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A Comparative Analysis of Regulatory and Supervisory Islamic Banking: Evidence from Pakistan, Malaysia, Bahrain, and the UK

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Abstract

This study critically analyzes the regulatory and supervisory frameworks that govern Islamic banks in the dual banking systems of Pakistan, Malaysia, Bahrain, and the UK. We discuss their core regulatory functions and find that conflicting views among Islamic jurists and policymakers have aggravated sharia-related problems. Over the years, the regulatory framework in each country has developed in a certain way. Malaysia and Bahrain have established indigenous governance systems. Islamic banks in the UK still fall under the conventional setup, while in Pakistan, they are governed by an orthodox regulatory framework combined with an evolving Islamic banking regulatory system. However, the effectiveness of the existing regulatory frameworks has never been fully tested by the nascent Islamic banking industry, which remains very conservative.

Keywords: Islamic finance, capital requirements, disclosures.

JEL classification: G20, G21.

1. Introduction

Over the past several decades, the growth of Islamic banking and finance (IBF) and its socially responsible principles have attracted attention the world over. The concept of IBF, which was introduced in the mid-1960s, now has a global presence. Despite its tremendous growth both in Muslim as well as non-Muslim countries, IBF faces a number of barriers in fitting in with the regulatory, legal, and economic frameworks of these countries. IBF is practiced in different countries under different Islamic schools of thought and laws, which means that the regulatory and supervisory frameworks vary considerably between countries. This variability has affected the reliability, growth, and worldwide applicability of IBF as an alternative to conventional banking.

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This study critically evaluates the IBF regulatory and supervisory structures of four countries: Pakistan, Malaysia, Bahrain, and the UK. Barring the UK, all these countries have a Muslim-majority population, but IBF is practiced differently in each case and under different regulatory and supervisory frameworks. In this context, we look at issues such as capital requirements, risk management, information disclosure, the role of sharia supervisory boards (SSBs), and legal frameworks for IBF. We then examine its compatibility with global regulatory standards such as the Basel accords and the regulations set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB).

2. Methodology

This is an exploratory case study of the selected countries, and relies primarily on secondary data and analytical tools such as Thomas One Banker, DataStream, and Bloomberg for its content analysis. We adopt this methodology, given the complex nature of the research: IBF regulatory and supervisory systems are multidimensional and subject to geographic variability. Moreover, the basic elements of a regulatory system – capital requirements, risk management frameworks, and the role of SSBs – are almost impossible to quantify and analyze in isolation because of their interdependence. Finally, every country has unique cultural, socioeconomic, and religious values that govern how they operate.

The case study approach is particularly suited to research such as this, which requires a detailed understanding of social and organizational processes, given the rich data collected (Cassell & Symon, 2004). Unlike historical viewpoints, there is growing confidence in the case study method as a rigorous research strategy in its own right (Yin, 1994; Cassell & Symon, 2004).

3. Literature Review

This section examines the literature on IBF regulation and the problems of developing a globally accepted regulatory and supervisory framework.

3.1. The Fundamentals of IBF

The key aim of an IBF system is to comply with the guiding principles of the Quran rather than to maximize returns as in a conventional financial system (Zaher & Hassan, 2001). Ayub (2007)

explains that Islamic common law is derived from (i) the Quran, (ii) the *sunnah* (the practical example set by the Prophet) and *hadith* (the Prophet's sayings), and (iii) other sources of sharia, including *ijma* and *qiyas*.[1] Sharia does not allow financial transactions that involve *riba* (interest), *gharar* (risk/uncertainty), or *maisir* (games of chance). On this, there is unanimity among the different schools of thought in Islam (Khan, 2010).

3.2. Prohibition of Riba

The Quran clearly prohibits *riba*. Surah al-Rum (30: 39) states: "That which you give as *riba* to increase the people's wealth increases not with God, but that which you give in charity, seeking the goodwill of God, multiplies manifold." Similarly, Surah al-Nisa (4: 161) says: "That they took usury, though they were forbidden, and that they devoured men's substance wrongfully; we have prepared for those among them who reject faith a grievous punishment."

Surah al-Imran (3: 130) orders Muslims to refrain from interest for their own good: "O ye who believe! Devour not usury, doubled and multiplied, but fear Allah that ye may (really) prosper." Finally, Surah al-Baqarah (275–281) clarifies the difference between trade and interest in great detail.

3.3. Avoidance of Gharar

Gharar refers to excessive uncertainty in contracts, where details concerning the sale item are unknown or ambiguous, or there is a lack of information or control (Ayub, 2007). The *hadith* of the Prophet (PBUH) refer to the prohibition or avoidance of *gharar* in several instances. Ahmad and Ibn Majah, citing Abu Said Al Khudriy, say that, "The Prophet (PBUH) has forbidden the purchase of the unborn animal in its mother's womb, the sale of milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver."

3.4. Prohibition of Maisir

Maisir refers to the easy acquisition of wealth, whether or not it deprives someone else (Diwany, 2010). The Quran uses the term to prohibit gambling:

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[1] *Ijma* refers to the deliberations by which Islamic scholars resolve emerging problems. *Qiyas* is the exercise of finding a solution through analogies in the light of the Quran and *sunnah*.

> O ye who believe! Intoxicants and gambling, sacrificing to stones, and divination by arrows, are an abominable action of Satan's handiwork, so abstain from them that you may prosper (5: 91).
>
> Satan intends to excite enmity and hatred among you with intoxicants and gambling, and hinder you from the remembrance of Allah, and from prayer; will ye not abstain? (5: 91)
>
> They ask thee concerning wine and gambling. Say: 'In them is great sin and some benefit for people, but the sin is greater than the benefit (4: 219).

3.5. Growth and Evolution of IBF

IBF started in the mid-1960s in the Middle East, but is now practiced in all major financial cities of the world. Karbhari, Naser and Shahin (2004) point out that IBF is one of the fastest growing phenomena of the last few decades. According to BMB Islamic (2010), the size of the global IBF industry is around US$ 1 trillion, with an annual growth rate of 15 percent. Indeed, IBF has the ability to capture 40 percent of the total savings of Muslim countries (Zaher & Hassan, 2001). Sundararajan and Errico (2002) argue that, in order to capture the growing IBF market, many Western conventional banks (such as HSBC, BNP Paribas, and Citigroup) have entered IBF either directly or through window operations. Thus, in the last 15 years, IBF has transformed from a niche market that existed in only a few Muslim countries to an alternative financial system (Siddiqi, 2008; Ayub, 2007; Chapra, 1996).

Different studies have analyzed the performance and development of Islamic banks. Laldin (2008) chronologically documents the Malaysian IBF market and its development from inception. In another study, Lodhi and Kalim (2005) explore the strategic policy orientation needed to promote IBF in Pakistan. Similarly, Anwar (1992) has conducted a survey of the IBF experience in Iran and Pakistan. Samad (2004) studies the Bahraini banking system during 1991–2001 and finds that both Islamic and conventional banks performed well in terms of profitability and liquidity, although Islamic banks were less exposed to credit risk.

Dewi, Sulaiman, and Ferdian (2010) investigate the efficiency of 25 Islamic banks in 14 countries for the period 2002–06, and find that Islamic

banks in the OIC least developed countries were more efficient. Khan and Bhatti (2008) explore the unprecedented growth and development of IBF in the contemporary world. A report by Verity (2002) highlights the active role of the UK government and concerned authorities to develop an Islamic mortgage market in the UK. Similarly, Ainley et al. (2007) provide a comprehensive overview of IBF and the UK government's attempts to resolve regulatory and tax issues. Today, IBF attracts both Muslim and non-Muslim market participants across the globe and is a focal point of economic policy, even in the most advanced conventional banking sectors (Monger & Rawashdeh, 2008).

3.6. Need for IBF Regulation

The recent global financial crisis underscores the fundamental problems of conventional financial systems, and the inefficiencies and failure of regulatory and supervisory frameworks (see, for example, Goodhart & Lastra, 2010; Financial Services Authority, 2009; European Commission, 2009). Although IBF provides safeguards against such problems as excessive leverage, risk, and uncertainty, IBF institutions must take care not to repeat the mistakes associated with conventional financial systems by ignoring the basic principles of IBF (Dusuki, 2008). Islamic banks proved to be more resilient in a financial crisis and some studies argue that, had the principles of IBF been adopted, the crisis could even have been prevented (Ahmed, 2009; Hassan & Kayed, 2009).

The financial crisis has also increased the need to overcome the institutional and systemic irregularities inherent in IBF regulatory structures if it is to grow in a sustained manner (Smolo & Mirakhor, 2010). Ramady (2009) analyzes the role of the Saudi Arabian Monetary Agency's regulatory policies and concludes that these comply with international financial regulations, but face challenges in the context of IBF regulation and supervision. Post-crisis, IBF institutions urgently need to develop and implement a comprehensive, uniform, and globally accepted regulatory and supervisory framework (Mirakhor & Krichene, 2009).

3.7. Regulatory and Supervisory Issues

Over the last ten years, IBF has raised a number of key issues for policymakers and regulators. Initially, Islamic banks were regulated by conventional regulatory frameworks (Joyosumarto, 1995), with slight modifications in terminology. Profit-sharing IBF institutions are still regulated and supervised by the prudential regulations adopted for

conventional banks. These issues persist even today and, as Solé (2007) argues, the introduction of IBF into conventional systems has made it difficult for supervisory authorities, most of which are unfamiliar with the supervision of Islamic banks. The study also highlights the main phases of supervision and the challenges faced by countries that operate a dual financial system.

In practice, Islamic banks differ from their counterparts in terms of institutional aspects and structural requirements (Iqbal, Ahmad, & Khan, 1998). Differences in the theory and practice of IBF across countries is one of the major obstacles in applying a uniform regulatory framework, besides other controversial issues such as interbank markets, *sukuk*, contracts such as *tawarque*, and *fiqh* differences (Siddiqi, 2006).

Karim (2001) emphasizes the need for IBF accounting standards to be harmonized with AAOIFI principles, also arguing that regulators should enforce firewalls between the commercial and investment banking services offered by Islamic banks. El-Hawary, Grais, and Iqbal (2007) note that various IBF institutions have been established – notably the AAOIFI, Islamic International Rating Agency, IFSB, and Liquidity Management Centre – but their role remains limited due to the divergence of theory and practice in IBF, the lack of risk management tools, idiosyncratic business conduct shaped by SSBs, and differing legal traditions and interpretations of sharia.

3.8. Regulatory Capital Requirement

It is widely debated whether Islamic and conventional banking are the same. Chong and Liu (2009) study the Malaysian banking system and argue that, in practice, Islamic banks are not interest-free or profit-loss sharing (PLS) because basic PLS contracts such as *modaraba* and *mosharka* involve a 0.5 percent return on assets and a 70 percent return on liabilities, while other contracts are closely pegged to conventional banking. This would imply that Islamic banks should be regulated by the same capital requirements as conventional banks. Other studies conducted by Errico and Farahbaksh (1998), Chapra and Khan (2000), and Noibi (2004) argue that the regulatory capital requirements for conventional banks are based on their balance sheets and debt-based operations, which are different from the profit-sharing operations and risk profile of Islamic banks.

A number of studies analyze the characteristics of profit-sharing investment accounts (PSIAs) and their implications for capital adequacy and corporate governance (see Al-Deehani, Karim, & Murinde, 1999;

Archer, Karim, & Al-Deehani, 1998; Archer & Karim, 2006). PSIAs present a number of problems for regulators, especially in Western regulatory jurisdictions where customer accounts are "capital-certain" and equity-type investments lack governance rights. Archer and Karim (2009) observe that such problems could be resolved by distinguishing structurally between Islamic banks in the narrow sense on one hand and the entity that manages PSIAs on the other.

Errico and Farahbaksh (1998) note that the "number of standards and best practices established by the Basel Committee on Banking Supervision… are not always applicable [as they stand] to Islamic banking. An appropriate regulatory framework governing Islamic banks needs to place greater emphasis on the management of operational risks and information disclosure than is normally the case in conventional banking." The first comprehensive study on the need to regulate Islamic banks was carried out by Chapra and Khan (2000), who discuss the regulatory and supervisory challenges of calculating the capital requirement and risk associated with IBF. Similarly, Noibi (2004) discusses the applicability of the Basel regulatory framework to IBF operations, concluding that the two are not compatible.

Serious efforts have been made by AAOIFI (1999) and the IFSB (2005a, 2005b) to address the issues of regulatory capital requirement and the unique risk profile of Islamic banks. However, these standards are still at an evolutionary stage as Muljawan, Dar, and Hall (2004) point out in their evaluation of the capital adequacy framework defined by AAOIFI for IBF institutions. Their study also raises key issues concerning the established standards and they propose a new framework based on this criticism.

Ariss and Sarieddine (2007) study the implications of Pillar 1 of the Basel II accord for Islamic banks following the IFSB and AAOIFI guidelines; they recommend developing a capital adequacy framework that better accounts for Islamic banks' activities. Archer, Karim, and Sundararajan (2010) establish a quantitative analytical framework for the exercise of supervisory discretion over the alpha term to assess the adequacy of Islamic banks' capital. The capital adequacy ratio (CAR) is highly sensitive to the value of alpha: if calculated reasonably carefully, it yields an adequate measure of Islamic banks' capital requirement. Hersh (2011) describes the regulatory framework adopted in Bahrain and emphasizes the role of the IFSB in filling the regulatory gaps between Islamic and conventional banking.

3.9. Information Disclosure and Risk Management

In the context of IBF, the main objective of corporate reporting is to enable IBF institutions to indicate their compliance with sharia (Baydoun & Willett, 1997, p. 6), given that PLS modes of financing raise several considerations for regulators, specifically when different risks are directly transferred to investment account holders. Thus, a clear information disclosure system in Islamic banks is more important than in conventional banks (Jabbar, 2010).

Makiyan (2008) argues that Islamic banks are exposed to unique risks inherent in PLS operations and, therefore, need greater information disclosure to keep regulators and investors up to date and to monitor banks' performance. Ariffin, Archer, and Karim (2009a) investigate the level of transparency in 28 Islamic banks in 14 countries, and find that Islamic banks still lack information disclosure on issues of risk management, investments, and corporate governance. This has theoretical and policy implications for the issue of transparency, with particular reference to risk reporting in Islamic banks.

Ariffin, Archer, and Karim (2009b) study the risk perception of Islamic bankers in terms of risk significance, measurement, and management techniques. The results obtained indicate that Islamic banks are exposed to similar risks as their counterparts, but the level of risk differs across products and contracts. To harmonize risk identification and management, the IFSB (2005b) outlines a set of best principles for establishing and implementing risk management in IBF institutions. The report identifies six risk categories: credit risk, equity investment risk, market risk, liquidity risk, rate-of-return risk, and operational risk. These guidelines help standardize risk exposure in IBF. Similarly, the IFSB (2007) has also issued standards for disclosures to promote transparency and market discipline for IBF institutions.

Maali, Casson, and Napier (2006) develop a set of benchmarks for social disclosure based on the importance given to social responsibility and accountability under Islamic principles. These are compared with the social disclosure standards given in the annual reports of 29 Islamic banks around the world, using a disclosure index. The results reveal that information disclosure falls below expectation in Islamic banks. Similarly, Besar, Sukor, Muthalib, and Gunawa (2009) critically evaluate the role, responsibilities, and sharia review reports issued by the SSB in Malaysia – under the guidelines set by AAIOIFI and Bank Negara Malaysia (BNM) –

to evaluate Islamic banks in the country. The results show that these banks meet only the minimum requirement set by BNM.

3.10. Role of SSBs

SSBs monitor the compliance of IBF activities with sharia laws. As the industry develops increasingly sophisticated contracts and instruments, the challenge for Islamic scholars is to ensure that these comply with the sharia (de Sa'Pinto, 2009). In this context, Dar (2011a) explains that the sharia audit function is even more important for conventional institutions offering Islamic financial services. Dar (2011b) examines the role of classical sharia scholars and their influence in different regions, showing that there is no widespread consensus on such issues.

Growth and innovation have also increased compliance issues for Islamic banks. Jabbar (2010), for instance, establishes that financial crimes such as insider dealing, market abuse, fraud, and money laundering are prohibited in Islam, which makes SSBs responsible for overseeing these issues. At the moment, however, most SSBs have neither the capacity nor the time and resources to fulfill these basic duties.

Farook and Farooq (2011) raise different sharia-related issues such as the concentration of sharia scholars, multiple board representation, knowledge and due diligence, and the selection criteria for shareholders of IBF institutions. They also recommend solutions to organize and develop sharia scholars to increase the legitimacy of the IBF industry. Zaidi (2008) argues that, while there are different schools of thoughts on specific issues, there should at least be consensus on major issues. Thus, the matter of sharia harmonization must be left to scholars specialized in their field. He also suggests that the process of harmonization requires collaboration among sharia scholars, market leaders, and regulators, which can be achieved by the apex sharia body.

3.11. Legal Issues

The rising market share of Islamic banks means that the importance of (and need for) Islamic law has also grown. There is growing concern as to whether the existing laws in countries where Islamic banks operate fully accommodate IBF transactions (Hesse, Jobst, & Solé, 2008). Some researchers contend that, in most jurisdictions, the conventional law is flexible enough to accommodate the agreed terms and conditions of contracting parties (DeLorenzo & McMillen, 2007), but in practice, this can

be very difficult. In Saudi Arabia, for instance, where the legal system is based on strict sharia principles, defaulters of IBF institutions have caused problems given the dual Saudi legal system (Marar, 2004). In the UK, Ercanbrack (2011) points out that British courts may be unwilling to comply with sharia rules.

Dispute resolution is also a key concern for Islamic banks, which, Oseni (2009) argues, cannot be handled by conventional legal systems. He analyzes different case studies and concludes that a separate legal framework should be established for IBF.

3.12. Liquidity Management and Consumer Safety Nets

The infrastructure of a financial system – elements such as an inter-bank money market and deposit issuance – are essential for Islamic banks to carry out their daily operations and ensure consumer safety. Despite being the cornerstone of an efficient banking system, these elements remain underdeveloped, with considerable disagreement across countries as to how they should be adopted (Solé, 2007).

Malaysia and Bahrain have tried to develop an IBF liquidity management system. Bacha (2008) describes BNM's initiative in establishing the Islamic Interbank Money Market and examines the issues and challenges it faces operating in a dual banking system. Turkey was the first country to establish sharia-compliant deposit insurance in 2003, whereby all Islamic banks were allowed to create an Islamic deposit *takaful* (International Association of Deposit Insurers, 2006). This was followed by Malaysia, which passed the Malaysia Deposit Insurance Corporation Act in August 2005.

4. Comparative Analysis

Table 1 provides a comparative analysis of different regulatory and supervisory aspects of IBF in the four countries under study.

Scope of Regulatory Authorities

Of the four countries under study, the UK and Bahrain have single regulatory systems for the entire financial sector. In Malaysia and Pakistan, the financial sector is regulated by different regulatory bodies. The UK is the only country whose financial regulatory body is separate from its central bank, which also looks after the economic affairs of the country.

Historical Development of Regulatory System

The regulatory systems of these countries are mostly evolutionary and planned, except for Pakistan, which is constitutionally bound to bring all financial affairs under the sharia. Malaysia has enacted a separate law to operationalize Islamic banks, while the other countries have amended existing laws to do so, their regulatory systems having transformed or now transforming toward principle-based regulation. The UK has a completely principle-based system while Pakistan's is still predominantly rule-based.

Separate Regulatory Setup for Islamic Banks

All these countries have developed or are developing separate regulatory/supervisory setups for IBF, except the UK where Islamic banks are governed entirely by the conventional setup.

Accountability Funding and Governance of Concerned Authorities

In each case, the country's regulatory body is accountable to the government via its board, whose members and top management are mostly appointed by the head of state (except in the UK, where this function is performed by Her Majesty's Treasury). Moreover, all regulatory bodies are government-funded, except in the UK, which has its own revenue sources from the regulated firms.

Consumer Protection

Except in Pakistan, the other three countries have consumer safety programs in place for IBF. However, their validity under sharia principles is still under debate among various Islamic jurists. Malaysia has completely separated its IBF deposit insurance schemes from those of conventional banks.

Table 1: Comparative analysis of IBF across countries

IBF characteristic	Pakistan	Malaysia	Bahrain	UK
Development of IBF and its regulatory system	Initially revolutionary but failed. Now evolutionary.	Evolutionary	Evolutionary	Evolutionary
Scope of regulatory authorities	Multiple regulators	Multiple regulators	Single regulator	Single regulator
Regulatory framework	Mixed regulatory setup	Separate regulatory setup	Separate regulatory setup	Regulated by conventional setup
Accountability and funding of regulatory authorities	Accountable to parliament through finance ministry. Government funded.	Accountable to parliament through finance ministry. Government funded.	Accountable to parliament through finance ministry. Government funded.	Accountable to parliament through treasury. Self-funded.
Licensing and authorization	Under SBP	Under BNM	Under CBB	Under FSA
Consumer protection	Not available	Available	Available	Available but not dedicated for IBF
Supervisory system	CAMEL/CAEL with onsite and offsite supervision	Risk-based supervisory framework	Onsite supervision and offsite surveillance	ARROW framework with onsite supervision and offsite surveillance
Capital adequacy standards	In process, but currently under conventional setup	Yes. Compatible with IFSB and Basel.	Yes. Compatible with IFSB and Basel.	Conventional framework
Risk management standards	Yes. Compatible with IFSB.	No specific risk management standards	Yes. Compatible with IFSB.	Conventional framework
Information disclosure standards	Yes, but very general compared to IFSB.	Yes	Yes	Conventional framework
Corporate governance standards	Conventional framework	Yes	Yes	Conventional framework
Dedicated accounting standards	SECP accounting standards. Not fully developed but follows AAOIFI.	Yes, but follows MASB accounting standards	Follows AAOIFI	Follows IAS/IFRS
Role of sharia board	Appellate SSB at SBP. SSB also at bank level.	Appellate SAC at BNM. SSB at bank level.	SSB only at bank level. Follows AAOIFI standards.	SSB only at bank level, with no link to FSA.
Institutional harmonization	Low	High	Medium	Low

Licensing and Authorization

The licensing and authorization of Islamic banks in all countries fall under the jurisdiction of the regulatory authority and central bank.

Supervision

All four countries have different supervisory frameworks and offsite surveillance systems. However, the nature and frequency of onsite supervision is often subject to an institution's ranking, financial conditions, risk profile, and conduct of business.

Regulatory Capital

All four countries comply with the Basel capital requirements, but there is considerable divergence in the guidelines followed by Islamic banks (Table 2). Malaysia and Bahrain have enacted separate guidelines for Islamic banks to calculate their regulatory capital under the IFSB's guiding principles. The UK and Pakistan have adopted conventional frameworks for capital calculation for IBF, but the latter is also developing a separate framework.

Table 2: Capital requirement standards

Characteristic	Pakistan	Malaysia	Bahrain	UK
Follows Basel capital standards	Yes	Yes	Yes	Yes
Dedicated standards set by regulator	No	Yes	Yes	No
Compliance with IFSB guidelines	No	Yes	Yes	No
Uniform capital standards across countries*	No	No	No	No

Note: * Every country has separate guidelines.

Risk Management Framework

Barring the UK, every country has a risk management framework for IBF tailored to the guiding principles of the IFSB. These diverge, however, on the specific types of risk, and each country has set its own guidelines according to the type and nature of risks associated with its financial industry (Table 3). The effectiveness of these guidelines in critical situations is also a major concern among industry practitioners.

Table 3: Risk management framework

Characteristic	Pakistan	Malaysia	Bahrain	UK
Dedicated presence of risk management framework	Yes	No	Yes	No*
Compliance with IFSB	Yes	Yes	Yes	No
Scope of risk management framework	Principles cover six type of risk	Broad principles adopted	Only credit, market and operational	Completely adopted Basel framework

Note: * The UK follows the Basel framework based on the ARROW approach.

Role of SSB

While the role of the SSB is central to IBF, there is no consensus on this across the selected countries. On one hand, Malaysia has established a comprehensive framework for sharia compliance and application with very little chance of misunderstanding at the operational level. On the other, regulators in the UK do not deal with sharia compliance, which is left to the IBF institutions concerned to select a suitable framework subject to proper disclosure to their stakeholders.

In between are Pakistan and Bahrain, which have well-structured sharia compliance systems. Pakistan's is similar to that of Malaysia, with the main SSB established at the central bank level, but it has limited powers compared to Malaysia's SAC; there are also boards at the institutional level (Table 4). In Bahrain, sharia boards exist only at the institutional level and there is no central body.

Table 4: Role of SSBs

Characteristic	Pakistan	Malaysia	Bahrain	UK
Presence of SSB at main regulatory level	Yes	Yes	No	No
Complete authority over all sharia issues in the country	No	Yes	No	No
Presence of SSB/committee at IBF level	Yes	Yes	Yes	Yes
Separate guidelines for sharia compliance	Yes	Yes	No	No
Compliance with AAOIFI sharia standards	Yes	No	Yes	No

Note: In Malaysia, the SAC has complete authority over all sharia issues. In the UK, the presence of SSBs at the IBF level is optional. Bahrain follows AAOIFI sharia standards.

Corporate Governance

Bahrain and Malaysia have tailored corporate governance frameworks under the guiding principles of the IFSB and keeping in view local contexts. In the UK and Pakistan, Islamic banks follow the same corporate governance standards as the conventional industry.

Accounting Standards

AAOIFI was established with the objective of setting accounting standards for Islamic banks. At the moment, Bahrain is the only country to have completely adopted the AAOIFI standards, while Malaysia and Pakistan use these indirectly. The UK, however, has completely different accounting standards under the IAS/IFRS (Table 5).

Table 5: Accounting standards

Characteristic	Pakistan	Malaysia	Bahrain	UK
Dedicated accounting standards	Yes*	Yes	Yes	No
Compliance with AAOIFI standards	Yes	No	Yes	No

Note: * Partially developed.

Information Disclosure

Although regulations and guidelines for information disclosure exist in all four countries, their effectiveness is questionable. The UK has well-established disclosure standards and practices, but these apply to conventional banks. Pakistan has only basic disclosure standards (Table 6).

Table 6: Information disclosure

Characteristic	Pakistan	Malaysia	Bahrain	UK
Dedicated guidelines for information disclosure	Yes	Yes	Yes	No
Compliance with IFSB	No	Yes	Yes	No

Institutional Harmonization

Institutional harmonization is pivotal to the success of IBF. Only Malaysia has a well-developed institutional framework in which each institution (the judiciary, money market, etc.) is organized under a planned government strategy. The other countries have

underdeveloped and conflicting institutional structures, which can cause problems in IBF operations.

Role of International Standard-Setting Organizations

The role of international standard-setting bodies such as AAOIFI and the IFSB is generally acknowledged at the policy level, but remains limited to the region in which they are based at the operational level.

5. Conclusion

The constant support for the development of IBF from regulators and governments is predominantly for economic rather than religious reasons (except in Pakistan where revolutionary actions in this context have been taken but have failed). Historically, Islamic banks operated under the conventional setup, but with the expansion of the IBF industry, countries have adopted separate regulatory structures based on their institutional setup and market dynamics. This segregation of regulatory frameworks establishes the need for separate governance structures, given that the socially responsible objectives and operational efficiency of IBF cannot be achieved under conventional setups.

At present, the global harmonization of prudential standards and guiding principles is not a primary concern among regulators, which has resulted in the development of indigenous regulatory setups. Among these, the most prominent are SSBs. Despite their pivotal role, there is no consensus among different countries on this issue, given divergent institutional frameworks and sectarian thought. The regulatory frameworks that exist for capital requirements, corporate governance, risk management, and financial reporting generally comply with international standards, but how effective they are will emerge only when IBF institutions begin to operate widespread financial activities at a global level.

The guiding principles for regulatory functions tend to overlap with each other. This makes application more difficult and is a cause for concern. A significant development in IBF regulation is its tendency toward principle-based regulation, which involves greater responsibilities at the operational level and is needed in Islamic banks.

Islamic banks in the UK still fall under the conventional setup, given that the country is secular and has a smaller IBF market compared to its conventional counterparts. Malaysia is in the forefront among the four countries, with completely harmonized and developed regulatory systems

for Islamic banks. The success of IBF and its rising market share may have increased its viability in a financial system, but it is not in a position to provide a full-fledged alternative system in any country at present. Over time, the introduction of new products and means will enable Islamic and conventional banks to better collaborate within a dual banking system.

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