

Bridging Islamic Banking Ethics and Practice Through Digital Financial Innovation Technologies

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ABSTRACT

This article explores how technology-innovation can enhance the ethics of Islamic banking (IB) and help to promote sustainable business. Incorporating both theoretical and analytical reasoning, this study combines the literature on IB ethics, fintech innovation, and sustainability frames. By drawing from existing empirical studies, this paper demonstrates how technology innovations like AI, blockchain and digital banking can enhance the Shariah governance aspect and ethical financial practices when taken holistically. The findings indicate that digitization provides strong potential to close the practical gap between Islamic banking and its ethical ideals. Blockchain technology enables monitoring and can mitigate information asymmetry, enhance transparency in profit-and-loss sharing which help to uphold Shariah compliance. digital could support sharia boards, islamic banks and regulators to enhance sustainability reporting, operational efficiency and compliance. This paper provides a new line of sight, which highlights digitization as an enabler for ethical and sustainable Islamic finance by relating the Islamic ethics to digital transformation and environmental commitment.

Keywords: *Blockchain, Digital Banking, Islamic Bank, Shariah Compliance, Technology Innovation*

Introduction

The debate over the role of ethics in the financial system has intensified alongside increasing criticism of global banking practices that frequently overlook principles of fairness, transparency, and sustainability. Financial scandals and widening economic inequality indicate that the modern financial architecture continues to struggle with ensuring responsible and ethical conduct (World Bank, 2020). Within this context, Islamic banking has been promoted as an alternative framework that integrates moral values and socio-economic objectives through the prohibition of *riba*, *gharar*, and *maysir*, and through its emphasis on honesty, trustworthiness, and justice, as articulated in the Islamic ethical tradition (Enyinda & Hamouri, 2014; Saidi, 2009). These normative foundations aim to realize *al-falāh*, a condition of holistic well-being achieved through economic activities aligned with sustainability and societal benefit.

The objective of these normative foundations is to actualise *al-falāh*, a state of holistic well-being accomplished through economic activities that are congruent with sustainability and societal benefit. Notwithstanding this robust ethical foundation, a

mounting body of research discloses a persistent discrepancy between the normative ideals of Islamic banking and its practical operational realities. Empirical studies demonstrate that financing portfolios in numerous jurisdictions continue to be dominated by debt-based instruments such as *murabahah*, whilst equity- and profit-sharing modes like *mudharabah* and *musyarakah* remain limited due to elevated monitoring costs, information asymmetry, and heightened moral hazard risks (Chong & Liu, 2009; Fatimah et al., 2019). These dynamics have given rise to critiques which argue that Islamic banking frequently deviates from its foundational ethical and distributive justice objectives (Asutay, 2012). A fundamental element underpinning this divergence can be attributed to the challenge of ensuring effective Shariah governance. This challenge is characterised by constraints in transparency, oversight capacity, and audit mechanisms necessary to maintain consistent compliance.

Recent progress in digital finance has created new ways to deal with ongoing problems in Shariah governance. Research shows that blockchain, artificial intelligence, and digital tools can improve how we oversee things, make it easier to hold people accountable, and make information more equal. They can also make profit-sharing and sustainability information clearer (Alshater et al., 2022). These new ideas are especially important for making sure that Shariah compliance processes are strong, and for helping to make the world more sustainable and inclusive in a way that follows *maqāṣid al-sharī'ah* and the Sustainable Development Goals.

Against this backdrop, this article examines the relationship between Islamic banking ethics, the practical challenges that hinder their implementation, and the potential role of digital innovation in supporting Shariah governance and reducing the ethics–practice gap. By integrating literature on Islamic banking ethics, financial technology innovation, and sustainability, this study develops a conceptual framework that illustrates how digitalization may function as a supporting mechanism to strengthen ethical alignment and promote sustainable practices within the Islamic finance industry.

Theoretical Background: Ethical Foundations of Islamic Banking

Ethics occupies a central position in shaping the behavior and institutional conduct of Islamic banking. Unlike conventional finance, which is often grounded in utilitarian considerations, the ethical architecture of Islamic banking derives from divine law and emphasizes accountability, distributive justice, and the promotion of societal welfare (Baloch & Chimenya, 2023; Hasmawati, 2024). Islamic ethical principles encourage alignment between economic activities and moral-spiritual values, creating a framework in which financial decisions must avoid harm, promote fairness, and contribute to human well-being.

A core feature of this ethical system is the prohibition of *riba*, *gharar*, and *maysir*, which collectively aim to prevent exploitation, excessive uncertainty, and speculative behavior that may undermine social justice (Baihaqy et al., 2025; Chowdhury, 2015). Islamic finance requires transactions to be backed by real economic activities and encourages equitable sharing of risk and return through modes such as *mudharabah* and

musyarakah. These principles embed the notion that finance should serve society rather than operate in isolation from real economic and ethical consequences.

The ethical foundations of Islamic banking are further reinforced by the objectives of the Shariah—*maqasid al-shariah*—which seek to preserve essential human interests, including faith, life, intellect, lineage, and wealth (Auda, 2007). In the context of financial intermediation, *maqasid* translate into commitments to transparency, honesty, justice, and the avoidance of harm. Prior studies argue that Islamic banking's normative emphasis on justice and socio-economic welfare forms its key distinction from conventional financial systems, especially in promoting inclusiveness and sustainable economic practices (Asutay, 2012).

Shariah governance plays a crucial role in operationalizing these ethical principles. It provides institutional mechanisms for ensuring that financial products, processes, and business conduct adhere to Shariah standards. Empirical and bibliometric studies on Shariah governance suggest that attributes of the Shariah Supervisory Board (SSB) — including size, composition, independence — as well as internal audit mechanisms and governance structure, are associated with better compliance and performance in Islamic banks (Haron et al., 2022; Mansour et al., 2017). Given the complexity of modern financial operations, the presence and composition of Shariah Supervisory Boards (SSBs), as elements of governance quality, are significantly associated with improved CSR disclosure in Islamic banks — an indicator often taken as proxy for legitimacy and stakeholder trust (Ratna et al., 2023).

The rapid growth of Islamic banking globally has intensified discussions about whether its operational realities consistently reflect its ethical aspirations. Prior studies show that the ethical ambitions of Islamic finance, particularly risk-sharing, transparency, and distributive justice are often constrained by structural factors. Weak governance arrangements, entrenched information asymmetries, and broader institutional limitations restrict banks' capacity to implement Islamic principles in practice (Kamla & Hussain G, 2013). As a result, the ethical identity of Islamic banking depends not solely on jurisprudential principles, but on the effectiveness of institutional structures that govern its practices.

The Ethics–Practice Gap in Islamic Banking

Despite the theoretical underpinnings of Islamic banking in values such as justice, transparency, and socio-economic welfare, a mounting body of empirical research signifies persistent discrepancies between these ethical ideals and their practical implementation. Transparency, a key distinguishing feature of Islamic banks that sets them apart from their conventional counterparts, remains limited in practice. According to Gilani's (2015) interviews with Islamic bank managers and clients, disclosure processes were frequently cursory and did not give stakeholders enough information to evaluate compliance, risk exposure, or socio-ethical performance. Even while transparency is a fundamental ethical need in Islamic finance, these restrictions have the consequence of undermining accountability and eroding trust (Gilani, 2015). These limitations have the

effect of undermining accountability and weakening trust, despite transparency being a central ethical expectation in Islamic finance.

A significant domain in which the discrepancy between ethical principles and practical implementation is most evident pertains to the prevalence of debt-based contracts. Despite the conceptual underpinnings of Islamic banking being rooted in profit-and-loss sharing (PLS) principles, such as *mudharabah* and *musyarakah*, empirical research consistently demonstrates that these financial instruments constitute a relatively minor segment within financing portfolios (Chong & Liu, 2009; Fatimah et al., 2019). The preference of financial institutions in countries such as Indonesia for *murabahah* and other debt-based instruments, which frequently account for 60-70% of financing, is indicative of a strategic inclination towards lower-risk, more easily monitorable alternatives. This preference is driven by practical challenges inherent to PLS, including information asymmetry, moral hazard, and the high cost of monitoring entrepreneurial activities (Sudarsono & Ash Shiddiqi, 2022). While these choices may be operationally rational, they give rise to significant concerns regarding the extent to which current practices are aligned with the distributive justice and socio-economic empowerment objectives espoused by Islamic finance (Asutay, 2012).

Another dimension of the ethics–practice gap pertains to the criticism that many Islamic financial products replicate the structure of conventional instruments with minimal substantive difference. Hassan & Cebeci (2012) have observed that contracts such as *murabahah* and *ijarah* are frequently engineered to mimic fixed-return mechanisms. In many cases, *sukuk* structures resemble conventional bonds with predetermined cash flows, thereby diluting the intended risk-sharing characteristics of Islamic finance. These findings serve to reinforce concerns regarding the notion of "form over substance" compliance, a concept whereby legal adherence to Shariah standards does not necessarily translate into ethical or socio-economic outcomes. Some empirical and review studies suggest that limitations in Shariah governance such as variability in supervisory board quality and weaknesses in disclosure practices, may hinder consistent application of ethical principles or reduce banks' willingness to adopt equity-based financing (see (Mansour et al., 2017; Nomran & Haron, 2022)).

The evidence indicates that the discrepancy between ethical principles and practical implementation in Islamic banking is not merely a theological or ideological concern, but rather an institutional and operational challenge. Constraints related to information asymmetry, monitoring inefficiencies, product design, and governance limitations collectively prevent Islamic banks from fully materialising their ethical ideals. This underscores the importance of investigating technological advancements as potential instruments to bolster Shariah governance, enhance transparency, and facilitate the implementation of ethical and sustainable practices within the context of Islamic finance.

The Potential Role of Digital Financial Innovation

The persistent discrepancy between the ethical principles of Islamic banking and its practical operations has been attributed to structural constraints rather than a lack of

normative commitment. Documented cases of the prevalence of debt-based financing, limited transparency, and inadequate monitoring capacity have been identified in studies, suggesting a financial architecture that frequently compels Islamic banks to engage in practices that are in opposition to distributive justice and risk-sharing principles. Digital financial innovation is not a matter of ethical quality in itself; rather, its pertinence derives from its capacity to effect profound changes in the very structures that give rise to ethical tensions.

One way to observe this structural problem is through the behaviour of consumers in Islamic digital banking. Wahyuningsih (2025) shows that users adopt Islamic digital banking primarily for ethical and religious reasons, not because it offers superior efficiency. This pattern reveals a landscape in which ethical expectations are already high, but the institutional capacity to meet those expectations remains limited. Users demonstrate readiness for ethical finance, but their trust depends on clarity, transparency, and the ability to verify compliance. Technology becomes significant only insofar as it addresses these informational vulnerabilities. A digital interface that merely automates *murābahah* does not advance ethics; one that clarifies contract terms, tracks profit-sharing, and reports Shariah compliance in real time begins to reshape the ethical contract between bank and customer.

The governance literature extends this point by exposing the fragility of current supervisory structures. Abu Afifa et al. (2024) show that Islamic banks with stronger governance—especially boards with sustainability expertise and Shariah Supervisory Boards (SSBs) with clear access to information—produce more reliable disclosures and stronger alignment between ethical claims and operational decisions. A study in Bangladesh highlights the opposite dynamic: SSBs often operate with limited authority and incomplete information, reducing their ability to enforce ethical behaviour even when their normative stance is uncompromising. Technology matters here not because it moralizes the institution, but because it reduces management’s informational monopoly. The data asymmetry that presently limits SSBs is altered by digital reporting systems, blockchain-based audit trails, and real-time compliance dashboards. Even in the absence of official changes in regulatory authority, supervisory authorities are better able to demand ethically consistent activity once they have visibility into contract flows, risk exposures, and client outcomes.

Customer-side evidence supports the same structural interpretation. According to Al-Habashneh et al. (2025) customer satisfaction in Islamic digital banking is directly impacted by trust, security, and privacy. These characteristics strongly align with Islamic ethical concepts like *shiddiq* (truthfulness) and *amanah* (trustworthiness). The significance of these findings lies not in the fact that digital banking improves the client experience, but rather in the fact that it makes the ethical stakes more clear: the moral relationship between a bank and its customers stabilizes when information is safe, traceable, and communicated explicitly. Ambiguity, which frequently allows for opportunistic interpretations, decreases, making ethical practice more viable.

The risk-management literature takes the argument deeper. Apriantoro et al. (2025) show that fintech development—especially blockchain and algorithm-based monitoring—is increasingly framed as a response to operational risk in Islamic banking. This has direct implications for equity-based financing. One of the main justifications for avoiding PLS structures has been the high cost and uncertainty of monitoring partners. When digital tools reduce monitoring costs and make business performance observable, the structural reasons that drive banks toward debt-based products weaken. Again, the ethical shift is not a property of technology, but of the altered informational environment technology creates. If banks can verify real-sector activities, trace revenue flows, and detect anomalies automatically, the practical barriers to risk-sharing contracts decline—bringing operations closer to the distributive justice ethos of Islamic finance.

Sustainability-oriented studies point toward a parallel mechanism. Research on Islamic green finance (Ismail et al., 2025), shows that digital infrastructure supports the measurement and verification of environmental impact in green sukuk and other sustainable instruments. Classical concepts such as the elimination of harm (*al-darar yuzāl*) and the pursuit of public interest (*maṣlahah*) become operationalizable when environmental outcomes can be tracked and reported. Digital monitoring introduces accountability that was previously unavailable, making it harder for institutions to claim ethical commitment without demonstrating measurable benefit. Technology, therefore, reshapes the disciplining environment in which Islamic banks operate.

Finally, organisational readiness determines whether these structural shifts translate into behavioural change. Oladapo (2024) shows that sustainability outcomes improve when management commits resources, training, and long-term planning to environmental performance. Technology amplifies intent; it cannot substitute for it. A digital tool can record environmental metrics, but only leadership commitment ensures that those metrics drive operational decisions.

Across these bodies of evidence, a clear pattern emerges: digital innovation becomes ethically meaningful only when it changes the institutional conditions under which decisions are made. It strengthens Shariah governance by improving visibility, reduces the informational barriers that undermine risk-sharing, and creates traceability that supports both ethical finance and sustainability reporting. Its significance lies not in its novelty but in its capacity to reshape the structural constraints that have historically diverted Islamic banking from its normative trajectory. When those constraints shift, the distance between ethical ideals and practical outcomes can narrow in ways that were previously unattainable.

Conceptual Framework: Digital Innovation as a Structural Enabler of Ethical Islamic Banking

The gap between Islamic banking's ethical ideals and its operational practices is well documented across empirical studies. The persistence of debt-based instruments such as murābaḥah, despite the normative emphasis on profit-and-loss sharing (PLS), reflects the *Structural Limitations* identified in Figure 1. Specifically, information

asymmetry, high monitoring costs, and weak governance visibility make equity-based contracts difficult to implement in practice (Asutay, 2012; Chong & Liu, 2009; Fatihah et al., 2019). These limitations undermine the core Ethical Principles—justice, transparency, and welfare—that are central to Islamic financial ethics (Enyinda & Hamouri, 2014; Saidi, 2009). Therefore, as illustrated in the framework, a conceptual shift is required to explain how *Digital Innovation Enablers* can transform these structural conditions to support a more faithful implementation of Shariah commitments.

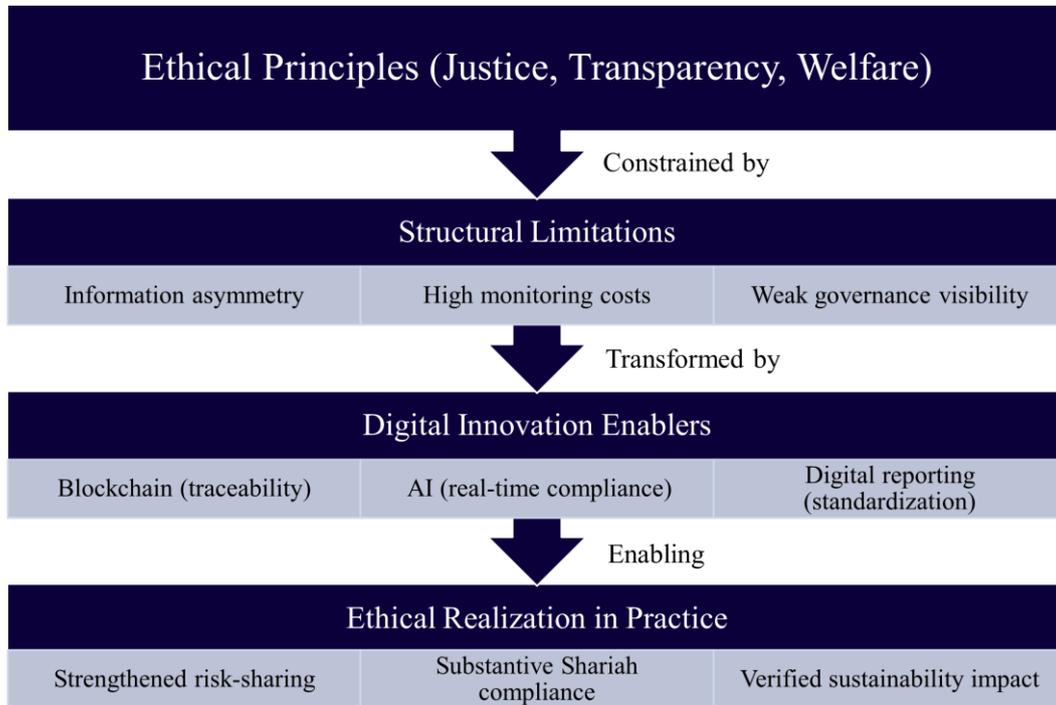


Figure 1
Advised Conceptual Framework

Digital technologies intervene at the core of the information problems that hinder ethical banking. *Blockchain (traceability)* creates immutable transaction records that improve transparency in PLS-based financing, thereby reducing agency problems and moral hazard (Ahmed et al., 2017). Similarly, *Artificial Intelligence (real-time compliance)* can automate monitoring and anomaly detection, increasing the accuracy of oversight beyond traditional manual auditing. Empirical findings support this: Apriantoro et al. (2025) demonstrate that technological innovation particularly blockchain and fintech has become a central theme in Islamic banking risk management because of its potential to enhance transparency, stability, and governance quality. In the framework's logic, these technologies act as the primary drivers that "transform" constraints into *Ethical Realization*, specifically by facilitating *Strengthened Risk-Sharing*.

Shariah governance represents a second structural layer where digital tools shift the ethical landscape. Research indicates that Shariah Supervisory Boards (SSBs) frequently lack the real-time visibility needed for operational decision-making. This

visibility gap weakens their ability to enforce ethical principles. However, *Digital Reporting (standardization)*, real-time dashboards, and automated audit trails expand the informational access of SSBs, strengthening their capacity to identify non-compliant activities and enhance internal accountability (Abu Afifa et al., 2024). When governance bodies gain reliable data, their oversight moves from being merely formal to **Substantive Shariah Compliance**, fulfilling the framework's promise of translating ethics into practice.

A third component of the framework concerns sustainability, conceptualized as an extension of *maṣlaḥah* and the elimination of harm (*al-darar yuzāl*) (Ismail et al., 2025). Sustainability goals require measurable outputs, yet many Islamic banks struggle with fragmented reporting and weak disclosure. Evidence shows that stronger governance, especially board-level expertise improves environmental disclosure (Abu Afifa et al., 2024). Digital systems further catalyze this by enabling real-time sustainability reporting and clearer traceability of green sukuk proceeds. This ensures that the final stage of the framework—*Verified Sustainability Impact*—is achieved, addressing critical challenges identified in green finance literature.

Synthesizing these strands, the conceptual framework proposes that digital innovation functions through three interconnected mechanisms: transforming informational structures by reducing uncertainty and monitoring costs, thereby lowering barriers to ethical financing models; enhancing the operational capacity and independence of Shariah governance, enabling more consistent enforcement of ethical and legal standards; and improving transparency and verifiability in sustainability practices, which operationalizes Islamic ethical principles within environmental and social domains.

When these mechanisms operate concurrently, digital innovation creates an environment where ethical norms—justice, transparency, and shared responsibility—become practically implementable rather than aspirational. The framework does not assume that technology is inherently ethical; instead, it positions digital innovation as a set of tools that reshape the institutional conditions under which Islamic ethical principles can be enacted. In doing so, it narrows the persistent ethics–practice gap that has characterized Islamic banking operations across multiple jurisdictions.

Conclusion, Implications, Suggestions, and Limitations

This article set out to explain how digital financial innovation can help narrow the ethical gap in Islamic banking by reshaping the informational and governance structures that constrain ethical implementation. The analysis demonstrated that the divergence between Islamic banking's ethical ideals and its operational realities does not arise from a lack of normative clarity. Rather, it stems from persistent information asymmetries, high monitoring costs, and governance arrangements that place supervisory bodies at an informational disadvantage relative to management. Empirical studies show that these structural limitations weaken the enforcement of equity-based financing, transparency, and distributive justice—principles that lie at the core of Islamic ethical finance. The conceptual framework developed here argues that digital innovation, when understood as

an infrastructural rather than symbolic transformation, alters these constraints by redistributing informational access, enhancing the operational capacity of Shariah governance, and improving the verifiability of sustainability claims. In doing so, digital tools make ethical norms more enforceable and allow Islamic banking to move closer to the ethical commitments embedded in its foundational principles.

The implications of this analysis extend to both theory and practice. The framework puts forward the concept that the ethical principles of Islamic banking cannot be supported exclusively through jurisprudential formulations; rather, they necessitate institutional architectures that are capable of generating the informational conditions under which ethical expectations can be realised. This reframing of the debate on Shariah governance entails a shift from a focus on authority and jurisdiction to a centrality of epistemic access and informational parity. The article under scrutiny highlights the transformative potential of digital reporting systems, blockchain-enabled audit trails, and AI-based compliance tools as mechanisms that enhance transparency, reduce agency problems, and strengthen supervisory independence. It is also conceivable that regulators may find value in this framework, as it suggests that effective ethical governance does not necessarily require expanding formal regulatory mandates. Rather, it suggests that the focus should be on ensuring that supervisory bodies can access reliable, continuous, and standardised operational data. For the sustainability agenda, the analysis underscores the importance of digital systems in verifying environmental impacts, tracking green sukuk proceeds, and integrating Islamic ethical maxims with measurable environmental performance.

This study has several limitations. As a conceptual article, its arguments rely on synthesising existing empirical findings rather than generating new data. Consequently, the framework is analytically grounded but not empirically tested. Moreover, the extant literature on the subject is predominantly drawn from Islamic banking systems in Asia and the Middle East; therefore, it is hypothesised that institutional variations in Africa, Europe, and emerging fintech jurisdictions may reveal different governance dynamics. The technological mechanisms under discussion, including blockchain, AI, and real-time reporting tools, are also subject to uneven adoption across markets, and their effectiveness is likely to vary according to regulatory maturity, digital infrastructure, and the degree of organisational willingness to incorporate technological change into governance processes.

In view of these limitations, it is recommended that future research should be empirical in nature, with the objective of testing the propositions developed in this study. Such testing should involve the examination of how specific digital tools affect Shariah governance performance, transparency, and ethical financing outcomes across a range of institutional settings. The execution of comparative studies that evaluate Islamic banks with varying degrees of digital adoption could provide clearer evidence of the causal mechanisms proposed in this framework. It is evident that further research is required to explore the manner in which regulators can design supervisory systems that leverage digital capabilities without imposing excessive compliance burdens. It is evident that the

integration of Islamic legal theory, data governance, and sustainability science through interdisciplinary work would facilitate a more profound comprehension of the operationalisation of ethical and environmental commitments through digital infrastructures.

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