



## ISLAMIC BANKS: AN OVERVIEW OF LEGAL, REGULATORY AND SUPERVISORY FRAMEWORKS

ZIANI Imen Hiba <sup>1,\*</sup>

<sup>1</sup> Lecturer Professor, Ecole Supérieure de Gestion et d'Economie Numérique, Kolea (Algeria)

Author's E-Mail Address: [hi.ziani@epsecg-alger.dz](mailto:hi.ziani@epsecg-alger.dz);

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### ABSTRACT

This paper aims to identify challenges faced by regulatory and supervisory agencies regarding Islamic banking, to develop a better understanding of Islamic banks (IBs) and to provide policy recommendations to enhance the supervision of IBs.

In light of the risks experienced by IBs, the article states that they need:

A sound legal, corporate and regulatory framework; which is a key precondition for a safe development of Islamic Bank (IB). They also need developing a better understanding of Islamic banking , providing policy recommendations to enhance the supervision of IBs, adoption of *Shari'ah* law standards across jurisdictions, creating an effective, efficient and robust regulatory structure, implementing the AAOFI, IFSB and Basel II legal and regulatory standards. In addition, the creation of Islamic financial benchmark and *Shari'ah* harmonization with existing legal and policy frameworks.

**Keywords:** Islamic finance, Islamic banks, legal framework, regulatory framework, banking supervision

**JEL Classification :** G18, G21, G28, P51

### الملخص

تهدف هذه الورقة إلى تحديد التحديات التي تواجهها الهيئات التنظيمية والإشرافية المتعلقة بالخدمات المصرفية الإسلامية، فهم أفضل للمصارف الإسلامية وكذا تقديم توصيات سياسية لتعزيز الإشراف على البنوك الإسلامية.

في ضوء المخاطر التي تتعرض لها البنوك الإسلامية، تنص المقالة على أنهم بحاجة إلى:

إطار قانوني، إطار تنظيمي مؤسسي سليم؛ وهو شرط مسبق رئيسي للتنمية الآمنة للبنك الإسلامي. كما يحتاجون إلى تطوير فهم أفضل للخدمات المصرفية الإسلامية، تقديم توصيات متعلقة بالسياسة لتعزيز الإشراف على البنوك الإسلامية، اعتماد معايير الشريعة الإسلامية عبر البلدان المعنية، إنشاء هيكل تنظيمي فعال وقوي، وكذا تنفيذ المعايير القانونية والمعايير التنظيمية لكل من AAOFI، IFSB و Basel II. بالإضافة إلى ذلك، وضع معايير مالية إسلامية توافق الشريعة الإسلامية مع الأطر القانونية والسياسية القائمة.

**الكلمات المفتاحية:** المالية الإسلامية، البنوك الإسلامية، الإطار القانوني، الإطار التنظيمي، الإشراف على البنوك الإسلامية.

**تصنيف JEL:** G18, G21, G28, P51

\* ZIANI Imen Hiba is the corresponding author.

## I. INTRODUCTION

Islamic finance has grown rapidly over the past decade, and its banking segment has become systemically important in a dozen countries in a wide range of regions. Islamic finance is projecting to continue to expand in response to economic growth in countries with large and relatively unbanked Muslim populations.

Despite this development, Islamic banking faces a number of challenges and remains uncharted territory for many practitioners and policy makers. For example, even with the efforts of Islamic finance standard setters, in many countries the industry is governed by a regulatory and supervisory framework developed for conventional finance. Therefore, it does not fully take account of the special nature of Islamic finance. However, there is already a substantial literature that discusses key IB features and their consequences for regulation and supervision. Based on a short review of this literature, this note seeks to build a stronger knowledge of IB and to provide policy recommendations to improve further the supervision and regulation of Islamic banks (IBs).

### Problematic issues

#### **What is the appropriate legal environment for Islamic banks to adopt to improve their supervision?**

The article is divided into six parts. Section I the Introduction, Section II Overview of the recent legal and institutional Developments of IB Industry. Section III discusses the legal, corporate and regulatory frameworks of IBs; whereas section IV reviews approach towards IB regulation and supervision. Section V the conclusion.

## II. OVERVIEW OF THE RECENT LEGAL AND INSTITUTIONAL DEVELOPMENTS OF IB INDUSTRY

### A.BACKGROUND

Initiative to finance enterprises based on interest free principle can be traced as early as 1940s in Pakistan and the Indian subcontinent. Later, in 1963, one pioneering experiment for IF was that in Mit Ghamr in the Nile valley in Egypt but it closed down for various reasons. The same experiment was introduced in few other countries, such as India, Pakistan and the Philippines but survived for long. During the 1970s, a number of private interest-free banks came into existence in North Africa and the Middle East (Zulhibri Abdul Majid and Ghazal, 2012).

The Islamic finance industry (IFI) is climbing to new heights on the back of strong global demand for sustainable and socially responsible investments, the newly released fifth edition of the Islamic Finance Development Report and Indicator (IFDI), found. It states that growth in the industry is unabated despite a partial economic slowdown in a number of the industry's main markets caused by the decrease in oil revenues over the past years (World Bank Islamic Finance Bulletin Issue 31, January 2018).

The industry's total worth across its three main sectors (banking, capital markets and *Takāful*) is estimated at USD 2.05 trillion in 2017 (see Table 1), marking an 8.3% growth in assets in US Dollar terms and reversing the preceding two years of assets' growth stagnation (SR2017 : USD 1.89 trillion, SR2016: USD 1.88 trillion). The robust growth was contributed actively by all three sectors of the IFSI, but the key rebound in performance was experienced by the Islamic capital markets. Meanwhile, the gradual reversals in previously steep depreciation

of several emerging market currencies in 2017 has also contributed towards better asset values in US Dollar terms (IFSI Stability Report 2018).

**Table 1. Breakdown of Global IFSI by Sector and by Region (USD billion, 2017\*)**

Region	Banking Assets	<i>Shukūk</i> Outstanding	Islamic Funds' Assets	<i>Takāful</i> Contributions	Total	Share (%)
Asia	232.0	239.5	24.8	3.3	499.6	24.4
GCC	683.0	139.2	26.8	12.6	861.6	42.0
MENA (ex. GCC)	569.0	17.8	0.1	9.5	596.4	29.1
Africa (ex-North)	27.1	2.0	1.6	0.7	31.4	1.5
Others	46.4	1.5	13.3	0.0	61.3	3.0
<b>Total</b>	<b>1,557.5</b>	<b>399.9</b>	<b>66.7</b>	<b>26.1</b>	<b>2,050.2</b>	<b>100.0</b>

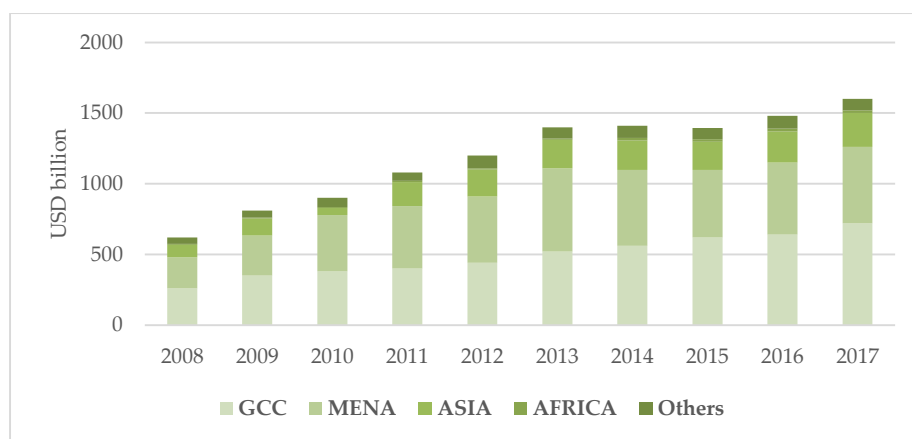
Source: Islamic Financial Stability Report 2018

\*Data for *Shukūk* outstanding and Islamic funds' assets are for the full year 2017; data for IB are for the six months ended June 2017 (1H2017); and data for *Takāful* are as at end-2016.

In the view of those facts, the report estimates that the IFI will reach a global asset volume of no less than \$3.8tn by 2022, up from \$2.2tn at the end of 2016, which translates into an expected compound annual growth rate of 9.5%. (World Bank Islamic Finance Bulletin Issue 31, January 2018).

Islamic banking assets globally are forecast to climb to approximately USD 1.61 trillion in 2017 (see figure 1). Currency exchange rates, particularly in key Islamic banking markets where exchange rates are not pegged to the US Dollar, continue to influence the value of global Islamic banking assets and other indicators of the industry. Geographical concentration of Islamic banking assets remains substantial, with 91.5% of these assets now in countries in which the Islamic financial sector is considered systemically important, up from 88% reported in 2Q2016. The increase is partly explained by the inclusion of Bahrain as a new addition to the list of systemically important jurisdictions for Islamic finance in this year's report. The top 10 Islamic banking jurisdictions by asset size now account for 93.2% of the global Islamic banking industry, up from 91.8% in 2Q2016, while four countries – namely, Iran, Saudi Arabia, the UAE and Malaysia – hold more than 73% of the industry's assets globally.

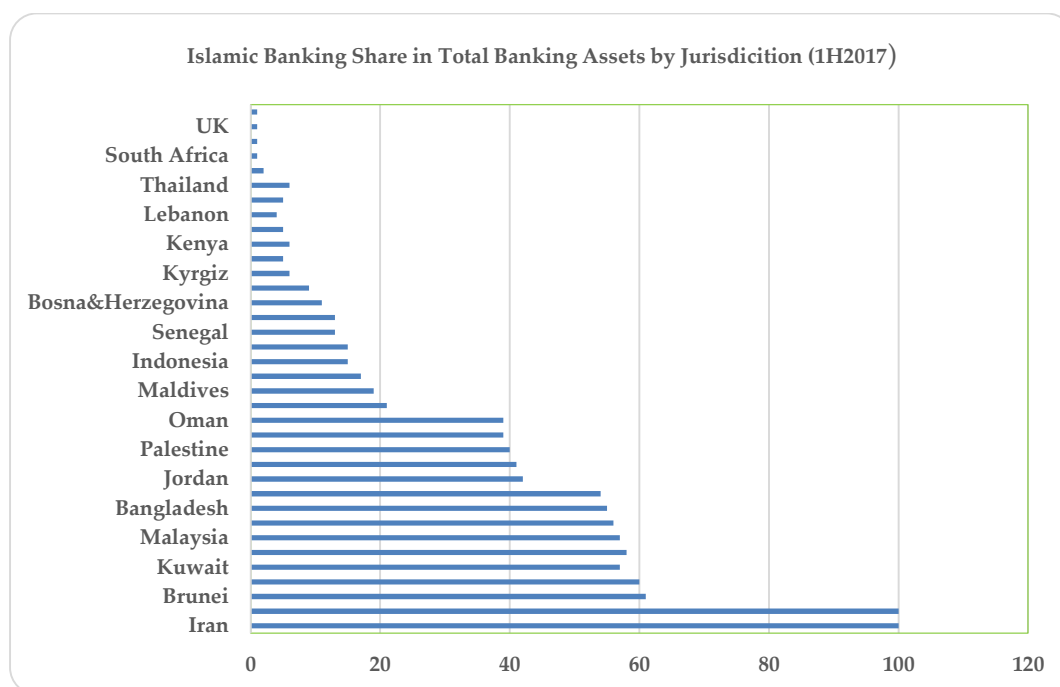
**Figure 1: Islamic Banking Assets (2008-2017)**



Source: Islamic Financial Services Industry Stability Report 2018, p 16

In line with the improved asset growth performance, the domestic market share for Islamic banking in relation to the total banking sector has continued to increase in a large number of countries, further deepening the sector's penetration. Between 1H2016 and 1H2017, tracking an expanded list of 36 jurisdictions (see Figure 2), Islamic banking experienced an increase in domestic market share in 19 countries while remaining constant in seven others (including Iran and Sudan, which have 100% market shares). Only six jurisdictions experienced declines in market share; however, they include Qatar and Egypt, which are two key Islamic banking markets. The four newly added jurisdictions in the Islamic banking market-share tracker are Senegal (5%), Bosnia and Herzegovina (3.6%), Kyrgyz Republic (1.5%) and Tanzania (0.7%).

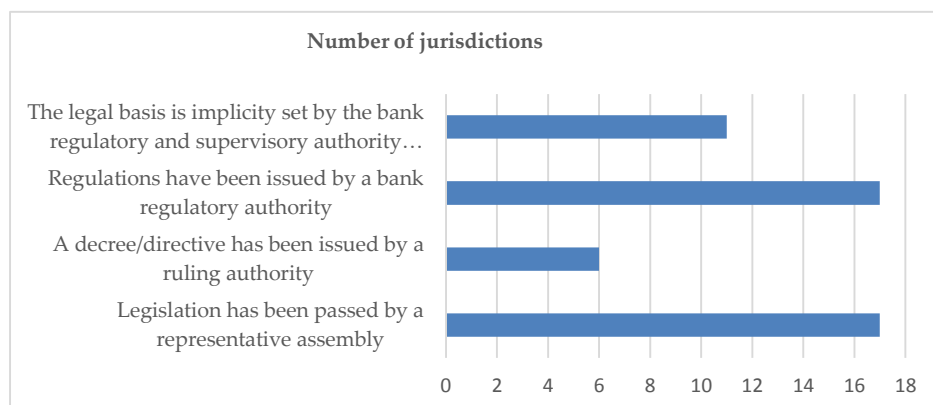
Figure 2: Shares of Global Islamic Banking Assets\* (1H2017)



Source: Islamic Financial Services Industry Stability Report 2018, p 12

Figure 3 illustrates the introduction and regulation of Islamic banks and banking. Representative assembly has passed Legislation in 17 jurisdictions (e.g., Indonesia, Iran, Jordan, Kuwait, Malaysia, and Sudan), While a ruling, authority has issued a decree/directive in six jurisdictions (e.g., Kazakhstan, and Qatar). In addition, regulatory authority have issued Regulations in 17 jurisdictions (e.g., Afghanistan, Bahrain, and Ethiopia), While the bank regulatory and supervisory authority implicitly has established the legal basis to facilitate the presence of Islamic banking in 11 jurisdictions (e.g., Botswana, Kenya, and the U.K.).

**Figure 3: Legal Bases for the Practice of Islamic Banking**



Source: Song and Oosthuizen, 2014

The legal practice governing IBs varies across different countries. IB and financial institutions generally operate under three different regulatory regimes: self-regulation through constitutional limitation (i.e. Al-Baraka International Bank); private regulation through government private legislation (i.e. Jordan Islamic Bank); and public regulation through national legislation (Zulkhibri Abdul Majid and Ghazal, 2012). Under the public regulation, IBs operate mainly in three types of operating environments:

- 1) Countries whose constitution requires the banking system to be fully-Islamic;
- 2) Countries having specific enabling Islamic banking legislation; and
- 3) Countries that have no specific enabling legislation but have specific regulation and/or provisions under general financial market regulation for IF.

To date, although some countries have specific legislation for IBs to regulate IBs, while most of the countries have specific provision under general legislation and specific regulation (with the exception of Saudi Arabia and Turkey). For example, Indonesia has also passed a new Islamic banking law in 2008 that will allow commercial banks to be converted into *Shari'ah*-compliant ones and for foreign entities to set up IBs in cooperation with Indonesian partners. However, in Jordan, IBs are dealt under the common banking law similar to convention banks with specific provisions with respect to definition of IB (Zulkhibri Abdul Majid and Ghazal, 2012).

These countries laws and legislation render IB binding on both conventional and *Shari'ah* laws. With the exception of Iran and Sudan, these institutions carry out their banking operations in accordance with the

*Shari'ah* provisions, as well as the provisions of conventional laws. In most legislation the use of the term banking business does not reflect the real essence of Islamic banking, that is, it does not include the basis and basic values of the of Islamic banking practice. Some of these laws simply state that the behaviour of banking business is in accordance with the *Shari'ah* law but, did not require the provisions to be incorporated by law and in the association memorandum to make *Shari'ah* compliance compulsory for the IB. A fully-Islamic banking scheme allows only financial services that comply with *Shari'ah*. A tendency towards complete Islamization is more likely to evolve in countries with a majority Muslim population. Iran, Sudan and Pakistan are remarkable examples of this trajectory among the countries. The conversion of Iran to a fully-Islamic Financial System began with the implementation of the Usury Free Banking Law of 1983. Similarly, with enactment of the Banking Law of 1992, Sudan pursued the full Islamization of its financial system. On the other hand, for full Islamization of its financial system, Pakistan took the same step. However, it was declared un-Islamic by Islamic court of Pakistan (the Federal *Shariat* Court) in 1991.

IBs' fast development internationally and operating beyond the national jurisdictions require the creation of its own financial infrastructure to promote the IFI's stability and efficiency. To bring the IFI infrastructure of up to the international standards, the establishment of these institutions is vital. There are three main arguments for the needs of these institutions. 1) Developing guidelines and principles in line with the IF's *Shari'ah* requirement in the form of accounting and auditing standards, regulatory rules for different kinds of institutions, business rating techniques, transparency and ethical code. 2) Mechanism for adopting rules and principles in term of active monitoring and supervision. 3) Country-wide coordination of the rules and principles, between market players, standard setting body, regulatory and supervisory institutions.

According to Alharbi (2015): to date, there are nine major international infrastructure institutions namely Islamic Development Bank (IsDB); Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Islamic Financial Market (IIFM), General Council of Islamic Banks and Financial Institutions (GCIBAFI), International Islamic Financial Market; Liquidity Management Centre (LMC), International Islamic Rating Agency (IIRA), International Financial Services Board (IFSB); International Islamic Centre for Reconciliation and Commercial Arbitration (IICRCA); International Islamic Liquidity Management (IILM); Arbitration Center for Islamic Banks and Financial Institutions (ARCIFI); and International Islamic Liquidity Management Corporation (IILMC) that actively support the development of the Islamic finance industry with various degrees of mandates and roles.

## **B. LEGAL AND INSTITUTIONAL DEVELOPMENT**

Islamic banking and IF are distinct and separate from conventional banking and finance. They are based on compliance with the legal framework referred to as *Shari'ah* Law. IBs and Islamic banking are largely merchant

and investment banking oriented, as they typically relate to or involve the real economy, especially trade and investment.

The original and fundamental source for IF, including Islamic banking, is *Shari'ah* Law, which plays a varying role in different countries. Whereas in several jurisdictions (e.g., Afghanistan, Bahrain, Iran, Pakistan, Saudi Arabia and Sudan), *Shari'ah* Law is the fundamental law of the land (or a key source of the law of the land) in others it does not constitute part of the legal framework (Song and Oosthuizen, 2014).

The public policy on the area and role of Islamic banking in different jurisdictions is underpinned by various motivations. Islamic banking is regarded as an acceptable financial innovation in some countries (e.g., the United Kingdom), whose existence further inspires their status as an international financial center. Other jurisdictions such as Kenya, South Africa, and Tanzania accommodate Islamic banking in perspective of its significant Muslim minority communities' demand. Islamic banking is typical in jurisdictions where the majority of the population is Muslim, where *Shari'ah* Law is the fundamental law and Islam is the religion of the state.

Formalization of Islamic banking is a recent phenomenon. The first formal institutions claiming to provide Islamic banking appeared in the 1960s (Verhoef, Azahaf and Bijkerk, 2008).

Considering the recent formalization of Islamic banking and finance, Islamic banking is still in a development phase. Subsequently, the official implementation and regulation of IBs and banking methods are widespread. These vary from a custom decree for a specific organization that wishes to perform Islamic banking to stand-alone and concentrated Islamic banking law. Moreover, the range of methods differs from those where Islamic banking law constitutes a part of a jurisdiction's general banking law, to regulate Islamic banking as financial innovation. Thus, there is still no generally accepted international legal, regulatory, and supervisory framework dealing with Islamic banking, although different initiatives are in different phases of development.

Conventional investors have also shown increasing demand for Islamic banking goods, including for diversification reasons. Only Islamic banking is allowed in a few countries. In most countries, Islamic banking is performed alongside conventional banking, which is still predominant in general. However, in these countries Islamic banking is typically growing faster than conventional banking. Jurisdictions have distinct approaches to the kinds of organizations that allow Islamic banking to be conducted. In some jurisdictions like Malaysia and Saudi Arabia, stand-alone IBs and so-called Islamic windows are allowed. The legal requirements influence the variety of structural forms of institutions that offer Islamic financial services. These restrictions range from allowing CBs to open an Islamic window within an existing subsidiary or branch, to setup a full IB from CB subsidiaries or to establish new IBs (McMillen, 2008). For an IB window, the bank runs a window within a CB that allow customers to access IF products. In non-Muslim countries (Muslim minority) and in the developed countries, Islamic windows are more common. Islamic subsidiaries and new IBs are more prevalent In the Middle East and large Muslim population. This can, in many cases, be a

more cost effective way for a current bank to enter. CBs with significant bases of customer may decide to set up an Islamic subsidiary. This could enable a bank to give the Islamic market a wider range of *Shari'ah*-compliant banking products.

The growth opportunities and challenges confronting Islamic banking development have raised public policy issues in many countries they operate, including legislation and regulatory framework. IB over-reliance on trade and commodity financing instruments has restricted their choice of maturity structure, as a significant part of such financing is of short-term. The theoretical model expects a full range of maturity from financial intermediaries.

Banks are reluctant to indulge in PLS instruments due to their inherent riskiness, additional monitoring costs and lack of transparency in markets (Van Greuning and Iqbal, 2008).

Therefore, further growth and development of the Islamic financial system (IFS) needs a standardized regulatory structure and a legal framework that supports it. The current framework that based on Western banking model may generate difficulties for the IB to function effectively in the longer-term.

To keep IBs growing at a sustainable rate, despite the slow rate of development since IF arose in the 1970s, the IFI is in great need of ongoing development and innovation. Especially in the area of sector-specific problems that need to be resolved. In particular, the major problems that the Islamic banking industry faces include: (i) the liquidity risk management infrastructure and instruments that in many jurisdictions remain underdeveloped; (ii) a legal framework, which is incomplete or untested; (iii) the lack of harmonized contracts; and (iv) insufficient expertise (at the supervisory and industry levels) relative to the industry's growth (Hasan and Dridi, 2010).

### III. THE LEGAL, CORPORATE AND REGULATORY FRAMEWORKS IN ISLAMIC BANKING

IBs need legal, corporate and regulatory frameworks just as much as CB does, due to the risks experienced by IBs. The purpose of these frameworks should be to strengthen the bank operating environment, inner governance, and market discipline to assist tackle moral hazard factors, safeguard demand depositor interest, and systemic risk.

#### A. The Legal Framework

Almost all of IB cases are treated under non-*Shari'ah* court (i.e., civil court) jurisdiction as in the case of Malaysia, Kuwait, UAE, Turkey, Jordan and Bahrain. However, in Saudi Arabia's case, it relates to Banking Dispute Settlement, and in the case of Indonesia, it refers to *Shari'ah* court. Based on this interpretation, Islamic law has no particular application to other individuals or legal entities such as banks and financial institutions. Since the civil court hears Islamic banking matters, those matters will, undoubtedly be governed by the principles of common law or civil law.

The other part of IB-related legislation is that most legislation does not indicate or include a clause on a definite and particular point of view for distinct fatwas (legal decision) that constituted a dispute and affected institutional advancement such enforceability (as in the situation of Pakistan). In analysing the enforceability



problems under the *Shari'ah*, contract regulations in the *Shari'ah*-compliant operation, a range of variables needs to be considered according to McMillen (2007): i) Existing law including case law in common law jurisdictions; ii) Current transactional practice relating to the construction and drafting of contracts in *Shari'ah*-compliant transactions in different jurisdictions; iii) Current transactional practice with respect to legal opinions; and iv) Matters of certainty and predictability in *Shari'ah*-compliant transactions in different jurisdictions.

For IB's safe development, the main requirement is a sound legal framework. General banking rules (or specific IB laws) have to define the nature of these banks and their connection (if applicable) with the central bank and other conventional banks in order to provide the legal foundation for IB oversight. Jurisdictions have embraced distinct strategies in creating the legal framework that enables IBs to function. These strategies are adopted because IBs function across nations in very distinct legal settings that represent distinct legal traditions and differing opinions on the *Shari'ah* as a source of law. In particular as stated by Song and Oosthuizen (2014):

- *Shari'ah incorporated jurisdictions*: have aimed at developing harmonized *Shari'ah* standards for IB, although variations reflecting local standards persist. As a result, these jurisdictions have different approaches to the type of institutions that are permitted to conduct IB.
- *Purely secular jurisdictions*: have aimed at enacting legislative changes to ensure a level playing field for IF products, while not necessarily incorporating *Shari'ah* elements in the substantive law of the land.

#### **B. Corporate Governance**

The aspect of the IB business model creates distinctive governance challenges, including safeguarding equity account holders' interests and defining *Shari'ah* compliance governance's function. As mentioned previously, the divergence of interests must be acknowledged in the governance framework of the bank between holders of investment accounts and shareholders. To that effect, the 2006 guiding principles of the Islamic Financial Services Board (IFSB) on corporate governance of IBs advocated: i) transparency in policies and performance related to the investment accounts to help ensure adequate monitoring by their holders, and ii) the establishment of an internal board-level governance committee that will be empowered to oversee the governance policy framework, including protecting the interests of investment account holders.

However, important gaps still need to be addressed including: i) it is impractical for IBs to provide to investment account holders with all relevant information to alert them on the risks facing the bank, and ii) since the governance committee reports directly to the bank board, any conflict of interests between investment account holders and shareholders will likely be disclosed ex-post, if at all. In order to address this issue a potential avenue would be to mandate that one or more of the directors of the bank are accountable for enforcing the rights of investment account holders. *Shari'ah*-compliance is a unique feature of IB and is key to help ensure the integrity of IBs (McMillen, 2008).

The IFSB emphasised the need for IBs to establish a mechanism to obtain and apply *Shari'ah* scholars' rulings and to supervise *Shari'ah* adherence. The governance of *Shari'ah*-compliance in IBs anticipate, in accordance with IFSB guidelines to include:

i) a *Shari'ah* supervisory board (SSB), composed of qualified scholars appointed by shareholders and reporting to the board of directors, and with the responsibility of approving products and services and conducting reviews to ensure *Shari'ah* -compliance (among others); ii) an internal *Shari'ah* review process, carried out by an independent department to monitor, evaluate and produce reports on compliance; and iii) periodic *Shari'ah* reviews covering policies and transactions, which form the basis of the report of the SSB (McMillen, 2008).

The key decision to be made (in relation to SSBs at a bank level) is to establish a centralized SSB to oversee the governance framework of the *Shari'ah* in IBs. A centralized SSB has the advantage of harmonizing *Shari'ah* rulings, decreasing *Shari'ah* and IB compliance costs. The regulator may put up a centralized SSB, or IBs may be encouraged to set up such a board together (which is applicable in secular countries where the substantive law of the regulator prevents immediate participation in *Shari'ah* issues).

In some jurisdictions (e.g., Sudan, Turkey, the United Arab Emirates) the centralized SSBs has been set up as an independent public institution, while in others (e.g., Afghanistan, Bahrain, Malaysia, Pakistan, and Palestine), the SSB has been set up at the central bank (Song and Oosthuizen, 2014).

SSBs also tend to differ in their mandate and accountability to the IBs' board of directors.

While some SSBs that have been set up at the central bank have legislative and adjudicative powers on *Shari'ah* issues, other SSBs are simply consulted on proposed amendments to the regulatory framework. On accountability, a key challenge is whether SSB members are accountable to the IBs' board of directors. In most cases, it seems that the relationship of an IB's SSB with the bank is of an advisory type as the ultimate responsibility for *Shari'ah* compliance appears to lie with the bank's board of directors. While this is in line with IFSB standards on *Shari'ah* governance, transparency about the mandate, accountability and independence of the SSBs could be enhanced further to reduce reputation and legal risks associated with *Shari'ah* compliance (Song and Oosthuizen, 2014).

### **C. The Regulatory Framework**

The authorities should ensure the regulatory structure for IBs and thus allow them to be on a level playing field with CBs. Ensuring also that the legislative structure is properly aligned with the standard setter rules is critical to resolving the major hazards associated with IB operations. The standard framework in most nations where IBs are present is the Basel Committee on Banking Supervision's (BCBS) fundamental legislative framework. Nevertheless, to implement *Shari'ah* law, several jurisdictions supplement it with the standards of the Islamic Financial Services Board (IFSB) and the Islamic Financial Institutions Accounting and Auditing Organization (AAOIFI). Around 65% of countries that allow IBs have adapted their standard finance laws for IB activities.

Several elements of the regulatory structure need to acknowledge the distinctive characteristics of IB. These characteristics will be addressed below.

### **Licensing**

Appropriate licensing processes in Islamic banking structure are as essential as in conventional banking. Jurisdictions enforce various licensing criteria on candidates who wish to set up Islamic banks. These processes assist supervisory authorities guarantee sound management of new banks. Licensing conditions in non-*Shari'ah* law states (where Islamic and conventional banks are present), do not specifically and clearly tackle the problem of *Shari'ah* adherence. Nevertheless, in the endorsement process, the problem of *Shari'ah* adherence plays a significant indirect and explicit part. Compliance with *Shari'ah* is a main precondition (where *Shari'ah* law constitutes or is part of the country's fundamental law) for whether a suggested Islamic bank authorization application would be positively regarded. As part of the registration system, the supervisory agency should guarantee that suitable corporate governance structures and procedures are in place, including the right of investment account owners to monitor the efficiency of their assets and the transparency of financial reporting of investment reports.

Various countries grant Islamic banks distinct types of licenses. According to a survey conducted by Song and Oosthuizen (2014), 17 jurisdictions a stand-alone Islamic bank will be issued with an Islamic banking license. In the remainder 12 jurisdictions a single (generic) banking license is issued to a bank, irrespective of whether the bank is an Islamic or a conventional bank (in some of these jurisdictions the authorities are empowered to issue only an Islamic banking license).

### **Liquidity**

A mixture of BCBS and IFSB liquidity regulations can usually address the liquidity hazards that IBs face. Implementation of key elements of the newly internationally agreed liquidity framework, that is Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are probable to present important difficulties for IB-strong jurisdictions. This is especially the situation with regard to the handling of equity reports, determination of run-off rates on deposits in many nations in the absence of Islamic deposit insurance systems, and limited availability of short-term liquid tools. The IFSB anticipates introducing LCR level for IBs in the close future in this regard. Implementation of LCR will require thorough scheduling and devoted resources (e.g., the creation of a dedicated unit in the supervisory agency).

The objective for areas where there is no LCR rule and cross-border operations are minimal should be to switch gradually to the LCR structure in order to allow banks time to enhance their ability. Meanwhile, thought should be provided to whether the LCR parameters are adequately stringent or need to be adjusted to appropriate the local context. Furthermore, evaluating the therapy of PSIA (Profit Sharing Investment Account) from a liquidity view would be crucial. In the event of licensing an Islamic banking window, the CB applying for it

should guarantee efficient segregation of resources in each window (conventional and Islamic), including a suitable inner systems and reporting procedures. For example, the LCR requires banks to hold a diversified portfolio of High Quality Liquid Assets (HQLA), but the room of diversification is constrained in many jurisdictions, with limited access to other HQLA than sovereign debt. In an effort to address this issue the latest Basel LCR rules promote *Shari'ah* compliant instruments, such as *Sukuk*, as HQLA. Improving the liquidity legislative structure will need to address the accessibility of short-term resources efficiently. Jurisdictions with a greater IB presence has produced some advancement, but many difficulties remain. Jurisdictions, in fact, have:

- Developed special liquidity management instruments, including commodity *Murabahah*. This instrument has spread rapidly based on its reliance on existing financial infrastructure (i.e., international commodity markets) and is being used in about 45 percent of jurisdictions with IB presence (Song and Oosthuizen, 2014).
- Developed interbank markets for IBs. Significant progress has been achieved in few countries (e.g., Malaysia, Sudan and Bahrain) including through the development of *Shari'ah*-compliant government bonds (*Sukuk*). Interbank markets are spreading to other countries and now operate in about 45 percent of jurisdictions with IB presence. However, the development of these markets has been affected by a chronic excess of liquidity in several jurisdictions, and concerns of IBs to deal with CBs out of concern of *Shari'ah* noncompliance (Song and Oosthuizen, 2014).
- Achieved less progress in developing liquidity facilities with the central bank, particularly those that would assist banks faced with liquidity shortages. This largely reflects the aversion of central banks (often reflected in their mandates) to engage in transactions involving real assets, which is the basis of Islamic finance. In this context, the legal and operational frameworks of central banks need to be enhanced by allowing the development and use of Islamic liquidity management instruments. This would help ensure financial stability and increase the effectiveness of monetary policy in jurisdictions with sizable IB presence (*Mejía, Aljabrin, Awad, Norat, and Song, 2014*).

### Capital

In most countries where Islamic banks are present, the BCBS's regulatory minimum capital adequacy requirement applies. Consequently, most countries endeavor to abide with the BCBS capital structure (either Basel I or Basel II and Basel III). The Islamic banking survey disclosed that the recommended minimum general Capital Adequacy Ratio (CAR) for Islamic banks varies from 8% to 12% (Song and Oosthuizen 2014). Jurisdictions have adopted distinct methods to the implementation of capital requirements. In some countries (e.g., Bahrain, Jordan, Malaysia, and Sudan), legislative capital adequacy conditions comprise prescriptions that are often based on IFSB prudential norms and guiding values on necessary modifications to the BCBS capital structure, to accommodate for certain Islamic banking characteristics. In other countries (e.g., Ethiopia,

Kazakhstan, Turkey, the United Arab Emirates, and the United Kingdom), the selected BCBS capital structure refers to all banks, including IBs.

The regulatory framework in these jurisdictions contains a single set of capital adequacy provisions that are relevant to all banks. Therefore, there is no difference between the capital requirements that apply to Islamic banking banks and conventional banking banks. It may therefore be hard to compare capital ratios among Islamic banks in distinct nations. There appears to be little consistency in the modifications made by Islamic banks to the selected BCBS investment structure to accommodate for certain characteristics of Islamic banking. For instance, as proposed by the IFSB, some jurisdictions use an alpha factor to detect the difference in risk exposure between a risk-sharing product for Islamic banking and a conventional banking product. The authorities in Turkey did apply a risk weight of 70% to Islamic banking risk-sharing products. These modifications appear to be based on expectations as to the magnitude of the risk arising from the specific transaction and/or resulting asset. And/or whether an efficient transfer of risk to or from a third party has occurred.

#### **Transparency and disclosure**

Enhancing disclosure is essential to provide regulatory officials and the public with a stronger understanding of the policies and appropriate hazards of banks. Disclosure requirements should aim at providing sufficient information to assess: i) the appropriateness of policies regarding portfolio diversification and investment objectives (including with respect to concentration); ii) the degree of exposure to illiquid assets, which could be the case particularly in banks operating under a two-tier *Mudharabah* arrangement; iii) the main risk factors associated with the investment portfolio and the quality of the internal procedures, organization and infrastructure for monitoring and handling these risks; iv) the adequacy of arrangements for internal controls, which is a complex issue given the need to determine PLS ratios on projects financed by the bank; and v) the methodology used by the bank to calculate its performance to help investors choose well managed institutions when placing their investment deposits (Song and Oosthuizen, 2014).

In this sense, transparency of IB's standing policies (e.g. appropriations made to PER and IRR, the level of these reserves, and the amount used to smooth income over the period) would help minimize uncertainty about the loss-absorbing nature of investment accounts and reduce potential systemic risks. IB's formal integration into legal and regulatory frameworks has progressed at a slow rate, despite the significance of a transparent accounting and financial reporting structure adapted to it. Moreover, AAOIFI accounting standards are compulsory only in a few countries (Bahrain, Botswana, Iraq, Jordan, Qatar, Sudan, Syria, and Yemen), with most countries implementing International Financial Reporting Standards (IFRS) or domestic accounting norms.

The nature and extent of information disclosed to the general public varies across jurisdictions, partly

depending on whether *Shari'ah* law is the fundamental law of the land and the coexistence of IBs and CBs (Song and Oosthuizen, 2014).

#### **Deposit insurance and bank resolution**

The key to promote the stability of IBs is the accurately dealing with the issue of deposit insurance. The main challenge for IB concerning deposit insurance is to identify its scope, comprising whether it covers benefit sharing investment accounts (IFSB, 2013).

To this end, the presence of a sound strategy to determine the importance of the alpha factor would be essential in determining the amount of coverage required by equity account owners. In reality, the security of deposits in Islamic banks has little consistency between countries. Deposit security arrangements vary from single systems applicable to all banks to distinct systems in which Islamic and conventional banks are protected individually. Since there is a distinct deposit security system for Islamic depositors (shareholders), this system typically invests its money only in Sharia-compliant investments from ex ante deposits. Comprehensively addressing bank resolution in the context of IB is also important. While international principles for good bank resolution are applicable to IB, regulatory work needs to be developed further, including clarifying whether there should be a separate resolution framework for IBs, the priority of claims by investment account holders, and the nature of the resolution process, particularly if it involves a takeover by a CB. Few countries have comprehensively addressed these issues (Song and Oosthuizen, 2014).

#### **IV. Approach towards Islamic Banking Regulation and Supervision**

The task for Islamic banking agencies to develop and enforce financial regulation and supervision is to adopt a framework that takes into consideration the distinctive characteristics of Islamic banking company. Though, without being a regulatory burden and restricting its ability for growth or providing arbitration possibilities between conventional and IFS.

Therefore, regulation is a wider contextualization by a regulatory regime for the following reasons:

i) prescriptive regulation is invariably not effective in reducing the probability of bank failure and the resultant costs; ii) regulation may be costly due to the direct costs and unwarranted distortions associated with the inaccurate risk weight applied in capital adequacy arrangements; iii) alternative routes to regulation may achieve the desired success at a lower cost; regulation may be inflexible and inadequately differentiated; iv) a monopolist dictator may be dangerous; v) and regulation may impair the effectiveness and efficiency of other mechanisms for achieving financial stability (Hassan and Chowdhury, 2004). This is vital to ensure the stability

of the overall financial system. However, the absence of statistical data makes it almost hard to compare IBs across nations, which complicates the job of supervisors in conjunction with the lack of prevalent reporting and accounting standards. IBs need a regulatory framework that encourages greater disclosure of information and strengthens the accounting standards. It is necessary that either the general banking laws or specific laws pertaining to IBs define in detail the nature of these banks and their specific operating relationship with the central bank and other conventional banks. Such legal framework should contain provisions relating to licensing, permissible mode of financing and the power to address compliance with laws and regulations clearly. Such provision should determine which enterprises might call themselves IBs, collect deposits and carry out banking practices based on Islamic principles. Moreover, the laws should state clearly that central bank (or supervisory authority) has the authority and all necessary powers to supervise IBs and conventional banks (Zulkihibri Abdul Majid and Ghazal, 2012). Errico and Farakhbah (1998) noted that to develop an appropriated regulatory framework, Islamic banking supervision should also be designed to ensure:

- i) legal foundations for the supervision of IBs are in place;
- ii) investment and other risks are dealt with adequately taking into account the financing;
- iii) through PLS adds additional risks and element of complexity; and
- iv) adequate information is disclosed to allow the supervisory authorities to exercise a more effective prudential supervision and to enable the public to make reasonably investment decisions.

On a comment similar to that, Karim (2001) argues that the structure and processes of IBs do not readily fit in with those of conventional universal banking which combines both commercial and investment business. This seems to have led to the implementation by regulatory boards of separate techniques for controlling Islamic banking. IBs experience enormous difficulties due to rivalry from conventional banks, the continued existence of complex financial instruments and the uncommon asset-liability framework. IBs are distinct from standard banks where IBs bear some extra hazards linked to asset ownership underlying certain Islamic methods of operation and activities. However, the study by Noraini (2005) on the perceptions of the nature of risks found that IBs are mostly exposed to similar types of risks to those in conventional banks, but there are differences in the level of the risks. Thus, for IB to operate in a system, which is designed for interest bearing instruments, brings many complexities.

The aspect of Islamic banking products and the related hazards such as risk management, corporate governance and transparency arose, where IBs operate alongside with conventional banks. Islamic economic intermediation is essentially different from the present practices of conventional financial institutions. El-Hawary, Grais and Iqbal, (2004) mentioned four aspects of differences. The first difference appears in the significant deviation of the structure of assets. On the asset side of the balance sheet, as expected, a clear

preference for asset-backed securities (based on trade finance) is evident. The second difference is the choice and application of accounting policies that affect the allocation of income between shareholders and account holders or between different classes of account holders. In its essence, IF would be consistent with clear barriers in the deployment of assets between those funded by demand deposits, general investment accounts, special investment accounts and equity. The third difference between practice and principles, related somewhat to the preceding issues, is the status of investment accounts and the fourth difference stems from the governance rights granted to investment account holders.

Overall, in most nations where IBs operate, the same regulatory structure refers to both conventional and IBs with some degree of variety. This regulatory structure tends to follow the Basel Committee on Banking Supervision standards and procedures. IBs and conventional banks with Islamic banking windows in Malaysia comply with prudential standards similar to those imposed on CBs. In a rapidly changing economic environment with different issues around the globe, IBs was taking shape in the early years. Most IBs need to resort to developing their own accounting methods for their new products, rendering institution-wide comparisons difficult and sometimes even providing the impression of lack of transparency. Whether they are a window, a subsidiary, a global organization or a full-fledged IB, depends on the jurisdiction in which IFs operate their current rates of transparency exercise. Banks ' increasing business orientation also required to tailored legislative and supervisory methods. Thus, as new and more complex instruments were marketed in distinct countries, the need for a collection of accounting standards specifically designed to reflect the specificities of Islamic products became even more urgent. With regard to the implementation of accounting standards for IBs, most IBs have currently followed their domicile laws such as International Accounting Standards (IAS).

However, there are three main areas of difference between financial accounting standards developed for IBs and CBs: i) the treatment of investment account; ii) the concept of substance over form; and iii) the time value of money (Ashruff, 2002).

AAOIFI have implemented in many nations requirements in the accounting system for IBs in regards to IAS. Accounting norms specifically intended for IBs will give better accounting processes compatible with Islamic economic goods. These norms will also ensure the accuracy and comparability of financial statements. In those fields where IF is still evolving, regulators and financial institutions should become acquainted with the AAOIFI standards and enforce them at the greatest possible level. Enactment of tested accounting and auditing schemes could alleviate the burden on executives facing the new challenges presented by Islamic banking. Moreover, promoting global stability would not only ease the task of supervising globally committed organizations, but would eventually favour controlled organizations as Islamic activities would become better recognized and therefore more attractive to Muslim and non-Muslim shareholders worldwide. It would also encourage the



integration of Islamic institutions into global financial society. However, the current AAOIFI standards and the principle of regulatory transparency do not include quantitative risk measures such as the value at risk and the likelihood of error.

As stated above, the fact that supervisory bodies in distinct nations tend to rely on their own *Shari'ah* experts may lead to contradictory allegations about the acceptability of a specific instrument. Therefore, economic products that are allowable in some nations in others could be regarded non-Islamic. Such disparity could discourage the cross-border use of Islamic products and limit the future development of this industry. It may also contribute to damaging arbitration of the law. Indeed, the Islamic Financial Services Board (IFSB), which operates as an international standard for legislative and regulatory organisations, conducts the task of formulating a framework targeting the distinctive risks associated with Islamic banking. To present, the IFSB has published ten prudential standards on risk management, capital adequacy, corporate governance, disclosure to promote transparency and market discipline, corporate behaviour, *Shari'ah* governance, supervisory evaluation process, leadership of *Takaful* and collective investment schemes, and capital adequacy for *Sukuk*, securitisation, and real estate.

For managers in nations where IB and CB operate hand-in-hand, the implementation of the Basel II provision was very challenging. In 2005, IFSB adopted to a big extent a complex Basel II capital adequacy standard and streamlined it to an understandable and plausible *Shar'iah*-based norm with minor methodological variations. IFSB shifted away from the structured and systematic approach to capital adequacy of Basel II rather than starting with a standard strategy to credit risk management and followed by an indicator strategy for operational risk management. Implementing the revised IFSB norm is not without barriers, while most of the problems are due to poor legal framework and inadequate skills.

Basel II requires IBs to meet legal and regulatory standards as specified in Basel II. Some opine that IBs should not be subject to all regulatory measures specified by Basel II, but they should be subject to regulations similar to corporations due to the participation of the investments depositors in the risk of IBs (Hassan and Chowdhury, 2004). IBs have several grounds for adhering to Basel II guidelines. IBs are at an early stage of growth and tend to be small to medium in size. Adherence to Basel II becomes a cornerstone of worldwide recognition. In addition, the legislative structure will standardize IBs as quickly as suggestions from AAOIFI and IFSB can be introduced to Basel II. The new legislative structure of Basel is intended to establish greater market discipline, which is crucial for stabilizing the international financial system. This is also crucial for domain levelling purposes. There is no theoretically optimal system or norm for controlling and monitoring the structure and process of IFIs, considering new techniques and mechanisms for ongoing IFI supervision to be better ready to satisfy numerous newly created challenges presented by financial innovation and globalization. Most IB monitoring is currently focused on the Capital-Asset-Management-Earnings-Liquidity-Sensitivity (CAMELS)

standard set by the Basel Committee to judge and evaluate the tasks and effectiveness of IBs and IFIs. However, the rating system cannot qualify as an effective and appropriate scheme to analyse the right effectiveness of the Islamic banking system, as there is no single component in it to assess the effectiveness of the *Shari'ah* activities of a bank in an Islamic framework. From a secular perspective, if evaluated through the CAMELS rating system, an IB's safety would be visualized, but its compliance with *Shari'ah* would not be defined. Moreover, if it is to be the concept and spirit of *Shari'ah*, the present CAMELS rating framework may not include all characteristics of Islamic banking. Although not all CAMELS features are disgusting or conflicting to the *Shari'ah* perspective, there should be some separate rules in place to make it favourable and suitable for evaluating the full IB operation. After all, in its overall operations, the present evaluation technique is not adequate to evaluate an IB as to how far it is Islamic. In many fields they function, central banks are the main regulators and managers of IBs. Almost all of these central banks, except very few, are focused on CBs' business structure (borrowing and lending) regulatory strategies and instruments.

Banking supervision, based on the ongoing analytical review of banks, serves the public good as one of the key factors in maintaining stability and confidence in the financial system. It discusses the relationship between banking risk analysis and the supervisory process. The methodology for a supervisory review of banks should be similar to that used by private sector analysts, external auditors, or a bank's own risk managers, except that the focus of the analysis differs somewhat.

Bank supervision is an integral part of a much broader and continuous process. It normally includes off-site surveillance and on-site examinations. This process includes the establishment of a legal framework for the banking sector, the designation of regulatory and supervisory authorities, the definition of licensing conditions and criteria, and the enactment of regulations limiting the level of risk that banks are allowed to take. Other necessary steps include establishment of a framework for prudential reporting and off-site surveillance and execution of these activities, followed by on-site supervision.

The results of on-site examinations provide inputs for the institutional development of banks and for the improvement of the regulatory and supervisory environment.

In addition to effective supervision, other factors necessary for the stability of banking systems, financial systems, and markets include sound and sustainable macroeconomic policies, a well-developed financial sector infrastructure, effective market discipline, and an adequate banking sector safety net (Van Greuning and Iqbal, 2008).

## **V. Concluding Remarks and Recommendations**

The fast growth of IF provides significant range and selection of Islamic financial instruments to give IF a pluralistic flavour, not only for Muslims but also for non-Muslims. Nevertheless, the lack of truly worldwide

IFS based on *Shari'ah* implies that Islamic banking and finance's ongoing growth and development is somewhat haphazard. Islamic financial markets stay segmented after more than 40 years on the ground and vary significantly across countries. The outcome has been a divergent interpretation of *Shari'ah*, different domestic legal systems, different regulatory approaches and the use of different financial instruments. Despite the abolition of legal barriers, it does not seem to have attracted attention from legislative authorities in most nations so far. The assessment demonstrates that the regulations concerning financial institutions in these nations are framed in the portrait of conventional banking before IF is initiated. The other part of IB related legislation is that most legislation does not indicate a reference point for such enforceability in controversial problems. For example, with the exception of a few, many nations are regulated by common law. This brings companies at a disadvantage using both Islamic banking methods and IBs. In Islamic banking and finance, the incorporation of these two traditions is essential. This harmonization contributes valuably to the development of Islamic banking. *Shari'ah* compliance is also of great importance to IBs. The reason IBs exist is to give products that comply with *Shari'ah*. While each of the products should respect *Shari'ah*, the bank as a whole should also conform. The fact that IB clients demand adherence with *Shari'ah* should be expanded to monitor adherence with *Shari'ah*.

Indeed, standardized fatwas and centralized *Shari'ah* boards assist streamlined IB activities and boost public trust. The governance of *Shari'ah* brings extra principles to IFIs' current corporate management structure. The replication and conversion of conventional financial products into their respective IF analogue has significant consequences for IFI regulation and oversight. The analysis proposes that IFIs should concentrate on seven main objectives in order to address these gaps, enhance, and implement best methods:

- i) Developing the suitable IB and IFI legal framework;
- ii) In order to comply with the *Shari'ah* values, reviewing the current legislation and ongoing revision of appropriate legislation is recommended;
- iii) Establishing an efficient, reliable and effective legislative framework;
- iv) Implementation of the legal and regulatory standards of AAOFI, IFSB and Basel II;
- v) Managing and tracking IF's risk-return framework;
- vi) Centralization of the *Shari'ah* board, supervisor and verdicts;
- vii) Ensuring tax neutrality and exemptions for *Shari'ah* operations;
- viii) Establishing *Shari'ah* compliance audit structure and audit program.

Islamic banking's fast growth adds significant range and selection for Muslims as well as non-Muslims who want to participate in financial operations. Indeed, the lack of a truly worldwide *Shari'ah*-based IFS, as well as the distinct methods Islamic banking operates in distinct countries, has resulted to somewhat haphazard growth and development of Islamic banking and finance. The Islamic banking industry should concentrate on six main

objectives in terms of policy reaction to enhance and implement best practices for the industry to add to mutual growth.

1. The Twenty Joint IMF-World Bank Group on IF integration with global financial structures could function as a useful road map as mentioned earlier. Shift towards banking and procedures based on *Shari'ah*. Islamic banking based on *Shari'ah* compliance currently serves primarily established corporate entities and individuals of relatively high net worth.

To support *Shari'ah*-based finance systems, the working system of IFs requirements to be reviewed. This will guarantee that more funding is accessible using risk-sharing tools for micro, small and medium-sized businesses.

2. Harmonize the *Shari'ah* standards. Initiatives must be produced to create worldwide *Shari'ah* reference bodies that can help harmonize cross-country fatwa related IF and help speed up the industry's development. The first stage towards higher harmonization of the Islamic banking system may be to facilitate national harmonization. Scholars' straightforward and coherent rulings on *Shari'ah* issues would be appropriate so that no ambiguity persists.

3. Creating an appropriate legislative atmosphere. Provided the changing global financial landscape, key legislative challenges include maintaining a level playing field for both conventional and IBs by means of coherent legislation, maintaining continuous execution of the Basel III regime, ensuring that systemic risks are resolved in dual banking schemes, and enforcing cross-border oversight.

4. Improve the IF scale and access. In order for Islamic banking to live up to the promise of reasonable growth, it is essential that the scale, access and outreach of Islamic banking be increased to include low-income earners. Improving risk leadership methods are needed; reducing expenses; making greatest use of accessible technology; and using a variety of platforms to offer financial services, such as branchless banks, e-money, and portable banking.

5. Improve liquidity and maintain consistency. In order to develop new tools through research and innovation, the issue of liquidity leadership must be addressed. Developing a reliable liquidity leadership structure will assist speed up the industry's development. Sustainable growth and stabilization in IBs involve an extensive risk management structure that is tailored to their particular position and specifications.

6. Enhance the literacy of human capital and IF. The industry's human resources could be reinforced by establishing reliable IF expertise platforms through regular training, seminars, and workshops, as well as developing specific border expertise in IF for the industry, with industry and academia assistance. There is a need to increase confidence and trust in using Islamic financial facilities. By encouraging Islamic financial literacy including understanding of which economic goods are best suited for specific reasons, public awareness can be improved.

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