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Genealogical Study on the Legitimacy Strategies in the Islamic Banking

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Abstract

This study aimed to explore legitimacy strategies in Islamic financial institutions and understand the process and reason for their shifting over time. A reflective approach was used towards literature data sources and a thematic analysis of interview results. Islamic Banking and financial institutions were seeking a legitimacy strategy by adopting sharia compliance to distinguish them from conventional banks. This study examined the development of Indonesia's Islamic banking and assessed responses from participants with an Islamic banking background. The results showed that the legitimacy strategy of Islamic banking changes over time. Initially, it used labeling, but the stakeholders' pressures and demands have led Islamic banking to change its strategy. It has moved through integrating financial and non-financial performance to a sharia compliance strategy. This study contributes to understanding Islamic banking's legitimacy strategy that has developed over time. Additionally, it helps develop a better legitimacy strategy in line with the future philosophical and ideological basis of Islamic banking.

Keywords: Islamic banking, institutional legitimacy, sharia compliance, sharia legitimacy

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INTRODUCTION

Islamic banking institutions are not similar to conventional financial institutions that have existed and operated for a long time. An Inclusive Ethical Economy: State of the Global Islamic Economy (GIE) Report 2018/19 (haladinar.io, 2018) categorizes the Islamic financial sector as a faith-based industry, including sharia banking. The faith-based financial industry stands and operates based on values, philosophy, practice, and religious laws and is driven by its followers' faith (Izberk-Bilgin & Nakata, 2016; Lesser et al., 2016; Dharani et al., 2019). Furthermore, faith-based finance measures success based on materialistic and non-materialistic indicators. The non-materialistic indicators are founded on the faith-based philosophy. The philosophy implies maintaining and implementing the values and practices of one's religion. Therefore, Islamic banking financial institutions are also religious (Soediro et al., 2019). Faith-based financial institutions must have distinctiveness in maintaining and developing their legitimacy strategy. The strategies adopted and implemented in conventional and faith-based financial institutions differ due to their uniqueness.

The company's condition and location, the social environment, and the diversity of stakeholder interests determine appropriate legitimacy strategy. Companies could form a legitimacy strategy in many ways in line with the management's interests and policies (Islam & Kokubu, 2018). Furthermore, it is influenced by age, maturity, and the company's era (Su et al., 2015). A legitimacy strategy could change according to the company policies in dealing with conditions such as crises (Maroun, 2018). It is crucial for developing companies in various countries and businesses (Vollero et al., 2018), including the banking industry (Islam et al., 2020). Legitimacy is a crucial matter that must be managed wisely, procedurally, and structurally. The company's position before the public and stakeholders depends heavily on the legitimacy strategy planned and implemented by the management (Chedrawi et al., 2020). Therefore, this study defined the legitimacy strategy as an effort to gain stakeholders' acceptance, recognition, approval, and permission for an institution's existence to operate freely and smoothly to achieve its goals.

The ultimate stakeholder for Islamic financial institutions must be Allah (Soediro et al., 2019). However, the conventional stakeholders' expectations should also be considered to achieve the banking institutions' sustainability for Islamic banking to operate legitimately. One major factor determining the stakeholders' support and loyalty is the conformity between the sharia label, philosophy, and the institutional value of Islamic banking. However, few studies have examined legitimacy strategies in Islamic financial institutions, especially Islamic banking. Islamic financial institutions' patterns and types of legitimacy strategies have rarely been explored, discussed, and understood. Therefore, this study aimed to explore and understand the legitimacy strategies in Islamic financial institutions. It also sought to examine how the strategies have shifted over time, enabling people interested in Islamic financial institutions to determine an ideal legitimacy strategy to implement in the future.

METHOD

This study used a historical method that combines a reflective approach toward literature data sources and a thematic analysis of interview results. Data were collected from books, internet information, and previous studies on the development of Islamic banking from its emergence in Indonesia until now. The data were analyzed to show how Islamic banking has developed and changed regarding the legitimacy strategy. This includes the factors and conditions that make Islamic banking adopt and implement certain policies and strategies. The study analyzed the results of interviews with ten Sharia Supervisory Board members and five top-level management personnel at Indonesia's Islamic banks. The analysis was added to examine the phenomenon studied from the executor's perspective. The literature data and the interview results were analyzed to obtain common themes and related facts to understand the changes in the legitimacy strategy of Islamic banking under various conditions. The information and analysis were presented chronologically from establishing Islamic banking in Indonesia until now.

RESULT AND DISCUSSION

Labeling as a Strategy

The growth of Islamic banking in Indonesia began with Bank Muamalat in 1992. Bank Muamalat's establishment was driven by the growing enthusiasm to operate a non-usury business as an alternative to the bank interest system considered haram by some Indonesian Muslim scholars. For some observers, establishing Islamic banking and finance in Indonesia was late compared to other Muslim or non-Muslim-majority countries, such as Britain. These countries have established the Islamic finance industry since the 1980s (Di Mauro et al., 2013). The concern is more because Indonesia has the largest Muslim population worldwide. According to Venardos (2005), this delay originated from the opinion of most Indonesian Muslim scholars that bank interest was not haram and was permissible as profit-sharing. Respondent DPS02, that played a role in the Sharia Supervisory Board of several Islamic banks, stated that opinion differences regarding prohibiting usury hindered the establishment and development of Islamic banking. Some Muslim scholars allowed bank interest because it is permissible to take excess debt when not burdensome and oppressive. However, respondent DPS02 stated that this could not be a basis for permitting the banks' interests. The extent of the burden and oppressive nature inferred could vary with individuals.

The Indonesian government accommodated this request due to strong encouragement from parties that believed in prohibiting bank interest and impelled by preceding profit-sharing banking in countries with few Muslims. After explorations and discussions in the late 80s, the government included the Islamic banking system in Law Number 7 of 1992 concerning the Banking System specified in several regulations. According to Khan and Bhatti (2008), Bank Muamalat's establishment in 1992 was a milestone in developing Islamic banking. It was a pioneer in the Islamic banking and finance industry worldwide.

The Indonesian Islamic banking industry emerged as a response to establishing Islamic banks in several countries with fewer Muslims. Therefore, the preparations for establishing the first Islamic bank in Indonesia were accompanied by several fundamental problems. The first problem was the lack of human resources that adequately understand how Islamic banking should operate. Second, no scholars understood Islamic economics, especially in the financial and banking industries. Third, the Indonesian Muslim community did not understand Islamic banking and finance. Fourth, the country's already established banking system was not very supportive. Respondent M03 stated that the human resources at the beginning of establishing the Islamic banking industry in Indonesia were not ideal. Most of the Islamic banking personnel came from conventional banking. They lacked knowledge of Islamic banking and fiqh muamala, though they had a great Islamic spirit. Therefore, the establishment of the first Islamic bank was driven by great enthusiasm and encouragement from these issues. This was accompanied by several problems that had to be managed to ensure that banking operations could continue. Among the problems was the uncertainty regarding the bank's survival. As a newly established banking system with a type and style outside the mainstream, the Islamic bank management had difficulties finding a model to emulate. Surrounded by large, older conventional banks, the management had to find a way to start and compete. Also, with the profit-sharing system offered to potential customers, the next question was how to ask them to place or transfer their funds to Islamic banks. The key points to be answered were how much competitive returns could motivate prospective customers to move their funds. This is substantiated because the customers had long been accustomed to the riba

Islamic banking m(Suharto, 2018) based conventional banking system. At the beginning of its operation, Islamic banking management sought and used other aspects besides material benefits. Islamic banking policies and management styles in other countries could be used as a reference. However, the varied demographic and social conditions required different treatment and implementation. Another problem was the limited human resources that understood Islamic banking's operations and management. The time between the passing of the mandate of the IV MUI National Conference on 22-25 August in Jakarta to establishing Bank Muamalat in 1992 was relatively short. This affected the preparation of qualified and appropriate human resources to work as professional Islamic bankers.

As the first to be established and the only Islamic Bank in Indonesia, Bank Muamalat must calculate its strategies to ensure that its operations last and improve. The other factors considered were the environment and consumer coverage, which were limited to certain circles. These early potential consumers did not care about profit or loss, had a devout Muslim background, and always avoided transactions related to bank interest. Customers were invited to participate in Islamic banking by being told about the prohibition of usury. Furthermore, they were provided with non-usury or Islamic banking as an alternative to the existing banking system. Consequently, Islamic banking operated and developed by relying on fatwa and the halal label as its main point of attraction. Using the fatwa or halal labeling was a strategy to legitimize Islamic banking at the beginning of its existence. Although not ideal, labeling was a legitimate strategy for use in such situations.

Islamic banking's performance was not questionable because it was enshrouded with benevolent labeling. It seemed to function only as a fund-collecting instrument for customers with excess funds and believed in prohibiting usury. Subsequently, many hoped this model would lead the banking industry market in the future (Khan & Bhatti, 2008). Several entities have begun expressing the desire to establish Islamic banking as not just an ordinary system (Dixon, 1992; Dusuki, 2008). However, it seemed that Islamic banking actors were still honeymooning. The institutional legitimacy strategy implemented was only concerned with the incessant fatwa prohibiting usury (Shook & Hassan, 1988; Haron et al., 1994). When not managed properly, this condition could make Islamic banking operations look unorganized and stray from what was expected (El Din & Ibrahim, 2006).

Financial Performance as a Strategy

The next crucial period for Indonesia's first Islamic bank was the 1997-1998 economic and financial crisis. The crisis was marked by a political crisis and a change of state leadership (Nakamura, 1999; Chua, 2007; Marks, 2009). A social crisis also emerged due to social unrest in various places in Indonesia (Zha, 2000; Panggabean & Smith, 2011; Winarnita, 2020). The banking industry had entered into this catastrophe, including newly established Islamic banking. One pride of many supporters of Islamic banking was the ability of the first bank to survive the financial and economic crisis. Many parties doubted this outcome for various reasons. These events prove that the Islamic banking industry is more resilient to crises (Nofinawati, 2015; Rahman, 2015; Khoiri & Hendri, 2017). Several recent studies also confirmed this resilience (Zarrouk, 2014; Mohammed & Muhammed, 2017; Baber, 2018; Hashem & Abdeljawad, 2018).

The resilience to crises was one reason Indonesia's Islamic banking industry started gaining great demand from investors and potential customers with an inadequate understanding or interest in Islamic banking. The banking was still unable to compete optimally with conventional banks. However, the transfer of funds from conventional to Islamic banking forces Islamic banks to start competing in financial performance. The banks began focusing on financial performance because it was considered fundamental to business continuity (Ning & Wong, 2019; Ukko et al., 2019; Yan & Huang, 2020). In this case, good financial performance attracts more investors and customers (Liaoa et al., 2012; Wohlgemutha et al., 2016; Mbama et al., 2018). An increase in financial performance positively impacts asset development (Rahayu, 2019; Migliaccio & Tucci, 2019). Moreover, regulations regarding banking did not accommodate Islamic banking's operational style and contract ('aqd). It was because there were no specific regulations regarding Islamic banking in Indonesia (Iqbal & Molyneux, 2005). Islamic banking was forced to compete with conventional banks in the same arena and with the same rules. Subsequently, problems arose due to differences in sharia principles and banking-related regulations (Djojosugito, 2008). Other technical problems, such as determining the margin (Hutapea & Kasri, 2010) and liquidity limitation rules, are regulated uniformly across all banks (Ismal, 2010b; Alexakis & Tsikouras, 2009). These problems made Islamic banking work extra to prove their competitiveness in financial performance for the continuity of their operations. Respondent M02, a former Islamic banking manager, stated that the management worked under the pressure of the predetermined financial performance achievement targets. Various policies and strategies were implemented to achieve these financial performance targets. The implementation also aimed to protect the institution from the fiercely competitive financial industry, which was recovering from the 1997-1998 crisis (Tilman, 2002; Tilman & Rajadhyaksa, 2002; Ghosh, 2003; Kamer, 2004). In the 2000s, Islamic banks had to compete with conventional and fellow Islamic banks emerging in the .

financial industry competition. The intense pressure often made Islamic banking management committed, unethical and even violated Islamic rules (Awang & Ismail, 2018; Awang et al., 2019).

The expansion of customer coverage not limited to traditional customers means that Islamic banking must think and act in a planned manner to compete with conventional banking in financial performance (Ismal, 2010a). They must satisfy the expanding customer network and comply with government regulations or financial authorities that equate the performance measurement of Islamic and conventional banking (Alam, 2013). Furthermore, Islamic banking must compete in financial performance measured by conventional approaches (Ahmad & Luo, 2010; Ismal, 2010b). Without their convenience, the banking could not hide behind the label and had to fight to prove they were better. It shows that Islamic banking was starting a new stage of its legitimacy strategy by competing in the financial aspect (Siddiqui, 2008; Ismal, 2010c).

Adding a Non-Financial Performance as a Strategy

In the first decade of the 20th century, business development began to be influenced by the new financial performance concept. Non-financial performance was the discourse of some studies on management and accounting. The studies' attention to the importance of non-financial performance could be drawn from the introduction of the Balanced Scorecard (BSC) concept in business in 1992 by Kaplan & Norton. In this case, Kaplan and Norton (1992) incorporated three elements of non-financial performance within the four types of performance in the BSC. This provided a basis for developing the discourse on the use and measurement of non-financial performance in business (Low & Suesfeld, 1998; Kloot, 1999).

The non-financial performance has found increasing acceptance in the business world (Gonzalez et al., 2011). The private sector implemented non-financial performance in their businesses due to internal and external managerial purposes. For the internal purpose, non-financial performance was applied in concern with information asymmetry, efficiency, productivity, and quality (Arvidsson, 2011; Gonzalez et al., 2011; Orens & Lybaert, 2010; Uyar, 2011), and as a tool to increase and create values in companies (Malgharni et al., 2010). Regarding the external purpose, the performance was tightly related to how the company deals with the external stakeholders (Cardinaels, 2010; Corama et al., 2011; Kang et al., 2010; Assaf et al., 2012; Belal & Cooper, 2011) and seeks legitimacy (Mahadeoa et al., 2011; O'Dwyer et al., 2011). The studies on non-financial performance in the private sector mainly discussed the company's sustainability report and the search for legitimacy to deal with the stakeholders and social, environmental, and other topics. Moreover, non-financial performance management concepts penetrated and were adopted by the banking and financial services industry (Hussain et al., 2002; Hussain & Gunasekaran, 2002; Hussain & Hoque, 2002; Hussain & Islam, 2003; Al-Enizi et al., 2006). According to Respondent M01, Islamic banking has begun focusing on customers, society, and the environment in recent years. This aimed to face competition in conventional banking. The progress was also supplemented by customer and community engagement programs. Community engagement activities were generally performed to show that the bank cared and was vital in providing community services. The condition forced the Islamic banking management to work hard to deal with the new competition. This happened even when the competition upon the financial aspect had yet been completely taken in reign. According to Respondent M02, several management policies were implemented to compete in non-financial performance. The policies included strengthening customer service innovations, such as 'Cash Pick Up & Delivery programs. Furthermore, various reward programs for customers imitated conventional banking styles. Islamic banking also used a corporate social responsibility (CSR) policy to build its image in society and prospective customers. In this program, the banks combined and used CSR and non-halal funds that cannot be included in their income. Many banks also have zakat institutions with at least two benefits in dealing with potential devout Muslim customers. The first benefit was facilitating customers in fulfilling their obligation to pay zakat comfortably and easily. Second, the funds collected from customers by this zakat institution could be used for the public benefit while building the image of a caring Islamic bank. The banks also began emphasizing ritual obedience to management and employees. This aimed to instill Islamic values in employees from various backgrounds and give customers a good religious impression. After the 1997-1998 financial crises, Indonesia's Islamic banking had reformed in many ways and from various aspects. The reformation started with formulating regulations governing the Islamic banking industry. The banks also improved the quality of human resources in sharia to face increasingly fierce competition in the financial industry (Khan & Bhatti, 2008).

Institutional legitimacy in business was enhanced by incorporating the non-financial elements into the institution's performance aspects (Buallay et al., 2020). This was complemented by the growing awareness of the significant benefits of accommodating the stakeholders' interests. Similarly, non-financial aspects and stakeholder interests in Islamic financial institutions have also begun to receive incredible attention from practitioners and academics (Al-Beshtawi, 2014; Marie et al., 2014; Tumewang, 2019). The concept was pointed out by Dusuki (2008) for Islamic banking but only received significant attention in recent years. The legitimacy effort regarding non-financial performance was conducted in various ways. These included developing a corporate social responsibility program (Zafar & Sulaiman, 2021, Amran et al., 2017) and accommodating stakeholder interests (Abubakar, 2018; Janahi & Al Mubarak, 2017). Also, the banks focused more on environmental problems (Bukhari et al., 2019), customer relationship management, service quality, and organizational performance (Khan, 2015; Lebdaoui & Chetioui, 2020).

Practical Sharia Compliance as a Strategy

The shifting in Islamic banking's legitimacy policies, approaches, and operations decades ago significantly trailed the financial and non-financial strategies of existing conventional financial institutions (Julia & Kassim, 2019). This made Islamic banking generally resemble conventional banking and its competitors. In line with this, several studies showed that many customers think Islamic banks are similar to conventional banks, with slight differences only in appearance and practices (Tobin, 2014; Ahmed, 2016; Miah & Suzuki, 2020).

The public demand and pressure on the immediate improvement of Islamic banking management were increasing (Oladapo et al., 2019). This pressure came mainly from supporters concerned about the banking practices that resembled conventional banking (Hamza, 2013). According to Respondent DPS01, this condition could not be tolerated because it concerned the Islamic banking industry, sharia, and Islam. Therefore, many studies warned and recommended from their various perspectives. Mayes and Alqahtani (2015) stated that sharia compliance could eliminate uncertainty due to a lack of information at initial public offerings (IPOs). Sharia Compliance could also provide and build good perceptions from customers of Islamic banks and their operations (Saqib et al., 2016). Moreover, Ullah and Khanam (2018) showed that sharia compliance could facilitate increased financial performance by providing internal and external strengthening for Islamic banks in achieving financial performance targets. The most recent studies explored the efforts to legitimize Islamic banking institutions. The results showed the importance of sharia auditing and governance (Algabry et al., 2020; Buallay, 2019) and the urgency of sharia compliance (Hanif, 2018). Islamic banking was different in philosophy and practices (Soediro et al., 2019) and could be equated with conventional rivals (San-Jose & Cuesta, 2019). From the internal perspective, Respondent DPS01 stated that the importance of sharia compliance was not only for materialistic financial and non-financial purposes. This statement showed that Islamic banks were not ordinary financial institutions. Therefore, the necessary legitimacy strengthening must also be consistent with its characteristics.

Internal parties of Islamic banking realized this and started reforming to ensure that all activities refer to and are shariah compliant. This was corroborated by the respondent's statement seen from several interview excerpts. DPS03, a member of the National Sharia Council of the Indonesian Ulema Council (DSN MUI), stated:

> *"Sharia compliance brings a sacred religious identity in business activities that are heavily polluted and permitted by all means for profit. Islamic financial institutions find it difficult to survive without sharia compliance. Despite the dynamics and ongoing challenges, there is a diversity of understanding and conditions in society. Insyaallah, with Allah's permission, sharia compliance could be the foundation of the legitimacy of sharia financial institutions. This is because sharia comes from teachings with a permanent and dynamic character (tsawbit and mutaghoyyirot). As long as there is the Qur'an and Sunnah, Islamic financial institutions would still exist, including Islamic banking."*

Likewise, DPS04, also a member of the Indonesian Waqf Board (BWI), stated:

> *"Sharia compliance is very important and should be maintained. Today, many sharia businesses that did not exist at the time of the Prophet, such as Islamic banks, sharia insurance, and sharia guarantees, should be consistent with sharia. Furthermore, sharia compliance is vital for Islamic banking. It means that Islamic banking cannot exist without sharia compliance. I'm worried about because people say that Islamic banking is the same as conventional banking. Sharia compliance justifies the existence of Islamic banking. This is because sharia has clear objectives (maqasid sharia: Hifzud din, hifzun nafs, hifzul aql, hifzun nasl, and hifzul maal), clear contracts, and clear processes."*

All respondents emphasized that sharia compliance determines the existence and sustainability of Islamic banking and financial institutions.

Islamic banking was an institution guided by sharia in its operations holistically. Therefore, sharia compliance had to become its method and strategy of legitimacy. Islamic banking institutions began referring to sharia compliance as a strategy for institutional legitimacy consciously or by following the fashion. Brown et al. (2007) stated that Indonesia's Islamic banking was far behind conventional banking with a special Muslim population.

CONCLUSION

Islamic banking requires a legitimacy strategy to maintain its operational sustainability. All institutions have their ways and models of legitimacy strategies, including I slamic financial institutions. However, Islamic banking is relatively new, and its operating characteristics and philosophies differ from conventional rivals. This requires Islamic banking to work harder to compete using approaches and methods different from conventional.

Islamic banking has changed its legitimacy strategy. These strategies are labeling financial and non-financial performance and sharia compliance. Initially, the banking institutions relied on a legitimacy strategy of using the Islamic label or fatwa. This was maintained for some time, reinforced by the fatwas of the scholars. The next stage was competition with conventional banking institutions in financial performance. Due to the strong awareness of matters regarding non-financial performance, Islamic financial institutions modified their legitimacy strategy by considering stakeholder interests. The institutions are still looking for an appropriate legitimacy strategy. It appears that Islamic banks are integrating sharia compliance as a legitimacy strategy that differentiates them from their rivals, the conventional banks. *Allahu'alam.*

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