS decision-making is conducted properly and transparently. RUPS has the authority to approve or not to approve directors or commissioners, to appoint and remove the members of the board of commissioners and directors, to ratify changes to the status of the company, to approve the company's annual report, to establish the allocations of profit, to appoint a public accountant, as well as to set the number and type of compensation and facilities.
2. The board of commissioner is an internal component of the company, it is responsible for overseeing and advising the board of directors and ensuring that Islamic banks comply with Sharia governance at all levels of the organization. In order to support the effective implementation and responsibilities, the board of commissioner establishes the audit committee; risk monitoring committees, remuneration and nomination committees. The board of commissioners does not take or receive personal gain from the bank in addition to remuneration and other facilities set out in the RUPS. Accountability of commissioners to the RUPS is an

indicator of accountability for supervising the management of the company in order to implement the principles of Sharia governance. The board of commissioner performance is evaluated based on the elements of performance appraisal at the end of each period, and the result of performance evaluation is presented at the RUPS.

3. SSB is an independent body of Islamic banks, where the National Sharia Boards (DSN) appoints the SSB members. The system for financing and saving products, operation, and services must be approved as compliant with Sharia principles by the SSB.
4. The BoD is a component in a company that is fully responsible for maintaining the interests and objectives of the company in accordance with the provisions of statutes of the organization. The BoD is responsible for managing the company in order to generate the added value and ensure business continuity of the company. Directors are answerable to the RUPS, which is a manifestation of the management accountability in the implementation of the principles of Sharia governance. The performance of BoD is evaluated by the board of commissioners both individually and collectively by the elements of performance assessment drawn up by the remuneration and nomination committee. The BoD assesses Islamic banks at the end of each period, and the results are submitted to the RUPS.

CHAPTER 4: SHARIA SUPERVISORY BOARDS

4.1. Introduction

The unique characteristics of Islamic banks can be acknowledged from the regulatory infrastructure that supports the growth of CG mechanisms in the institutions (Grais & Pellegrini, 2006a). The most crucial difference between the CG structure of conventional banks and Islamic banks is the presence of SSB and the Sharia review unit (Grais & Pellegrini, 2006b).

Islamic banks employ the SSB to act as a religious auditor (Daoud, 1996) to make sure the religious expectations of those who deal with Islamic banks are met. The SSB produces a report, which includes the necessary assurance to stakeholders concerning the businesses and provides assurance to stakeholders that their business is accrued out in accordance with Sharia principles and values (Fuad, *et al.*, 2011).

4.2. The Definition of Sharia Supervisory Boards in Islamic Banks

With regards to the nature of SSB, it is the key organ of governance in Islamic banks since has a unique characteristic to comply with the Sharia principles and rules as part of the CG framework. Nathan & Ribiere (2007) implied that the existence of the SSB is crucial for assuring the integrity and credibility of Islamic banks. They serve as a representative of equity holders as well as to protect investors' rights and also ensure transparency between those parties (Hasan, 2011; Karim, 1990). The auditing role of SSB, both internally and externally, ensure the correct implementation of Sharia law. AAOIFI (2010) states that the role of SSB is central to creating trust between the banks and the stakeholders by transparency and accountability in providing sufficient information (financial and non-financial) in regards to operation and performance. The

Islamic banks have unique challenges for CG (see Figure 4.2). Two broad sets of issues in IFIs need to be treated specifically to achieve reliable CG in Islamic banks (Van Greuning & Iqbal, 2007).



Daoud (1996) opined that the SSB has the objectives to guide the IFIs in the setting of policies and regulations according to the Sharia law. SSB also approves products and transaction based on Sharia law. Even though SSB have become vital resources in Islamic banks, their authority is derived from different resources, which is the BoD. SSB authority originates from religious, legal and systematic resources. Further, SSBs must give advice to the BoD as well as the top management in regards to religious

matters and conduct internal auditing regularly on the Islamic banks' documents to ensure their compliance with the Sharia law. The quality and control of CG in Islamic banks are monitored by the SSB (Choudhury & Hoque, 2005). The purpose of the SSB is to ensure that Islamic banks conduct business activities in compliance with Sharia rules (Ghayad, 2008; Usmani, 1998). The SSB is employed by Islamic banks and performs as an internal control body in the organization. Therefore, enhancing the credibility of Islamic banks gives the company a good image (Algaoud & Lewis, 1997).

Prior researchers have provided the definition of the SSB functions. For example, Banaga *et al.* (1994) categorized the roles of SSB are to answer enquiries made by the public, to issue formal legal opinions complying with the Sharia law and answer questions asked by bank management or any other parties, to review and revise all the dealings and transactions according to Sharia principles, to evaluate and issue research on any relevant issue; to arrange regular meetings to discuss all enquiries received, to plan and distribute draft of opinions, to release the final opinion document if the board does not have any second opinion on the issue, to make an agreement in collaboration with the legal advisor, to contribute to the drafts of decisions and orders presented by the bank, to prepare explanatory notes, to organize the distribution of *Zakat* resources to eligible parties, to determine the percentage or the amount in accordance with the Sharia, and to perform a technical evaluation and follow up to make sure that the bank abides by Sharia regulations.

In addition, Hassan *et al.* (2010) opined SSB should make an initial inspection of the products and the outcome of the review and suggestion from SSB should be tabled in official meetings to ensure the products and transactions comply with Sharia law. The SSB should take an action if they feel that there are transactions or activities in the Islamic bank that does not comply with or breach Sharia principles. The SSB must take some steps including finding alternative solutions to make the transaction or activities comply

the Sharia rules. If, however, there is no alternative then such transaction or activities will be discontinued and if there is an alternative, and the transaction and/or the activities have been previously executed before it was discovered to violate the approved Islamic business activities, the SSB should give an opinion to the shareholders and the management to take immediate steps to reduce the income that come from the transaction and or activities and distribute its income to a charity. Hence, the Islamic banks risk a potential financial penalty as well as adverse publicity for non-compliance profit (Lewis & Algaoud, 2001).

The Sharia Supervisory Board role definitions are shown in Table 4.1.

Table 4.1: The Sharia Supervisory Board Role Definitions

	AAOIFI (2010)	IFSB (2009)	Bank Indonesia (2009)
Monitoring role	To direct, evaluate and monitor the business activities of the IFIs to ensure they operate in accordance with Sharia rules and principles.	To evaluate and validate Sharia-related policies and guidelines; to recommend and endorse relevant documentation for the new products and services used in the IFIs business transaction and activities; to manage the calculation and distribution of <i>zakat</i> and any other profit to the charity.	To supervise the bank's activities in accordance with Sharia principles; to judge and ensure the bank's products and operations comply with the Sharia rules; to supervise the process of product's development to be in accordance with Sharia principles; to review the mechanism of the process of the funds and the services periodically; to request the data and information related to the Sharia aspect from the internal unit of the bank.
Strategic role	None	None	None
Service role	To present a recommendation to the board of directors for the consideration of the local legislation; to recommend the IFIs to publish the <i>fatwa</i> , procedures and recommendations issued by the SSB.	To advise the board of directors on Sharia matters; to help and guide any relevant parties like legal counsel, auditor or another consultant; to record in written form any opinion related to the Sharia issues.	To give an advice and recommendation to the board of directors; to make a monitoring report in the semester.
Resource dependence role			To ask for <i>fatwa</i> from the National Sharia Board – (Majelis Ulama Indonesia/MUI) about new products.

Adapted from: Wan & Ong (2005)

The international association of Islamic banks (IAIB) stated that the SSB should be made up of jurists and scholars of Islamic jurisprudence who have a firm belief in the knowledge of Islamic banks. For implementing the SSB's freedom to initiate their opinion, the following are considered to perform their obligation as personnel in the bank and is not subjected to the authority of the BoD, SSB members are appointed by general legislature, the legislature determines the remuneration for the SSB members; and as a legitimate control body, SSB members have the same means and jurisdictions as auditors (El-Nagar, 1980).

The members of SSB should produce some benefits, which are the benefit from collective opinions and Sharia decisions (DeLorenzo, 2004; Al Qaradawi, 2001), the elimination of any conflict of interest that might arise from Sharia decision-making (Al Baali, 2001), issuing *Fatwa* and taking Sharia decisions is approved by voting (Garas & Pierce, 2010; Al Baali, 1991), and enhancing client's confidence in the products, contracts and services (Hammad, 2006). Furthermore, AAOIFI (2010) added that SSB members should have knowledge of IFIs. SSB is responsible for directing, supervising, and reviewing the activities and operations of the IFIs in order to comply with Sharia law. Hemaish (2005) stated that SSB members should possess knowledge and skills related to the Islamic banking industry. The mandatory function of the SSB is *Fatwa*, Sharia decisions.

However, in many cases, the review reports submitted by the SSB to the management has become a routine, with no adequate implementation (Warde, 1998). Furthermore, Hassan (2001) added that there are two roles of SSB, which are to guide and to control. The guidance roles are related to the revision of policies, contract and agreement, and training in applying Sharia law. The control roles of SSB are linked to a review of transactions and services to comply with Sharia law. Al Nashmi (2002) suggested that the roles of SSB cover the implementation of Sharia law on the transactions

and supplementary roles between SSB members and other Sharia governance actors in the Sharia governance structure. Al Zarrqa (2002) categorized SSB roles into internal functions that are related to issuing *Fatwa*, controlling the implementation of *Fatwa*, and assisting the company goal's achievement; and external functions which include the assurance that all the transactions, operations, and products comply with Sharia law.

SSB roles can also be categorized into moral, practical, consultation, administrative, and control aspects (Fayyad, 2004). In addition, Hammad (2009) stated that there are academic and executive roles in the SSB. The academic roles include the development of Islamic jurisprudence through research for the non-compliance activities. These roles also cover the education of managements in Islamic jurisprudence through seminars, conferences, and workshops. The executive roles relate to the preventive processes or review processes, remedial or audit control, and complementary control or reviewing all transactions and products along with the Sharia internal auditor's reports. Overall, Garas & Pierce (2010) concluded that there are two important roles in SSB, such as the issuance of *Fatwa*, approving new products, contracts and services, auditing, and the implementation of Sharia law along with Sharia internal auditors, auditing the financial statements at the year end, and approving the net income distribution between shareholders and IAHs. Further, the consulting roles incorporate presenting *Fatwa* and Sharia decisions to answer compliant solutions during the implementation of transactions, contracts and agreement, explaining the calculation of *Zakat*, guiding the allocation of non-compliance Sharia income for charity, and conducting workshops, training, seminar and lectures for the management and clients.

SSB members must comply with a number of rules to ensure the Islamic legitimacy of financial products and transactions are implemented (Saeed, 1996). The *Quran* and *Sunnah* are the primary sources for SSB (Abdullah, *et al.*, 2014). SSB members' remunerations are fixed. BoD members' remuneration is related to the annual

net income; however, the remuneration for SSB is a fixed amount independent of the net income (Garas & Pierce, 2010).

There are four parameters to enhance a Sharia compliant position for the Sharia governance framework. The first parameter is the *Al-aqd* approach. *Al-aqd* means an obligation. Islamic financial products have to be fully determined by the legality of permissibility (*Halal*) and prohibition (*Haram*) of actions. The second is the *Maqasid* parameter which means Sharia principles must be understood from an angle of purposes and objectives of Islamic law. The third is the accounting and financial reporting approach. The last approach is the legal documentation of contract (Rosly, 2010). Compliance with the Sharia law is also the main item for Islamic banks. The stakeholders expect Islamic banks to be compliant with the Sharia law. Compliance with the Sharia law by Islamic banks can guarantee a good image and reputation. Supervision of ethical character to transactions and product development is not enough, the behaviour of directors and the frameworks of the company organization should essentially be monitored by the Sharia boards (Racha, 2008).

Regardless of the development of Sharia governance in IFIs, some issues are important in the Sharia governance process, such as the Sharia board's independence, competence, conflict of interest, confidentiality, transparency, disclosure (Hasan, 2011; Grais & Pellegrini, 2006c). IFSB (2006) presented some essential components or key elements of Sharia governance:

1. Competence, which means the IFIs have to ensure that there are fit and proper conditions, professional training and formal assessment for the Sharia board. In the context of an operational framework that is, *ex-ante*: screening process and *ex-post*: review and assessment.
2. Independence means that the IFIs should be given an adequate capability to exercise objective judgment and complete with adequate and timely information.

3. Confidentiality is strictly to observe the confidentiality. At the *ex-ante* stage, there should be secrecy and at the *ex-post* stage, there should be review and assessment.
4. Consistency means to require the full understanding of the legal and regulatory framework, which should be strictly observed according to the framework. This principle must be consistent in all *ex-ante* and *ex-post* Sharia governance process.

A definition of governance effectiveness will be presented next based on the information from AAOFI, IFSB and PBI 2009. Table 4.2 shows the definition of the Sharia governance effectiveness in Islamic banks, which was drawn by applying five indicators from Van Greuning and Iqbal (2007).

Table 4.2: The Sharia Governance Effectiveness in the Islamic Banks' Definitions

	AAOIFI (2010)	IFSB (2009)	Bank Indonesia (2009)
Independence	A manner of thinking which does not let the objectivity and conclusion become the influences and pressures of conflicting interest. The principle should be constructed on the obligation that SSB members must be fair, honest and neutral.	In order to encourage integrity and credibility, SSB members must not allow an individual or group to influence decision-making. In addition, SSB members must not have a blood and intimate relationship with the IFIs.	Professionals must make an objective decision free from any influence and pressure, they must have a strong commitment to achieve this objective.
Confidentiality		SSB members have to ensure that all internal information is kept private.	
Competence		The IFIs have to ensure that any person mandated will fulfil the qualification and appropriate criteria. The members of the board have must have the capability and skill required for the technicalities of the business, the risks, and the management process to conduct the operation effectively.	Accountability of function and implementation for effective management of the bank.
Consistency		The IFIs should ensure that SSB members are fully aware of the appropriate procedures and processes before the <i>ex-ante</i> period of the product and the <i>ex-post</i> period is developed and concluded. The IFIs also have to be very careful when it disseminates or issue a conference to the press or the public.	The responsibility of the management of the bank to comply with laws and regulations.
Disclosure			Transparency in expressing any relevant information, as well as in implementing the decision-making process

Adapted from: (Van Greuning and Iqbal, 2007)

4.3. Profile of Sharia Supervisory Boards in Indonesian Islamic Banks

The latest development for Islamic banks in Indonesia was on the 7th of December 2009, BI published regulation No. 11/33/PBI/2009 (PBI 2009) on GCG practices for BUS and UUS (Abdullah, 2010). In the regulation of Indonesian Central Bank (PBI) 2009, GCG has several principles. First, transparency means a disclosure to express all the relevant information, as well as honesty in the decision-making process. Second, accountability is a clear feature required in the banks. Third, responsibility is compliance with the regulation and the principles of bank management. Fourth, professional means competent or able to act objectively, it should be free of pressure from any party and have a high commitment to develop Islamic banks. Finally, fairness means equality in fulfilling stakeholders' rights based on agreements and rule.

PBI 2009 was formed to achieve CG effectiveness in practice. It was also developed to improve the Islamic banking industry, which requires a healthy and strong implementation of Sharia compliance principles. Moreover, GCG protects the interests of stakeholders and improves compliance with Sharia rules and values. The implementation of the CGC includes the following:

- a. Ensuring that the board of directors perform their duties;
- b. Ensuring that the SSB performs their roles;
- c. Ensuring external and internal audits are carried out;
- d. Setting a standard for the distribution of funds;
- e. Ensuring transparency of the financial and non-financial aspects of Islamic banks (Abdullah, 2010; Bank Indonesia, 2009).

In general, the structure of CG in Islamic banks must be adjusted to the legal entity structure in Indonesia. In particular, the regulation requires the establishment of SSB in the internal structure of all Islamic banks. In PBI 2009, the SSB holds a crucial position to ensure compliance to the CGC along with Islamic principles (Abdullah, 2010). The

nomination the SSB members should be done by the general meeting of shareholders (RUPS) on the recommendation of the Indonesian *Ulama*¹ Council (MUI) or National Sharia Board (DSN)², considering suggestions and or recommendations of the Remuneration and Nomination Committee³ (see Figure 4.2). It should be ensured that the CG structure of Islamic banks in Indonesia fully follows the requirements of the BI unless specifically regulated in PBI 2009. There are 5 requirements for the implementation of the CGC:

1. Establishment of the vision, mission and corporate values;
2. Design of the CG structure;
3. Establishment of a corporate culture;
4. Declaration of assets for public disclosure; and
5. Improvement of bank's policy to meet the principles of GCG (Abdullah, 2010).

¹ *Ulama* are Muslim scholars trained in Islam and Islamic law.

² National Sharia Board formed by Indonesian Council of *Ulemas or Ulama* in 1999, is an independent body duly recognized by Bank Indonesia and is responsible to issue Sharia rulings on products of Islamic banks. Bank Indonesia issues regulations for Islamic banking products based on *Fatwa* issued by National Sharia Board

³ The duties for this committee are to assist the board in determining the criteria for selecting the candidates for the Board of Commissioners and Directors and their remuneration system. They help to prepare candidates for the Board of Commissioners and Board of Directors and the right amount of the remuneration. An independent commissioner chairs the Nomination and Remuneration Committee and the members consist of the Commissioner and or professionals from outside the company (Bank Indonesia, 2006).

Table 4.3: The Sharia Compliance Frameworks – Country Wise

Country	Islamic Banking Law	Sharia Committee		Fit and Proper Criteria for Sharia Advisor/ Committee	Sharia Compliance Inspection	Sharia Standards
		At Central Bank	At Bank Level			
Malaysia	Islamic Banking Law 1983	Sharia Advisory Council	Sharia Committee	Approval by BNM	Governance through Sharia Committee	All Products Approved by SAC, Role of Sharia Committee defined by BNM
Bahrain	Regulation for Islamic Banks	Sharia Supervisory Committee	Sharia Supervisory Board	N.A	Internal and External Sharia Audit as per AAOIFI standards	AAOIFI
Indonesia	Laws for Islamic Banking Introduced in 1992 and Amended in 1999	National Sharia Board	Sharia Supervisory Board	N.A	Internal and External Sharia Audit	Fatwa on Products by NSB
Iran	Usury Free Banking Act 1983	Council of Guardian	N.A	N.A	No	Guidelines Provided by Council of Guardians
Brunei	Islamic Banking Act Cap. 168	Sharia Financial Supervisory Board (SFSB)	Sharia Advisory Board	SFSB Approves Appointment of Sharia Advisory Board Members	No	SFSB Approves Islamic Products Introduced by Financial Institutions
Pakistan	Banking Companies Ordinance, 1962 and Policies for Islamic Banking in 2001 and 2003	Sharia Board	Sharia Advisor	Fit and Proper Criteria by SBP	Manual developed in 2004, now being implemented	Essential for Islamic Modes

Source: (Akhtar, 2007)

A special rule for SSB in Indonesian Islamic banks started with the decree of BI board directors dated 12th May 1999, in Paragraphs 2 and 3 of Article 19 which stated that Islamic banks have an obligation to direct the SSB. The establishment of the SSB is

regulated by the DSN. DSN is an autonomous institution under the Indonesian *Ulama* Board (MUI), which published the legitimacy Act No. 21 of 2008. SSB is regulated by Act No. 10 of 1998 concerning amendments to Act No. 7 of 1992 on banking, which accommodates SSB as an ombudsman for Islamic banks in Indonesia (Abdullah, 2010).

The DSN carry out the following functions:

1. Assessment of the *Fatwa* issued by the SSB;
2. Issuance of *Fatwa* which assists in implementing the regulations issued by the Ministry of Finance and BI;
3. Recommend competent individuals as SSB members to Islamic banks;
4. Invite experts to explain problems related to Islamic finance;
5. Reprimand Islamic banks for the lack of implementation of *Fatwa*; and
6. Counsel relevant authorities to take an action if the warnings are not adhered to (Kementerian Agama, 2008).

PBI No. 6/24 / PBI / 2004 states that the SSB is a board which supervises Sharia principles in business activities of IFIs (Bank Indonesia, 2004; Bank Indonesia, 2009). Act No. 21 of 2008 emphasized that the SSB in BUS and UUS is responsible for advising the board of director (BoD) and to supervise the bank's business activities to comply with the Sharia law. Article 32 of Act No. 21 2008 states that the SSB should be appointed during the RUPS on the recommendation of MUI. Article 56 regulates the roles of the SSB to ensure that their duties are carried out according to the Sharia (Kementerian Agama, 2008).

SSB is basically an extension of the DSN in the understanding that *Fatwa* is regulated by the DSN. The role of SSB is the gatekeeper of the IFIs, namely the Islamic banks, Islamic insurance, Islamic capital markets, and others. These institutions work in accordance with the demands of Islamic law. Supervision, in addition to aspects of Islamic financial products also includes the management and administration of IFIs to

conform to sharia. On the other hand, SSB regulations are published with approval from the DSN (Kementerian Agama, 2008). DSN members must meet the following requirements: have good character and morals, have the ability, knowledge and experience in the field of Sharia and *Muamalah*, an example of the SSB is the MUI (Indonesian *Ulama* Council), it performs the task required of the SSB.

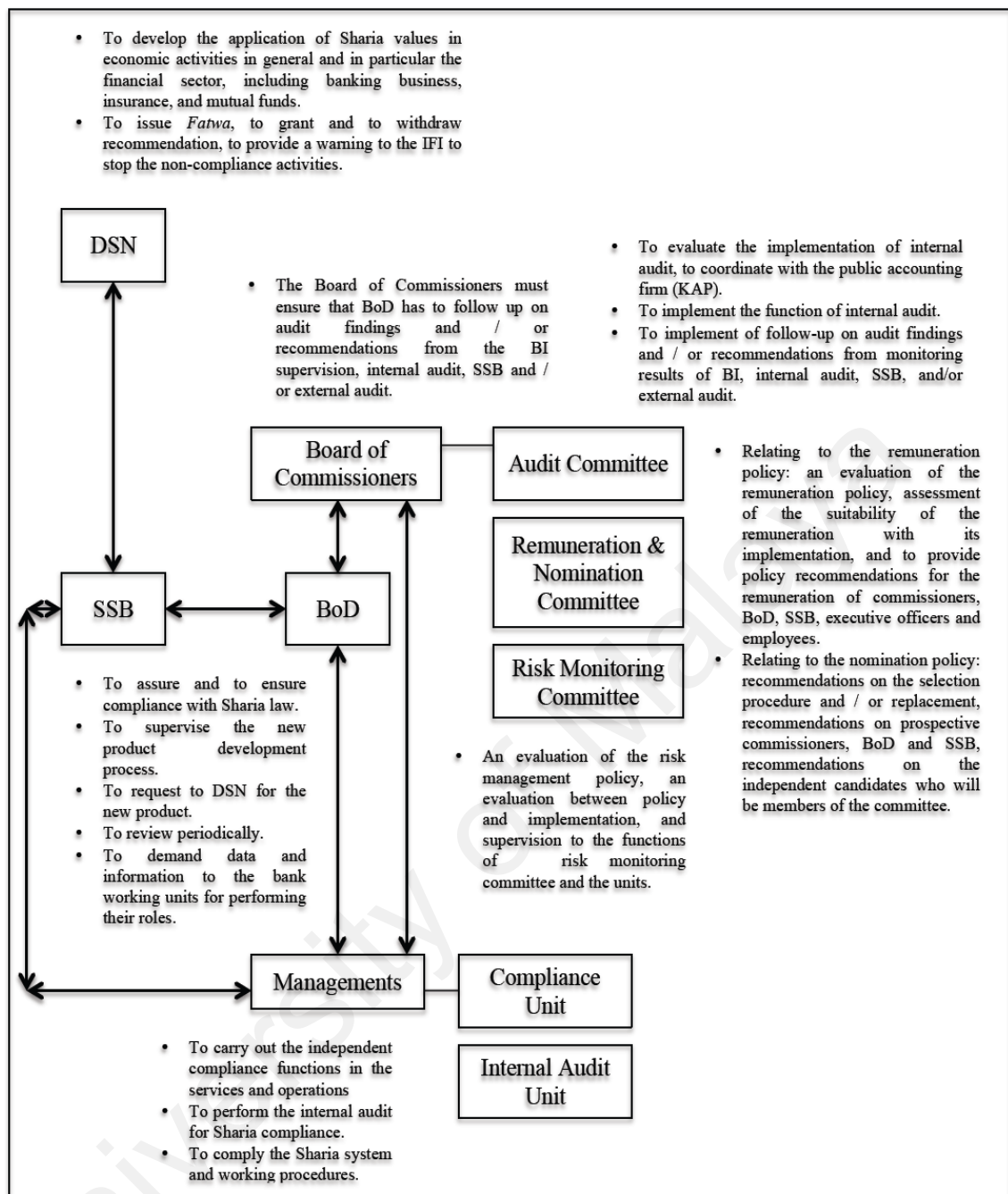
SSB is an independent body in Islamic banks whose roles include overseeing the application of Islamic principles in banking operations. Its' members consist of experts in the field who has the knowledge of *Fiqh Al-Muamalah* common in banking and other capabilities that are relevant to daily tasks. SSB is regulated by the DSN to ensure the compliance of bank products and services to the Sharia. According to Article 46 PBI No. 11/33/PBI/2009, SSB has an obligation to perform their roles and responsibilities in accordance with Sharia governance. Article 47 PBI No. 11/33/PBI/2009 mentioned that SSB has roles and responsibilities of advising the BoD. SSB also carry out the following functions:

1. Implement *Fatwa* and assure that bank's products and operations comply with the Sharia;
2. Ensure the approval of a new product by the SSB is in line with the Sharia;
3. Regularly conduct reviews to fulfil the Sharia law of funding and disbursement of fund in Islamic banks; and
4. Provision of relevant data and information by the banks' task force unit (Bank Indonesia, 2009).

SSB members should possess some basic requirements: First, an SSB member should necessarily have a formal education. SSB should have a background in Sharia and religious studies in general. SSB members should support this with such skills as management, banking operations and auditing. Second, an SSB must be a professional and should work full-time (full-time). SSB members who work part-time are members,

which occupy in other positions in the society, for example lecturers, experts, consultants, preachers and so on. Third, SSB member can hire members from professional associations, such as associations of accountants, lawyers and others. There is no discourse to establish the existence of a new profession. The professional association can be formed to improve their reputation with stakeholders. Fourth, SSB members are committed to improving the quality of knowledge and skills, either through seminars, training, and workshops or through other media. This can be done through services generally provided by professional associations. SSB functions are not limited to Islamic banks, they also work in Islamic insurance, Islamic capital markets, and others, SSB should be run in a professional manner. Finally, SSB members must suggest a resolution for non-compliant activities, operations and products. SSB members not only have the knowledge of *Fiqh-Al Muamalat* but also banking, economy, capital market, accounting and others (Abdullah, 2010).

SSB have an obligation to publish reports under the right permissions. Article 48 PBI No. 11/33/PBI/2009 stressed that SSB members have to be given sufficient time to perform their roles and responsibilities optimally. Article 49 emphasized regular meeting. Further, Article 50 and 51 discussed the transparency issue of SSB members, such as dual position, personal interests, remuneration and facilities that are provided by the bank (Bank Indonesia, 2009). Figure 4.2 illustrates SSB roles and functions in the Sharia compliance process in Indonesian Islamic banks based on PBI No. 11/33/PBI/2009.



Source: (Bank Indonesia, 2009)

Figure 4.2: The Sharia Compliance Framework in Indonesian Islamic Banks

The law of Islamic banking in Indonesia does not clearly give the understanding of the principles of governance. The definitions are given explicitly via PBI. According to Hasan (2010), the governance principles the same as in PBI 2006, namely *TARIF*:

1. Transparency means to publish appropriate and relevant information; this could also include information about the decision-making process.

2. Accountability is the clarity of function and its implementation. This enables the bank to run effectively.
3. Responsibility means consistency of the management in complying with Sharia laws and regulations.
4. Professional, which means has a competent to make an objective decision free from any influence and pressure, and have a strong obligation to achieve the development.
5. Fair means fairness and justice to assure the stakeholders' based on the rules and the legal contract.

PBI 2009 was formed to achieve CG effectiveness in practice. It was also developed to improve the Islamic banking industry, which requires a healthy and strong implementation of Sharia compliance principles. Moreover, GCG protects the interests of stakeholders and improves compliance with Sharia rules and values. The implementation of the CGC includes the following:

1. Ensuring that the BoD perform their duties;
2. Ensuring that the SSB performs their roles;
3. Ensuring external and internal audits are carried out; and
4. Setting a standard for the distribution of funds;
5. Ensuring transparency of the financial and non-financial aspects of Islamic banks (Abdullah, 2010; Bank Indonesia, 2009).

PBI 2009 also governs the following tasks of the SSB:

1. Assessing and ensuring compliance with Sharia principles and operational guidance of products issued by banks;
2. Supervising the new product development process to fit the *Fatwa* from DSN and MUI;
3. Reviewing the DSN-MUI *Fatwa* for new products;

4. Periodically reviewing the mechanisms and disbursement of funds and bank services for compliance with Islamic principles; and
5. Requesting data and information relating to aspects of Islamic bank unit in the implementation of tasks.

The presence of SSB is acknowledged by the law as a representation of the MUI to ensure Sharia compliance. The implementation of GCG through (Abdullah, 2010):

1. Establishment of the vision, mission and corporate values;
2. Forming CG structure;
3. Formation of corporate culture;
4. Establishing the facilities of public disclosures; and
5. Improvement of bank policies to meet the principles of GCG.

4.4. Issues of Sharia Supervisory Boards Effectiveness

Although the Islamic bank industry has become a social phenomenon, there are some issues in the industry, which depict the state of the SSB performance. The SSB are the key principles of Sharia compliance at Islamic banks in order to ensure constant surveillance and check-and-balance over the Islamic bank's business and operations (Alwi, 2007). The addition of SSB on the governance structure shows that SSB has important responsibilities to perform *ex ante* and *ex post* Sharia compliant process, which enables it to justify to what extent Islamic banks' operations and business comply with Sharia law (IFSB, 2015; AAOIFI, 2010). According to Bank Indonesia (2009) the role of SSB has similarities with external auditors for Islamic banks. SSB must monitor and confirm that the bank's products and transactions, as well as daily operations comply with Sharia law.

However, some findings from previous research show the issues related to SSB performance. Islamic banks have suffered from a shortage of young and experienced Sharia scholars (Garas, 2012). Karim (1993) stated that the members of SSB and external auditors ideally should be from one organizational body since Sharia law does not recognise any separations between business and religion. Banaga, *et al.* (1994) also highlighted the misunderstanding and conflict between SSB and management of Islamic banks have influenced the Sharia compliance process atmosphere, resulting in a number of Sharia misapplications. This condition affects the degree of monitoring and supervising by the SSB, as the guard role to cover the Sharia compliance.

Research from Hassan (2010), Syafei (2002) and Rahim, *et al.* (2002) studied Islamic banks in Malaysia and Indonesia regarding the SSB roles, functions and competency. Their research highlighted that there is an urgent need to improve the responsibilities, independencies and the competency for the SSB members. SSB are constantly criticised for being moderate, rushed and incomprehensive in certifying new products because of lack of depth in the field of accounting and finance. Furthermore, Ghoul (2008) conducted a case study research to examine the impact of scholar-related issues on CG in Islamic banks. His result revealed the need for Islamic banks to develop an internal Sharia audit unit. This unit will conduct internal Sharia audit as part of internal control system. This unit also will help to lighten the load of SSB, and standardization of Sharia interpretation to harmonize the process of Sharia compliance assurance in Islamic banks.

Some issues in the Islamic banks about the lack of consistency in the application and interpretation of Sharia has been researched by Abbas (2008) and Karim (1990). SSB has been employed by the Islamic banks as their own Sharia advisors, but there are fears that the SSB might approve products and transactions that might not fully comply with Sharia requirements. The result of their research showed that the differences within the

Islamic banks and among religious jurists in various Muslim countries in relation to which financial products and transactions are truly Islamic.

Further, Abbas (2008) also conducted a research about Sharia governance and transparency. His research showed that the issues about governance of Sharia principles and rules in Islamic banks affect the actual practice of Sharia application and monitoring. It is due to the lack of consistency in this industry for Sharia supervision standard. It might influence the roles of SSB in the Sharia compliance process. As a result, Islamic banks have traditionally been secretive about their Sharia practices due to fears of criticism from competitors and the wider religious bodies.

4.5. Prior Studies

Generally, most of the research in Sharia compliance of study focused on the central requirement of the roles of SSB. Khan & Ahmed (2001) conducted a study on the effectiveness of the Sharia board's performance, bank management and the monitoring roles. They provide interpretations about obligations to assure the products, services and transactions comply with the Sharia law. One such obligation was revealed by Muslim & Zaidi (2008) whereby the SSB acts as a safeguard in assuring the compliance with the Sharia law. In terms of compliance, Dusuki & Abdullah (2007b) emphasized that the compliance with Sharia law is crucial in every aspect of its operations and transactions. According to then, compliance to the Sharia law is a holistic view of Islam, which is as an integrated code of life to cover individuals and the society at large.

Similarly, Karim (1990) affirmed that the SSB is a unique feature to perform a religious safeguard in Islamic banks. Karim's (1990) findings highlight concerns regarding the SSB's independence as an internal adviser and its influence on the Islamic bank's credibility. From another viewpoint, Raman and Bukair (2013) examine the influence and characteristics of SSB on the corporate social responsibility (CSR)

disclosure. The finding of their research showed that the characteristics of SSB were the main factors in determining the CSR disclosure.

More recently, Mohammed & Muhammed (2017) conducted a study on the SSB by adopting the agency and stakeholder theory. The authors followed the critical review discussion to present theories and link those theories with the Islamic standpoints. Their results showed that SSB as an independent board can influence to the firm. Likewise, Nomran, *et al.* (2018) investigated the Sharia compliance on 15 Malaysian Islamic banks to study the performance and the effects of SSB characteristics. This study revealed that there is a significant relation between SSB size, doctoral qualification, and change with the SSB composition and performance. This study also implied that the important variable to improve the performance of Islamic banks are SSN cross-membership and reputation.

Meanwhile, Rafay and Farid (2018) studied the role of the SSB in Islamic banks adopting an experimental method from investors' perspective. The objective of their study is to define the impact of information in relation to the SSB's performance in Islamic banks. They used Sharia compliance and other conventional parameters to test the impact of information in SSB. The evidence indicated that SSB has become an important factor to invest in the Islamic banks. Then, the primacy effect also become a significant influence for financial and investment decisions.

Furthermore, Malkawi (2013) studied the SSB in the governance structure of IFI. His study stated that SSB as an independent body has an obligation to direct, review and supervise all the transactions and operations for complying the Sharia law. His study underlined that the SSB must have a clear framework and structure to assure their independence and effectiveness. The study also discovered that SSB is part of Sharia governance structure with a unique feature in financial system due to the religious aspects in the overall transactions and operations. The SSB needs to have a strong governance framework. This is because effective Sharia governance is an important variable to

enhance the credibility of the IFI. The effect of failures in the Sharia governance can cause the serious disorders and dire values for the IFI.

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CHAPTER 5: THEORITICAL FOUNDATION OF THE RESEARCH

5.1. Introduction

This chapter provides an overview of the literature on the roles of SSB in Islamic banks to build a framework. This chapter defines these phenomena and then provides the theoretical perspectives to form the determinants that were identified in the literature. After reviewing previous studies, it is intended that this paper would contribute to the collective knowledge in this area.

The chapter reviews literature in the field of behavioural theory of boards and professionalism. In this chapter, the relationships among the study's themes which form the research questions are examined to understand the roles of SSB in the Sharia compliance process. The discussion in this chapter is made to draw attention to the behavioural theory of boards and professionalism as found in the extant literature.

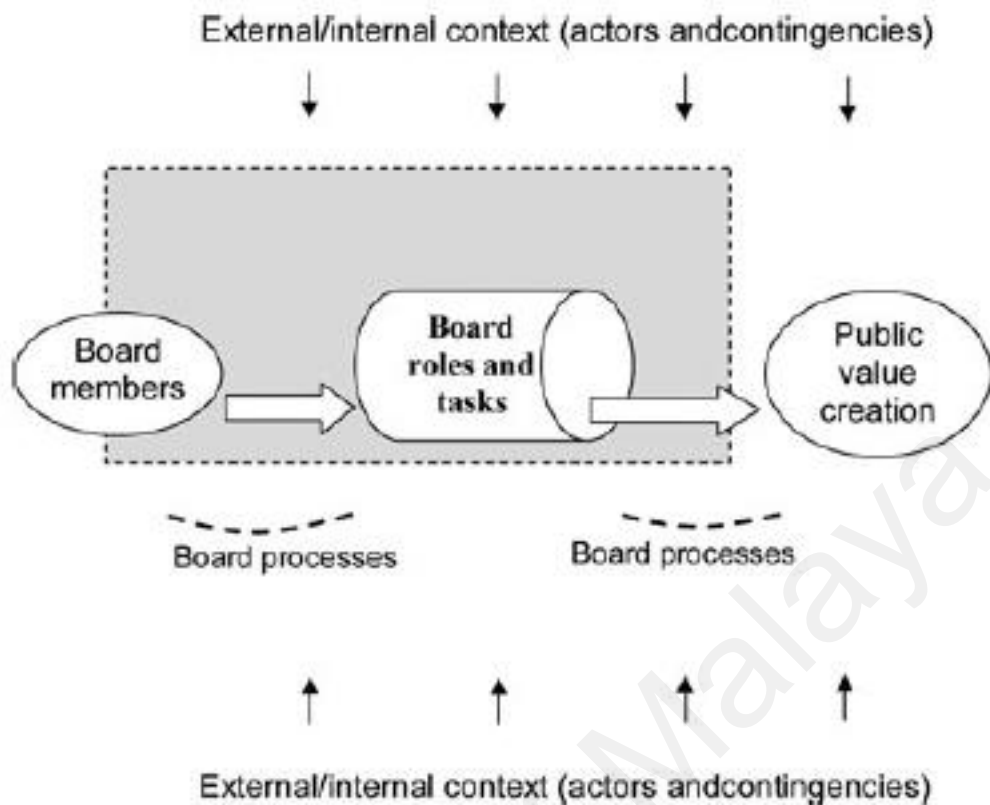
5.2. Behavioural Theory of Boards

A behavioural theory of the firm developed by Cyert & March (1963) stated that understanding the board processes is a key factor of board effectiveness with the purpose “to open up the black box of internal workings of organizations” and enlighten the way decisions are made (Ees, *et al.*, 2009). Huse, *et al.* (2009) stated that the behavioural theory of board mainly relates to the study of interactions and behavioural processes. Behavioural theory of board gives an understanding of new concepts and behavioural research in board effectiveness.

Behavioural theory discusses interactions among actors that influence decision-making outcomes (Huse, 2007). Collaboration among board members is a process, which takes place within the board and among board members and can encourage and hinder a

given group's outcomes. Since the board consists of individuals who consistently have communicate with each other both inside and outside the boardroom, collaboration and interaction play an important role in understanding them.

Board behaviour has barely been studied, hence there is need to better understand what makes a board function and how do boards contribute to company wealth (Huse, 2007; Gabrielsson & Huse, 2004; Daily, *et al.*, 2003). Specifically, the socio-psychological process is crucial for understanding board effectiveness in creating social and economic value for the company, as well as group collaboration and the exchange of information. Huse (2009) filled the gap in board behaviour using the behavioural perspective. In this perspective, the board is considered as an open system with interaction between board members, the top management team, and various other actors both inside and outside the board environment (see Figure 5.1). This figure explains the board members' functions and roles inside the black box; however, it also recommends that boards have to use an open system interact within the internal and the external context. In this framework, the board dynamics, processes and their roles are influenced by the board and also depend on other contextual factors, such as actors and/or contingencies, which can have an effect on board effectiveness (Forbes & Milliken, 1999). Due to the pressures arising from the request of the different actors involved, boards are likely to categorize the issues differently and to embrace different opinions about the appropriate responses to these problems (Dutton & Jackson, 1987).



Source: Huse (2009)

Figure 5.1: Revised Model of Board Behaviours

The interactions of boards are classified based on types and degrees of trust and emotions, stakeholder orientations, cognitive perspective. The power of boards is classified based on the interaction of boards with their environment, this is influenced by the actors within the organization (Brundin & Nordqvist, 2008; Huse, 2007; Huse & Rindova, 2001, Zahra & Pearce, 1989). Amason (1996) divided the task element of boards into: policy development implementation, incorporation of both the affective reactions and the cognitive processing of decision makers. Lord (1979) classified the conflict that occurs within groups as a result of decision-making into: cognitive, interest, and value. Cognitive conflict is defined as the judgemental differences about the best solution to achieve the organizational goal, and it is based on a technical disagreement regarding how information should be interpreted. Interest conflict refers to the differential effects of strategies on various stakeholder collations where different stakeholders obtain different

benefits and costs under alternative policies (Berg, 2007). Amason (1996) described the affective conflict as personal incompatibilities; they tend to be emotional and more ideological in nature, and reflects different preferences or values. In this case, there is no political consensus for actual outcomes, particularly outcomes that are related to non-monetary impacts. Group decision-making conflict must be solved in order to arrive at the best decisions. Board members have to be held accountable for their judgments and actions and pursue a common vision and interest by way of conflict resolutions in the boardroom.

Generally, most research on board in CG are based on incomplete and inadequate models (Huse, 2005). The human element is seldom incorporated and the primary reason behind board failure is an improper investigation (Finkelstein & Mooney, 2003). Thus, the decision-making and judgment processes should be discussed due to the complexity of behaviour assessment (Daily, *et al.*, 2003). Huse (2005) categorized the behavioural perspective with formal regulations and policies; however, these concerns are not sufficient to fully understand effective governance. Huse's article (2005) focused on the performance of board functions in assuring stakeholders of Sharia compliant of Islamic bank's products. Huse's article focused on the performance of board functions and revealed that the board is obliged to carry out various activities in order to fulfil the stakeholder's expectation.

Another challenge highlighted in Huse's article was meeting the need for behavioural best practices of boards and governance. Due to the growing number of studies in this field, there is the need to explore an intermediate intervening process between board composition and outcomes (Gabrielsson & Winlund, 2000; Forbes & Milliken, 1999). On the other hand, most researches only discussed the actual work of the board as a block box, by assuming that the behaviour and conduct of directors can be successfully gathered from demographic characteristics of the board. Balancing the

power between external and internal board members would result in effective governance. Past studies did not cover some issues, such as the relationships, motivations, abilities among various kinds of boards. The more important concern in behavioural perspectives is the relationship among board members and the processes in governance (Huse, 2005).

Furthermore, Ees, Gabrielsson, & Huse (2009) in their research used some approaches to assess the behavioural theory of board in CG. The first approach focused on the interactions and behavioural processes among and between actors in and around the boardroom rather than on the outcomes, such as the performance of boards. Most studies like Gabrielsson (2004), Forbes & Milliken (1999) and Pettigrew (1992) examined boards from an economic perspective and more or less neglected actual board behaviour. Their research did not study the relationships between ideal-typical board structure and corporate performance. They conducted unquestioned behavioural assumptions as the basis for the recommendation of analysing the interaction, communication, and information sharing among board members. On the other hand, Huse (2005) exposed the starting point for the behaviour of boards and CG for the interactions and behavioural processes in and around board's environment.

The emphasis on actual board practice is compulsory, but not a sufficient; condition for behavioural theory of boards and CG. There is a challenge to expand beyond the simple description of behavioural concepts of decision making. The following principal notions explain the behavioural theory of board and CG: bounded rationality, satisficing behaviour, routinization or heuristic decision-making processes, and political bargaining in the context of the corporation as a stakeholders' coalition. Consequently, these principal notions have become a new research agenda grounded in the behavioural theory of board and address past performances in the board context, the alternative searches, the decision-making routines and procedures in and around the boardroom (Ees, Gabrielsson, & Huse, 2009).

For starters, the first argument is that the behavioural perspective of board and CG focuses on the decision-making processes rather than structure and outcomes. Karreman, Alvesson & Wenglen (2006) showed that if there is a structure in existence, it is due to constructs and reconstructs of intentions and actions by the actors so they have their own identities. Spender (1989) and Jensen & Meckling (1976) proposed that much more studies are conducted on the effects of past behaviour, previous experience, and shared beliefs on the current decision-making behaviour in and around boards. For example, the highlighting of context and history in the behavioural theory on board and CG are in contrast to a more conventional approach taken in economics, where the companies follow a complex process; here, the objectives of the conflicting individuals are balanced within a framework of contractual relations.

The second approach for behavioural theory of board is to conceptualize the corporation as a link of coalitions of stakeholders without any preceding assumptions of organizational goals and objectives. For example, a starting point for comparing the dominant perspective may perhaps sound a bit radical stating that the principal objective of the corporation is to maximize shareholder wealth. However, the behavioural theory underlines that the background of goals and objectives are influenced by power play and politics in and between coalitions. Other examples also showed that the behavioural theory will accept that board decision-making behaviour is contingent upon the relative power and relationships among various coalitions of internal and external actors. Then, Zahra & Filatotchev (2004), Lynall, *et al.* (2003) and Huse (1998) stated that the relative power and relationships between the various coalitions and actors might be contingent upon the different stages of the firm's development, and board composition can also reflect the larger power relationships between internal and external actors at the time of board information. Lorsch & McIver (1989) and Mace (1971) added that the power and influence of the BoD might change in times of crisis compared to normal times, and

various types of crises might also change in times of crisis compared to normal times, and various types of crises can also change the level of power and activities of various actors. Therefore, Zahra & Filatotchev (2004) and Lynall, *et al.* (2003) opined that the goals and objectives of the firm can change. Moreover, contingencies have an influence on the firm's industry, as well, the firm's life cycle may affect the interactions and relationships among coalitions of stakeholders in and around the corporation in a way that affects both positions and the roles of the boards.

The third approach for a behavioural theory of boards deals with the conflicts resulting from contradictory preferences of stakeholder coalitions. It emphasizes on board members' contributions in dealing with the complexity and associated uncertainty, which is related to the strategic decisions and the search for existing or new knowledge to solve the corporation's problems. There is inadequate cognitive capacity due to organizational problems, they need to plan and control routines to improve the analysis of complex tasks, and also to avoid making errors in decision-making. Rindova (1999) and Andrews (1990) added conflicting goals among organizational factors, for example, the actors' participation in strategic decision making in early stages might enable board members to protect stakeholders' interest through problem identification and definition. Suggestions by SSB members from a variety of experiences results in effective monitoring. Rindova (1999) and Forbes & Milliken (1999) added that board members use their strategic problem-solving expertise to provide solutions to challenges faced. Furthermore, a behavioural theory emphasized the problems of coordination, exploration, and knowledge creation to solve the conflict of interest, exploitation and the distribution of value.

Consistent with this study, Forbes & Milliken (1999) concluded a conceptual model to identify board processes. In most cases, board process is defined as the interaction and behaviour of board members as they fulfil their duties (Finkelstein & Mooney, 2003). Board process impacts strong and rigorous discussion on corporate issues

and problems so that decisions can be reached and supported. Thus, the three aspects of board process chosen in this study are based on those advocated by researchers' in-group process: effort norms, cognitive conflict and use of skills and knowledge (Jehn & Mannix, 2001; Forbes & Milliken, 1999; Shanley & Langfred, 1998; Hackman, 1983).

The analysis from Turley & Zaman (2007) in their research showed that there was significant influence on power relations between organisational participants, such as board committee members. The existence and operation of the committee has pervasive behavioural effects. The analysis illustrated that the committee members can have varied roles to support their authority of other organisation participants. The success of both formal and informal process with the organisation is the level of the organisational participants of their judge involvement in potential values to affect outcomes, and enhancing the committee members' responsibilities in the organisation.

Some scholars use the behavioural-based approach board studies by incorporating processes and relational dynamics in and around the boardroom (McNulty & Pettigrew, 1999; Pettigrew, 1992) and develop new insights and theories from other disciplines (Huse, *et al.*, 2011). Likewise, a number of behavioural researches focused on power and relationships in and around the boardroom, such as Ng & Cock (2002), Stiles (2001), Westphal & Zajac (1995) and Stewart (1991). There are some set of director and board characteristics that differ from the usual behavioural characteristics. Forbes and Milliken (1999) mentioned three attributes of group behavioural approach that might influence the ability of boards to perform their roles: effort norms, cognitive conflicts and the use of skills and knowledge.

5.2.1. Cognitive Conflict

Conflicts result from different opinions by different parties; this leads to disagreements (Jehn & Mannix, 2001). Conflict is the results from each SSB member holding different opinions (Namoga, 2010; Dutton & Jackson, 1987). According to Babic, *et al.* (2011), cognitive conflict is the disagreement which occurs among board members. Cognitive conflict is a result of different ideas, opinions and knowledge that the board members have.

Cognitive conflict is related to task-orientation (Namoga, 2010; Forbes & Milliken, 1999; Amason, 1996). Extant literature suggests that cognitive conflict is a good entity for the board to promote their critical analysis and investigative interactive activities. Cognitive conflict facilitates the evaluation of choices, the encouragement of multiple ideas, and the exchange of positive and negative feedbacks (Amason & Sapienza, 1997; Eisenhardt, *et al.*, 1997).

Cognitive conflict has been linked to better-quality discussions (Simons & Peterson, 2000). The link between task conflict and board performance is complex and complicated, although a number of studies showed varied and inconclusive results de Wit, *et al.* (2012) and DeDreu & Weingart (2003) suggested that the conflict is dependent on a number of other variables, like the type of group and the presence of other types of conflict. Some cognitive conflicts in boards can be considered beneficial to the strategic decision-making process by encouraging productive debates thereby presenting more alternatives and better evaluation of alternatives (Latendre, 2004; Forbes & Milliken, 1999).

Trust among board members is very important to gain the benefit of cognitive conflict and without intra-group trust; conflict might result in negative consequences (Simons & Peterson, 2000). For example, Mace (1986) found that some board members responded to cognitive conflicts by withdrawing from the discussion and decreasing their

commitment. Bettenhausen (1991) stated that conflict is a fact of group existence. The consensus formation among board members can consume a lot of time, particularly, the conflicts between individuals within board members require additional time and energy. The debate between individuals within a group can lead to separation of other members (Forbes & Milliken, 1999), reduce communication levels and reduce overall group efficiency by diverting time and energy away from the group's objectives (Simons & Peterson, 2000).

Also, cognitive conflict can create negative emotions, which decrease interpersonal collaborations and result in dissatisfaction and withdrawal from board issues (Petrovic, 2008; Li & Hambrick, 2005). Further, the presence of cognitive conflict among board members is a reminder to management about the power structure of boards. Board groups perform better when different ideas are exchanged during meetings, diversity of solutions is present in boardrooms (Watson & Michaelson, 1988; Schweiger, *et al.*, 1986; Wanous & Youtz, 1986).

5.2.2. Effort Norms

Effort results from motivation and embodies the dynamism of an individual's behaviour or total cognitive behaviour to the target tasks (Kanfer, 1992). Effort norms can be defined as the shared belief of groups in the performance of a task (Wageman, 1995). According to Babic, *et al.* (2011), Ees, *et al* (2009), Zona & Zattoni (2007) and Forbes and Milliken (1999), effort norms are used to evaluate the board members' degree of activity in performing their roles. The degree of effort norms depends on their beliefs and expectations of being properly rewarded for accomplishment and it leads to board effectiveness. Thus, effort norms show an indication of the level of effort necessary for board members to achieve set objectives. Strong effort norms are expected to enhance the performance of board roles.

Furthermore, the level of effort norms can be represented by the amount of time exerted (Lorsch & MacIver, 1989). Lipton & Lorsch (1992) suggested that boards which put an effort into meetings tend to perform better due to the discussion of issues faced by boards. Extant literature showed that a board that devotes sufficient time to fulfil their functions and uses the information they have judiciously are better able perform their roles. Vafeas (1999) and Monks & Minow (2004) added that the effective usage of time during meetings is more critical. They, however, opined that boards that spend similar time in board meetings could exhibit different levels of efforts.

Boards have many unique characteristics and it might create challenges to the effective fulfilment of the role of the board, for example, boards can meet infrequently and episodically (Leblanc, 2004). Boards are formed of individuals from diverse area of expertise and they have a role to monitor and influence the strategy used; however, they are not involved in its implementation nor are they involved in the day-to-day administration of the company (Monks & Minow, 2011; Fama & Jensen, 1983). Therefore, boards consist of busy individuals with limited direct disclosure to the organizations' operations (Forbes & Milliken, 1999). Boards' decision has the potential to have a significant influence on the organization and potentially the wider community (Golden & Zajac, 2001). Boards have formal and informal roles and also stable membership, so as a group they have common obligations that require interaction and joint decision to achieve cohesiveness (Forbes and Milliken, 1999).

Effective board as a group decision-making body needs time and effort to gather their members, discuss and interpret information. As a result, the level of effort the board members expend in decision roles impacts the quality of their decision (Hirokawa & Rost, 1992). A high level of effort norms might lead to increased interaction and sharing of knowledge, increased trust and increased effort among board members (Forbes & Milliken, 1999; O'Reilly & Chatman, 1986). Board members as a group are more

concerned with how they are perceived, there are great expectations for their roles (Forbes and Milliken, 1999). Furthermore, effort norms are important to a board's overall ability to perform their roles as a team and in governance duties (Khurana & Pick, 2004; Alder & Kwon, 2002).

However, Mace (1986) mentioned that a board that spends similar amounts of time in meetings have different levels of performance, so it does not equate to an effective performance. Board members need to be focused on their efforts to perform the roles effectively in boardroom activities. Jensen (1993) argued that time is not indicative of a good outcome. Time spent on meetings may not be necessarily important as boards almost always set the programme. Mace (1986) suggested the empirical evidence for demonstrating which boards perform their roles of attending meeting and registering votes without careful consideration of issues and problems. For example, the number of questions for substantive issues and problems are beyond the routine idle functions and tasks to be examined.

5.2.3. The Use of Knowledge and Skills

The term "skill" also means expertise, ability, performance and knowledge. The level and type of skills are not constant among members, cooperation should be encouraged (Cohen & Bailey, 1997; Weick & Roberts, 1993; Hackman, 1983). According to Dulewicz, *et al.* (1995), Nonaka (1994), Ancona & Caldwell (1988) and Fama & Jensen (1983), two types of skills are required for the board to perform effectively. First, functional skills are required to achieve business tasks, including strategic and analytical thinking, and result-oriented outlook. The second type of skill is firm-specific skills that pertain to comprehensive information about the firm, and an in-depth understanding of the firm operation and internal management issues. This skill includes communications, interaction and management. The presence of knowledge and

skills refers to the ability to perform on a board. Most prior literature suggested that boards must present some variety to function effectively in recent business environments, such as strategic thinking, analytical thinking, communication skills, interaction skills, management skills and result-oriented perspectives.

Instead, the use of skill and knowledge might be influenced by board composition. Generally, outsiders are appointed as board members to transfer their knowledge, skills and expertise in specific areas of significance to firms, such as lawyers, financial experts, auditors, business executives, government officials, community group leaders or important persons within the community (Hillman & Dalziel, 2003). Further, board composition affects both the use of knowledge and skills and performance. Cohen and Bailey (1997) added that the use of skills and knowledge along with behaviour with social integration affects a group's ability to cooperate. McNulty, *et al.* (2013) suggested that board members must be aware of each other's skills and knowledge to encourage collaboration and integration for better performance and group effectiveness.

Extant research proved that it is very crucial to show board's expertise and knowledge in order to achieve high levels of monitoring (Abbott, *et al.*, 2012; Bedard, *et al.*, 2004; Xie, *et al.*, 2003). Having an outsider on the board does not guarantee that knowledge and skills would be effectively utilized to achieve organizational objectives. The application of knowledge and skill results in interpersonal learning and development, this enable boards to perform their roles effectively.

Most researches agreed that boards need a high level of skill, knowledge and expertise to achieve their governance roles (Finkelstein & Mooney, 2003; Forbes & Milliken, 1999), and the level of an individual's knowledge and skills impacts board's effectiveness (Kula & Tatoglu, 2006; Zahra & Filatotchev; Westphal & Fredrickson, 2001). The knowledge and skills of boards are often considered as a whole as against those of individuals that comprise it; a constant challenge for boards is to ensure that they

can control the collective knowledge and skills in order to reach the potential of the groups. The presence of skills and knowledge in the boardroom does not mean they will be used (Forbes & Milliken, 1999), nor can it be assumed that they will be used in value creation (Hillman, *et al.*, 2008). Some studies indicated that the ordinary presence of skills and knowledge does not guarantee their use. If the board members cannot interact and communicate effectively within the group, the probability of risk increases significantly and reduces the capacity to draw from the accumulated at their disposal (Steiner, 1972). Boards as a group can experience difficult interaction and fail to use resources to reach their goals.

Board members must have a high degree of skills, knowledge and experience to fulfil their governance roles, both monitoring and advising provision (Finkelstein, *et al.*, 2009; Forbes & Milliken, 1999). Therefore, board members must be composed of individuals who want to contribute capabilities and skills to match the requirements of the organization (Nicholson & Kiel, 2004; Hilman & Dalziel, 2003). There are also other types of skills and knowledge that influence board, such as industry-specific experience (Kor & Sundaramurthy, 2009; Kor & Misangyi, 2008) and political skills and experience (Etzion & Davis, 2008; Hillman, 2005).

5.3. Professionalism

The term “professionalism” refers to the learned professions through which board members serve the society. Professionals are committed to meeting the critical needs of the society through selfless service for the common good (Feeney, 2012). Evans (2011) added that professionalism is influenced by competency, behaviour, attitude and intellect. In the behavioural aspect, professionalism consists of processes, procedures, productivity and competitiveness. The attitude aspects consist of the perceptual, evaluative and motivational factors. The intellectual aspects of professionalism include epistemological,

rationalistic, comprehensive and analytical reasoning skills. Further Karila (2008) suggested professionalism is impacted by a cultural, organizational, and individual phenomenon that is multi-faceted and include socio-cultural issues, national regulations, instituted policies, work environments and communities.

Many professions have a claim to professionalism and need a new environment and condition for their legitimacy power. Decentralization, deregulation, privatization and market form changes many professional work organizations into clearer and more delimited organizational units. The demand for new professionalism in this discusses can lead to social change and the leadership of work organization. Competence and human capital can be highly valued if self-regulated and client-conscious work becomes the requirements of confidence and trust in organizations and professional experts. Svensson (2006) stated that professionalism has a strong relation with confidence in abstract systems and organization as well as a trust in individual professional practitioners. It is heightened by modernization's fewer traditional links and individuals' greater personal responsibility. The complexity of the concepts of confidence and trust can be concretized and operationalized in many ways. Professionalism is mainly related to different types and perceptions of knowledge and competence. Many studies for the concept of professionalism strongly emphasize on knowledge, competence and skill, coupled with occupations and occupational practice rather than as a general capability. Practical knowledge, experience and familiarity, and the utilization of practical knowledge are only focused on theoretical knowledge and formal education.

Svensson (2006) claimed that professionalism is achieved when individuals are confident of the post-bureaucratic work in organizations. It shows that the cognitive aspects have a dominant influence, while the affective, ethical, and moral aspects are minority. Authority, license and legitimation rarely occur in professionalism. The concept of professionalism does not have a direct link to either confidence or trust; but it has an

indirect link through concepts, such as ethics and responsibility. On the other hand, cognitive attitudes are evaluated based on professional's trust. It can be said that the contextual achievements by professional practitioners are the main foundation for both confidence and trust. Trust can be hidden or mediated by cognitive contextualized competence perception.

Various studies emphasized a particular case study of professional or specific occupational group and provided different descriptions of professionalism. Some researches avoided giving a definition of *profession* and offered some lists of perspectives from the occupational group (Hanlon, 1998; Abbot, 1988). Other studies used the disagreement and continuing uncertainty as the definition of profession, and eliminated the distinctiveness of the intellectual factor, though it is not relevant for analytical discussions. Such studies as, Crompton (1990) considered the contradictions and inconsistencies from the sociological arguments that professions can reflect wider and more general tensions within the sociologies work, occupation and employment. Many researchers regard tertiary education and vocational training as essential knowledge for professionals.

Furthermore, Evetts (2013) explained profession could be classified into the following: structural, occupational and institutional engagements for work, which is associated with the uncertainties of modern lives in risk societies. Professionals manage risks through the use of expert skills, empowering customers, and dealing with the uncertainties of customers and clients. In sociological research, there are three concepts, which have been used to explain the professional groups: profession, professionalization, and professionalism. The concept of profession describes a distinct and generic category of occupational work. Professionalization is the process of pursuing the status of professionalism and can be interpreted as the process of achieving, developing and maintaining an occupation due to maintaining the practitioners' self-interest, such as

salary, status, and power or the monopoly protection of the occupational jurisdiction (Abbott, 1988; Larson, 1977). Finally, the concept of professionalism translates as an occupational or normative value for something worth preserving and promoting.

As a result, the concept of professionalism is flexible, yet the sociological analysis demonstrates the changes over time both in its interpretation and function. From all differences in the interpretation, the concept of professionalism is needed in order to fully understand the appeal of professionalism for the current and old occupations, and it is also used to promote and facilitate occupational change within this concept (Evetts, 2013). Fournier (1999) defined professionalism as an ideology mechanism from the imperfect form of governance. This blank space can be filled for all occupational groups and for professional workers to perform as a countervailing power against organizational as well as political and state bureaucracies of ideological control. Thus, professionalism can be explained as both the normative value system and the ideology of control which needs to be questioned and confronted in the new and old occupational contexts.

The definition of professionalism according to Freidson (2001) is an unconventional ideology for the organization of work, otherwise to the dominant market-competition ideology, which affects the rational of informed consumers whose preferences are achieved by competition among producing companies resulting in low-cost services. The dominant market-competition ideology states that consumer preferences through the productions and the management of procedures focus on the way workers meet consumer preferences. Essentially, the ideology of professionalism means that members of a profession regulate their work to fulfil specific duties. Freidson added that there are three major prerequisites for maintaining a professional body. An important element for such social agreement is the public acknowledgment of the contribution from the profession for a transcendent public good, a high degree of discretion from the grounding of the profession within a body of knowledge, which is based on specialized

abilities, and the credibility of higher education for the requirements of profession. There are also Freidson's ideal elements for the institutional professionalism as part of the social contracts: the public's grant for significant control their work to the profession, such as qualified credible entries, continuation for membership and career, the public's grant for exclusive jurisdiction over the labour's division in employment to the profession, and the reciprocal promise of the profession and each member to confine self-interest to some degree to serve public good in the area of the obligation from the profession.

This study uses a more comprehensive perspective of professionalism. Siegrist (1990) observed that professionalism has occurred with institutions of learning, the division of labour, the economic market, and areas of political and social power to create the final outcome known as profession. Vollmer & Mills (1966) stated that professionalism concerns the quality of its works and its benefits to society, the right to complete a particular work, control over training and access to it, and control of the right to establish and assess how work can be performed. Further, Larson (1977) clarified professionalism as one order of scarce resources, such as special knowledge into social and economic reward as an outcome. Professionalism is related with social mobility and market control as an outcome for the consistent and comprehensible course of action, but some of the goals and strategies that will be achieved by the group are not entirely clear and understood by the all the members. Therefore, professionalism can be depended on the exclusionary closure in the labour market and consumer marketplace.

Some researchers who contributed to the explanation of professionalism, including Carnegie & Potter (2000), West (1996), and Kalbers & Fogarty (1995), opined that professionalism can enhance the decision-making process, to reduce competition from other professional groups, and to enhance the jurisdiction or professional authority within certain areas. Ramirez (2001) conceptualized that professionalism is deployed to monopolize economic and social rewards. A study by Birkett & Evans (2005)

characterized professionalism into three: professional power, associational control and sustaining ideology.

The effect of professionalism on auditors' professional judgment was examined by Heyrani, *et al.* (2016). This research showed the result that is indicated by the existence of a meaningful and reserve effect for professionalism level on the judgements. It expressed that as the amount of professionalism increases, the judgment level decreases. This became evident from the fact that there is lack of professionalism among different professional bodies including academicians. Another reason decrease in the level of professionalism is the lack of crucial structures and organisations from the agencies, and these lead to unprofessionalism. Adeyemi & Fagbemi (2010) added that some factors can increase unprofessionalism such as lack of ethical standard, and the lack of spiritual intelligence.

In the research of Heyrani, *et al.* (2016) the evaluation of the effect of professional judgement on conflict was done, and it showed that the higher the professional judgement level, the higher the conflict and hence, the resolution can be a challenge. Some reasons can be stated about the appearance of the effect, such as size, experience, professional ethical values, expertise, independence level, individual versus collectivism, popularity, credit, family, and religion, which affect the judgement and might lead to conflict as a result not receiving the expected report by customers or pressures by colleagues. Though the research stated that there is no effect of professionalism on conflict due to the lack of relationship between existing pure rules and regulation in the organizational structure from the actors and the practical. The application result of the rules was therefore suspected to be the main reason of conflict within organization. There is also the meaningful effect of professionalism on professional judgement and the effect of professional judgement on the conflict. The result indicated that the professional actors do not use professional standards or in other word the actor do not act professionally when

doing professional operation especially for their judgment. It further suggested that more effective action could be taken by the authorities to integrate the professional standards and make a link between the existing standards so it will not lead to the conflict or contradiction in standard and unprofessional judgement.

In forming the theoretical perspective for organising and understanding the roles of SSB into Sharia compliance process, in line with Birkett & Evans (2005), this study proposes professional power and sustaining ideology have to be met to attain professionalism in the roles of SSB. In this study, professionalism defines the roles of SSB as they move toward the Sharia compliance process by managing their professional power and sustaining ideology.

5.3.1. Professional Power

Power is an integral player in social relationships. The difference of distribution of power in the relationships can lead to the situations where life-chances are unequal. Power is also developed from the possession of scarce economic resources or social status (Weber, 1978). Weber (1978) stated that the ruling groups used power to legitimize their positions, which are acquired through the three bases of power: tradition, rational-legal authority and charisma. A previous study by Lukes (1974) highlighted three manners for the exercise of power. The first is power in decision-making with a focus on the behaviour in decision-making, where there is an apparent conflict of interest as stated by different policy preferences. The second manner is power in non-decision making. Individuals or groups try to limit the range of decisions by using power to prevent certain issues that are discussed or certain decisions that are taken. In a third manner, power can be exercised by influencing the wishes or desires of individual or groups affected.

Professional power refers to a certain form of authority in society, by professional associations over both the production and supply of services to consumers in a specific domain or jurisdiction (Birkett & Evans, 2005; Freidson, 1994). Professional power is recognized as gatekeeping activities due to an institutional control over desired resources and involves interpretation and judgment of the benefits achieved by consumers. Professional power has been defined as the greatest in situations that combine a monopoly of situational knowledge and gatekeeping in interaction with consumers (Freidson, 1994).

Some research showed that the power of boards as a decision-making group is superior to that of individuals in many situations. Groups are better than individuals in exercising evaluative judgment (Hiltz, Johnson & Turoff, 1986; Miner Jr, 1984) and in complex problem solving (Watson & Michaelson, 1988). Evaluative judgment and complex problem solving are both required and are critical to the board's professional power. As a decision-making group, the board has the legal professional power to advise BoD being the apex of corporate decision-making (Baxt, 2009; Bainbridge, 2002).

Professional power includes the power to determine the producers in the labour market, the power to regulate the services that is provided by producers in the market, the power to legitimate, the power to support the exercise in the society at large, the power to identify the occupation, and the power for the existence of ideologies by using practical exercises (Birkett & Evans, 2005). Professional power also serves idealization as an approach rather than realization in the occupational domain. Johnson (1972) argued that professional power is developed to resolve social tensions in service markets where there is a high social gap between consumers and producers. Professional power is developed to ensure the quality of services and to meet the need of consumers. Individuals or groups can reduce the social gap created as a result of legitimacy and social acceptance of professional power. Boards possess a power because of their significant impact on

organizations, as well as the wider community, piquing a great interest in the inner workings of boards.

5.3.2. Sustaining Ideology

Ideology is defined as a set of beliefs or ideas, or attitudes, within a community (Eagleton, 1983; Plamenatz, 1970). Therborn (1980) proposed that ideology is the social phenomena that is embraced from everyday concepts and experience, and elaborated intellectual dogmas, either consciously or institutionalized thought systems and discourses of a given society. Van Dijk (1998) emphasized that ideology is related to the system of ideas, especially the social, political or religious ideas shared by an individual and groups. Members of the groups who assign such ideologies stand for a number of ideas that are very common at the basis of their particular beliefs about the world, guide their interpretation of events, and supervise their social practices.

Ideology becomes the essential beliefs of a group and its members. A system of ideas from a group and its members for ideology not only make sense in order to convince the world from their group point of view, but also as a foundation for their social practices. On the other hand, one important pattern of the social practices that has an influence on ideology is language use and discourse (Van Dijk, 1998). Elliot (1973) added that the concept of the ideology of professional is a basis in daily experience that members in the occupational environment tend to have aims and behave in characteristic ways. The use of ideology by professionals does not relate to claims or assumptions as to whether the actual beliefs are right or wrong.

Whatever the differences in the definition of ideology in the social sciences are, they are similar to the ideas or beliefs of groups. Van Dijk (1998) categorized the ideology into patterns with flexible rules of application:

1. Membership criteria: who does (not) belong?
2. Typical activities: what do we do?
3. Overall aims: what do we want? Why do we do it?
4. Norms and values: what are good and bad for us?
5. Position: what are our relationships with others? And
6. Resources: who has access to our group resources?

Also, Birkett (1984) noted that ideology deals with the particular ways in which producers and consumers in the market for occupational services are expected to behave in relation to each other. In professionalism, ideology is associated with services, competence and integrity by producers to consumers. According to Prasad & Prasad (1994) and Derber, *et al.* (1990) ideology in professionalism is an integral part of the institutional belief system and mainly relates to expertise, services and a set of occupational norms. Given the importance of ideology in professionalism, Palomino & Canas (2011), and Steenhaut & Kenhove (2006) examined the ideology through idealism and relativism to assess the achievement of the goal structure and goal-determination processes.

5.4. Constructing a Theoretical Foundation

The framework for this study was constructed from a combined theoretical framework and the objectives in this study. Professionalism supports this study with two themes, which are professional power and sustaining ideology. Behavioural theory contributed three themes to this study: cognitive conflict, effort norms, and the use of knowledge and skills.

5.4.1. Professional Power

Professional power refers to a certain form of authority in society, by professional associations over both the production and supply of services to consumers in a specific domain or jurisdiction (Birkett & Evans, 2005; Freidson, 1994). Professional power consists of the power to determine the producers in the labour market, the power to regulate the services provided in the market, the power to legitimate, the power to support the exercise in the society at large, the power to identify the occupation, and the power to acknowledge the existence of ideologies by using the practical exercise (Birkett & Evans, 2005).

Further, Finkelstein (1992) stated clearly that power has a crucial role in strategic decision-making. Power becomes a relative concept capable of being understood in only particular contexts. Pettigrew and McNulty (1995) also claimed that power cannot be transferable to other settings. Power is also inherently situational with dynamic and potentially unstable. Strategic decisions are uncertain and laden ambiguities by nature. According to Li & Zahra (1991) that BoD has equal power liken to the chief executive officer (CEO), for example in proactive and participating sense. CEO can be more efficient, better informed and decision making with an effective BoD.

This study proposed the professional power as the power in decision-making. The power in decision making for the role of SSB is the SSB's behaviour in making decisions based on the issues of an observable conflict of interest expressed as different policy preferences. This study also offered professional power in the form of the SSB manipulating their wishes and desires for those affected by their roles. The professional power in this study also sought to investigate remuneration and norms that influence the roles of the SSB.

5.4.2. Sustaining Ideology

The concept of the ideology of professional power is based on daily experience that members in the occupational environment tend to have aims and behave in characteristic ways. The use of ideology in professional does not relate to claims or assumptions that the actual beliefs are either right or wrong (Elliot, 1973). Birkett (1984) noted that ideology deals with the particular ways in which producers and consumers in the market for occupational services are expected to behave when relating with each other. In professionalism, ideology is associated with services, competence and integrity by producers to consumers. Palomino and Canas (2011) and Steenhaut & Kenhove (2006) examined the ideology through idealism and relativism to assess the achievement of goal structure and goal-determination processes.

Further, Evetts (2013) confirmed that ideology in professionalism defines as an appealing to occupational group, which has been included some aspects, such as power for exclusive ownership of an area of expertise and knowledge, and power to express the nature of problems with the control of access of potential solutions. Ideology also consist of an image of relation in collegial work with mutual assistance and support rather than competitiveness control. Evetts (2013) and Colebatch (1997) added that ideology in professionalism explains about autonomy in decision-making and discretion in work practices, decision-making in public interest through financial constraints, and self-regulation of occupational control of work.

This study provided the sustaining ideology in roles of SSB through idealism and relativism. Idealism in this study means that the SSB believes in their independence to perform their roles or that the ultimate determinant of right or wrong of their acts depends on the outcomes produced by their action. This study proposed relativism as the extent to which SSB members understand their own ethical standard (Forsyth, 1992). Idealism and

relativism as part of sustaining ideology can cover up for professionalism by offering service with competence and integrity.

5.4.3. Cognitive Conflicts

Cognitive conflict was addressed to examine the level of disagreement among board members that relates to the tasks of boards and it stems from different ideas, opinions and perceptions that the board members master (Babic, *et al.*, 2011). Cognitive conflict is particularly effective in small groups if it is controlled towards diverse solutions due to superior decision perspectives (Scarborough, *et al.*, 2010). The presence of disagreement and criticism from the SSB serves to remind the management of the power and role of the SSB and of the importance of considering shareholders' interest.

Cognitive conflict is explained as a disagreement about the content in form of viewpoints, ideas, and opinions as the tasks being performed (Torchia, *et al.*, 2015; Jenh, 1995). Ong & Wan (2008) and Schwenk & Valacich (1994) emphasized that cognitive conflict is an open debate with the different point of views in groups, which lead to faster completion of tasks and efficiency for use of sources. In cognitive conflict, there is an effort to encourages a group of people to develop their new ideas and approaches to enhance learning and assessment situation (Wan & Ong, 2005; Jehn & Mannix, 2001). Cognitive conflict can improve the board's effectiveness in monitoring role and the quality of strategic role of board (Wan & Ong, 2005; Eisenhardt, *et al.*, 1997).

This study concluded that good quality decisions likely happen when SSB members are given a space to powerfully explore and have an in-depth analysis of options. Furthermore, cognitive conflicts become valuable for quality decisions if the culture within boardroom encourages SSB members to express their disagreements and concerns

in full and frank debates. Cognitive conflict covers some attributes, such as tolerance for different opinions, cognitive competence to express disagreement in an elegant approach.

5.4.4. Effort Norms

Effort norms defined at a group level concept refers to group's shared beliefs on the degree of activity each individual performs in their roles (Wageman, 1995). Strong effort norms help boards to prepare, participate and analyse issues in meetings. Mace (1986) suggested that higher degree of effort norms results in a proper scrutinization of the information that is provided during board meetings and researching important issues, taking notes during board meetings and actively participating in discussions. It is very important for board members to prepare before board meetings and actively participate in critical discussions during board meetings (Minichilli, *et al.*, 2009; Judge & Zeithaml, 1992).

According to Ong & Wan (2008) and Wageman (1995) that effort norms is explained from group-level construct, which refers to the group's shared belief with the expectation from individual's contributions. In effort norms, there is always a possibility of process loses due to the lack of interaction not reaching its full potential. The most important area in effort norm is a quality of board meeting, because board with the similar amount of time can demonstrate different levels of efforts (Ong & Wan, 2008; Monks and Minow, 2004).

This study analysed the effort and time spent on preparing for SSB meeting, going through the reports and embarking on extra research to verify information in the reports. This study examined higher effort norms that might drive a critical analysis and discussion regarding the monitoring of the Sharia compliance process. Attentive listening, applying intuitive and moral judgment during meetings and intense interest on Sharia

compliance issues and problems by SSB might encourage monitoring effectiveness due to well-informed evaluations.

5.4.5. Use of Knowledge and Skills

The use of knowledge and skills mean the ability of the board to perform their roles effectively (Forbes & Milliken, 1999). The term knowledge and skills denote expertise, abilities and knowledge. The use of knowledge and skill can minimize process costs, encourage board members to cooperate and encourage joint actions (Cohen & Bailey, 1997; Weick & Roberts, 1993; Hackman, 1983). Board must implement a diversity of skills and knowledge to function effectively in the current business environment, such as strategic thinking, analytical thinking, communication skills, interaction skills, management skills and result-oriented perspective (Dulewicz, *et al.*, 1995). Sonnefeld (2002) suggested that the use of skills and knowledge present a supreme significance. The use of skill and knowledge also relate to transaction costs due to uncertainty in the business environment.

The effectiveness of the boards can be identified with their variety of skills to functions effectively in the business environment (Ong & Wan, 2008). The role of board is the top decision-making in the organizational structure. Therefore, if the boards want to provide a good service, they must be able to apply their knowledge and skills of various areas to firm's specific issues (Forbes & Milliken, 1999). Board must have an integrated knowledge to employ their monitoring role effectively. Board as an elite group in the organizational structure must own members with possess skills, which can utilise the information gathering and strategic evaluation (Ong & Wan, 2008; Sonnenfeld, 2002).

This study identified both the expert knowledge and cognitive capacity of SSB members in achieving the cognitive objectives of corporation's business environment.

SSB members as the gatekeeper in Islamic banks ensure Sharia compliance of operations, services and transactions. SSB members are expected to have an external network to bridge knowledge and capacity gaps that may exist. This study also analysed the presence of other professional, such as lawyers, accountants, and economists in the SSB (IFSB-10, 2009). This shared knowledge and skills can enhance the functions of SSB. This study also argued that it is very important to identify, integrate and coordinate the relevant expert knowledge and skills that result from effective monitoring of the Sharia compliance process.

CHAPTER 6: RESEARCH METHODOLOGY

6.1. Introduction

The selection of an appropriate research methodology is very crucial in a good research, whether social or scientific. This study examines the roles of SSB and Sharia compliance process through Sharia governance in Indonesian Islamic banks. In the context of Ph.D. research, this study carried out an empirical work that has been previously conducted, but without in-depth analysis. This study presents an in-depth analysis of existing materials, and this is substantiated with new evidence to old issues in the field. Similar research to this has not been carried out in the study area. The researcher employed the qualitative sampling method and engaged two different perspective theories to study the Islamic banking system.

The uniqueness of SSB as an extra layer in the Sharia governance structure in the Islamic banks was examined. This chapter emphasized CG research in Islamic banks to create an understanding of the roles of SSB in the Sharia compliance process. This chapter also examines the research methodology adopted in this thesis. First, it outlines the philosophy that underpins the approach taken with the research. The next section discusses the rationale for the research design, approach in Islamic banking and SSB research, and research design. Further, case study approach, data collection, instrumentation, data analysis, validity and reliability, and ethical consideration are also discussed in this chapter.

6.2. Research Philosophy

It was noted that some writers used the terms: *methodology* and *method* interchangeably. Methodology refers to the overall approach taken, as well as the

theoretical basis while method refers to the various means by which data is collected and analysed (Hussey & Hussey, 1997). Strauss & Corbin (1998) referred to research methodology as a way of thinking about and studying social reality. Further, Murray and Lawrence (2000) stated that *methodology* may encompass such terms as research design, theoretical frameworks, the selection and analysis of literature, and justified preferences for particular types of data gathering. On the other hand, the foundation of the methodology, as an obligation, is a philosophical stance in relation to the purpose and place of research in general, this research, in particular, emphasized research philosophies (Bryman & Bell, 2007; Travers, 2001).

In any research inquiry, the researcher should mention the methodology of the study, whether qualitative or quantitative. Quantitative and qualitative researches lean on divergent paradigms; hence, (Guba & Lincoln, 1982). Bryman & Bell (2007) complemented that the quantitative and qualitative debate are distinguished by the choice of answering particular research questions. Hagen & Gallagher (1997) viewed the qualitative approach as being concerned with nature and phenomena as against quantity or amount. As a result, a qualitative research design was chosen as most suitable for understanding the nature of the roles of SSB and Sharia compliance process in practice.

Furthermore, qualitative research as a concept covered several forms of inquiry that explains the meaning of a social phenomenon with several interferences of the natural setting as possible, and in which the focus of the study is on interpretation and meaning. Qualitative research also takes places mostly in natural settings where the phenomenon under study occurs. It is also viewed as being predicted upon a prior set of assumptions about the study of social reality from the point of view of those being interviewed (Bryman & Bell, 2007). Qualitative research is a multi-method in focus, involving an interpretive, naturalistic approach to its subject matter. In qualitative research, the researcher observes and records the conversation, actions, and events and then interprets

them and their meaning through a range of concepts and theories which have the exploratory power to include other factors other than statistical techniques or formulas (Denzin & Lincoln, 1998; Riley, *et al.*, 2000).

Qualitative research stems from an ontology foundation that explains the reality of some types of projection of imagination, the point of view of at least one actor, or at best a social construction that can be investigated through a scientific meaning, phenomenological perspectives and subjective processes. Different norms about the constitution of knowledge mean that there is a clear compromise about what comprises a fact. Bryman (1987) stated that a justification in qualitative research is not the same with positivist assumptions. However, it is linked to a subjective view of an empiricist or subjective theory of being able to view the actors, and communicate through case studies.

This study followed an *interpretivism* position that tends to view the world in quite a different manner from positivism and require a different response from interviewees. Bryman & Bell (2007) stated that an *interpretivist* views the subject matter of social sciences in a different form from the natural sciences. The study in the social world requires a different logic of research procedure. Furthermore, this different logic within an *interpretivist* stance might prompt a researcher to use inductive theory construction, reversing the deductive process by using data to generate theory. Researchers could observe aspects of the social world and seek to discover patterns that could be used to explain wider principles (Trochim, 2006). Moreover, it can be seen that there is no one reality, rather the reality is based on an individual's perceptions and experiences (Robson, 2002). Hughes and Sharrock (1997) argued that the facets of the real world as being distinctly human are lost when they are analysed and "reduced" to the interaction of variables.

Interpretivism also means that researchers study meaningful social action, not just external or observable behaviour of people and try to capture the rich complexity of social

situations (Neuman, 1997). The interpretative approach attempts to understand the ideas stemming from the subject perspectives and interprets the information provided based on the understanding of the situation. Sonnefeld (2004) analysed the *interpretivism* perspectives on how boards and directors perform as human dynamics in social systems consisting of leadership character, individual values, decision-making processes, conflict management and strategic thinking. As a result, the *intepretivism* position was adopted in this research. It was considered that there are multiple realities that make measurement difficult, and it can only be understood by using the real-world phenomena in detail within the context in which they occur.

6.3. Rationale for Research Design

Within a qualitative framework, and an *interpretivism* stance, this study was concerned with identifying the factors from the roles of SSB that impact the compliance process. With this in mind, the aim of this research is to explore and explain the perceptions of SSB members regarding their roles in the Sharia compliance process adopting the similar method as used by Gendron & Bedard (2006) in their behavioural audit study. The nature of this research is exploratory in nature, building on the existing knowledge and theories. It sought to generate a theoretical foundation in suggesting the possible relationship among the SSB members, the Sharia compliance processes and the Sharia governance in Islamic banks. This research also analysed the activities and opinions of significantly related actors in Indonesian Islamic banks.

With this in mind, the aim of this research is to explore the perceptions of SSB members regarding their roles in the Sharia compliance process adopting the similar method as used by Peecher & Solomon (2001) in their behavioural audit study. The nature of this research is exploratory in nature, building on the existing knowledge and theories. It sought to generate a theoretical foundation in suggesting the possible relationship

among the SSB members, the Sharia compliance processes and the Sharia governance in Islamic banks. This research also analysed the activities and opinions of significantly related actors in Indonesian Islamic banks.

The reality cannot be objectively determined; however, it is socially constructed in *interpretivism* (Kelliher, 2005; Hussert, 1965). The main assumption in the *interpretivism* is to place people in the social environment, where there is a big opportunity to earn understandings about the perceptions about their own activities (Kelliher, 2005; Hussey & Hussey, 1997). *Interpretivism* supports the value in qualitative data to build the knowledge. The *interpretivism* paradigm shapes the uniqueness from the specific situation for contributing the underlying pursuit the in-depth context (Kelliher, 2005; Myers, 1997; Kaplan & Maxwell, 1994).

This study used a qualitative method as the research methodology. The case study research is more concerned about the description of the real world phenomena rather than normative decision models (Halinen and Tornroos, 2005, Dubois and Gadde, 2002). In terms of the contributions of case study research, Flyvbjerg (2006) opined that a numerous number of good case studies strengthen the social sciences.

A qualitative research with in-depth interviews derives meaning from the experience of participants. It is how people interpret, understand and experience the social world and how social experiences are formed and how experiences are given meaning (Creswell, 2013). The responder plays an important role in qualitative research and the critical role of the data collector is an initial identification of personal values, assumptions and biases. A prospective warning to qualitative research is biased during data collection due to the involvement of single research interviews. To solve this, the researcher must identify and declare personal views and generate useful information free of bias (Lee, 1999).

This study used a qualitative case study as the research methodology. The case study research is more concerned about the description of the real-world phenomena rather than normative decision models (Halinen & Tornroos, 2005, Dubois & Gadde, 2002). In terms of the contributions of case study research, Flyvbjerg (2006) opined that a numerous number of good case studies strengthen the social sciences. A case study is not only useful for generating hypotheses, whereas other methods are more suitable for hypothesis testing and theory building. The case study also can be used to explore the phenomenon happening in practice. Conversely, the researcher has to be mindful of the greater misunderstanding of case study research, such as theoretical knowledge being more valuable than practical knowledge; one cannot generalize from a single case study.

For reducing the bias in this study, this study sets a research protocol as a research blue print to draw the case design (table 6.1) (Yin, 2003; Klein & Myers, 1999).

Table 6.1. Research Protocol

Activity	Description	
Research Objective	To have an in depth understanding of the roles of SSB in the Sharia compliance process	
Research method	A single case study	Islamic banks in Indonesia
Critical Incident	The roles of SSB in the Sharia compliance process	
Case Selection Process	<ul style="list-style-type: none"> Environmental criteria: The Sharia compliance process influence the reputation of the Islamic bank, which has to comply with the Sharia law. Internal criteria: The SSB as extra layer in the Sharia governance structure in the Islamic banks must ensure all activities, transactions and products complying with the Sharia law 	
Research Instruments	This study employs the open-ended interview.	
Boundary Device	The Sharia governance framework	
Research Techniques	This study uses a semi structured interview with the open-ended interview questions.	
Data Management	Collection methods and process, such as the controlling of the research instruments' influence, specifically the balance of the participants/interviewee	

According to Walsham (1995) the *interpretive* case study emphasis on in depth understanding on human actions and interpretations on the development of the environment *Interpretive* case study draws the organization from the interpretation of the pattern of symbolic action, which can create and maintain a sense of organization. This study proposes the contribution to the future development of the *interpretive* school of Islamic banking research by providing discussion on an in depth understanding of the roles of the SSB in the Sharia compliance process.

6.4. Approach in Islamic Banking and Sharia Supervisory Board Research

The main objective of this study is to have an in-depth understanding of the roles of SSB in the Sharia compliance process at the Islamic banks. This study employs the qualitative research method to identify the roles of SSB in the Sharia compliance process. This study emphasizes on the in-depth understanding about the roles of SSB. Therefore, this study addresses the *dig the gold* approach from Kazmi (2003) to determine the roles of SSB in the Sharia compliance process.

On the nature, most of studies in the Islamic bank and SSB employ a quantitative method and conceptual approach. For example, Raman and Bukair (2013) worked on the influence of SSB in the CSR disclosure. Their study employs the quantitative method to examine the influence of SSB with the CSR information in the annual reports of Islamic bank by using a bank size, financial performance and economic performance.

Further, Garas (2012) engaged the quantitative method to evaluate the conflict of interest in the SSB in the IFI. This research used a questionnaire to analyse the relation between the conflict of interest in the SSB from six variables, such as, executive position, remuneration, the relation between the SSB members and the BoD, and their memberships in the other of financial institutions.

Rafay and Farid (2018) also conducted a research to examine the SSB report from the investor's perception. Their research concluded that information from the SSB report, which used terms of Sharia compliance and other conventional constraints, had an impact on the investor's behaviour and perception about the Islamic bank performance. Their research was developed by extending previous research in this area to assemble the information. Their experimental study research used the belief adjustment model to calculate the desired effects of information.

Most of previous research on the Sharia governance and compliance in the Islamic banks also employ similar research approach in methodology. Grassa (2013) explored Sharia supervisory system in IFIs by using Southeast Asia and the Gulf Cooperation Council (GCC) models. Grassa's (2013) review used different steps of the development on the Sharia governance system and the practices in IFIs internationally. This paper engaged relevant literature, existing laws and regulations in order to provide a reflective synthesis on the practical work of the Sharia governance system across different jurisdictions.

Further, Hamza (2013) also did a research on Sharia governance in Islamic bank to analyse the effectiveness and supervision model. Since the Sharia supervision is a crucial, and SSB plays an essential part in the governance system of Islamic banks. This paper explored it by comparing the two model of the decentralized model in GCC and the centralized model in Malaysia.

In the light of the above, the reasons of this study for undertaking a qualitative approach are:

- (1) Most of previous researches in Islamic banking and SSB employ the quantitative approach as the methodology research,
- (2) The main purpose of this study tries to get an in-depth understanding for the roles of SSB in the Sharia compliance process. Statistical analyses and quantitative measures

do not fit with the research objective, and a qualitative approach appears to be a better fit, and

- (3) Qualitative approach becomes exploratory and has the capacity to embody the perspectives and views of those being observed. As the main focus of this study is the roles of SSB, a qualitative approach provides meanings to real-life and not only the values, perceptions, or meaning held by the researcher.

6.5. Case Study Approach

The case study methodology is defined as an approach in which the researcher carries out an in-depth research on a program, event, activity, process or one or more individuals (Stake, 1995). According to Yin (2009), there are five elements for an effective case study research design: (1) research questions; (2) proposition of the study; (3) unit analysis; (4) logic that links data propositions; and (5) criteria for interpreting findings. Creswell (1994) added that the objective of a qualitative study is to understand the process of a social or human problem based on building complex, holistic pictures formed with words, and conducted in a natural setting.

The purpose of this section is to make an explicit match between the research focus of this study and the selection of the exploratory, and qualitative case study method. For this study, the phenomenon under investigation was the roles of SSB in the Sharia compliance process. The case for the current study was SSB members from Islamic banks in Indonesia. For this study, data was collected using in-depth interviews with the SSB members in Islamic banks. Particularly, interviews were audiotaped, and later transcribed into word documents, transcribed documents were reviewed and data were coded for emerging themes.

The case study research method is a very useful method, it allows for expansion and generalization by combining the existing theoretical knowledge with new empirical perspectives (Vissak, 2010; Yin, 2009). The application of this method for this study is very useful for transcending the local boundaries of the investigated cases, capturing a new layer of reality, and developing new, testable and empirically valid theoretical and practical concepts. A case study is suitable for studying topics that did not attract much attention from previous researches (Vissak, 2010; Eisenhardt & Graebner, 2007; Voss, *et al.*, 2002). According to Eisenhardt (1989), case study research does not always rely on previous literature or prior empirical evidence. This research method is also suitable for examining current perspectives, conflict, and studies that contradict available researches.

Some studies have adopted qualitative case study approach from Yin (1989). For example, Hoque (2005) conducted a research using a qualitative case study approach. In this research, the methods included face-to-face interview with six key people to examine the impact of the National Competition Policy and pieces of the Local Government Act and the Local Government Finance Standards on the internal practices of a large Australian local authority. A case study approach is the most appropriate approach to address the objectives of this study, which is intended to answer the question of “how” of the phenomenon of SSB roles and the compliance process in Islamic banks. In the context of this study, the how questions are posed to the phenomena relates to organisation and individual behaviour in infusing, implementing, and enacting the Sharia rules and principles.

The most suitable questions for this type of qualitative case study research are: *how* and *why* forms of questions. This study explored the roles of SSB to ensure compliance in Indonesian Islamic banks. The next component of this study was defining

the purpose clearly. The major objective of this study was to examine the roles of SSB in the Sharia compliance process.

Furthermore, the case study design focused on unit analysis. Unit analysis is directly tied to the research questions developed by the researcher (Yin, 2009). This study's unit of analysis is SSB members (cases to be studied) in Indonesian Islamic banks. The case study research design also emphasized the connection. As data were analysed, the researcher matched patterns that appeared in the data to the theoretical propositions of the case study. This study's theme provided answers to the research questions posed in Chapter one. To enable examining the roles of SSB and the compliant process as the research focus, this study decided the basis criteria for base selection. This study chooses Islamic banks from three types of Islamic banks in Indonesia as case banks, which have a substantial length of operation, as well as the availability of Sharia compliance and internal audit department/division. Finally, the case study design proposed the criteria for interpreting findings. This study carefully extracted meaning from the findings to recommend future practice and research.

Overall, the research justification for using case study approach are:

- (1) In order to have an in depth understanding about the roles of SSB in the Sharia compliance process, this study employs the single case study, which is Islamic banks in Indonesia.
- (2) Because of the limited contexts in which these studies are examined, this research only applied the single case study methodology by using three types of Islamic banks in Indonesia: BUS, UUS, and Islamic rural banks. Even though, this study using three types of Islamic banks Indonesia, this study is a single case study because the election for the SSB members in Indonesia is similar according to PBI No.11/33/PBI/2009 (Bank Indonesia, 2009). It is due to this study want to have an in-depth understanding from the roles of SSB in the Sharia compliance process in Indonesian Islamic bank.

Therefore, this study employs a single case study because this study *digs the gold* for the interpretation, understanding, and experiences of the SSB members to ensure the Sharia compliance process in the Indonesian Islamic bank.

- (3) This research was carried out in the form of a qualitative inductive approach following the tradition to employ an embedded case study design. It explored and gained the understanding of how the Sharia compliance process works and sought to understand the roles of SSB in the Islamic banks in Indonesia. Yin (2003) confirmed that the use of case study for this research considered some purposes: (a) to understand *how* they operate and *why*, to identify the processes involved; (b) whether there are manipulations in the behaviour, because this research explored the SSB experience; (c) this research also used the contextual condition to analyse the phenomenon of this study; and (d) to explore the unclear boundaries between the phenomenon and context. Consequently, this study examined the decision-making process of the SSB in assuring Sharia compliance.
- (4) The qualitative case study in this research was exploratory. Yin (2003) stated that explanatory research is conducted if the researcher requires in-depth answers to questions related to real-life challenges/scenario because it would be complex to explain this using other research methods. (Joia, 2002). Exploratory is a type of a research that is used to explore the situations in which the intervention being evaluated has no clear or single set outcome, for instance, Lotzkar and Bottorff (2001) use this research method to study the development of a nurse-patient relationship. Bonoma (Pre-1986) emphasized that this explanatory and exploratory case study attempts to determine the relationships between concepts from the data. It examines and understands the dimensions and characteristics of emerging concepts, such as field activities, behaviour, practice and belief. Thus, case study contributes to the foundation of theory development. As a result, this research sought to

understand, explore, analyse and determine the roles of SSB in the implementation of Sharia principles and rules by using the case study research method, and

(5) Kazmi (2003) added the *dig the gold* approach in the study of Islamic perspectives.

This approach results in a straightforward manner of looking into the Islamic knowledge sources for nuggets of wisdom to be used through interpretation based on individual or group *Ijtihad*¹ (the making of a decision in Sharia by personal effort (*Jihad*)²), independent of any school (*Madhhab*)³ of jurisprudence (*Fiqh*)⁴. These nuggets should be valuable and convincing enough to appeal to the rational mind that it is effective. The case study approach was used to achieve the objectives of this research. This research adapted an exploratory approach, and Kazmi (2003) advised that the *dig the gold* approach could make for an effective procedure in using the qualitative methods to achieve an in-depth understanding through philosophical and discursive approaches.

6.6. Data Collection

This study employed the purposeful sampling technique. Qualitative research does not have a setting of generalization to a population as in quantitative research. However, qualitative research obtains insights regarding a specific phenomenon, individual, or events through the process of purposely choosing specific individuals, groups, or situations that are relevant to the arguments and perspectives of the chosen phenomenon (Onwuegbuzie & Leech, 2007). Understanding the interpretation and experiences among SSB members in regard to the profession of Sharia boards in the Islamic banks was accomplished through interviews. The sample in a qualitative research

¹ The independent or original interpretation of problems not precisely covered by the Qur'ān and Hadith (Kazmi, 2003)

² The religious duty for Muslims on maintaining their religion.

³ The entire school thought of a particular Imam.

⁴ A person knowledge and understanding.

can be a resource, participants, informants, friends or teachers. Samples in qualitative research cannot be defined as a statistical sample; on the other hand, the theoretical sample for the purpose of qualitative research is used to generate theory. Sampling in a qualitative research is based on choice including the aspects, events, and who is to be the focus at a time and in certain situations. It is recurrent throughout the study. Qualitative research generally takes a smaller sample and is more focused on the research process rather than product and usually limited to a case.

Qualitative research, where the participants are required to represent the population of interest, involves selecting participants who can best inform the purpose of the study by providing answers to research questions (Creswell, 2013; Marshall and Rossman, 2011; Patton, 2002). Therefore, the objective of this study does not support the selection of participants randomly. Chosen participants were purposefully selected based on their prior experience of the Sharia compliance process in Islamic banks. In a purposeful sampling technique, the researcher tries to get all possible cases that fit a particular criterion (Devers & Frankel, 2000). Purposive sampling can be defined as a sampling method in which respondents are carefully selected. This ensures that respondents are chosen by the researchers in accordance with specific traits and certain characteristics. Purposive sampling technique was used in this study to aid the gathering of useful information.

In the present case, the population for this study is all the SSB members in Islamic banks in Indonesia, which are BUS 11 banks, UUS 25 banks, and Islamic rural banks (*Bank Pembiayaan Rakyat Syariah*) 163 banks (Bank Indonesia, 2014). According to the PBI No.6/17/PBI/2004, PBI No.6/24/PBI/2004, and PBI No. 8/3/PBI/2006 that the number of SSB members is at least 2 – 4 members in each Indonesian Islamic bank (Bank Indonesia, 2006; 2004).

The research design should have some specific patterns for selecting participants that are qualified to answer the research questions, For the purpose of this study, the selection of the interviewees was based on meeting one or more of the following criteria (see table 6.2): (a) SSB members who are employed by the Islamic banks in Indonesia, (b) According to the PBI No.7/35/PBI/2005 and PBI No.8/3/PBI/2006 that SSB members are allowed to hold concurrent positions at two different banks (Bank Indonesia, 2006, 2005). Therefore, the number of populations will be reduced, and (c) This study focuses to get an in-depth understanding on the roles of SSB, so the emphasize is on the appointment of SSB members. The appointment is sent by using an email and a formal letter. The feedback letter from the SSB members become a way to get a sample.

The interviews were conducted with SSB members in Indonesian Islamic banks, which have three types of Islamic banks. This study is single case study, which means this study is conducted in Indonesian Islamic banks. A flexible interview guide was used for semi-structured interviews, in which this study tailored the questions according to the interviewee and the situation. To preserve the comparability between different interviews, the interviews questions were typically centred around three main themes:

- (1) The interpretation on the roles of SSB in the GC,
- (2) The implementation of the roles of SSB in the Sharia compliance process, the creation or formalization and the maintenance of Sharia law within the Islamic bank's operation, and
- (3) The dynamics of the roles of SSB and the Sharia compliance process. This is due to the objective of this study to examine the roles of SSB in the Sharia compliance process. Therefore, the interview tried to *dig the gold* SSB's dynamic of their roles not only on their position as individuals but also their position at the regulatory and institutional.

A total of 25 individuals of SSB members were interviewed over a period of a year across various Islamic banks in Indonesia. The collection of data is undertaken from august 2014 to June 2015. 25 participants have been selected because (1) they are SSB members of the Indonesian Islamic banks, (2) If any of the members holds the position as a SSB member in more than one Islamic bank, they will only be interviewed once, (3) the feedback letter from the SSB members are ascertain due to the length of the interview session which are taking around 60 to 90 minutes per participant.

Table 6.2: Research Participants Details

Code	Gender	Education level	Experience (years) as SSB members	IB	Training (times)
SSB_M1	M	Professor	> = 10 years	Full	> 5
SSB_M2	M	Professor	> = 10 years	Full	> 5
SSB_M3	M	Professor	> = 10 years	Full	> 5
SSB_M4	M	Professor	> = 10 years	Full	> 5
SSB_M5	M	Doctorate	> = 10 years	Full	> 5
SSB_M6	M	Master	> = 5 years	Full	< 5
SSB_M7	M	Professor	> = 5 years	Full	< 5
SSB_M8	M	Doctorate	> = 5 years	Full	< 5
SSB_M9	M	Master	> = 5 years	Full	< 5
SSB_M10	M	Doctorate	> = 5 years	Full	< 5
SSB_M11	M	Master	> = 5 years	Full	< 5
SSB_M12	M	Master	> = 5 years	Full	< 5
SSB_M13	M	Doctorate	> = 5 years	Full	< 5
SSB_M14	M	Master	> = 5 years	Full	< 5
SSB_M15	M	Master	> = 5 years	Full	< 5
SSB_M16	F	Doctorate	< = 5 years	Window	< 5
SSB_M17	M	Master	< = 5 years	Window	< 5
SSB_M18	M	Professor	< = 10 years	Window	< 5
SSB_M19	M	Master	< = 10 years	Window	< 5
SSB_M20	M	Master	< = 10 years	Window	< 5
SSB_M21	M	Doctorate	< = 10 years	Window	< 5
SSB_M22	M	Master	< = 10 years	Rural	< 5
SSB_M23	M	Master	< = 10 years	Rural	< 5
SSB_M24	F	Doctorate	< = 5 years	Rural	< 5
SSB_M25	M	Master	< = 5 years	Rural	< 5

6.7. Type of Interview

A well-conducted case study can bring benefits from having multiple sources of evidence to ensuring that the study is as robust as possible. The concept of methods refers in general to the applicable use of techniques of data collection and analysis (Yin, 2009; Green, *et al.*, 2006; Prasad, 2005). For case studies, interviews must be conducted carefully. In the earlier stages of analysis, the researcher should consider him/herself as the “gatekeeper” of knowledge and should be able to interact with the participants to ensure the data collected is as rich as possible. When conducting interviews, relationships and connections must be established, coupled with trust.

Interviews should be conducted in a conventional style to encourage participants to offer deeper insights (Kvale and Brinkman, 2009). Open-ended questions were used in this study. To avoid the risks, which might result from the researchers’ perceptions, this study allowed more detailed responses and unanticipated experiences that were shared by the participants. Further, the questions were asked in a situational context to draw deep and rich experiences from participant responses. This study was designed to gain an insight into the working of the SSB. Interviewees were asked a number of questions in Bahasa to eliminate communication error. The depth of interviews allowed participants to express personal stories on the roles of the SSB in the Sharia compliance process. According to Rabionet (2011,) conducting a semi-structured interview format ensured that specific topics were covered during the process. The purpose of the interview was to allow SSB members to share their aspirations for the future and discuss self-efficacy feelings that have contributed to individual and collective growth of the SSB in the Sharia compliance process.

Active listening and non-judgemental behaviour are the most common practices that should be prioritized when conducting the interviews for a case study. Some data should surface from the interview of a case study, such as experience or behaviour,

opinions, feeling, knowledge, sensory and demographic (Merriam, 2009). For this study, interviewees were assured of confidentiality, the option to decline participation and the option to withdraw from the interview at any point. Permission was sought for recording participants' responses. The researcher also took field notes during each interview that enabled the tracking of key points which were later discussed during the interview or to highlight ideas of particular significance or relevance.

Recorded interviews were transcribed in a timely manner to allow the researcher to fully understand and explore the interviews in-depth. After the interviews were conducted, a set of field notes were written that described the people, places, activities and conversations. Field notes are written accounts of what the researcher hears, sees, and thinks in the course of collecting and reflecting on the data in a qualitative study. When conducting interviews, a researcher can be more effective in achieving the right meanings and contexts of the interview if field notes are written out. Trusting only the content of the interview might result in missing the impressions and extra remarks revealed during and after the interview. Field notes can deliver the context when the interviews are transcribed and also allow a researcher to record opinions, schemes and reflections as they emerge rather than waiting until the completion of data analysis.

6.8. Interview Guide

Interview guides can be helpful to researchers who are conducting semi-structured in-depth qualitative interviews. The interview guide can anticipate that each in-depth qualitative interview will last about one hour and two hours. This study employs three sections as an interview guide approach involves open-ended interview questions, each of which is focused on one aspect of topic. Qualitative interviews offer a means of collecting in-depth information about your topic so for limiting the number of questions

the researcher pose in order to enable your participant to have time to talk about the topic at length, without feeling rushed.

For the starting part of the interview, the interview guide begins with important features, such as a personal introduction; a statement of purpose, including what will be done with the result of the study; a statement informing the interviewee why he or she is being interviewed. Begin by concentrating on the demographic features to keep research question uppermost in mind. Then, thinking about the critical points about the participants to address related to research question. The participants must be given an information that they had the right to withdraw at any time.

At the beginning of the interview, the interviewees were given a copy of a document that explained the interview procedures and were asked to sign a participant certification form at the end of informed consent sheet. The purpose of this form is to ensure that the interviewee is to provide the opportunity to give free and informed consent about participation. A copy of the interview guide (Appendix A) and informed consent letter (Appendix C). This research ensured that the privacy of information and anonymity of research participants were reserved.

The next step discusses about information on the interviewees' background. The demographic information included gender, education level, experiences, types of Islamic banks and trainings (table 6.2). Demographic profile helps the researcher to characterize interviewee as well as the sample during the analysis and report writing stage. This research ensured that the privacy of information and anonymity of research participants were reserved.

Semi-structured interviews should be conducted with an outline set of topics, beginning with common information that is usually obtained, allowing the participant's story to be told without having a pre-set order of standardized questions, and determining the remaining questions, to allow the flow of the interview. When applying a general

interview, a guide should be provided as a basis for meaningful information on concepts that are central to the objective of the research to allow the researcher to make valuable statements as the interview progressed (Gall, et al., 2007; Gonzales, et al., 2008). In this study, the researcher used a uniform set of open-ended questions to gain demographic information of the participants and participant's perspectives and detail the roles of the SSB in the Sharia-compliant process (Appendix A: Interview Guide) and determine how participants perceive their situation, its meaning to them or significant about it to them and others. Open-ended questions were used to *dig the gold* of participant's knowledge and experiences about the roles of SSB in the Sharia compliance process and also to encourage participants to respond freely and openly to queries. Follow-up questions were used when necessary to elaborate participant's response.

To develop in-depth data, this study conducted semi-structured interviews with open-ended questions. The purpose was to allow the respondents to share their personal perspectives, experiences and knowledge of the roles of SSB in the Sharia compliance process. Gall, *et al.* (2007) opined that semi-structured interviews allow respondents to share their story without having a pre-set order of standardized questions, and enabled them to determine the flow of the interview for originality. These types of interviews ensure that the interviewer prepares a number of questions. These questions are structured as open-ended questions.

The basic theory for my interview guidelines is adapted from Msweli & Singh (2014), Birkett & Evans (2005), and Forbes & Milliken (1999) to capture various aspects of interaction, motivation and relationship, emotions and collaborations, or dynamism of SSB members. The interview guide is developed to ascertain the above mentioned aspects based on Forbes & Milliken (1999) and Msweli and Singh (2014).

This study digs the information and experiences of the interviewees with the questions of their perceptions and experiences with regards to the roles of the SSB in the

Sharia compliance process. The interview question guide divided into two themes to examine the individual roles of the participants as the SSB members to explore their roles in the Sharia compliance process.

Therefore, the objective of the questions regarding the SSB members' interaction in the Sharia compliance process were to define the participants' perceptions about their roles to iron out issues and solutions in the Sharia compliance process. The questions sought to determine what value is put upon each role and what factors contribute to a comfortable interaction in the roles of SSB. The interview questions in this study tries to reveal the participants' experiences and opinions about the issues and problems that has been needed in this study.

6.9. Interview Process

This study employed one-on-one interviews with each participant. In this study, the semi-structured format was used. The interview guide offered a mix of more or less structured questions. Then, this study used follow-up questions to discover how the participants felt about specific experiences and their opinions on the subject in order to stimulate more in-depth information. The research questions were used to determine the appropriate subject of discussion. Merriam (2009) opined that the collection of quality data in interviews is dependent on the ability to ask skilful questions and the researcher must be careful in considering the questions in order to gather the greatest amount of information possible. The design of the interview is a very crucial step in the interview process. Detailed planning for the interview helps the researcher to increase the depth and richness of responses from the participants, this ensures that the objectives of the research are achieved (Patton, 2002). Planning can reduce the potential effect of interviewer bias that can arise due to the researchers' own values and assumptions.

Data was gathered through in-depth face to face interviews. Face-to-face interviews were employed with the participant to ensure that the views expressed during the interviews were correctly translated and transcribed. Each interview lasted a maximum of two hours. Interviews varied in length from 60 to 90 minutes. Semi structured interviews that guide the conversation, but allow for participants to provide information that is important to the participants, however, not necessarily reflected in the interview questions. For example: “we can come to understand the details of people’s experience from their point of view”

For developing the trust and the comfort in the interview process, the researcher started by thanking to the participants for their times and willingness for their participations and commitment to help the researcher in this study. The interview session was not directly asking the interview questions, but it begin with a social conversation to create the comfort moment before the interview process begin. The interview questions ask in Bahasa due to the location of the Islamic banks is in Indonesia. The researcher has an insider translator, because the researcher needs a guide and a translator for cultural mores and, at times, jargon or language. The insider translator not only translates from Bahasa to English, but also to collaborate with the researcher for adding layers of meaning and interpretation. The researcher solved some potential issues by employing a number of strategies, such as communication via email and formal letters prior to the interview and sent them a brief of the study and the agenda of the meeting. Then, the researcher gets the feedback letter to confirm the interview schedule. It was done to seek the permission of interviewees as the interview could spend between 60 to 90 minutes per participant. Hence, the interviewees were less likely to talk about irrelevant issues. The interviews were conducted during business hours in the interviewee’s offices. Some of the interviewees were comfortable with audio recording but some were not, which made it difficult to engage the interviewee. Notes were taken during the interview.

During the semi-structured in-depth interviews, a set of interview questions (Appendix A) was used to guide opportunities to explore the roles of SSB in the Sharia compliance process. Interview questions asked participants to recall their experiences and perceptions with their roles as SSB members and their roles in the Sharia compliance process or any combination thereof. Participants' perceptions of their experiences were elicited and recorded so as to assess their experience, either directly or indirectly. The processes of the interview in this study are: first, the participants have been asked their demographic information, such as gender, age, education and their experience as SSB member. Then, the interview moves with the questions based on the interview guide.

For elaborating during interviews in order to gain more detail, to invite the participant to elaborate on something, provide more clarity about an issue, or to help the participant more fully understand some process. These are statements that help the researcher facilitate the interview. For example: "Can you give me an example of what you mean?"; "What you are sharing (or have said) is important; "Can you say more?"; Tell me more about that experience (or that time)?"; and "If you could change anything about that experience, what would it be?". Each open-ended question included in the researcher's interview guide (Appendix A).

However, not all the guide provided to the interview for the participants. It allows flexibility for the researcher to stay on track with the interview, especially during the silence's moment with the participants. Often the silence will facilitate a response from the participants since it provides them a small bit of thinking time. Since many of the participants are uncomfortable with silence, practicing waiting five seconds after asking a question can be helpful. Thanking for the information and the participant's contribution and participation to develop the success of the interview. In the final section of the interview, the researcher makes the gratitude moment to the participants for their

cooperation in the study and presented them with a small token of appreciation for their involvement and help in the study.

Further, all participants' identities are anonymous and only identified through the code numbers. The interview was recorded with a digital recorder and each participant must fill the consent letter, and subsequently transcribed and coded for analysis. Each transcription from the interview was read to avoid the errors or omissions. Then, the field notes were taken for the unrecorded interview because it consists with key phrases, list of major points made by the interviewee and key terms, which capture the interviewee's own language (Patton, 1986). In the unrecorded interview process, field notes provide an opportunity for the researcher to record the interviewee's comments or any opinions about the setting from the participants' activities and experiences. For example, data, which can provide a contribution to further steps in subsequent fieldwork and issues relevant during the analysis section (Ritchie & Lewis, 2003; Merriam, 1998).

6.10. Data Analysis

Qualitative research studies engage a continuous interplay between data collection and data analysis. Following Merriam's (2009) position on data analysis, she analysed a process undertaken simultaneously with data collection. This interactive and recursive process allow the researcher to have emerging insights, hunches and tentative hypothesis to direct the next phase of data collection that leads to modification or reformulation. Denzin and Lincoln (2003) added that qualitative analysis is a form of scholarly craftsmanship that has no single specific way of achieving the aims of a case study since data analysis is a process of deriving meaning. The process of this study was guided by the conceptual themes for the study, which provided clues to relevant data sources as well as to concepts that guided data analysis (Table 6.2).

Table 6.3: Research Questions and Conceptual Themes

Research Questions	Conceptual Themes
What are the roles of SSB in Sharia compliance process? SQ1. What are the definitions of an effective roles of the SSB?	<ul style="list-style-type: none">• Professional power• Sustaining ideology
SQ2. How are the roles of SSB in the Sharia compliance process?	<ul style="list-style-type: none">• Effort norms• Cognitive conflict• Use of skills and knowledge

Data collected from interviews and documents were validated, coded, aggregated and presented. Specific procedures were used for assuring the quality of the data collected. First, the data were checked for credibility, consistency, truthfulness of account, detail of account and interconnectedness. The researcher observed the appearance and honesty of interviewees in order to gauge if their accounts were considered trustworthy and precise. The researcher evaluated and checked all collected data for clarity, accuracy and credibility and worked to validate information across interview sources and between interviews and documents. The purpose of data analysis in a qualitative study is to establish classifications, relationship and assumptions that reflect the participants' view of the world in general and of the research focus in particular (McCracken, 1988). Data analysis is iterative and cyclical in qualitative research (Strauss & Corbin, 1998). Not all of the information can be used since qualitative data is so dense and in-depth (Creswell, 2013). Therefore, the analysis of qualitative research requires processes that focus on relevant data and disregarding the remaining.

The qualitative data analysis software, NVivo, was used in this study to manage and organize the data analysis process. This software assists researchers to mark, move and code data segments into categories and themes. The analysis was done based on the

codes and themes, using a constant comparative method. After the compilation of transcripts, the summary of field notes, and post-interview notes were transferred into NVivo. Merriam (2009) added that data could be analysed within and across sources for emergent themes or categories. Categories or themes were entitled according to their analogy with the conceptual framework and literature or as suggested by participants. Coded interview transcripts were reassessed for consistency, clarity and congruence among and between coding categories.

The analysis process cycles through data cutback until original categories were reduced and grouped to form a consistency and marinated categories (Merriam, 2009; Miles & Huberman, 1994). The researcher used the strategy of memo writing to facilitate the recursive process of data coding. The recursive process is applied to prepare the case narrative. A preliminary summary of the case allowed researchers to review emerging study findings, examine the quality of the data and plan for the next step of the data collection process.

The analysis for data using case study research is categorized into four common processes (Creswell, 2013; Perry, 2001):

- (1) Data preparation. This step involves organization of the raw data and a preliminary review of the data available. As previously mentioned, 25 participants were conducted and each of these interviews was transcribed and the transcript was read thoroughly. This assisted the researcher in making corrections and complete unclear sentences. It also assisted the researcher to make note regarding tone or emphasis by the participants. This stage also involves a journal to record general ideas, themes and opinions as they come to mind. Then, this step includes the open research issues at the end of the literature review. The reflective memo-writing process provides an opportunity to reflect on the meaning emerges from the data. Re-reading the transcript is done to refresh the initial observations and to include any observations about how

the participant responded to the questions and their focus on particular aspects to provide themes to the data.

- (2) Data coding. Data is broken into segments and each segment is assigned a technical term, which represents a category of the data. Assigning codes to the data does not only facilitate the reduction of data, but also encourages the researcher to reflect on the data, and to interact with it. Data coding is done once the first transcript is complete. A method of constant comparison is implemented to review each line, sentence and paragraph segment of the transcript. During the data analysis process, a journal is kept to record themes and ideas resulting from the coding process.
- (3) Evidence of saturation. This process is the point where no new insights are revealed through data collection and data analysis. Further, it can indicate the point at which data analysis is complete. This study commenced a process of coding and constant comparison of themes and ideas were also recorded using memo writing. Categories are used for identifying similarities and differences. Categories with commonalities were merged, while single incidents or categories with minimal evidence were rejected, as these were regarded less critical. The development of themes becomes clear when theoretical saturation was reached. Once no new insights and opinions are revealed, this is an indication that information has been exhausted and the coding process has ended.
- (4) Data interpretation. This phase involves aggregating the final codes and categories into overarching themes that reflected the core themes of the study, so it provides the foundations for the study findings and conclusions. The memos and notes taken are further read, the data coded are also revised. Following this, each category of data coded is also re-checked. After the coding process, the researcher is able to physically group, disassemble and regroup to provide meaningful explanations and insights into the research questions. The iterative process of data collection, coding and data

analysis results in a number of central themes, which addresses the research questions and provides answers to the original research questions. During data analysis, the results can be addressed through a further round of iteration between theory and data.

6.11. Validity and Reliability

Qualitative research requires the researcher to play an active role in the collection and interpretation of participants' responses as credible, good and trustworthy. The researcher should avoid narrow thinking, and should understand their participants' behaviour, rather than impose their own assumptions (Stake, 1995). To ensure the validity and reliability of the result of this study, the researcher used some strategies recommended by renowned qualitative researchers. To reduce the risks of incredibility, this study employed some approaches suggested by Merriam (2009); Yin (2009); Prasad (2005); and Stake (1995). The first approach is a triangulated data approach where the researcher used multiple sources of data or data collection method to confirm emerging findings. The second approach used member checks by sending the participants a copy of the result of interviews and asking them to verify the accuracy of the content. The last approach used the request peer review of findings as they emerged.

Maintaining a chain of evidence in which the readers can trace the conclusions of the researcher backward is critical for the validity of the research. This chain is formed by setting up an audit trail that clearly explained how the research was employed and how the findings were derived (Merriam, 2009). The trail is evident in the final report through a descriptive feature that enlightens the analysis process and findings. These details also provide links back to the original research questions and the objectives of the study. As a result, this study used the original research questions and the objectives of the study to increase the dependability of study findings, such as an audit trail to give a detail explanation of the data collection and analysis methods and how decisions were made

throughout the study. Merriam (2009) suggested that the strategy for ensuring rich description is to provide enough description of the contextual study so that readers would be able to determine the extent to which their situation matches the research context. The results are ethical practices and reliability of the study.

Maximum variation can become one strategy for seeking broad experimentation of the sample size to allow for a greater range of application of the findings that naturally happen within this study since all sites' principals were integrated into the interview process. This study purposely calculated the sample to ensure a representation of all related actors in the Sharia compliance process. This strategy uses multiple sources of data collection methods to confirm the findings. As a result, the validity and reliability of research are certified and strengthened. Finally, the strategy used in this study for addressing validity and reliability is member checking. Member checking grants the researcher an opportunity to check research accuracy. The participants were invited to make comments or corrections on the preliminary notes so that this task can offer no rival interpretation.

As a result, the quality of this study is judged by the validity and reliability that can be considered by four criteria (Shenton, 2004; Miles & Huberman, 1994):

(1) **Credibility.** This criterion is the most important factor in establishing validity and reliability. The credibility of this study refers to the accuracy with which the phenomenon of interest that has been identified and described. This study promotes confidence and increase credibility with an in-depth interview on data collection to enable rich understanding and deep descriptions of participants' experiences and insights, the opportunity to confirm and disconfirm the researcher's understanding from participants' responses, and establishing a relationship of trust with the participants.

- (2) Transferability. The objective of this study is to achieve an in-depth rather than statistical range; therefore, it is very crucial to use rich descriptive narratives from in-depth interviews. As such, comprehensive descriptions and contextual details are provided throughout this study and enable the transfer of the concepts to other settings and contexts.
- (3) Dependability. This stage refers to the study's reliability. Attaining dependability needs a clear description of the data collection and coding practices and a logical integration between the data collection, interpretation and conclusions. Using the research design, this study provided in-depth details of the process during the data collection and analysis phases.
- (4) Confirmability. This phase relates to the objectivity of the study and the needs of the researcher to confirm, as much as possible, the findings of the study are introspective of the experiences and ideas of the participants and not the preferences from the researcher. The social nature of interviews can pose a threat to achieving real objectivity since a level of bias by the researcher is predictable. Removing the influence of the interviewer would be impossible. To reduce any potential bias or influence over responses, this study used open-ended questions during the interview, and the participants were allowed to continue the conversations to explore participants' experience rather than guided by theories.

Table 6.4: Assessing the Validity and Reliability

Criteria	Test	Steps Taken
Credibility	Have the participants' experiences and ideas of the world been successfully captured?	In depth interviews Open frank dialogue Open ended questions (Appendix A)
Transferability	To what extent can the study's finding be transferred to another situation?	Detailed background context for the study Rich descriptions of how the study conclusions have been drawn (Chapter 7)
Dependability	If the study were repeated with some methods and the same participants, would results be obtained?	Details of data collection and data analysis (Chapter 6)
Confirmability	Could an independent person confirm the study's findings?	Contact summary sheet (Appendix C)

6.12. Ethical Consideration

Researchers, whether they employ a qualitative, quantitative or mixed method study, should deliberate the consequences of the research and, in turn, confirm that ethical decision-making exists in each stage of the research study. The researcher used due diligence to certify that all ethical considerations involved in the case study were fully met. This study used primary data and data from interviews, transcribed and coded. The researcher ensured that the decisions made at each step of this study were ethical, fully documented and without bias. This researcher also sent a consent letter (Appendix B: Consent Form) to the participants introducing the study and informing them of their rights; the letters were signed and returned. This study explored and examined the uniqueness of the SSB members in Indonesian Islamic banks, but their anonymity was maintained. All the participants were assured of anonymity. The participants were

appointed and referenced by number for data management and analysis. Citations of participants in the final research findings are identified by their general position by their names or specific, designated positions.

For the exploratory case study, the researcher ensured that there was no personal influence or opinion. All prejudgments and opinions were eliminated during the study to avoid the researcher judging the participants during the process. This action ensured that the stories and opinions of the participants were relayed without bias on the part of the researcher. There was no potential harm done to any of the study subjects.

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CHAPTER 7: FINDINGS AND DISCUSSIONS

7.1. Introduction

This Chapter uses the Islamic banks in Indonesia as a case study for evaluating Sharia compliance process. For the ethical purpose in this study, the company and the participants' name are anonymised. The research tools used in the collection of the information and data for this research are mentioned in Chapter six. A semi-structured interview with open-ended questions was used. This technique is more convenient and beneficial when the researcher intends that the readers share their ideas, knowledge and experiences. There were 25 participants for this study. They shared their knowledge and experiences about the role of SSB regarding Sharia compliance process in the Indonesian Sharia banking industry. The responses of the participants were quite encouraging, though the target of this study was to involve all the SSB members in Indonesian Islamic banks to gain a better picture of SSB roles in the Sharia compliance process. It was believed that results from a larger number of participants would be more reliable. However, some difficulties and reluctance were found through the data collection process. As a result, the sample of this study was conducted using purposeful sampling technique of the target population, which was the SSB members in Indonesian Islamic banks.

This chapter includes a presentation of the discussion of the data and the interpretation of the findings regarding the main research question, “*What are the roles of the SSB in the Sharia compliance process?*”.

7.2. The Profile of the Participants

The personal features and individual characteristics of the interviewees play a vital role in the analysis of the interview. Profile analysis was reviewed prior to the actual analysis of the collected data. The detailed description of the participants' characteristics can give a better understanding and presentation of the collected data (Robson, 2002). The participants were chosen through purposeful sampling. This sampling was used because it allows the researcher to obtain information from a multitude of experience and expertise. The participants were SSB members at Indonesian Islamic banks and related actors within the Sharia compliance process. Each of the 25 research participants in this study was assured highly confidential. All 'SSB members' participants who took part in this study were SSB members in Indonesian Islamic banks at the time being interviewed.

A profile for each research participants is provided below.

Table 7.1: Gender of the Participants

Gender	Freq.	Percentage
Male	23	92%
Female	2	8%
	25	100%

Table 7.1 above shows that the participants consisted of two females and 23 males, that is only 8% female and 92% male participants. The results in the table show that the sample is predominantly male. It is a fact that more men relate to the roles of SSB in the Sharia compliance process. There could be some cultural factors behind this, such as most SSB members in Indonesian Islamic banks are male.

Table 7.2: Education Level of the Participants

Education Level	Freq.	Percentage
Professor	6	24%
Doctorate	7	28%
Master	12	48%
	25	100%

Table 7.2 shows the education level of the participants. As can be seen, 48% of the participants have a Master's degree. Also, 24% of the participants are professors, that are the highest level of education. The remaining 28% participants have doctorate level of education.

Table 7.3: Experience as SSB Members

Experience as SSB members	Freq.	Percentage
More than 10 years	5	20%
less than 10 years	6	24%
More than 5 years	10	40%
less than 5 years	4	16%
	25	100%

Table 7.3 describes the experience of the participants as an SSB member. It shows that 40% of the participants have an experience as SSB members more than five years. Then, 24% of the participants have less than 10 years' experience as SSB members. 20% has more than 10 years' experience as SSB members. Finally, only 16% of the participants

Table 7.4: Number of Training Have Been Attended by the Participants

Number of Trainings	Freq.	Percentage
More than 5	5	20%
Less than 5	20	80%
	25	100%

Further, table 7.4 above illustrates the number of training, which has been attended by the participants when they have a position as SSB members. 80% of the participants have attended training less than five times during they have been employed as SSB members. Only 20% of participants have been attended training more than five times since they have a position as SSB members.

7.3. Findings

The findings of the case study on the roles of SSB in Indonesian Islamic banks are presented here. It documents the roles of SSB in the Sharia compliance process practices. The initial communication between the participants and the researcher was primarily used to collect basic information, set up a time for a sit-down interview, inform the participant about the study, and establish empathy with them to ensure no barriers existed in future collaborations. The interview has been varied in length from 60 minutes to 90 minutes. The data collection has commenced from August 2014 to June 2015. However, since the interview was semi-structured, the researcher did not strictly follow the order and allowed the participants to tell their stories.

The guide was formulated primarily with open-ended questions to allow participants to take the interview in any direction. The interview began with background and experiences and as the stories progressed, many questions in the guide were naturally answered. The researcher specifically asked the participants about the roles of SSB in the

Sharia compliance process. Although the researcher knew a great deal of the background as a result of extensive review of the literature, it was important to get the perspective of the participants, this could possibly change the researcher's perspective as well. As a result of the data collected, the following themes were chosen for the analysis: professional power, sustaining ideology, effort norms, cognitive conflict, and use of skill and knowledge.

7.3.1. Professional Power

Regarding professional power, the researcher asked some items that are related to the roles of the SSB. The following items were highlighted as significantly important: power to regulate, power to legitimate, power to manipulate wishes and desires, and remuneration. Research data summary shows:

The majority of respondents believed that the roles of the SSB regarding professional power are to judge, assess and give recommendations for the bank's operational procedures and products issues as stated on the BI. The SSB members have a special power to give advice and suggestions to the BoD. SSB members have obligation to supervise and manage all bank's activities and operations comply with Sharia law. SSB members have a legitimate power accordance to Sharia law to control, to manage, to regulate, to supervise, to monitor even to audit to ensure all the transactions, products and operations comply with Sharia law.

Most participants claimed that the roles of the SSB are clearly stated on the BI regulation. Participant SSB_M3 asserted that SSB members has very crucial roles in the Sharia compliance process, and SSB members have responsibilities and functions

according to the Sharia law and BI regulations. They have a strong power to be a guardian in the Sharia compliance process. Therefore, their position is clearly stated in the Islamic bank organization structure to ensure all the transactions and products comply with Sharia law.

Participant SSB_M10 confirmed that the roles of SSB are not only to manage, to manage and to control but also to audit about the problems and issues that will happen in the Sharia compliance process. Then, participants SSB_M2, SSB_M5, and SSB_M9 added that SSB members has a strong power to advise the BoD and management about the incompliance actions and activities. They agreed that They need more power as a board to supervise, to control and to advise due to their roles are very crucial to ensure the Sharia compliance.

Participant SSB_M11 clarified that the roles of SSB are very crucial in the process of Sharia decision making. There is very clear in the Islamic bank organisation structure that SSB members has no direct line to make decision-making for the managing board, however, SSB members have a special obligation to advise and give opinions about observable conflict of interest due to different policy preferences. It is very clear that SSB members own a legitimate power based on Sharia law.

Further, participants SSB_M15 and SSB_M20 explained that due to the crucial roles, which is owned by the SSB members, they must be independent to ensure transparency and efficiency. They concern about issues that some SSB members have dual positions in the two different Islamic banks. They highlight about the objectivity related with Sharia decision-making to perform their legitimate power due to the dual position by the SSB members

Moreover, participants SSB_M4, SSB_M6 and SSB_M19 concerned about the remuneration system. The obligation of SSB members is crucial in the Sharia compliance process and base at the Sharia governance structure in Indonesian Islamic banks, SSB has

the parallel position to the board of commissioners who has a coordination line with the BoD. SSB is a unique feature of the Islamic banks, which provide extra layer of governance structure. However, their remuneration is less than BoD. They suggested that ...the regulators must be clear about the remuneration system for the SSB members.... Therefore, they play crucial role to ensure all the bank's activities, operations and transactions complying with the Sharia law. They believed that a fair and good system of remuneration affect our performance and legitimate power. The SSB members assured that their remuneration system must be reconditioned to enhance their roles as an additional layer and has the same obligation with other boards on the Sharia governance structure.

On the understanding to previous studies, which established the roles of SSB in the Sharia compliance process. SSB members have the professional power to regulate and to supervise the funding and financing mechanism in Islamic banks (Hassan, *et al.*, 2010). SSB members have to prepare periodical reviews as part of their roles in the Sharia compliance process. The SSB as an internal unit is obliged to comply with Sharia governance regulations. The arguments of SSB members showed that legitimization of power is needed due to the important roles of SSB in the Sharia decision-making process. The finding showed that the roles of SSB are to supervise, to control and to audit. The concern is about jurists' understanding of the products and services of the Islamic banks (Toufik, 2015; Garas and Pierce, 2010).

We also can conclude that the roles of SSB are related to their professional power to advice, to regulate, to supervise, to comply, and to audit all the bank's activities, operations and products in line with the Sharia law. SSB has the power to value and judge bank's operational procedures and products and present their valuations and judgments in periodical reviews. SSB has a role in monitoring the actual implementation of their *Fatwa*, so they can perform their role of issuing *Fatwa* legitimately. SSB roles ensure that

funding and financing mechanisms comply with Sharia requirements (Birkett & Evans, 2005).

7.3.2. Sustaining Ideology

In this study, sustaining ideology relates with a daily basis experience that SSB members have in the occupational environment. The items emphasized in the sustaining ideology are independence, the understanding of ethical standards, and the attitudes to services, competency and integrity. Research data summary explained that

SSB members perform Ijtihad to decide on a matter based on the texts from the Quran and Sunnah. The Quran and the Sunnah contain rules and regulations revealed by Allah (S.W.T) and are known as the primary source of Islamic law. SSB members must have the appropriate knowledge of the source of the Sharia, and be familiar with prevailing customs of the society, be upright in character and have the ability to formulate independent opinion and judgment. Indonesia applies the dual banking system for Islamic banks. It means that Islamic banks in Indonesia have to comply with Sharia law as well as the Indonesian standard banking regulations. DSN and BI are the regulators of the Islamic banking industry in Indonesia, especially with regard to rules, and regulations related to the Sharia. In general, BI and DSN present a point of agreement for Sharia decisions (Fatwa). The SSB must be an independent body because of the role it plays in the reputation of Islamic banks. BI regulations do not ban SSB members from having dual positions. However, the independence of each SSB is regulated by PBI No 11/33/PBI/2009. SSB members are not controlled for ethical standards. The Quran and the Sunnah are the guidance for moral behaviour and obligation as the gatekeeper in Sharia compliance.

All participants agreed that the ethical standard and guidance for the SSB member to perform their obligations are the *Quran* and *Sunnah*. BI as a regulator for Islamic banks in Indonesia has added some regulations, such as PBI No. 11/33/PBI/2009 for fulfilling all their roles. SSB members perform *Ijtihad* before they any issue *Fatwa on* new products. The *Quran* and *Sunnah* are the primary sources of Islamic law. BI and DSN provide standard regulations for the Islamic banks in Indonesia.

Some participants, such as SSB_M1, SSB_M2, SSB_M5, SSB_M9, SSB_M10, SSB_M12, SSB_M14, SSB_M16 and SSB_M23 clearly stated on their interview that the ethical standard for the SSB member to perform their roles are the *Quran* and *Sunnah*. There are some regulations made by BI and DSN, however, the main guidance for their behaviour, characters and decision-making must be based on the *Quran* and *Sunnah*. They do not want any other ethical standard as their guidance, because the root of Sharia business, operations and transactions are coming from the *Quran* and *Sunnah*.

Participant SSB_M3 highlighted about appropriate knowledge of the source of the Sharia, and be familiar with prevailing customs of the society, be upright in character and have the ability to formulate independent opinion and judgements. It similar with Participant SSB_M4 stressed that SSB members should be specialized in *Fiqh Al-Muamalat*. It is due to SSB members should be guided by Sharia law, Sharia governance policies, the term of reference of the SSB meeting, and Sharia governance framework.

Participants SSB_M6, SSB_M8, SSB_M17 and SSB_M24 stressed about the independency and transparency of the SSB members. According to BI regulation, SSB members in Indonesia can have double positions. They think that SSB members must disclose their position in another Indonesian Islamic bank or IFI. They have to report it in the Sharia governance report to heighten their independency and transparency, so they increase their roles effectively. However, participant SSB_M18 added that the additional

Sharia standardization of the Sharia compliance process in the bank's organisation can give more strength to the *Ijtihad* to respond to uncertainty in the industry.

Finally, participant SSB_M7 exposed about the roles of DSN, which is the independent body in Indonesian institutions that has obligations to advice and monitor the SSB members. SSB is controlled by the *Quran* and *Sunnah* and BI regulations, this regulation details the ethical standard for banks. The moral of SSB members should be high as gatekeepers in the Sharia compliance process. However, DSN is the institution, which help the SSB members to perform their roles effectively and also BI to monitor the SSB members.

In conclusion, the *Quran* and the *Sunnah* serve as guidance for SSB members. SSB independence is very crucial for the credibility of Islamic banks since SSB consist of religious individuals who ensure Sharia compliance in Islamic banks (Abdullah, *et al.*, 2014). SSB members must be equipped with not just general knowledge of Sharia or other disciplines, but a specialized level of *Fiqh Al-Muamalat*.

7.3.3. Cognitive Conflicts

Cognitive conflicts were examined for the level of disagreement among SSB members as it relates to their roles in the Sharia compliance process. According to Bank Indonesia (2009), the SSB is obligated to give advice and suggest solutions to the BoD concerning Sharia matters. As a result, the items discussed in this study provided a fair opportunity for SSB members to debate decisions considering shareholder interests, their permissibility to express their disagreement and their ability to reach collectively-shared discussion. There should be a comfortable environment to express their opinions and ideas. Research data summary showed that

SSB was created to ensure bank's activities, operations and product comply with the Sharia law. The interpretation of the Sharia text strictly follows the Quran and Sunnah. The difference among schools of thought presents debates between SSB members. It is however not a problem. There are four different techniques: interpretation of revealed sources (Ijtihad), choice (Ikhtiyar), necessity (Darura) and artifice (Hila). In the case of difference of opinions, DSN issues a Fatwa and recommendation to solve the disagreement and abort non-compliance activities and operations. DSN follows the basic principle of permissibility unless legally proven otherwise, other principles include: the voluntary principle, the social services principle, the fairness and balance principle, the non-misleading/transparency principle, the profitable principle, and the principle of bringing benefit and avoiding harm. Ultimately, BI regulations serve as operational guidelines for Islamic banks in Indonesia. The DSN also govern all accounting and auditing regulations in Islamic banks.

Most of participants explained that conflicts should be seen in a positive manner. One is free to agree or disagree with SSB decisions. This is because conflicts allow various viewpoints and perspectives, and are especially important for decisions where there is a great degree of uncertainty. A good example is an overseas expansion whereby returns are never guaranteed and there are often disagreements. This is expected because of the different backgrounds of SSB members, leading to a debate. Even when SSB members have diverse opinions, boardroom discussions may still be productive. DSN fulfils the market and society needs in the process of collective authoritative interpretation (*Ijtihad*) with full consideration to offer solutions in a professional manner.

Participants SSB_M2, SSB_M3, SSB_M4, SSB_M5, and SSB_M7 confirmed that there is no problem about the differences among school thought between SSB members. In the case of difference of opinions, DSN will help SSB members to issue

Fatwa and recommendation to solve the disagreement and abort non-compliance activities and operations. Participants SSB_M9, SSB_11, SSB_M12, SSB_M16, SSB_M17, SSB_M20, SSB_M21, and SSB_M23 added that for handling the debate in the boardroom, SSB members must ask DSN for the recommendation.

Participant SSB_M5 showed that the role of the chairperson is very important when it comes to fair opportunity, support, express ideas and opinions, and the debate in decision making. Participant SSB_M6 confirmed that the chairperson must let SSB members to express their opinions and ideas related with the issues. The chairperson must have a judgement based on all the reasons and statements, but the decisions strictly follow the interpretation of the *Quran* and *Sunnah*. Cognitive conflicts are helpful for critical solution of the independence, qualifications and performance of SSB members. The concern is because there is no general operational guidance. Each Islamic bank can have their own interpretation. This pattern can cause conflicts between the SSB and the management. The common problems in bank's management are limited knowledge and the inability to achieve certain financial target.

Participants SSB_M7, SSB_M9 and SSB_M12 explained that conflict must be seen in positive manner for the way to express opinions and ideas. Debate and disagreement among SSB members are the positive culture in the boardroom. It is due to conflicts allow various ideas and perspectives, and important for decision where there is a great degree of uncertainty. The conflict becomes a discussion for the improvement among SSB members.

Participant SSB_M13 added that even when SSB members have diverse opinions, boardroom discussion still be effective. Conflict among SSB members is not a bad way to find a solution about the issues and problems, since it is not connected with personal. The *Quran* and *Sunnah* are the best guidance to guide for encouraging among SSB members to express their disagreement and concerns. Participant SSB_M14 clarified that

the *Quran* and *Sunnah* as guidance to perform the roles of SSB effectively in the discussion. In the discussion, the chairperson must have skill to support his members to raise a positive debate in the boardroom.

Participant SSB_M16 showed that conflict can be exist if there is an effective discussion among SSB members in the boardroom. Participant SSB_M19 approved that friendly environment in the boardroom means friendly to discuss, to debate and also a full and frank debate. It is not hard to get that condition since the *Quran* and *Sunnah* become a guidance to perform the roles of SSB effectively in the Sharia compliance process. Participant SSB_M23 also expressed that SSB members are composed of Sharia professional, which mean they have an in-depth understanding to make a Sharia judgement on activities, operations, and product's qualifications and conformity. The conflict cannot be viewed as a negative respond for their members to express their ideas, opinions and concerns.

Therefore, conflict must be perceived in a positive manner in. Islam never opposes legal pluralism in matters not specifically stipulated. Some disagreements cannot be solved through discussions among SSB members, and these will be taken to the DSN. Cognitive conflicts should be seen as a critical evaluation of independence, qualifications and performance of SSB members. DSN as a regulatory body standardizes Islamic banks to ensure the banking industry's competitiveness for sustainability and good financial performance are at par with conventional counterparts. DSN adopts a middle view, between liberal and conservative stances, to solve conflicts. Due to the dual nature of banks in Indonesia, DSN offers the perfect solution. the *Quran* and *Sunnah* serve as guidance for the SSB. The ethics and moral conducts of SSB members are also derived from them. External auditors are not concerned about the compliance of Islamic bank's activities and operations.

This study concluded that the SSB does not have a negative influence on the environment. The SSB is made up from Sharia professionals, so they have an in-depth knowledge to decide whether the products and activities of Islamic banks comply with the Sharia (Abdullah, *et al.*, 2014). The DSN issues *Fatwa* to resolve disagreements and prevent non-compliance of activities and operations of Islamic banks (Bank Indonesia, 2009). The SSB chairperson must also ensure that all opinions are explored. Diverse opinions and ideas from SSB members can be constructive in boardroom discussions; the integrity and consistency of SSB's reports should be maintained (Garas and Pierce, 2010; DeLorenzo, 2004; Al Nashmi, 2002; Al Zarrqa, 2002; Al Qaradawi, 2001).

7.3.4. Effort Norms

Effort norms can be defined as the degree of activity of each SSB member. The level of activity of any member is dependent on the level of effort norm of that individual. The items for effort norms in this study are effort and time spent on preparation for the meeting, extra research to verify reports, and critical analysis and discussion of the Sharia-compliant process. Research summary revealed that:

The regulation from BI about SSB meeting clearly describes in the PBI No 11/33/PBI/2009 regarding GCG in Islamic banks and unit links. SSB activities and meeting must be clear in the SSB report and in the GCG report. To improve the ability for SSB critical analysis regarding monitoring roles in the Sharia compliance process, BI and DSN provide professional training for SSB and Islamic banks' officers; this is related to SSB roles in the Sharia compliance process, such as the roles of the internal audit officer and compliance unit officer. These officers must support SSB in the performance of their roles in the Sharia compliance process.

Most of participants informed that there is a regulator outside the BI to supervise the Sharia compliance process. Many SSB members revealed that effort norms pertain to SSB member's preparation for meetings, participation in meetings, analysis of information and a sense of responsibility for their work. It can be concluded that this has a strong impact on the fulfilment of SSB roles. Strong effort norms put SSB members in a better position to monitor the performance of management, to advise the BoD, and debate positions on various Sharia compliance options, opportunities, and understand the needs of the company. SSB members are supported by ISRU.

Participants SSB_M1 and SSB_M8 stated that SSB must clear in the SSB report about non-compliance issues and problems. Participant SSB_M3 added that the clarity about SSB meeting and activities must be stated in the SSB report and the GCG report. Participant SSB_M9 further stated that the presentation must be display in the form of report, which must clearly state the purpose of the report.

The important highlight about SSB member's effort norm is many participants agreed to do a small research before meeting. Participants SSB_M4, SSB_M10, SSB_M11 and SSB_M14 claimed that a small research prior meeting about the issues and problems, especially when it relates with the non-compliance issues and problems in the Sharia compliance is a requirement as the role of SSB in the Sharia compliance process. Participants SSB_M9 and SSB_M20 went even further, saying the SSB members must prepare presentation of the request for decisions on Sharia-relate matters before meetings are conducted.

Participants SSB_M15, SSB_M16, SSB_M17, and SSB_M21 added that extra research before the meeting is crucial requirements to find the best recommendation about the issues and problems. It is also to perform the roles of SSB effectively in the Sharia compliance process. Then participants SSB_M19, SSB_M23, SSB_M24, and SSB_25

believed that a small research before meeting will help SSB members to understand and critical analysis the core issues presented.

Participants SSB_M2, SSB_M6 and SSB_M25 opined that Islamic banks in Indonesia must add Sharia research unit in their management structure. It is due to Sharia research unit can directly help SSB members to understand the recent issues and problems about the non-compliance activities and risks. Sharia research unit also can help the bank's management to ensure the implementation of Sharia activities and operations. This unit also perform under the SSB to prepare the in depth research on the problems and the issues in Islamic bank as an organization. The participants propose an additional unit called the Sharia research unit, which is expected to provide robustness in the Sharia deliberations and discussion for the Sharia final decision making.

The conclusion from the participants' interview is effort norms are really influenced by the degree of participation of each member. In performing their roles in the Sharia compliance process, SSB is assisted by the Sharia compliance unit and Sharia internal audit unit (Abdullah, *et al.*, 2014; Onagun and Mikail, 2013). An extra research and preparation on the part of SSB members will improve the degree of effort norms. Strong effort norms put SSB members in a better position to monitor the performance of management, to advise the BoD; thus, they can have a debate on various Sharia compliance options, and opportunities, and understand the needs of the company. SSB members must produce the review report as their responsibility to the Sharia compliance process. In summary, there is concern about a detailed disclosure of proceedings, reasoning and justification in respect of product approval and/or issuance of *Fatwa*. The need for high effort norm is important for SSB members to perform their roles in the Sharia compliance process.

7.3.5. Use of Knowledge and Skills

This report presents the use of knowledge and skills and its application by the SSB to perform their roles effectively in the Sharia compliance process. The items revealed in these variables are the application of SSB skills and knowledge in the Sharia compliance process, the influence of SSB members in the Sharia discussion, an understanding of their business environment, consultation with outside experts, updated knowledge and skills, and the influence of another professional on the SSB members. Research data summary highlighted

SSB members are knowledgeable about Sharia requirements of Islamic banks' services, products and operations, and many are keen to learn more about the background of the Sharia law. SSB members are provided with seminars and training where there is an exchange of ideas and opinions. SSB members are invited to have monthly meetings to discuss any issues or problems. These meetings also keep the world's economic system in mind. SSB members are encouraged to have more knowledge of business in general and thus complement their views on Sharia compliance law. It is not forbidden for SSB members to come from other professional, such as lawyers, accountants, bankers and economists to assist and advise on legal and financial issues. SSB members need various seminars, workshops, meeting, and training not only in Fiqh Al-Muamalat but also similar events on banking, finance, accounting, and capital market to support and to develop the understanding and knowledge of their roles in the Sharia compliance process. Those knowledge and skills are very important to enhance the roles of SSB in the Sharia compliance process due to the current development of the banking industry.

Most of participants agreed that they need to acquire some skills to perform their roles effectively. Expertise and experience in Islamic jurisprudence (*Usul Al-Fiqh*) and Islamic transaction/commercial law (*Fiqh Al-Muamalat*) is only one type of skill. SSB as the gatekeeper of the Islamic banks' decision-making structure must be equipped with such skills. The second type of skills is outside the Sharia domains to expand their knowledge and understanding of the development of Islamic banks. Such as, banking, finance, accounting, capital market and economics. The participants also reminded that due to the shortage of Sharia scholar, hiring and nurturing young members with the promising potential to expand the talent pool in the profession is needed.

Participants SSB_M1 added that SSB members can come from every education background, but they must have a qualified knowledge in the Sharia. Participants SSB_M3, SSB_M4, SSB_M5 and SSB_M17 recommended that SSB members can come from other professions, such as academicians, lawyers, accountant, former bankers or economist to improve their roles in the Sharia compliance process. Participants SSB_M6, SSB_M7 and SSB_M8 agreed that SSB members consist of the other professionals to enrich and enhance their knowledge.

Participant SSB_M9 thought that the other professional can significantly enhance the effectiveness the roles of SSB in the Sharia compliance process. Participants SSB_M11 and SSB_M12 further claimed that SSB members must have a skill and knowledge in business, banking, accounting and economics, besides the primary knowledge in Sharia. Participant SSB_M13 merely added that the other experts, such as academicians, bankers or accountants can help the SSB members to perform an effective decision-making on the non-compliance issues and problems in the banking system and operations.

Further, participant SSB_M14 highlighted about their weaknesses to perform their roles effectively at the ex-post stage in the Sharia compliance process. It becomes an

outlook that SSB members can hire or employ other professional, particularly like accountants, bankers, academicians in the Islamic bank or lawyers. Their knowledge can facilitate other SSB members to perform decision-making effectively on the non-compliance issues. Participants SSB_M15 and SSB_M16 specific mentioned that a shortage of Sharia scholars in Indonesia with the additional skill in Sharia banking, accounting and business. They suggest to hire and nurture young members with promising potential about Sharia and the talent pool in Sharia banking, accounting, management and business. Participants SSB_M19 and SSB_M20 strongly stressed that SSB members must have the knowledge of the finance and management in banking industry due to SSB as a gate keeper to supervise, control and monitor the Islamic bank's activities, operations and products complying with the Sharia law. However, SSB members also have to master the Sharia law.

From the interview, most of participants agreed that SSB members must attend seminars and training about recent issues and problems in the Islamic banking industry. Participant SSB_M2 thought that with seminars and training, SSB members can exchange their ideas and opinions about the issues and problem in the Islamic banking industry. Participants SSB_M4 and SSB_M6 adequately explained that seminars and trainings can enhance their roles due to their effective performance as a gate keeper.

This interview proved that Sharia knowledge should be enhanced, SSB members should be provided with various seminars, workshops, meeting, and training where there is an exchange of ideas and opinions (Abdullah, *et al.*, 2014; Al Zarrqa, 2002; Hassan, 2001). SSB members are supported to have much knowledge of the business in general. Some skills are required to enable them to perform their roles effectively. One type of skills is expertise and experience in Islamic jurisprudence (*Usul Al-Fiqh*) and Islamic transaction/commercial law (*Fiqh Al-Muamalat*). SSB as the gatekeeper of the Islamic banks' decision-making structure must be equipped with such skills. The second type of

skills is outside the Sharia domains to expand their knowledge and understanding of the development of Islamic banks. Such skills include banking, finance, accounting, capital market and economic. Due to the shortage of Sharia scholar, hiring and nurturing young members with promising potential expand the talent pool in the profession. SSB members can join other seminars and training on banking, finance, accounting, and capital market to support and develop the understanding of their roles in the Sharia compliance process. SSB members could include other scholars not only those specialized in *Fiqh Al-Muamalat* but also in other professions, such as accountants, bankers, academicians, and lawyers. Islamic banks can hire and nurture young SSB members with promising potentials to expand the talent pool in the profession (Abdullah, *et al.*, 2014; Abbas, 2008).

7.4. Discussion of Research Findings

The findings revealed that there are SSB members as respondent segments in evaluating the roles of SSB in the Sharia compliance process. Data was collected to provide the perspective for the roles of SSB in the Sharia compliance process. The major issues are the roles of SSB and how these roles affect the Sharia compliance process. One of the challenges faced during this study is the sentiments on the roles of SSB members in the Sharia compliance process in Indonesian Islamic banks. Investigating the behaviour and perceptions of the SSB has various implications and is vital to making positive changes in the Indonesian Islamic banking industry. The discussion is based on the research question of this research.

What are the roles of SSB in the Sharia compliance process?

7.4.1. The Definition of Effective Roles of the Sharia Supervisory Board

The definition of effective roles of SSB pertains to the ideas, viewpoints, experience, and knowledge about the roles of SSB in the Indonesian Islamic banks. In term of SSB roles, this process is especially valuable for the discussion of strategic issues and problems whereby alternative perspectives and courses of action are often required. It can improve the SSB's strategic roles map. SSB members must value and judge bank's operational procedures, products and report it annually in their review report. The implementation of *Fatwa* becomes a concern for the roles of SSB for their legitimation to issue Sharia approval or the Sharia decision-making.

The participants revealed that the power to legitimate the SSB position and using it to enhance their authority and charisma. Therefore, it involves ensuring the opinions and views of the participants indicate that the roles of the SSB in Indonesian Islamic banks are not only to advise, to regulate, to supervise, and to audit but also to have a legitimation in decision-making and in the society.

Other insights gathered from the respondents include, which is the remuneration of SSB member in accordance with their roles. The remuneration is expected to take place irrespective of any pressures from management due to the commitment to religious values and obligations. It also ascertains that the service is provided by the SSB to meet the customer's needs. The participants considered the SSB members as part of the board in the Sharia governance structure in the Islamic bank. Since the roles of SSB are similar with the functions of the board. However, the interview revealed that a re-evaluation of the remuneration of the SSB members in the Indonesian Islamic banks is required.

Furthermore, interview with the participants emphasized the *Quran* and *Sunnah* are the guides for SSB members in the Indonesian Islamic banks. The interview also suggested that the credibility of the Islamic banks is dependent on the perceived independence of the SSB. However, not all respondents are expected to be concerned

with the lack of SSB independence due to the transparency principles about the dual position in accordance with BI regulation on Sharia governance. The role of SSB in the Indonesian Islamic bank is also associated with the ideology is related to daily experiences in the business environment that tend to have objectives and behave in characteristics ways. SSB members must focus on the institutions' adherence to Islamic principles to assure customers that the SSB's report can reflect a genuine commitment or otherwise to Islamic law. SSB members are not governed by legal rules and professional codes of ethic like external auditors or lawyers. However, SSB members are ruled by the moral belief and obligations as a religious peer, benefiting the community and the injunctions from *the Quran* and *Sunnah* (Abdullah, *et al.*, 2014).

Based on the various findings of this study, the roles of SSB in the Indonesian Islamic banks include the following:

1. SSB members have the power to advice, regulate, supervise, and to audit all the bank's activities, operations, and products in compliance with the Sharia law.
2. The power of SSB members is also associated with the power to legitimate the SSB position and use it to enhance their authority and charisma.
3. The issue of the roles of SSB that arose from this study is the monitoring role about the implementation of *Fatwa*.
4. The SSB have an obligation to report all their valuation and judgments on operational procedures and products in their periodical reports.
5. The remuneration is expected to take place irrespective of any pressures from management to the SSB members in undertaking their roles due to the commitment to religious value and obligations.
6. The *Quran* and *Sunnah* serve as the guide for SSB members to perform their roles on the institutions' adherence to Islamic principles to ensure that all bank's activities, operation, and products can reflect a genuine commitment to Islamic law.

7. The credibility of the Islamic banks is dependent on the perceived independence of the SSB in the fulfilment of their roles.
8. SSB members are not governed by legal rules and professional codes of ethic like external auditors or lawyers. However, SSB members are ruled by the moral belief and obligations from *the Quran* and *Sunnah*.

7.4.2. The Effectiveness of SSB Roles in the Sharia Compliance Process

The interview with the participants demonstrated that SSB members has a crucial obligation in assessing the bank's activities, operations, and products compliance with the Sharia law. It showed that the SSB members can have a deep and deliberate discussion and it also creates the effectiveness of the SSB oversight roles on their review reports. The discussion continued with the respondents about the SSB members' understanding of pronouncing Sharia judgments. SSB members are Sharia professionals that have an in-depth understanding of Sharia judgment on activities, operations, and products qualifications and conformity in accordance with the *Quran* and *Sunnah*.

According to the participants, the role of DSN is very important in solving issues and problems related to *Fatwa*, recommendation for the disagreement, and preventing the non-compliance activities, operations and products. There is also a view from the respondents that the SSB chairperson has an important role in the cognitive conflicts to prevent the negative emotions that may decrease interpersonal collaborations and results in dissatisfaction and withdrawal from the issues.

In this study, it can be agreed that SSB that take a participative approach, are associated with higher level of their monitoring and service role. An extra research and going through the report on preparation for SSB meeting will improve the degree of effort norms. Strong effort norms make SSB members in a better position to do their monitoring

role on the performance of management, to advice BoD, and it can show a debate position on the various Sharia compliance options, opportunities, and understand resources the Islamic bank will need.

The participants put forward the argument that Sharia compliant unit and Sharia audit unit facilitate SSB to perform their roles. This, therefore, shows that effort norms affect to SSB's preparation for meetings, participation in meetings, analysis of information and a sense of responsibility for their roles. The interview revealed that effort norms have a strong influence on SSB member's behaviour and strong effort norms of SSB members as an individual to acknowledge their roles seriously. For example, SSB members must go through the meeting agenda carefully. It can facilitate the SSB members to be in a better position for monitoring on Sharia pronouncement, compliance of Islamic bank's operations, activities, and products. Similarly, by analysing the dissemination information very carefully, SSB are able to perform their roles of advice and guidance more effectively. The interview with participants disclosed that certain norms such preparation for meetings, proper documentation and analysis of information and a sense of work responsibility should empower the SSB to perform their roles better into Sharia compliant process. The apprehensiveness happens on the detailed disclosure of proceedings, reasoning and justification in respect product approval and/or issuance of *Fatwa*.

Some of the participants suggested that the Islamic bank in Indonesia need to add an extra unit in the Sharia governance structure, which is Sharia research unit. This Sharia research unit is proposed to help the SSB members to organise in depth research about the problems and issues in the Sharia compliance process. This unit have direct responsibilities to support for enhancing the roles of SSB in the Sharia compliance process.

In this study are skills and knowledge of SSB members relate with the application of SSB skills and knowledge in the Sharia compliance process, the influence of SSB members in the Sharia discussion, an understanding of their business environment, the consultation with the outside expert, the updated knowledge and skills, and the influence of other professional as SSB members. Based on the interview, participants showed that greater levels of skill support the SSB members to increase the number of items and information that can be engaged and withdrawn, expanding the number of critical judgements available to correct errors in implication and analysis, enhancing the number of potential solutions and multiply the perspectives on their roles, and an increase in capabilities could account for higher-quality decision. SSB members are supported to have much knowledge of business in general and thus start their views on Sharia law with the various seminar, workshops, meeting, and training. SSB members can join other seminars and training on banking, finance, accounting, and capital market to support and to develop their understanding and knowledge of their roles in the Sharia compliance process. By integrating the various knowledge and skills, SSB is in a better position to control and supervise the compliance process of operations, activities, and products. SSB members combine their knowledge and skills of various functional areas and use their skills on firm-specific issues. As a result, the SSB is able to offer valuable advice and guide to BoD. In other words, SSB members should utilize their skills and knowledge for the benefit of the institutions.

Furthermore, engaging other professionals, such as lawyers, accountants, bankers, and economists to assist and advise the SSB members, especially on legal and financial issues. The professionals may share their valuable knowledge and skills with other SSB members who do not have such knowledge and skills. It can be established to educate other SSB members. The shared knowledge and skills would enable deep and deliberate discussions that will guarantee well-informed judgments. The SSB might stress detailed

explanations for any changes and deviations from industry practices, and can as well request for detailed explanations for any changes in this business environment.

Based on the interview findings in this study, some recommendations are made to enhance the roles of SSB in the Sharia compliance process in Indonesian Islamic banks:

1. Cognitive conflicts can enhance the effectiveness of the SSB through deep and deliberate discussion.
2. The *Quran* and *Sunnah* are the principal guides that help SSB members make a Sharia judgment on activities, operations, and products qualifications and conformity.
3. The role of DSN is very important in resolving issues and problems relating to *Fatwa*, the recommendation for the disagreement, and the prevention of non-compliant activities, operations and products. The participants pointed out that the SSB chairperson has an important role in the cognitive conflicts due to the prevention of negative emotions that could reduce interpersonal collaborations and result in dissatisfaction and withdrawal from the issues.
4. The diverse opinions and ideas from SSB members can present a constructive environment in boardroom discussions and ensure the integrity and consistency of the review reports.
5. The need for an additional unit on the Sharia governance structure in Indonesian Islamic bank, which has an obligation to help the SSB members to do an in depth research about problems and issues in the Sharia compliance process.
6. Effort norms have a strong influence on SSB member's behaviour and strong effort norms of SSB members as individuals to acknowledge SSB for monitoring roles in the Sharia compliance process.
7. The question that arises from this discussion is the detailed disclosure of proceedings, reasoning and justification in respect of product approval and/or issuance of *Fatwa*.

8. SSB must be supported with two types of skills and knowledge, namely: expertise and experience in Islamic jurisprudence (*Usul Al-Fiqh*) and Islamic transaction/commercial law (*Fiqh Al-Muamalat*), and relevant skills and knowledge that are outside the Sharia domains to expand their knowledge and understanding of development in Islamic banks, such as banking, finance, accounting, capital market, and economics.
9. Greater levels of skills enable SSB members to increase the amount of information that can be engaged and withdrawn, expanding the number of critical judgments available to correct errors in implication and analysis, enhancement of the number of potential solutions, and increased capabilities could account for higher-quality decision. As a result, the SSB is able to offer valuable advice and guide to the BoD. In other words, SSB members should utilize their skills and knowledge to enhance their advisory and supervisory role.
10. The other professionals, such as lawyers, accountants, bankers, and economists can help SSB member by assisting and advising. The professionals may share their valuable knowledge and skills with other SSB members.

7.5. Analysis

The deficiencies revealed in this study are corroborated by those mentioned in the literature review. This study was carried out to identify the roles of SSB in performing their roles in Islamic banks using professional power and sustaining ideology. This study also examined the roles of SSB in the Sharia compliant process through cognitive conflicts, effort norms and use of knowledge and skills.

Table 7.5 shows the findings (discussed in Section 7.3), it explains a relationship between themes, which are chosen from the literature review and the findings.

Table 7.6 outlines the roles of SSB – from professionalism to behaviour of boards as follows:

- In line with professionalism, the main roles of SSB are issuing of *Fatwa* for Sharia compliance and supervising the implementation of *Fatwa* or Sharia compliance applications in Indonesian Islamic banks.
- Behavioural theory of boards concentrates on the monitoring and implementation of product, service and operations, and management of Islamic banks.

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Table 7.5: The Roles of SSB in the Sharia Compliance Process

Themes	Roles of SSB
Professional power	<ul style="list-style-type: none"> • Exercising the manipulating wishes and desires. • Advising the BoD. • Regulating policy preference related with Sharia compliance. • Supervising the Sharia compliance applications. • Complying with the Sharia law and requirements. • Auditing the report, such as internal audit report. • Valuing and judging the review report. • Legitimacy for the Sharia approval and decision – making.
Sustaining ideology	<ul style="list-style-type: none"> • Supervising the implementation of <i>Fatwa</i>. • Legitimacy for issuing <i>Fatwa</i>. • Ensuring their independence.
Cognitive conflicts	<ul style="list-style-type: none"> • Supervising and controlling the Sharia decisions/pronouncements/resolutions. • Monitoring the product implementation. • Reviewing annually the products, service, and operation verifications.
Effort norms	<ul style="list-style-type: none"> • Ensuring the Islamic legitimacy of financial products and transactions. • Monitoring for management. • Advising for BoD. • Consulting a detailed of proceedings, reasoning and justification in respect of product approval and/or issuance <i>Fatwa</i>.
Use of knowledge and skills	<ul style="list-style-type: none"> • Monitoring the implementation of products, services and operations. • Legitimacy of the Sharia decisions to judge critical issues in the Sharia compliance process.

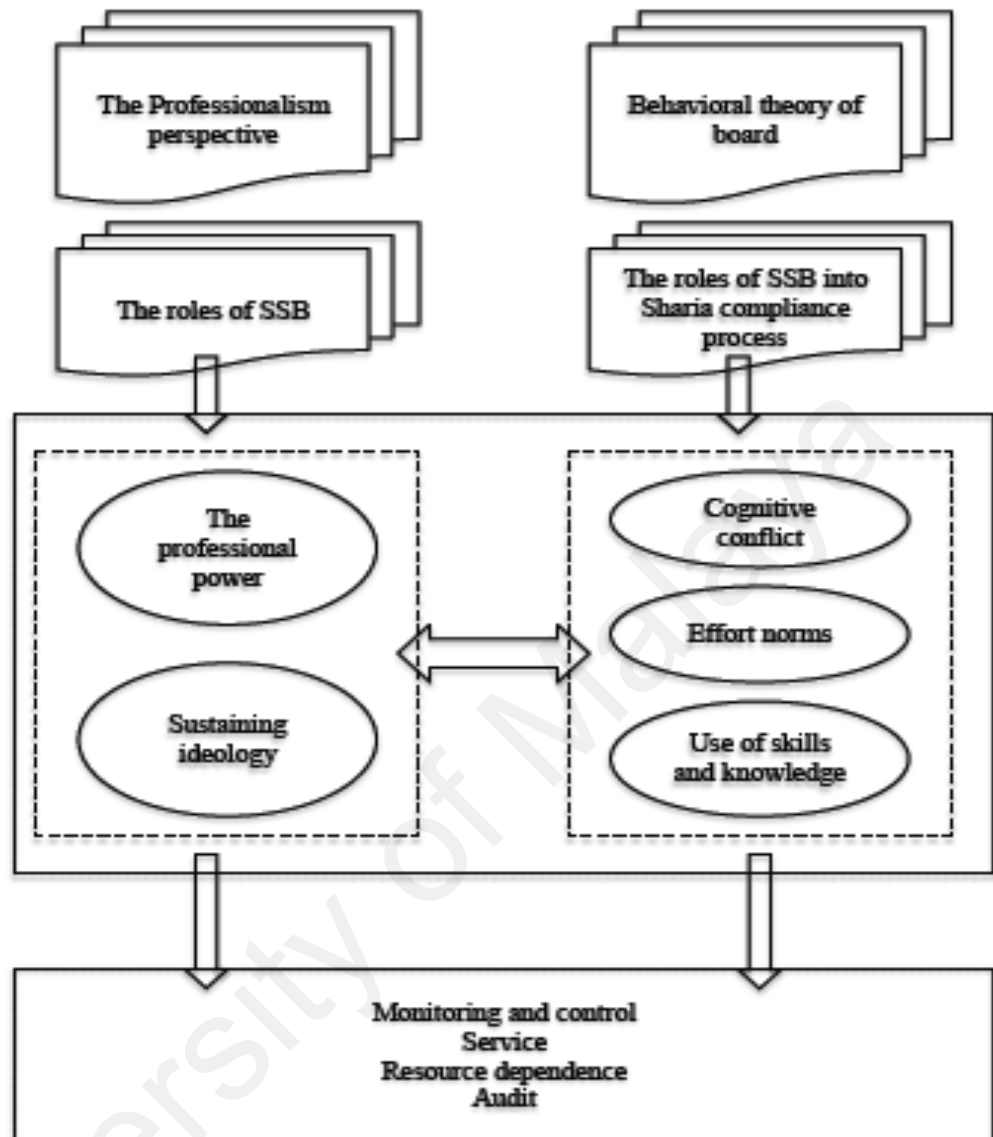
Source: Author's table

Table 7.6: The Evaluation of the SSB Roles

The roles of SSB into Sharia compliance process			
Monitoring role	Service role	Resource dependence role	Audit role
<ul style="list-style-type: none"> • Maximize the preservation of Islamic law and wealth. • Ensuring the management's activities that they are acting in the line with Sharia law. • Monitoring the products, services and operations, and the implementation or the Sharia compliance applications. • Ratification of <i>Fatwa</i>. 	<ul style="list-style-type: none"> • Giving advice and support to the BoD about the compliance with Sharia law. • Company representation. • Guiding the management to comply with the Sharia law. • Participation in formulation and implementation of <i>Fatwa</i>. • Legitimacy for the Sharia approval and decision-making, and <i>Fatwa</i>. • Ensuring their independency. 	<ul style="list-style-type: none"> • Asking <i>Fatwa</i> from DSN. • Consulting a detailed of proceedings, reasoning and justification in respect of product approval and/or issuance <i>Fatwa</i>. 	<ul style="list-style-type: none"> • Auditing the report. • Valuing and judging the review report. • Reviewing annually the products, services, and operations.
The professionalism perspective and the behavioral theory of board			

Source: Author's table

Table 7.6 explains that the roles of SSB in the Sharia compliance process are mainly cantered around monitoring and service role. It is due to this that the SSB has no significant influence over Islamic bank's strategic development, and its responsibility is merely defined within the evaluation domain of the strategy adopted by top management. It means that the role of the SSB does not include strategy review and ratification since the SSB are not assumed to be actively included in the process of strategy formulation and implementation. Though the SSB is a gatekeeper in Islamic banks, it only participates in Sharia decision-making at all level in the Islamic banks.



Source: Author's figure

Figure 7.1: An Integrative Model of the Roles of SSB in Sharia Compliance Process

Figure 7.1 presents an integrative model of the roles of SSB in the Sharia compliance process from the result of this study. This figure suggests solutions close the gap between the SSB's expectations and deficiencies as it regulates the Sharia compliance process.

7.5.1. Professional Power

This study brings a professional power to examine the roles of SSB in the Islamic banks. This study examined the roles of SSB in the Sharia compliance process in the light of professional power. Professional power is defined as a certain form of authority in the society, by professional association over the production and supply of services to consumers in a specific domain or jurisdiction (Birkett and Evans, 2005; Freidson, 1994). According to AAOIFI (2010), the SSB is an independent body in Islamic banks whose roles are to direct, review and supervise the activities of Islamic banks in order to comply with Sharia rules and principles.

In addition, Daoud (1996) suggested that SSB has a guiding role in Islamic banks with regards to setting policies and regulation according to the Sharia law. SSB is a vital resource and has the authority originate from religious, legal and systematic resources. SSB must perform their role of advising and as the top authority in matters of religion, and to conduct internal auditing regularly on documents to ensure compliance with the Sharia law. Algaoud and Lewis (1997) stated that SSB is employed by the Islamic banks to act as an internal control body in the organization and to enhance the credibility of the Islamic banks; this will result in a good reputation and image for the Islamic banks.

This study engaged professional power in terms of SSB's behaviour in Sharia decision-making based on issues of observable conflict of interest expressed as different policy preferences. Then, professional power examined the power of SSB for exercising the manipulating wishes and desires affecting their roles. The findings revealed that the roles of SSB, which is related to their professional power, are to advice, to regulate, to supervise, and to audit all Islamic bank's activities, operations, policies and products in line with Sharia law and requirements. SSB also has the professional power to value and judge Islamic bank's operational procedures and products and to report their valuations and judgments in review reports. SSB must monitor the actual implementation of their

Fatwa, as part of their legitimacy role so that they can implement their professional power on the issue of Sharia approval and decision-making.

The findings revealed that the roles of SSB, which is related to their professional power, are to advice, to regulate, to supervise, and to audit all Islamic bank's activities, operations, policies and products in line with the Sharia law and requirements. According to Cosh and Hughes (1997) and Kovach (1987), one of the important factors that motivate members of an organization and leads to a satisfactory performance is the working environment and the reward system or the remuneration. The remuneration system for SSB members is regulated by the PBI No. 11/33/PBI/2009 (Bank Indonesia, 2009). The remuneration system must be worthy since the roles of SSB members are very crucial to Sharia compliance in Islamic banks. Also, their work should be independent to ensure transparency and efficiency in the performance of their roles.

7.5.2. Sustaining Ideology

Sustaining ideology is defined as a set of beliefs or ideas, or attitudes, characteristics that is embraced in everyday concepts and experience, or elaborated intellectual dogmas, either consciously or institutionalized thought, especially with social, political or religious ideas (Van Dijk, 1998; Eagleton, 1983; Therborn, 1980; Plamenatz, 1970). This study utilises the routine experiences of the SSB members in the occupational environment to build the basis of the research for sustaining ideology. The sustaining ideology concept in this study includes the independence of SSB members, the understanding to the ethical standard, and ideas and attitudes of SSB members on their services, competencies and integrity.

The primary role of the SSB is to form an independent opinion of Sharia compliance and report it in their review report (Nienhaus, 2007). SSB must supervise the

implementation of *Fatwa* on the bank's operations and products (Karim, 1990). The *Quran* and *Sunnah* are primary sources of the rules and regulations set by the SSB in Islamic banks (Abdullah, *et al.*, 2014). SSB must also comply with a number of methods to ensure their legitimation role for issuing *Fatwa* on financial products, transactions and services. The *Quran* and *Sunnah* are the guidance text for Sharia decision-making and interpretation; however, SSB also issues standards if there is no text in the *Quran* and *Sunnah* stipulating such matters (Saeed, 1996).

Furthermore, the independence of SSB becomes an issue in the development of Sharia governance in Islamic banks (Hasan, 2011; Grais and Pellegrini, 2006c). According to IFSB (2006), the independence of SSB members is important to exercise objective judgment and complete, adequate and timely information. In order to ensure their independence, SSB members must not allow an individual or group to influence their Sharia decision-making, and must not have family and intimate relationship with the other board members and managements in the Islamic banks due to a conflict of interest. AAOIFI (2010) suggested that for independence, SSB members must have a manner of thinking, which does not let their objective and conclusion to be the influenced and conflicting interest within board members should not affect their performance. PBI No. 11/33/PBI/2009 that the independence for SSB members relates to professional behaviour. Objective decisions should be made and must be free from any influences and pressures, and there should be a strong commitment to achieving the development.

The role of SSB in Islamic banks is also distinguished by the responsibility to ensure that all business practices and products comply with the Sharia law, and to minimize the exposure to fiduciary and reputational risks that is related to Sharia compliance in Islamic banks. The independent assurance is an issue as it is the key control to add value and enhance effectiveness of the business operations and activities, including the Sharia compliance aspect. The independence of SSB members in the Islamic banks

covers a wide range of objectives, such as efficiency and effectiveness of business operations, safeguarding of assets, reliability and integrity of the reporting processes, and compliance with the Sharia law in all policies, procedures, and contracts.

The findings showed that the *Quran* and *Sunnah* are the primary guides for SSB members to perform their roles in Islamic banks. The *Quran* and *Sunnah* are the guides for the SSB members' moral behaviour and obligation as gatekeepers in the Sharia compliance process since SSB members are a specialized level of individuals learned in *Fiqh Al-Mualamat*. However, the fundamental concern in the sustaining ideology is the independence of SSB members. The participants in this study suggested that SSB members are skilled individual with the appropriate knowledge of the Sharia source, and have an upright character to formulate independent opinion and judgment. SSB members do not have any family relationship, financial, relationship management, shareholding relationship with another member of the SSB, the Board of Commissioners and BoD. SSB members must be independent due to their roles related to transparency principles and the reputation of the Islamic banks (AAOIFI, 2010; IFSB-10, 2009). There is no restriction in the Indonesian Islamic banks for the SSB members to have dual position, however, SSB members are prohibited from becoming consultants in another Indonesian Islamic bank (Bank Indonesia, 2009).

7.5.3. Cognitive Conflicts

Cognitive conflicts are defined as conflicts, related to task-oriented differences in judgment among board members of the group (Namoga, 2010; Forbes and Milliken, 1999; Amason, 1996). Cognitive conflicts can facilitate concern and evaluation of choices, encouragement of multiple ideas and exchange of positive and negative feedbacks, and the emergence of superior perspective by individual members (Amason and Sapienza, 1997; Eisenhardt, *et al.*, 1997). Cognitive conflicts among board members

remind management about the power structure of boards (Watson and Michaelsen, 1988; Schweiger, *et al.*, 1986; Wanous and Youtz, 1986).

This study examined the levels of disagreement among SSB members that are related to their roles and stems from the different ideas, opinions and perceptions about matters discussed. This study also revealed the meaning of good quality decisions, they are likely to happen when SSB members are given a space to powerfully explore and have an in-depth analysis of options. In addition, this study focused on giving the SSB members the opportunity to constructively challenge and debate decisions, the culture in the boardroom should encourage SSB members to express their disagreement and concerns about issues and problems. All these enable board members to reach a desirable decision in a comfortable environment.

The roles of SSB in the Sharia compliance process are to supervise and to control the launching of new products including pre-product approval that brings about the issuance of Sharia decisions/pronouncements/resolutions. Product structuring should be backed with comprehensive Sharia research, scrutinization of contracts and agreements and compliance checks. When consensus among SSB members cannot be achieved, it is referred to a central authority, such as the DSN in Indonesia (Bank Indonesia, 2009).

The primary objectives of Islamic banks are not only to guarantee the shareholder's wealth but also to protect the confidence and trust of the public and society who rely on the services provided by them. The non-Sharia compliant of products, services and operations can present a negative image to the public regarding confidence and legitimacy of the products and services offered by Islamic banks (Wilson, 2009a). The SSB has to ensure that the product of Islamic banks complies with the Sharia law and requirements (Onagun and Mikail, 2013). SSB must appropriately carry out an annual Sharia compliant review to verify that products, services, and operations comply with the Sharia law and requirements in Islamic banks.

DSN is a central authority in Indonesia besides BI, which has the power to solve disagreements among SSB members, especially when it is related to *Fatwa*. As a central authority, DSN has the obligation to supervise and to be the resolution party for disagreement about *Fatwa* (Venardos, 2005). Cognitive conflicts can be perceived in a positive manner to encourage productivity in the SSB. Cognitive conflicts can be seen as a critical evaluation of the independence, qualifications and performance of SSB members.

Further, the findings revealed that the SSB chair holds the crucial position of resolving disagreement among SSB members, especially when it happens in the boardroom. The position of the SSB chair is very crucial in making good quality decisions and in giving the chance to explore alternative opinions. The SSB chair should allow the discussion of diverse opinions and ideas in the boardroom to ensure the integrity and consistency of annual review reports (Garas and Pierce, 2010; Delorenzo, 2004; Al Nashmi, 2002; Al Qaradawi, 2001).

7.5.4. Effort Norms

In this study, effort norms are defined as the degree of participation of each SSB member. According to Babic, *et al.*, (2011), Zona and Zattoni (2007), Forbes and Milliken (1999) and Wageman (1995), effort norms are the shared belief of groups for evaluating the board members' activities in performing their roles. The degree of effort norms depends on their beliefs and expectations of being properly rewarded for accomplishment. Effort norms are a signal for the level of effort of the boards in achieving a set of objectives. Further, Lorsch and MacIver (1989) suggested that effort norms could be measured as the amount of time devoted by the board members to board activities. For example, Lipton and Lorsch (1992) explained that when the board put some efforts into

performing better in board meetings, it shows that the board dedicates sufficient time to fulfil their functions and roles.

Board members need to be focused on their efforts to perform their roles effectively in boardroom activities (Mace, 1986). This study focused on the preparation and participation of SSB members during board meetings as a means to evaluate their roles in the Sharia compliance process. This study also determined the effort and time spent by the SSB members in preparing for SSB meeting, going through the report and embarking on extra research to verify information in the reports. Effort norms in this study refer to the monitoring roles of SSB members within the Sharia compliance process. As a result, this study focused on the research carried out by SSB members prior to meetings, important issues and problems presented in SSB meetings, the time spent by SSB members in meetings and the activity level of board members.

The SSB follows Islamic bank's internal standard operating procedures about the council meetings conducted at least four times a year. SSB members must undertake self-evaluation and cross-evaluation (Hasan, 2011). Then, Adawiah (2007) stated that the SSB has a crucial role to ensure the legitimacy of products and services. This can be achieved by having a comprehensive Sharia supervision and efficient internal Sharia review unit. Saeed (1996) suggested that SSB members must comply with a number of rules to ensure financial products and transactions comply with the Sharia.

The finding of the results showed that effort norms have a positive association to the roles of SSB in the Sharia compliance process in terms of the preservation of Islamic law and wealth. Findings revealed that there is a regulatory body outside BI that serves as a local supervisory body for SSB members is the DSN. The supervision of SSB members by DSN is regulated clearly in PBI No. 11/33/PBI/2009. BI and DSN must also provide professional trainings, workshops, and seminars for SSB members and Islamic bank officers that have tasks and authorities related to SSB roles. SSB members agreed

that effort norms correlate with SSB members' preparation for meetings, participation in meetings, analysis of information and a sense of responsibility to their roles. Strong effort norms indicate that SSB members perform their roles of management, advising the BoD, and have constructive debates on various Sharia compliant options.

To enforce their roles in the Sharia compliance process, SSB members are supported by ISRU or ISCU. SSB members must audit the financial statements presented by internal auditors and Sharia auditors. SSB members must analyse the dissemination of information on Sharia pronouncement; thus, SSB members must perform their advisory and consulting roles to the BoD effectively. SSB members can also disclose details of proceedings, reasoning and justification in respect of product approval and/or issuance of *Fatwa*.

7.5.5. Use of Knowledge and Skills

This study analysed the use of knowledge and skills and the SSB's ability to perform their roles effectively in the Sharia compliance process. According to Cohen and Bailey (1997), Weick & Roberts (1993) and Hackman (1983), knowledge and skills are important resources. The maximum usage of knowledge and skills can minimize process costs and encourage board members to cooperate and act together. Dulewicz, *et al.*, (1995) opined that the implementation of the diversity of skills and knowledge among board members rises from strategic thinking, analytical thinking, communication skills, interaction skills, management skills and result-oriented perspectives. Further, Hoque (2005) explained that in organizational contexts, the utilization of knowledge and skills by internal actors can result in positive changes within the organization.

Furthermore, Bailey (1997) added that the use of knowledge and skills influences the behavioural dimension of social integration and affect board members' ability to cooperate. McNulty, *et al.* (2013) suggested that board members should be aware of each

other's skills and knowledge to achieve collaboration and integration for better performance and effectiveness. Abbott, *et al.* (2012), Bedard, *et al.* (2004) and Xie, *et al.* (2003) relayed that board members' expertise, knowledge and skills are very crucial due to their monitoring roles. Moreover, this study emphasized the utilization of knowledge and skills to achieve the objective of the company. This study evaluated and analysed the presence of other professionals, such as lawyers, accountants, and economists. This study also analysed shared knowledge and skills of SSB members to judge critical issues in the Sharia-compliant process. This study argued that the importance of identification, integration and coordination of roles among SSB members results in effective monitoring.

The result from the interview showed that BI and DSN as regulators give SSB members lots of opportunities to discuss any issues and problems related to Sharia compliance through seminars, workshops and discussions. Some Islamic banks hire other professionals like accountants, bankers and economists as SSB members. There is no restriction from the BI and DSN, and it is regulated by PBI No. 11/33/PBI/2009. There are some types of skills that are needed by the SSB member, namely: skills that relate to expertise and experience in Islamic jurisprudence (*Usul Al-Fiqh*) and Islamic transaction/commercial law (*Fiqh Al-Muamalat*). Skills that are outside Sharia domains are also required. They enable SSB members to expand their knowledge and understanding of development in the Islamic banking industry. Finding also revealed that hiring and nurturing young members of SSB with promising potentials expand the talent pool in the profession and it is very crucial due to the shortage of Sharia scholars in Indonesia. Various seminars, training, meetings, workshops and discussion on banking, finance, accounting and capital market are obligatory for SSB members.

Table 7.4 presents the number of training, which has been attended by participants after they are appointed as the SSB members. 80% of the participants have attended training less than five times during their tenure as a SSB member. Only 20% of

participants have been attending five trainings since their appointment as the SSB members. According to DSN-MUI¹ No 03 of 2000 about guidelines for the establishment of the SSB Members in Islamic financial institutions that to enhance the human resources for the SSB members' must be trained by special programs such as training and regeneration training, in addition to setting the criteria for mastering the two fields in the selection of SSB members with more specifics. However, the interview result explained that the needs for other professionals such as academicians, accountants, bankers, economists and lawyers is desirable. It is due to the shortage of human resources among the SSB members.

¹ DSN-MUI is National Sharia Council - the Indonesian *Ulama* Council is an independent institution, which is established in order to realize the aspirations of Muslims in Indonesia

CHAPTER 8: SUMMARY AND CONCLUSIONS

8.1. Introduction

This research explores the roles of the SSB in the Sharia compliance process in the Indonesian Islamic banks. Specifically, the main aim of this study is to examine the definitive roles of the SSB members in the Sharia governance process, in particular their roles in the Sharia compliance process.

The main difference between Islamic and conventional banks is in the CG structure and process. Sharia compliance is the bedrock of IFIs, including Islamic banks. Thus, an additional layer of the governance structure and process is needed to ensure the adequate governance mechanism is in place to ensure compliance with the Sharia law. This additional layer of CG or known as Sharia governance is put in place with the establishment of the SSB. SSB is positioned as an internal control body to advise and provide *Fatwa* regarding the Sharia matters as well as to oversee the Sharia compliance process which is necessary to enhance the credibility of Islamic banks (Muhamad, *et al.*, 2011; Ghayad, 2008; Grais and Pellegrini, 2006c).

This chapter comprises of seven sections. Subsequent to this introduction, Section 8.2 discusses the findings followed by section 8.3, which presents the implications of this study. Section 8.4 discusses the limitations of this study and section 8.5 presents recommendations for future research. Finally, section 8.6 presents the concluding remarks in this study.

8.2. Discussion

The fundamental role of Islamic banks is to provide Sharia compliant financial products and services as an alternative to the conventional financial products and services.

Grais and Pellegrini (2006c) argued that IFIs are developed without a clear foundation of the legislative and regulatory framework. Although Islamic banks perform almost the same functions as conventional banks, the conceptual foundation and operational practices are derived from the Sharia law which pose issues and challenges to regulators. The unique feature in the operationalisation of Islamic banking products and services is the requirement to comply with the Sharia law in all aspects these products and services. Abu-Tapanjeh (2009) explained that Islamic business and transaction have unique characteristics of norms, ethical and moral framework as contained in the Sharia law (Warde, 2000).

The main aim of this study is to ascertain the in depth understanding on the roles of the SSB in the Sharia compliance process. Semi-structure interviews are conducted with the SSB members of the selected Islamic banks in Indonesia to uncover the issues and problems regarding their roles in the Sharia compliance process. This section presents the key findings from the study based on the research objectives as stated in chapter One.

There are three specific objectives of this study as noted below:

1. To understand the definition of the effective roles of the SSB in the Sharia governance process.
2. To examines the effectiveness of SSB roles in the Sharia compliance process.
3. To determine issues and problems facing by the SSB in performing their effective roles in the sharia compliance process.

8.2.1. The Definition of Effective Roles of SSB

Sharia compliance is the bedrock of IFIs and thus, it is mandatory for IFIs to establish SSB, which has the duty to ensure that the operations, services and transactions are all compliance with the Sharia law. As part of the internal Sharia governance structure,

the SSB plays a crucial role in ensuring that Islamic banks at all times comply with the Sharia law (Ayedh and Echchabi, 2015; Warde, 2000).

The SSB as the key organ of in the Sharia governance structure and process should guide Islamic banks in setting the rules, policies and regulation in accordance to the Sharia law. The approach that has been used by Islamic banks in ensuring a good Sharia governance is to integrate all business activities taking into consideration the sharia law and Islamic moral guidelines (Rahman, 1998). Stakeholders of IFIs expect IFIs comply with the requirement of the Islamic law (Iqbal & Mirakhor, 2004) including the behaviour of the top management (Racha, 2008).

Furthermore, the SSB has an executive role of reviewing, advising on the remedial actions and monitoring the operations of Islamic banks. Garas and Pierce (2010) concluded that there are two important roles of the SSB, namely, overseeing the operations of the bank, in particular, the issuance of *Fatwa*, approving new products, contracts and services, supervising the conduct of Sharia audit by Sharia internal auditors and auditing of financial statements at the year end, and secondly to approve the net income distribution to shareholders and IAHs. The roles of the SSB in the Sharia compliance process can be improved if they effectively exercise their professional power. Professional power relates to the power that is exercise by the SSB to prevent their personal desires in influencing their roles as a gatekeeper to ensure Islamic banks comply with the Sharia law. The findings established that the roles of the SSB, in relating to their professional power, are to advice, to regulate, to supervise, to comply, and to audit all activities, operations, policies and products and services of Islamic banks are in compliance with the Sharia law and requirements. The SSB should also exercise their professional power to provide judgment on the operational procedures and products in the SSB report that is included in the annual reports of Islamic banks. The SSB must

monitor and ensure the issued *Fatwas* are actually implemented in the routine operations of Islamic banks.

8.2.2. The Effectiveness of SSB Roles in the Sharia Compliance Process

It can be concluded that the various factors to be considered in improving the effectiveness of the roles of the SSB in the Sharia compliance process in the Indonesian Islamic banks. First, the SSB members must possess knowledge and skills in Sharia and religious studies as well as management, banking operations and auditing knowledge. SSB members possessing a good knowledge in Sharia is very important to enhance the credibility and reputation of Islamic banks in the market place (Nawaz & Haniffa, 2017). Secondly, the SSB members must be a professional, i.e. they must hold a key position in the society, such as lecturers, experts, consultants, or religious scholars. Thirdly, it will be good to have other professionals such as accountants, lawyers or bankers to be appointed as members of the SSB as this will add the diversity in the membership of the SSB which can potentially improve the deliberation and discussion in arriving at a decision. The fourth point is the importance of having in place a good plan of continuous professional development for the SSB members. The SSB members should be committed to improve the quality of knowledge and skills such as attending seminars, training, or workshops. This can be done through services generally provided by professional associations. Finally, the SSB members should be able to provide advices to resolve issues on non-compliant activities, operations and products.

It is also found that there is a potential issue on independence as the SSB members in Islamic banks in Indonesia are employed by Islamic banks and perform as an internal control body in the bank. However, the independence issue can be minimising as the decision made is based the collective opinions by the SSB members (Garas and Pierce, 2010; DeLorenzo, 2004; Al Qaradawi, 2001) thus, the eliminating any conflict of interest

that might arise (Al Baali, 2001). The independence of the SSB members in the decision making is important to ensure confidence in products and services offered (Hammad, 2006). The roles of the SSB are classified into: moral, practical, consultation, administrative, and control (Fayyad, 2004). Hammad (2009) suggested that there are academic and executive roles in the SSB. The academic roles include the development of Islamic jurisprudence through research to resolve the non-compliance activities as well as their roles in educating the management of Islamic banks in the field of Islamic jurisprudence through seminars, conferences, and workshops. The independence of the SSB members in discharging their roles in the Sharia compliance process would enhance the credibility of Islamic banks (Algaoud and Lewis, 1997).

The expected roles of the SSB in the Sharia compliance process are to supervise in the launching of new products including pre-product approval process that relates to the issuance of Sharia decisions/pronouncements/resolutions, product structuring which are backed with comprehensive Sharia research through detail scrutinizing of contracts and agreements and compliance checks. The SSB be involved in the idea generation leading to the structuring and commercialisation of products in the market.

The other point highlighted from the findings in this study is the need for the SSB members to be effectively in the boardroom. The detail preparation for and active participation of the individual member in SSB meetings is crucial to effectively discharge their roles in the Sharia compliance process. The effort and time spent by the SSB members to prepare for the SSB meetings by going through minutes and reports provided as well as conducting appropriate research to verify information provided are necessary for the effective roles to be achieved. This is interpreted as effort norms, where the SSB members take the necessary efforts to critically analyse the available information in supervising and monitor the operations of Islamic banks through the Sharia compliance process.

8.2.3. Issues and Problems of Sharia Supervisory Board to Perform the Effective Roles in the Sharia Compliance Process

Issues and problems encountered by the SSB in performing their effective roles in the Sharia compliance process are presented in Figure 8.1. The figure shows that the SSB members need to improve their independency in providing opinions and judgments, possess the legitimate power, the needs to enhance the remuneration system, to have in place an operational guidance for *Fatwa* implementation, the establishment of a pool of talents, improving the knowledge on the contemporary issues and problems in the Islamic banking industry, need to be more pro-active in discharging their roles in the Sharia compliance process, to be more critical in reviewing and analysing reports, and to improve the professionalism of the SSB members possessing the Sharia qualification.

The results of this study showed that it is important for the SSB to perform their tasks and roles in an independent manner, without any form of influence or pressure from the management to favour the bank. The SSB only has the power to express their judgments or Sharia opinions; they do not have any capability or legal authority to influence or force the management and BoD to fully implement their opinions. Another concern is regarding the SSB's remuneration. According to Mohamad, *et al.* (2015) the management of Islamic banks should remunerate SSB members appropriately. SSB has an important obligation in the development of the operational processes and the products of Islamic banks, yet the SSB members are only awarded with a token sum compared to what other board members are paid.

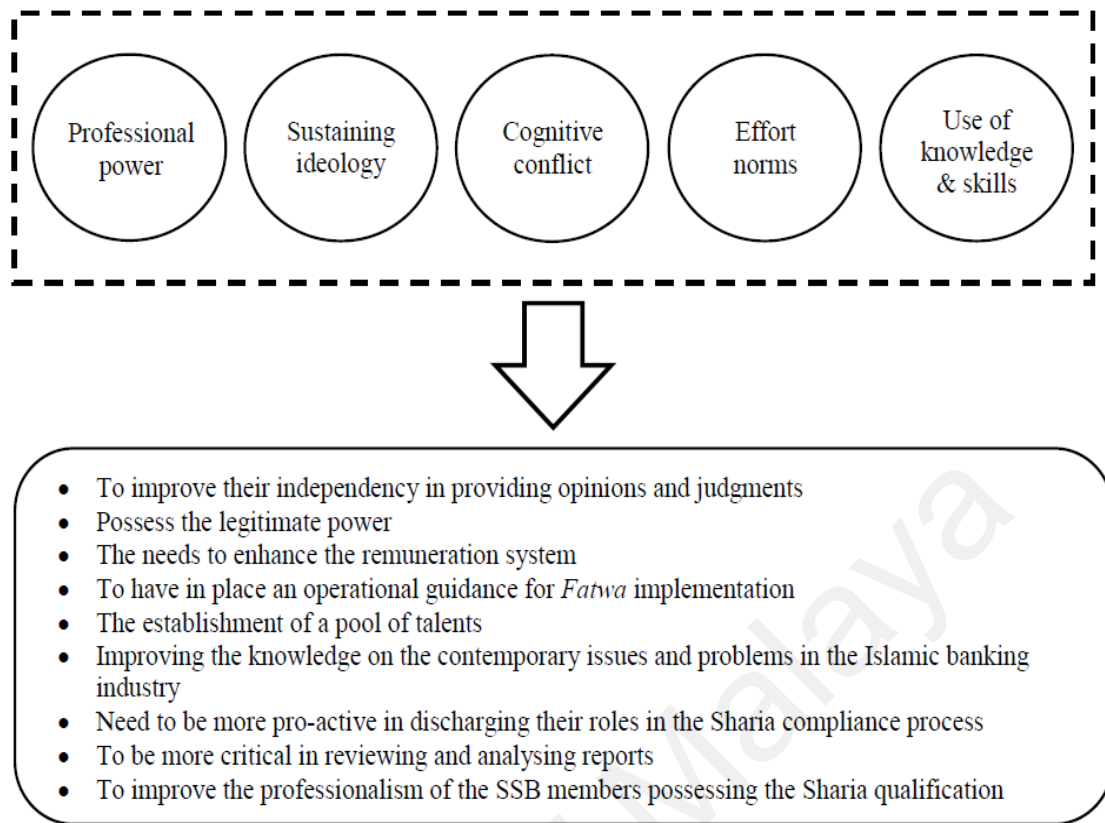
One of the obligations of the SSB is to provide opinions and judgement on the overall Sharia compliant of the bank's operations and activities in the SSB report. The SSB is required to supervise and monitor the Sharia review process carried out by the internal Sharia audit unit to ensure that all transactions and operations comply with the

Sharia law. This review process presents some difficulties because of the lack of an operational standard mechanism to facilitate the collection of information among SSB members and the internal Sharia audit unit. Even when the information is provided it may be partially completed and inadequate to deduce appropriate basis for decision-making and judgment.

Other challenges transpired from the findings of this study is on the issue of the independence of the SSB members. The rapid growth of Islamic banks in Indonesia necessitate for more qualified Sharia scholars to fulfil the needs of having the required number of members in the SSB of each Islamic banks. The regulation in Indonesia does not prohibit Sharia scholars from sitting in more than one board of SSBs which may lead to a possible conflict of interest and confidentiality of information. Multiple SSB membership might affect the SSB members' impartiality and objectivity in decision-making. As a result, a standard operational policy or regulation is necessary to safeguard the SSB members' credibility in the Sharia compliance process.

Another concern described in this study is the inconsistency and conflicting judgments and opinions on similar issues decided by scholars from different jurisdiction. The diverse interpretation of the Sharia law can result in a diverse issuance of *Fatwa*, where one Islamic bank might decide that it has complied with the Sharia law, but another Islamic bank may decide that it do not comply with the Sharia in facing with a similar Sharia issue.

The SSB members have also raised the need to establish a Sharia research unit, which function to provide assistance to the SSB members in conducting appropriate Sharia research to provide the needed information to ensure that they can carry out their roles in the Sharia compliance process effectively. The information provided by the Sharia research unit is expected to support the Sharia decision issued by the SSB.



Source: Author's figure

Figure 8.1: The Issues from the Roles of SSB in the Sharia Compliance Process

8.3. Implications

This section presents the theoretical and practical implications of the study. The findings in this study contribute in understanding the effective roles of the SSB members in the Sharia compliance process of Islamic banks in Indonesia. The findings of this study provide an opportunity for Islamic banks in Indonesia to reflect on their practices and improved the Sharia governance structure and processes. The established findings provide useful guidance for the regulator to revisit and review the existence regulatory framework and regulatory guidelines relating to the Sharia governance structure and Sharia compliance process.

8.3.1. Theoretical Implications

The findings of this study have significant theoretical implications. From a theoretical perspective, the concepts of SSB roles in the Sharia compliance process were analysed by exploring the intra-organizational processes in Sharia decision-making. Researchers who studied these concepts mostly explored the roles of corporate boards in the conventional institutions (for example, Dalton et al., 1999; Boyd, 1994; Zahra and Pearce, 1989). This study analysed the Sharia governance structure and processes in Islamic banks and specifically, the roles of the SSB members in the Sharia compliance process. The findings established in this study provide empirical evidence on what constitute the effective roles of the SSB in the Sharia compliance process.

This study focused on several specific objectives in examining the perceived roles of the SSB in the Sharia governance processes, identifying the processes involved ensuring compliance with the Sharia law, and identifying issues and problems faced as well as initiatives taken by the SSB members in the governance process.

The findings ascertain in this study are in line with the expectation as identified in the previous researches (see for example, Hassan, 2011; Muhamad, 2011; Grais and Pellegrini, 2006c; Maali, et al., 2003; Bakar, 2002; Rahman, 1998 and Karim, 1990). This expectation resonates mainly with SSB who are employed by the Islamic banks as a gatekeeper to ensure all activities, operations, and products are in compliance with the Sharia law. From the perspectives of the professionalism and behavioural theory it can be concluded that the roles of the SSB are to advise, to regulate, to supervise, and to audit all activities and operations of Islamic banks to ensure compliance with the Sharia law.

As the key participant in Islamic banks, the SSB forms an important element of the Sharia governance structure and processes, which the main obligation is to provide an assurance of Sharia compliance. The *Quran* and *Sunnah* are the principal guidance for Sharia judgment on activities, operations, and products approval.

This study emphasized on the professionalism and behavioural aspects of the SSB. The professionalism aspect is considered as more comprehensive in evaluating the roles of the SSB in the Sharia compliance process. Professionalism is defined as the behaviour of the SSB in conducting their effective roles in the Sharia compliance process. It was found that the professional power to advice, to regulate, to supervise and to audit is associated with the effective roles of the SSB in the Sharia compliance process. Remuneration package for the SSB has an influence on the professional power exercised by the SSB members. Further research should be conducted to examine the relationship between the remuneration packages awarded to the SSB members and the level of their professionalism.

The behavioural of board theory adapted from Forbes & Milliken (1999) is utilised to explain the roles of the SSB in the Sharia compliance process analysing the three aspects of the roles of SSB in the process, known as effort norms, cognitive conflicts and use of skills and knowledge. Cognitive conflicts aspects influence the roles of the SSB in supervising and monitoring the Islamic bank's activities, operations and products. The role of the SSB chairman is very important in controlling the quality of Sharia decisions, appropriate in-depth Sharia research should be conducted to ensure adequate information are ascertained on matters considered. Positive effort norms have a positive influence on SSB members in carrying out their roles to ensure Sharia compliance. The use of skills and knowledge also has a positive influence on the Sharia compliance process. These findings of this study which provide empirical evidence on the SSB roles in the Sharia compliance process complement the extant literature in this area of research, among others are Garas (2012), Al Haiti (2009); Adawiah (2007), and Abu Ghudda (2001).

8.3.2. Practical Implications

The findings of this study addressed the deficiencies in the SSB roles in the Sharia compliance process in the Indonesian Islamic banks. As detailed in Chapter Seven, the SSB members in the Indonesian Islamic banks experience numerous challenges in the development of new instruments, transactions, policies and Sharia governance processes. The participants expressed their view on the needs to appoint other professionals such as lawyers, accountants, bankers and economists to ensure diversity of knowledge in tackling the complexity of the business operations.

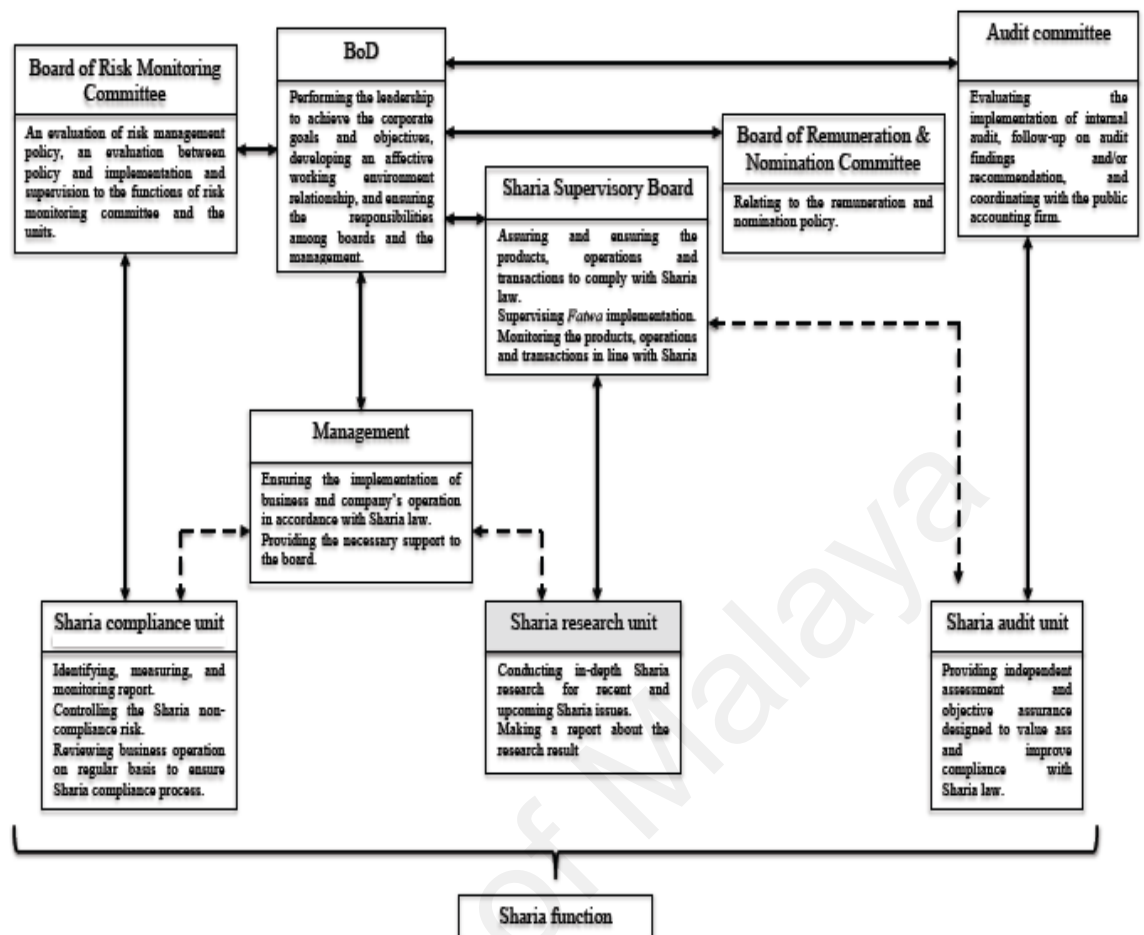
The DSN has a direct influence on the performance the SSB. The findings established that the roles of the SSB in the Sharia compliance process are to advise, to regulate, and to audit. The auditory role the SSB necessitate it to evaluate the level of Sharia compliance of products and services, activities and operations of the bank.

The SSB roles as a religious peer have the moral duty and obligation to comply with the Sharia law and to apply their knowledge in ways that benefit the relevant stakeholders. The rhetoric of the SSB roles, the routine discussion and practices of the Sharia compliance process is expected to shape the SSB members' morals and behaviour, and ultimately, to ensure that the *Quran* and *Sunnah* are used as the main guidance in carrying out their tasks.

The findings reveal that there is a shortage of Sharia jurists that possess knowledge of modern-day economics, finance, banking and accounting, to serve as the SSB members. Appointing other professionals to sit on the SSB is not the only option, training, seminars and workshops on economics, banking, finance, accounting and legal issues can improve the knowledge of the Sharia background SSB members. The SSB should provide a detailed disclosure of proceedings, reasoning and justification of SSB decision made in the SSB meetings, particularly in respect of product approval and/or issuance of *Fatwa*.

It was also found that there is a need for the establishment of a formal ethical standard to enhance the SSB member's independence, an operational procedure for *Fatwa* implementation in practice, and engaging other professionals with promising Sharia qualification. These concerns show the increasing expectation from the SSB as an extra layer within the Sharia governance structure in the Indonesian Islamic banks. To address these shortcomings, the propose improvement for the Sharia compliance framework is presented in Figure 8.2.

In the proposed framework, the Sharia research unit is established and should be accountable to the management. The unit is responsible in reviewing the contemporary issues to ensure the structured products and services, operations and transactions are kept abreast with the new development in the industry. In discharging its responsibilities, the Sharia research unit should have bilateral functional interactions with both the management and the SSB. The Sharia research unit should prepare detailed and specific reports on the Sharia compliance issues and effectively communicate the prepared information to the SSB and the management.



Source: Muhamad (2011); AAOIFI (2010); Bank Indonesia (2009); IFSB (2006)

Figure 8.2: The Proposed Sharia Compliance Framework for Islamic Banks in Indonesia

Due to the rapid development of the Islamic banking industry, the SSB members were forced to equip themselves with diverse knowledge. Other issues facing the Islamic banking industry in Indonesia are describe as below:

1. There is a shortage of talented Sharia scholars that possess Sharia qualification and knowledge relate to the banking business operations. A pool of young and talented Sharia scholars that exposed to the banking business environment would be needed to provide a holistic decision in matters pertaining to Sharia issues in the operations of Islamic banks.

2. An operational standard mechanism to facilitate the collection of information on the performance of the SSB members in the Sharia compliance process should be established to enhance the SSB's legitimating power. The mechanism will provide the necessary procedure for the SSB members to comply in making Sharia decision-making and judgment, as well as ensure their independence
3. The other issue of concern is related to the independence of the SSB members. The SSB members maintain their independence as an external advisor/consultant to Islamic banks. The regulation in Indonesia does not forbid Sharia scholars from sitting on more than one board of Islamic banks which may possibly lead to a conflict of interests and opinions. In addition, the privacy and confidentiality of information must be assured.
4. The absence of operational guidance for the *Fatwa* implementation in practices is a challenge to the development of Islamic banks in Indonesia. Conventional financial institutions are guided by the operational guidance and therefore, Islamic banks should also be monitored by the operational guidance for the *Fatwa* implementation to promote a reputable image of Islamic banks. Turley & Zaman (2007) also suggested that to enhance the effectiveness of board committee members, the combination of constitutional position with both the individual power is pertinent to produce significant outcomes.

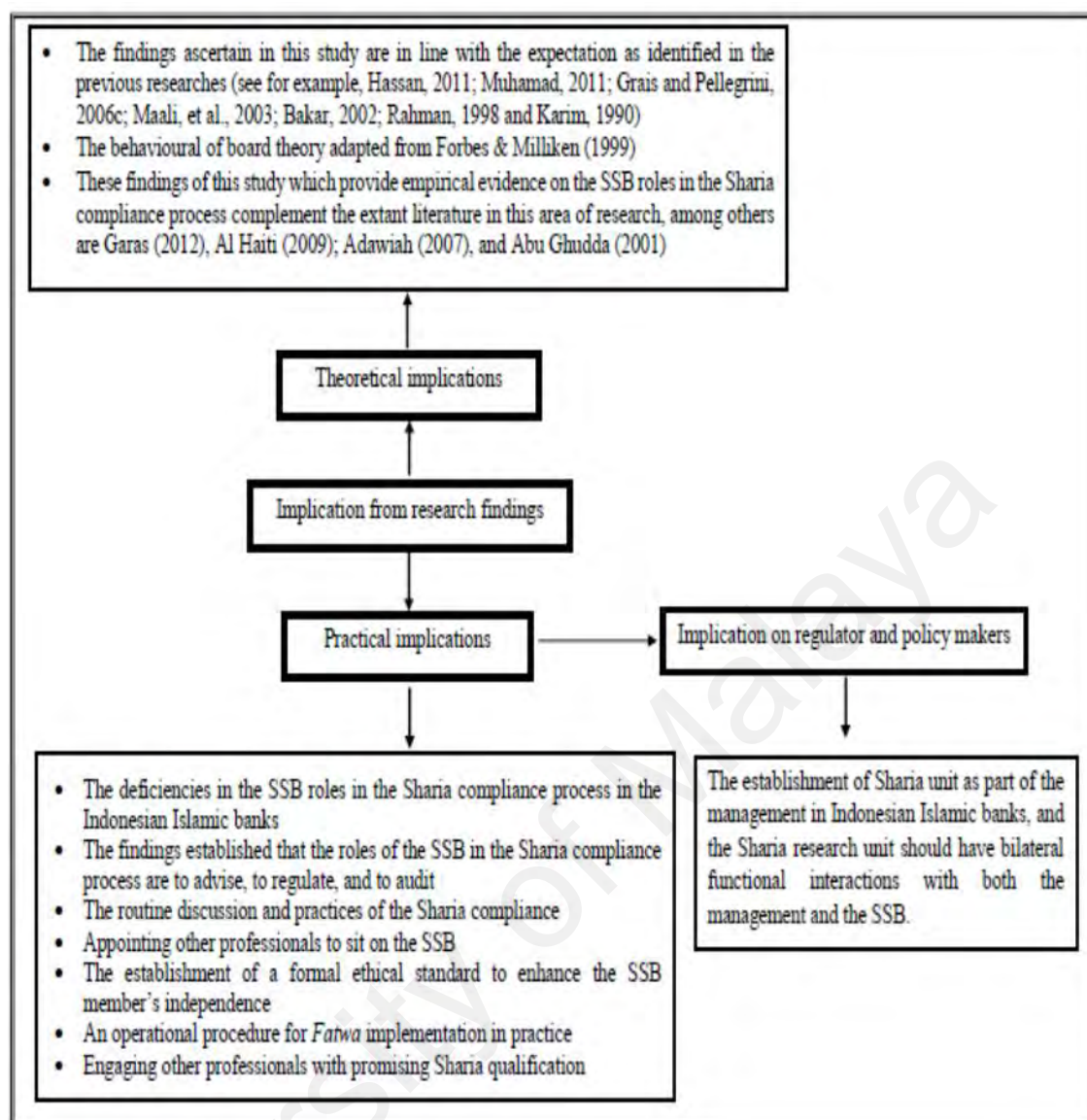


Figure 8.3: Implications from Research Findings

8.4. Limitations of the Study

This research has some limitations that should be considered in future researches. First, future studies need to investigate the phenomenon using more samples and different methodological approaches. For example, quantitative data can be collected from the SSB members and related actors in Islamic banks under the different settings which would certainly broaden individuals' perceptions and behaviours. The roles of the SSB include creating awareness on the Sharia compliance process. This study is only focused on the

roles of the SSB in the Sharia compliance process. The study does not consider the role of other institutional settings, such as external auditors in the Sharia compliance process although they are responsible in the auditing of the financial statements.

In addition, this study is limited to the cultural context of Indonesia; thus, the usual issues on the potential cultural differences should be considered. Future research can be conducted to investigate the roles of the SSB in other jurisdictions. Another limitation is that there is no attempt made to evaluate the performance of the SSB members in the Sharia compliance process.

This study adopted an exploratory approach using qualitative interviews and thus, facing certain methodological limitation, such as relatively small sample size and the subjective nature of interviews interpretation. Data collection is done using the interview method, with lasting from 60 minutes to 90 minutes. Limited information can be gathered from participants within this timeframe, limiting the extent of insight that could be drawn from participant's experiences. It was also difficult to comprehensively verify participants' responses within this timeframe. This study might benefit from a second round of interviews, which would offer an opportunity to further explore emergent themes and to verify the researchers' understanding of experiences as described by the participant. For future research, a longitudinal study might capture the changing dynamics of SSB roles as a decision-making group in the Sharia compliance process. Another methodological limitation in this study is the subjective nature of the interview interpretation. This study gained insight into participants' perspectives of the roles of the SSB in the Sharia compliance process from the lenses of the professional and behavioural of board theories.

8.5. Recommendations for Future Research

The findings of this study identified some areas for further research to enhance the roles of the SSB in the Sharia compliance process. First, further research should investigate the impact of the remuneration packages offered to the SSB members on the professionalism of the members of the SSB.

A longitudinal study can be used to enhance the methodological issues in the current research. This would capture the changing dynamics of the roles of the SSB. A longitudinal study has a longer timeframe to draw participant's responses. It explores emergent themes and also verifies researchers' understanding of experiences of the participants. Using this method of study presents a comprehensive understanding of the study.

Further research can be conducted to evaluate the practicality of the proposed Sharia compliance framework. Further research should examine the role of the Sharia research unit to prevent duplication of the SSB roles.

Finally, further research should examine the proceedings, reasoning and justification decided in the SSB meetings, specifically on product approval and/or issuance of Fatwa.

8.6. Concluding Remarks

The definition of the effective roles of the SSB are as possessing the power to advice, regulate, supervise, legitimate, audit and ensure that all activities, operations, and products of the bank comply with the Sharia law. The tasks should be carried out independently without any pressures from the management because the SSB have the legitimate power to express their opinions and judgements on matters pertaining to the Sharia compliance.

The *Quran* and *Sunnah* serve as the main guidance for the SSB members in performing their roles and tasks. The SSB members are entrusted with a crucial obligation as a gatekeeper in the Sharia compliance process. The credibility of Islamic banks is dependent on the perceived independence of the SSB in fulfilling their roles due to moral obligations and responsibilities. The crucial roles of DSN as an external independent body to advise and monitor the SSB members of Islamic banks in Indonesia to ensure progressive growth of the industry.

Cognitive conflicts can improve the performance of the SSB members through active deliberation and discussions of conflicting issues. Effort norms have a strong influence on the SSB member's behaviour and monitoring roles. The possession of various skills and knowledge provides support to the SSB members in improving the quality of discussions, hence enhancing the critical judgments made in analysing issues to provide alternative potential solution. As a result, the SSB is able to offer valuable advice and guidance to the management and BoD. The SSB members should utilize their skills and knowledge to empower their advisory and supervisory role.

The role of DSN is very important in solving issues and problems related to *Fatwas*, the recommendation for any arisen disagreement, and the prevention of the non-compliance activities, operations and products. Participants also highlighted the important role of the SSB chairman in resolving the arisen cognitive conflicts to prevent negative environment that will affect interpersonal collaborations. Other professionals, such as lawyers, accountants, bankers, and economists can be appointed to provide diversity of ideas and knowledge to assist in providing the holistic perspective in the decision making process.

Though the issues mentioned are expected to address the efficiency, effectiveness and consistency of the Sharia compliance process, the differences in the interpretation of the Sharia law between the different schools of thoughts continue to be the main challenge

for the standardization and harmonization efforts. Islam allows for these differences as long as the main precepts of the *Quran* and *Sunnah* are not contravened. Therefore, there is a possibility that the lack of harmonization and standardization can create more rigidity and stifle product development growth initiatives in the Islamic banking industry globally.

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