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INSTITUTIONAL THEORY AND ISLAMIC FINANCIAL INSTITUTIONS: THEORETICAL APPROACH

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ABSTRACT

The current paper is aimed to elaborate the theoretical approach ofresponsibility of Islamic Financial Institutions with institutional theory in terms of a covenant, which establishes Institutional consistency towards compliance of financial tools with shariah rules. The paper identified the institutional pressures and consistency imposed on financial institutions which are under the Islamic law.

Keywords: Institutional Theory,Islamic Financial Tools, Financial Institutions.

1. INTRODUCTION

Shariah compliance, as a concept, applies a standard criterion which focuses on the activities of Islamic institutions (Ahmed, Islam, Alabdullah, & Amran, 2019; Ahmed, Amran, & Islam, 2018;Ahmed, Islam, & Alabdullah, 2014). As such, subject to certain conditions, IFIs whose activities are not contrary to the Shariah principles will be considered Shariah-compliant securities (Sukuk) (Ahmed, Islam, & Amran, 2019; Ahmed, Islam, & Alabdullah, 2014;Ahmed, & Zuqibeh, 2013). On the other hand, IFIs will be classified as being associated with Shariah non-compliant securities if they are involved in the following core activities: riba (interest); shubuhat, gambling; gaming; sale of non-halal products or related products; manufacture or sale of tobacco-based products or related products; and other activities deemed non-permissible according to Shariah (Ahmed, Alabdullah, Amran, & Yahya, 2018; Ahmed, Islam, & Al-Harthy, 2013). The Shariah-compliant view asserts that controlling some characteristics and determinants, which are strategic and capable leads to a competitive advantage and superior performance of the IFIs to give more compliance with Shariah rules (Ahmed, Islam, & Ku Ariffin, 2015; Ahmed, Islam, Zuqibeh, & Alabdullah, 2014; Ahmed, Yahya, & Islam, 2013).

2. Shariah Compliance in Islamic Financial Institutions

According to Sulaiman (2001), religion is generally considered a crucial part of some cultures. Particularly for Muslims, Islam affects the way in which Muslims conduct their lives, including their involvement in business activities. Hence, Islam’s impact on accounting and economics is noticeable. Islam has more influence in accounting at the level of disclosure rather than the measurement of financial reporting, as the basic accounting measurement techniques are fundamentally similar to the conventional system (Ahmed, Aiffin, Alabdullah, & Zuqebah, 2016; Baydoun & Willett, 1997). Consequently, from an Islamic perspective the emphasis will be on proper disclosure rather than the measurement techniques. The Islamic perspective of disclosure is based on two general requirements of Islamic accounting: the concept of social accountability; and the full disclosure concept (Baydoun & Willett, 1997, 2000; Haniffa, 2002; Haniffa & Hudaib, 2002).

The concept of the unity of God is an important concept in Islam. The belief that there is only one ultimate creator, leads to the notion that the ultimate creator has absolute ownership and human beings are merely trustees in this world. As trustees, man is responsible for God's other creations, and will be accountable for his actions in the hereafter (Baydoun & Willett, 1997; Maali et al., 2006). Therefore, in Islam, man's accountability includes accountability to the community and the environment. Thus, in Islamic accounting organizations such as banks are accountable to the society hence they ought to disclose information which can help discharge this accountability (Baydoun & Willett, 1997). The social accountability concept in Islam has resulted in the concept of full disclosure, whereby the community has the right to know about the effects of the organizations' activities and operations on their society (Baydoun & Willett, 1997; Maali et al., 2006). Therefore, the concept of conservatism of information disclosure has no place in Islamic accounting in accordance with the findings of Alam (1998). Baydoun and Willett (1997, 2000) argued that full disclosure does not mean to disclose information to the last detail, but to disclose everything that is of importance to users. Similarly, Haniffa and Hudaib (2007) argued that the full disclosure of relevant and reliable information should assist external users in making both economic and religious decisions, in addition to assisting management in fulfilling their accountability to God and to society. Based on the social accountability and full disclosure concepts, users of the annual reports from Shariah approved companies may expect voluntary disclosure of relevant information, particularly Islamic-related information as discussed below. This information forms a basis for developing the Islamic items in the disclosure index.

Shahul (2009) argued that the disclosure of Shariah compliance is one of the fundamental Islamic accounting objectives. Thus, this information should be disclosed voluntarily, even though it may not be required mandatorily. The information about Shariah compliance is similar to that in the Shariah Supervisory Board (SSB) report in the case of IFIs. However, since some Shariah-approved companies do not have SSBs, the information on Shariah compliance is based on the Board of Director's declaration. Shariah-approved companies are presumed not to be involved in non-permissible activities or operations. However, should Shariah-approved companies be involved in prohibited activities, minimally (as allowed by the Shariah Advisory Council), it is the company's responsibility, based on social accountability and full disclosure, to disclose information about these non-permissible elements. This can help users to understand how amounts generated from such activities are disposed, and to monitor a company's efforts to reduce involvement in such activities in the future. In addition, previous studies such as Haniffa and Hudaib (2007) and Maali et al. (2006) claimed that IFIs and their insights are very useful for improving disclosure in the Shariah Board's report of the Islamic financial tools. They mentioned that improving disclosure concerning Shariah-compliance is inevitable not only to distinguish amongst the Islamic financial products themselves but also with that of the traditional financial institutions (Ahmed et al., 2013).

3. The Institutional Theory

Meyer and Rowan (1977) stated that the institutional theory is a theory that is extremely useful because it helps give an explanation as to why a Shariah Supervisory Board (SSB) reports the way in which it does. Institutional consistency, as mentioned by Di Maggio and Powell (1991), is a mechanism whereby practices of an organization are adopted by other organizations facing the same institutional pressures. Moreover, it has been demonstrated that this kind of consistency is based on the source from which such pressures are derived. Kasim (2012) explained that this consistency essentially has a relationship with organizational behavior with the regulative and political impacts for certain institutions like policies, and government regulators further to their regulations. Kasim also illustrated that simulation consistency uses the same set of practices used by successful organizations in order to reduce uncertainty and to normalize the consistency means of complying with the norms and expectations of professional bodies and society in general.

Based on the above, the structure of consistency includes three ways through which organizations can be changed to become like other ones. This change can come about by: legislation and rules imitating best practices; and finally, by being compatible with social traditions and expectations. Scott (2001) provided reasons for compatibility being an enhancement for legitimacy, that compatibility also alleviates the risk of threats and also that in taking this stance additional resource might become available.

Kasim, (2012) utilized the institutional theory to underpin the examination of the disclosure of Shariah compliance as reported by the SSBs in the annual reports of takaful (cooperative system of reimbursement) companies in Malaysia. The findings of the study indicated a similarity in the reports of the Shariah Boards, not only in relation to the Bank Negara Malaysia guidelines but also with that of other takaful companies. Furthermore, the concept of isomorphism is drawn from the institutional theory is useful and is used in the Shariah Board reports. Ahmed, et al., (2014) mentioned that the institutional theory is useful for the disclosure practices in the pronouncement of Shariah in IFIs. He noted two essential reasons. It relies on and uses the institutional theory because the concept of consistency is derived from such theory, as well as a clear similarity among all IFIs including the generation of reports by the Shariah Boards and guidelines from the central banks. Therefore, this article relies on these two essential reasons, and uses the institutional theory to underpin the discussion on its findings because there is a clear similarity among IFIs including the pronouncements of the SSBs and the guidelines of the central banks, as well as the concept of consistency derived from such theories.

Insummary, theSSB is the instrument of pressure that is predicted by the present study to have a positive impact on legitimacy and performance of Islamic financial tools because the Shariah board is the only entity in the IFIs that has the right to endorse the independent certificate of the Shariah compliance on the instrumentsstructure. The philosophy and interpretation behind choosing SSB as a variable in determine the comply of Islamic financial instruments is that the Shariah committee has the right to make the decisions about compliance or non-compliance of the business activities in the IFIs. In examining a committee of directors, the committee has no other choice other than to obey the decisions made by the SSB concerning legitimacy of transactions and operations (Ahmed, Islam, Alabdullah, & bin Amran, 2018). Thus, any decision made by the SSB is an instrument of pressure on the board of directors to align the interests to that of the Shariah committee with the instruments holders and this action will consequently enhance the level of Islamic financial tools performance.

4. CONCLUSION

Institutional theory shows that the regulatory pressures are needed on the Shariah boards to control and monitor the operations of IFIs due to their non-Shariah compliant risks. Drawing insights from institutional theory, conformance due to regulatory pressures, such as the Securities Commission (SC) guidelines demonstrates coercive isomorphism. IFIs are complying to meet minimum regulation requirements in fear of having their eligibility to offer Sukuk is disapproved by SC. It further contributes to Institutional consistency research by testing the normative isomorphism framework that assumes that similarity among IFIs including the Shariah pronouncements and the guidelines of professional bodies.

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