INTERNATIONAL JOURNAL OF MANAGEMENT AND ORGANIZATIONAL RESEARCH

Funding, risk and regulatory framework in Islamic banking: Organizational perspectives on an evolving financial landscape

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Article Info

ISSN (online): 2583-6641
Volume: 04
Issue: 03
May-June 2025
Received: 09-03-2025
Accepted: 13-04-2025
Page No: 39-46

Abstract
The aim of the current paper is to provide a comprehensive overview of the current state of research in Islamic finance, focusing on three key areas: Islamic banking, Islamic fund management and Islamic risk management. A descriptive analysis was conducted to examine the regulatory issues, with conventional finance serving as a point of reference. The findings of this study indicate that there is a pressing need for significant improvements to the regulatory frameworks of most Islamic banks in order to enhance their competitiveness and alignment with global financial standards. Furthermore, the requisite enhancements should encompass the integration of advanced technologies, the promotion of risk-sharing principles, and an emphasis on ethical practices, thereby reinforcing market integrity. The study anticipates future directions, suggesting potential improvements in the regulatory framework and innovative financing mechanisms. These organizational perspectives are essential to understanding how institutions are adapting to funding challenges, regulatory reforms and emerging financial risks. The findings of this study provide valuable insights for policymakers and industry practitioners navigating the dynamic landscape of Islamic banking, ultimately contributing to the sustainable growth and development of the sector.

DOI: https://doi.org/10.54660/IJMOR.2025.4.3.39-46

Keywords: Islamic banking, funds management, risk management, governance, sharia compliance, capital regulation

1. Introduction

The progression of Islamic finance has been marked by a number of significant milestones. One of the most significant events was the establishment of the Organization of the Islamic Conference (OIC) in 1970, which established the conceptual foundation for Islamic banking. Subsequently, the Islamic Development Bank (IDB) was established in Saudi Arabia in 1974 as a multilateral institution comprising 56 member states. Its mission was to facilitate foreign trade, alleviate poverty, provide financing for infrastructure projects (such as roads and dams), and fund social projects like the construction of schools and hospitals. The formal advent of the IB system commenced with the establishment of the inaugural Islamic commercial bank, the Dubai Islamic Bank, in 1975. This was followed by the inauguration of the Faisal Islamic Bank in Sudan in 1977 and the Bahrain Islamic Bank in 1979.

Compliance with Sharia principles represents the fundamental tenet of any Islamic financial institution. As (Kahf, 2002) [31] notes, the initial steps towards establishing Sharia compliance supervision in the sector were taken by the Faisal Islamic Bank of Egypt in 1976 and the Islamic Bank of Jordan in 1978. In the Islamic financial sector, the responsibility of confirming that a financial product or transaction aligns with Sharia law is vested in a Sharia Board (SB), which is comprised of respected Muslim jurists. As observed by the Islamic Financial Services Board ((IFSB, 2009), the primary responsibility of these boards is to certify the Islamic nature of a product or service. This process is instrumental in fostering trust in Islamic banks, which is a vital component of the functioning of Islamic finance. This sector is often regarded as a branch of ethical finance due to its pronounced emphasis on moral and socially responsible practices. Furthermore, the IFSB has established additional standards, including those pertaining to risk management, capital adequacy, and the supervisory review process.

These standards provide detailed guidance on the establishment of an effective Sharia governance structure. For example, (IFSB, 2005), which delineates guidelines on risk management, recommends that institutions offering Islamic financial services (IIFS) implement appropriate policies to address both legal and Sharia compliance risks, underscoring the necessity for a robust Sharia governance framework. Similarly, (IFSB, 2007), which addresses the supervisory review process, suggests that regulators ensure the presence of adequate systems, including Sharia boards, to oversee these processes effectively.

An additional body of scholarship has examined various dimensions of Islamic banking, with a particular emphasis on aspects such as financial stability. Prominent examples include the studies by Beck *et al*., 2013 [5]; Čihák & Hesse, 2010 [7]. The literature also encompasses studies on regulatory and supervisory frameworks (e.g., (Daoud & Kammoun, 2020, 2022, 2024; Smaoui & Ghouma, 2020)) [9-11, 19]. Furthermore, the IB sector has witnessed advancement as a consequence of technological innovation, enhanced infrastructure, and augmented regulatory support. These developments have been instrumental in expanding the industry, particularly in the context of the adjustments made to address the challenges posed by the global pandemic. The advent of digitalization, accompanied by robust governmental support, has served as a catalyst for the expansion of Islamic banking. Furthermore, a considerable number of jurisdictions have concentrated their efforts on strengthening the regulatory framework for Islamic banking. These improvements are designed to facilitate the growth of assets while also addressing issues related to risk management and corporate governance. These developments create a positive outlook for the sustained growth of Islamic finance, which is expected to surpass its current market share of 1.5% (IFSB, 2022).

The objective of this research is to make a contribution to the extant literature on Islamic banking, with a particular focus on three key areas: fund management, risk management, and regulatory frameworks. The findings of this study are relevant for a diverse range of stakeholders, including customers, bankers, fund managers, regulators, and policymakers within the Islamic financial services industry.

This paper is structured as follows: Section 2 outlines the research methodology employed. Section 3 presents the data analysis and interpretation, focusing on key dimensions of Islamic banking, fund management, risk management, and regulatory issues. Finally, Section 4 provides the conclusion and highlights potential directions for future research.

2. Research Methodology

The present study adopts a mixed qualitative-descriptive methodology, combining empirical observations from secondary data with a theoretical analysis grounded in the principles of Islamic finance. This methodological structure ensures both empirical grounding and conceptual depth, in line with the study's aim to bridge practice and theory within the framework of Islamic banking, fund management, and risk governance. The data has been derived principally from secondary sources, including institutional reports from the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (2020–2022). A descriptive statistical analysis was conducted of key financial indicators (e.g. capital adequacy, asset quality, return on assets, liquidity ratios) and regulatory practices. This was complemented by a qualitative content analysis of official documents to assess the consistency of banking practices with Sharia objectives and ethical standards. Our findings were interpreted through a theoretical analysis incorporating the principles of Islamic finance. This combination of descriptive and normative analysis is well suited to examining the intersections between ethical principles, regulatory frameworks and financial performance. The methodology aims to provide a balanced contribution to the discourse on governance and sustainability in Islamic finance.

3. Data analysis and interpretation

3.1 Islamic banking: an overview

In accordance with the most recent data, the global IFSI experienced 11.3% growth in 2021, reaching a total value of USD 3.06 trillion. Notwithstanding the challenges posed by the ongoing Russia-Ukraine conflict and the global pandemic, the IFSI demonstrated resilience (Taera *et al*., 2023). With a total value of USD 2.10 trillion and a 6.5% annual growth rate, the Islamic banking sector represents the dominant player in the IFSI, accounting for 68.7% of the total assets. This dominance is likely to persist as banks in this sector embrace digitalisation, prioritise ethical and impactful investments, and capitalise on the evolving landscape of Islamic banking regulation (IFSB, 2022). The 2008 financial crisis revealed the prevalence of unethical practices within conventional banks (CBs), whereas IBs demonstrated greater resilience (Berger *et al*., 2019) [6]. Islamic finance, with its ethical foundations such as profit and loss sharing (PLS), prohibition of interest (riba), and asset-backed financing offers a more disciplined and stable system (Mia, 2023) [17]. Islamic finance is aligned with ethical finance, incorporating environmental, social, and governance criteria. It prohibits uncertainty (gharar) and gambling (maysir), with zakat (charity) being of particular importance, especially during the ongoing pandemic caused by the Corona-virus (Hassan *et al*., 2020; Rabbani *et al*., 2021) [22, 32].

The robust performance of Islamic finance during periods of economic turmoil may indicate a growing preference towards more responsible financial practices (Iqbal & Mirakhor, 2017) [28]. In response to the pandemic, central banks in Islamic Development Bank (IsDB) member countries implemented a series of measures, including payment relief, liquidity support, and reductions in capital requirements. Additionally, the IsDB made contributions to innovations that were designed to mitigate the effects of the pandemic (IsDB, 2020).

3.2 Funds Management Practices

In the 1950s, Muslim professionals and economists began to devise an alternative financial system in line with the teachings of the Quran's precepts. Islamic finance gradually gained widespread acceptance and began to prosper as a result of the Muslim world's growing religious devotion and the oil price boom. For decades, Islamic finance has been trying to create financial products that comply with Islamic Sharia guidelines. IBs are trying to ensure partnership intermediation. IBs are expected to operate based on distinct ethical principles guided by Sharia, which differ from CBs. However, in practice, there are similarities in their operations. Non-PLS financing methods (e.g. Murabaha) are more commonly used than PLS instruments for Islamic banking financing around the globe, with only a few exceptions (see

figure 1). Various Islamic banking business models have emerged to bridge the gap between theories and practice (see figure 2). According to Ibrahim & Rizvi, 2018 [13], an IB manages deposits and provides banking services, excluding interest-based lending. The funds collected constitute the bank's liabilities, and it acts as an investment manager for account holders. Depositors share profits based on a predetermined formula, and clients are considered partners, sharing the risks of transactions funded by deposits.

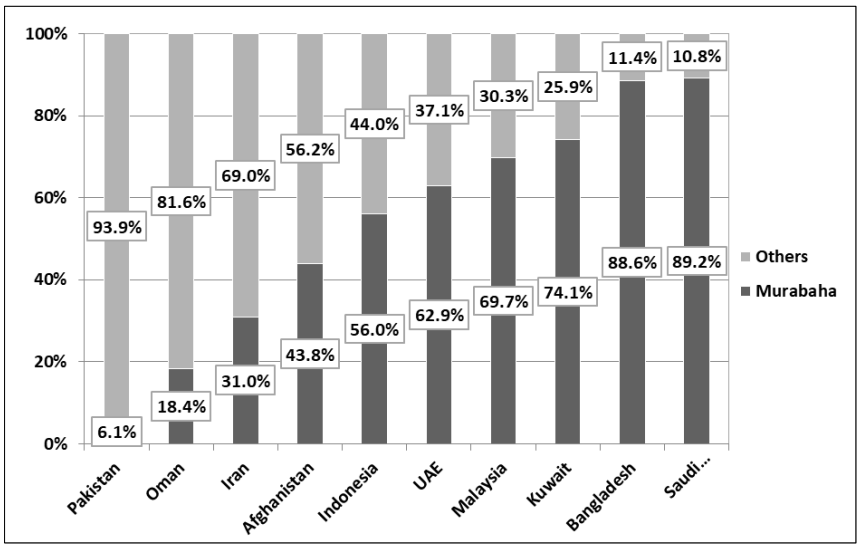


Fig 1: The percentage of IB financing by category of contract in the world (The 2023-Q1 data reported by the IFSB)

Islamic banking assets, unlike conventional ones, avoid interest-bearing loans. They are classified into three main categories: equity-like assets (Musharaka and Mudarba) based on the principle of PLS, lease-based products (Ijara) and sale-based products (e.g., Salam, Istisnaa and Murabaha). These modes of financial intermediation enhance the sustainability of the financial system, support real economic activities and preserve the rights of stakeholders (Hassan *et al*., 2020; Hassan & Aliyu, 2018) [22, 12].

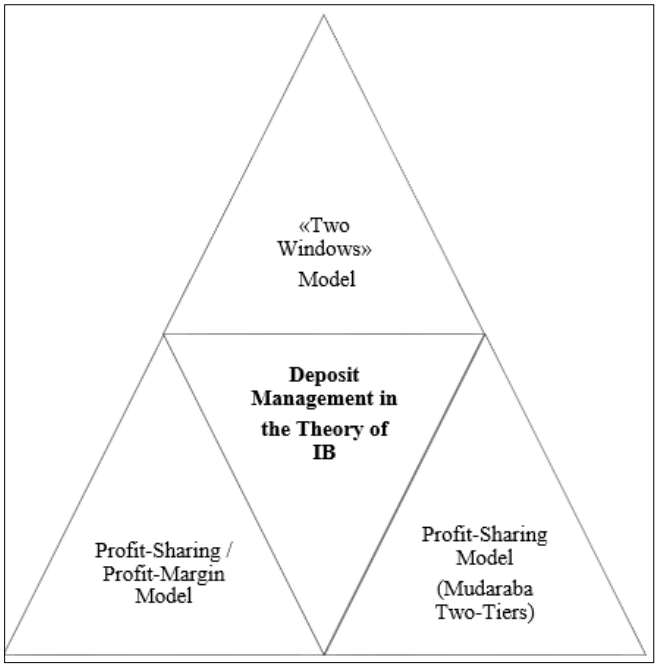


Fig 2: Islamic Banking Business Models

Siddiqi (1981) and Ariff (1982) have developed the Mudaraba Two-Tier Model for IBs. This model is based on profit sharing between depositors, IBs and investors. Depositors invest in Mudaraba accounts and share profits generated by the bank. IB acts as Mudarib with the depositors and Rab-El-Mal with the investors, functioning as a financial intermediary. In the case of losses, the investor is solely responsible. This model respects Sharia principles and offers no guarantee of funds or profits to depositors. The bank's role is to manage and invest these funds efficiently. In contrast, Profit-Sharing/Margin Financing Model combines profit-sharing (Mudaraba) on the liability side of the balance sheet with cost-plus margin financing techniques (Murabaha) on the asset side. Other financing methods, like Ijara, Istisnaa, and Salam, are also permissible on the asset side. In the "Two Windows" model of IBs, the bank's liabilities are divided into two categories: current deposits and investment deposits. Customers can choose between these options. Current deposits are subject to a 100% reserve requirement and are treated as a trust (Amana) held by the bank on behalf of depositors in line with Islamic principles (Errico and Farahbaksh, 1998). These funds cannot be used for profit or fractional reserve banking. On the other hand, investment deposits are placed with the understanding that they will be used for risky projects with no guarantee of value or return (khan and Mirakhor, 1994; Errico and Farahbaksh, 1998). Depositors in this category are considered more like "shareholders," and the contractual relationship with the bank is based on the PLS principle. In the event of losses, the initial amount may be devalued. Unlike conventional finance, Islamic finance offers a wide range of financial instruments that are interest-free, limit on excessive risk-taking, and relate to real activities. In fact, it is more resilient to crises affecting the international financial system (Hussain *et al*., 2015) [23]. Investors in Islamic funds do only appreciate the financial gains; they also perceive a non-financial benefit from the compliance of their investments with Islamic principles and therefore could make financial sacrifices in the name of their religious beliefs (Peillex *et al*., 2019; Azmi *et al*., 2018) [4]. In addition, previous research shows an asymmetric flow-performance relationship in Islamic banking funds. Investors

in these funds seem less responsive to poor performance but more enthusiastic about positive returns, possibly due to limited alternative investment opportunities (Aliani *et al*., 2022; Azmi *et al*., 2018; Daoud & Kammoun, 2017; Mehmood *et al*., 2023) [8, 2, 4].

To improve risk management in Islamic banking, it is advisable to opt for partnership-based financing instead of Murabaha financing (Tawfik Azrak, & Hani Hazaa. (2021) [20]. Policymakers must promote a transition to a more inclusive and risk-sharing financial industry. This transformation implies a high level of integration with capital markets in a specialised, debt-free universal banking structure ((Jatmiko *et al*., 2023) [15].

The Sharia-compliant nature of Islamic banking products leads to distinct risk management requirements for Islamic banks. The literature on Islamic investment funds often compares their performance to conventional funds, but the evidence is conflicting. Some studies suggest that Sharia-compliant screening limits the investment universe of Islamic funds, leading to less diversified portfolios that may underperform conventional funds. Additionally, some authors attribute Islamic banking funds' underperformance to a perceived lack of experience in active management and poor market timing abilities (Zouaoui, 2019) [21].

3.3 Risk Management Practices

Risk management is an important aspect of Islamic banking for the sustainability and operational security of banks, as well as for maintaining the confidence of customers and stakeholders. Islamic risk management in world affairs is backed by Quranic verses1 and Prophetic tradition (Hassan, 2009). Islamic scholars advocate Sadd Al-dharia2, proactive risk management in finance by taking precautionary measures against potential harm to humanity. Contemporary risk management within Islamic finance allows certain derivative-type contracts under Sharia principles. Funding contracts like Salam and Istisnaa, similar to forward contracts, involve initial agreements with asset delivery at a later date. Other permissible forward contracts, such as Bai Mouajjal and Bai al-Urbun3, leverage the concept of Waad (promise), enabling deferred payments or forfeited deposits upon default. The Urbun in the Bai al-Urbun contract can be viewed as the premium of an option contract. Additionally, a commonly used Sharia-compliant contract in Islamic banking is the profit rate swap, involving the exchange of fixed and variable payments. This exchange is executed through a combination of Murabaha and reverse Murabaha or Tawarruq contracts, enabling asset-liability management strategies for Islamic banks. In Islamic banking business, the use of participatory financing methods affects the nature of the risks incurred by IB. The traditional bank does not bear the losses as it transfers the risks to a single person. However, profit and risk sharing principle is a significant feature of Islamic banking. This means that losses or profits are shared between the investor, the entrepreneur, and the bank. IB needs to manage and control the risk factor. Sharia-compliant risk management options include risk avoidance (e.g., not taking out a financial product), transfer (e.g., through Takaful contracts), hedging (e.g., through Salam contracts) and management through strategies such as default treatment in lease contracts (Agha and Sabirzyanov, 2015). IFIs are exposed to risks associated with non-compliance with Sharia law and risks associated with the IFI's fiduciary responsibilities towards different providers of funds. Generally, these risks expose IFIs to funding problems and loss of income or invalidity of contracts, leading to a bad reputation or limitation of business opportunities (IFSB, 2022). Displaced commercial risk (DCR), according to the IFSB, arises when Islamic banks have to pay higher returns to depositors than contractually agreed, often because of underperformance. Massive withdrawals can result from a lack of confidence due to non-compliance with Sharia principles. To mitigate this, shareholders can reduce their profits in favor of depositors. The IFSB recommends two reserves to counter this risk: a Profit Equalization Reserve (PER), sharing gross income between depositors and shareholders, and an Investment Risk Reserve (IRR) to protect investment account holders against potential losses (IFSB, 2022). For IBs, the funds held in "restricted" and "standard" investment accounts are used to finance Sharia-compliant projects on the basis of profit and loss sharing instruments. This specific type of financing must be considered differently in terms of risk weighting. However, the capital invested in the investment accounts is not guaranteed by the Islamic bank, which means that there is no competition between Islamic and conventional banks and therefore no displaced commercial risk. In this case, any losses resulting from the projects financed by the investment accounts will be borne by the account holders. Assets financed by investment accounts (standard or restricted) do not require regulatory capital. These assets should therefore be eliminated from the calculation of the denominator of the total capital ratio (Harzi, 2011).

[1] The Quran outlines the first economic principle in risk management in the story of Prophet Joseph, stating: ["Joseph, O truthful one, explain for us seven fat cows which seven lean ones were eating and seven green spikes [of grain] and others [that were] dry, that I may return to the people, so that they may know. [Joseph] said, 'You will plant for seven years consecutively; and what you harvest, leave in its spikes except a little from which you will eat. Then will come after that seven difficult [years] which will consume what you advanced for them, except a little from which you will store. Then will come after that a year in which the people will be given rain, and in which they will press [olives and grapes"]. *Quran (12; 46-49)*

[2] The term "Sadd" literally means "to block", while "Al-dharia" signifies "means". Consequently, Sadd Al- dharia implies blocking the means of what could be damaging to individuals or society. As the ultimate aim of Sharia is to protect people's interests and benefits, in Islam, sin has been forbidden, implying that the path that leads to sin is also forbidden. The concept of "Sadd Al-dharia", extended to finance, is used as a defensive or preventive tool to preserve the Maqasid, through active blocking of any means that might impede the achievement of legitimate objectives (Ibn Ashur, 2006).

[3] Bai Muajjal involves deferred payment for goods received in advance, which promotes transparency of costs and profits. Bai al-Urbun requires an initial deposit (Urbun), with the rest payable on delivery; if the buyer defaults, the deposit is retained by the seller. Both contracts comply with the principles of Islamic finance and facilitate trade in compliance with Sharia law.

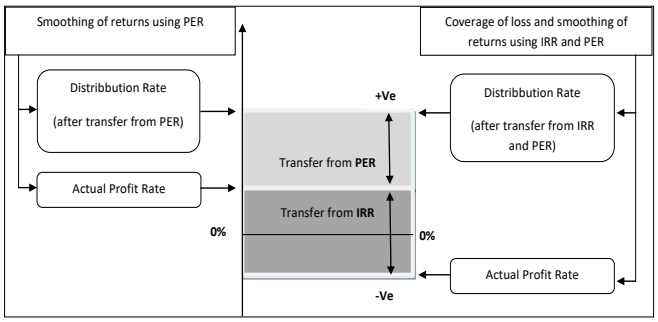


Fig 3: Risk management: Smoothing practices adopted by IB

IB commonly employs two standard practices to mitigate DCR: 1) PER is created from total income before profit allocation between shareholders and Unrestricted Investment Account Holders (UIAH). The purpose of PER is to maintain a margin to ensure future returns and to increase owners' equity to sustain future shocks. 2) IRR, which is used to protect investment account holders against potential losses on assets invested with PLS funds (see figure 3). IRR is retained from the profits attributed to UIAH after profit allocation. In a contractual agreement, UIAH decide in advance the proportion of their income that may be allocated to these reserves, as determined by the bank's management. These reserves are typically invested by the IB to generate additional returns for UIAH (Affandi, 2019; Isah *et al*., 2021) [1, 14].

Reyad *et al*., 2022 [18] conducted a study on risk management in Islamic banks of the Gulf Cooperation Council (GCC). They adopted a mixed-method approach, where qualitative data was collected from interviews with senior risk managers and quantitative data was extracted from financial reports. The study, which covers the period from 2013 to 2019, found that Islamic banks in the GCC are able to manage business risks efficiently by implementing strong corporate governance practices, and there is potential to improve asset quality and liquidity management. Despite the increasing significance of Islamic banks, challenges persist in the form of Sharia noncompliance risks and governance issues. Studies have also shown that IBs perform better in times of economic distress (Alqahtani & Mayes, 2018) [3]. Nevertheless, Ibrahim & Rizvi (2018) [13] reported that IBs revealed a higher level of risk during the financial crisis, but with a conservative business model of lending.

3.4 Regulatory issues

The global financial crisis has prompted a heightened focus on Islamic financial intermediation from a range of stakeholders, including national and international standard-setting bodies, policymakers, and academics. IBs are undergoing a period of rapid development on a global scale, with growth rates that are noteworthy. At the conclusion of 2022, the aggregate value of assets under administration by Islamic banking institutions had reached USD 3.06 trillion, representing a growth in market value of 45% compared to 2021. This represents a 69.3% share of the total assets of the global Islamic financial services industry (IFSI), up from 68.7% in 2021.

There are significant divergences between the principles of the Islamic financial system and those of conventional banking. Deposits in IBs are subject to a distinct set of risks, and employ a distinctive approach to asset management compared to conventional banks (CBs). Consequently, conventional prudential regulations must be adapted to accommodate these structural differences in order to ensure effective oversight of IBs.

Capital Requirement

The regulatory authorities are modifying the prudential regulations for Islamic banks; ho3wever, the Sharia-compliant financial instruments are not included in the scope of Basel II. The objective of aligning Islamic finance with standards such as Basel III while respecting Sharia principles presents a significant challenge. Bodies such as the IFSB and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) are working to address this issue.

The AAOIFI introduced a capital adequacy framework for Islamic banks (IBs) that is analogous to the Basel I framework. This framework was introduced to address the insolvency risks inherent in the Mudaraba model, in which the investment account holders bear losses. Nevertheless, IBs frequently distribute profits even in instances of financial loss in order to maintain public trust, resulting in higher capital adequacy ratios (CAR) than those observed in conventional banks (CBs). Although Basel III was not designed for Islamic finance, it can serve as a foundation for such a framework. The distinctive risk profile of IBs necessitates the application of adjusted weightings, with the exclusion of specific investment accounts from CAR calculations.

The formula for calculating the capital adequacy ratio (CAR) is as follows:

$$CAR = \frac{Tier1^{4} + Tier2^{5}}{\left[\begin{array}{c} Risk - Weighted\ Assets\ (RWA) \\ -RWA\ funded\ by\ restricted\ PSIA \\ -\left(1-\alpha^{6}\right)RWA\ funded\ by\ unrestricted\ PSIA \\ -\alpha\ RWA\ funded\ by\ PER\ et\ IRR\ of unrestricted\ PSIA \end{array}\right]}$$

Islamic financial institutions (IIFS) are not obliged to

[4] Tier 1 capital includes common Equity (common equity, retained earnings, and specified reserves) and additional capital (Sharia-compliant instruments and certain reserves).

[5] Tier 2 capital comprises instruments issued by IIFS that meet set criteria, general loss provisions, issuance premiums, and qualifying capital from subsidiaries that comply with Tier 2 standards (IFSB, 2013).

[6] "Alpha (α)" refers to the percentage of assets financed by unrestricted PSIA, with its value set by supervisory authorities based on individual assessments.

maintain regulatory capital to cover the risks associated with profit-sharing investment accounts (PSIA), focusing solely on operational risk. The global financial crisis demonstrated the inadequacy of capital quality as a determining factor in banking stability. In order to address liquidity risks, the Basel Committee introduced two key ratios: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). As indicated in the IFSB report (2023), the Islamic banking sector demonstrates a sufficient level of liquidity and has established a natural asset-liability management strategy to ensure long-term financial stability. This is evidenced by the maintenance of both the LCR and NSFR at a level exceeding 100 percent, as illustrated in Figure 4. The solid capital adequacy ratio (CAR) and Tier 1 capital ratios observed in Islamic banks are the result of increased internal capital generation from retained earnings. This increase is associated with elevated income resulting from economic reopening, recovery, and enhanced profitability.

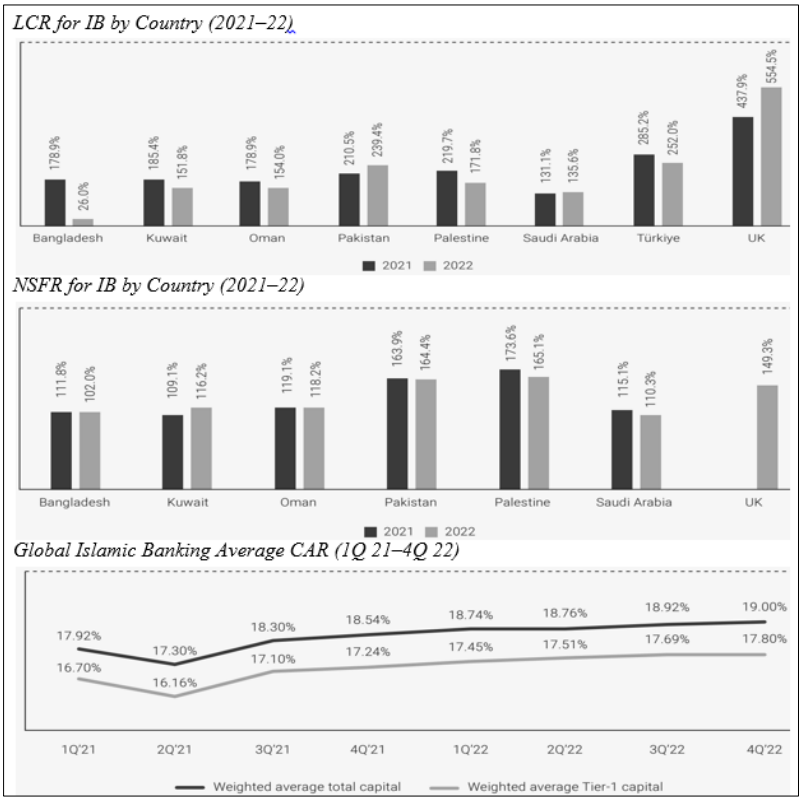


Fig 4: The LCR, NSFR and Global Islamic Banking Average CAR by Country (2021–22).

Islamic Digital Banking Regulation

The adoption of digitalization will strengthen the Islamic banks' ability to adhere to regulatory requirements and improve their risk management capabilities. Furthermore, the regulatory and supervisory authorities (RSAs) will experience heightened effectiveness in their oversight functions, thanks to increased operational efficiency achieved through the automation of supervisory procedures and enhanced capturing and use of real-time data.

Rapid technological advances in finance are posing new challenges for the financial sector. Regulators are proceeding cautiously in this landscape to ensure that their support for financial technological innovation does not compromise the integrity and stability of financial markets (Jeník *et al*., 2020) [30].

The regulatory implications of digitalization hinge on RSAs' ability to balance technological financial innovations, consumer protection, business support, and financial inclusion while upholding Sharia principles in Islamic banking. RSAs have responded by releasing guidelines, promoting regulatory sandboxes, and enabling digital banking institutions, including those adhering to Islamic banking principles. In IFSB jurisdictions, IBs are at various stages of incorporating digital transformation into their operations. Some are using software applications for payments and remote customer onboarding, while others are implementing technologies like robotics process automation, machine learning, and AI for repetitive tasks. Additionally, some IBs are utilizing predictive analytics, big data, cloud computing, and IoT to enhance their ability to anticipate customer requirements.

According to the 2020 IFSB report, RSAs are taking various approaches to regulating digital banking operations in different jurisdictions:

- **Specific Digital Banking Regulations:** In some countries, like Malaysia, RSAs have issued specific digital banking regulations. For instance, Bank Negara Malaysia introduced a licensing framework for digital banks in December 2020. This framework focuses on admitting digital banks with strong value propositions while ensuring the integrity and stability of the financial system and the protection of depositors' interests.
- **Amendment of Existing Regulations***:* Other countries are amending their existing regulations to accommodate the unique aspects of digital banking operations.
- **Clarity on Existing Regulation:** In certain cases, such as in Saudi Arabia, existing regulations remain unchanged, but clarity has been provided on how these regulations apply to digital banking operations. For instance, the Saudi Central Bank outlines specific

licensing conditions, including requirements related to the founders' experience, financial capacity, and other aspects like the business plan, exit plan, capital adequacy assessment plan, and internal liquidity adequacy assessment plan.

In these diverse scenarios, IBs are required to describe the prevailing regulatory approach in their respective jurisdictions regarding the digital transformation process and developments in the sector.

4. Conclusion and Future research directions

In 2022, there was a global increase in the value of assets, deposits and financing held by IBs. This growth was observed in the majority of countries and was attributable to a surge in export revenue (from oil and commodities), as well as in the hospitality and tourism sectors. Furthermore, strategic initiatives, including the establishment of new banking institutions and mergers, contributed to this growth. These actions were undertaken with the dual objective of pursuing growth opportunities while simultaneously addressing the challenges of profitability, asset quality, and prudent capital adequacy. It is of the utmost importance to have robust regulatory frameworks and to ensure capital adequacy, particularly in emerging markets where Islamic financial institutions are prevalent. The regulatory environment for dual banking systems, which combine Islamic and conventional banks, presents a number of distinctive challenges. The adoption of homogeneous standards is inherently challenging; however, the IFSB provides tailored guidelines to address this issue. The regulatory framework for Islamic banks necessitates the employment of a dedicated workforce with expertise in Sharia compliance, which presents a challenge in terms of human resource management. The existence of discrepancies in regulatory requirements has the potential to create arbitrage opportunities, which may subsequently impact market shares and the viability of financial institutions. It is the responsibility of the regulatory authorities to ensure the monitoring of disclosure practices in order to prevent the emergence of asymmetries, particularly in the context of individuals or entities opting to engage with financial institutions on the basis of their adherence to Sharia principles. In order to address these challenges, it is necessary to recognise the distinctive features of both banking systems and to adapt the regulations accordingly. With the publication of its guidelines, the IFSB has made a notable contribution to the modernisation of supervisory frameworks within Islamic risk management (IFSB, 2020), marking a significant advancement in the field. However, the implementation of these standards continues to be challenging as a result of limited expertise and insufficient training. To this end, IIFS would benefit from investing in comprehensive training programmes. Academic institutions, too, have a role to play, offering specialised courses in Islamic finance to meet the growing demand for expertise in this area.

This paper surveys the current research in Islamic banking, fund management, and risk management, focusing on the regulatory challenges associated with dual banking systems. The suggestion is to invest more in designing authentic Islamic financial products, moving beyond the replication of conventional finance models. The importance of financial engineering is highlighted, not just for technical product design but also for Islamic risk and fund management. It is argued that enhancing these competencies can improve the responsiveness of Islamic financial institutions. Additionally, considering the expanding research in Islamic finance, the paper proposes further investigation into active risk management within Islamic financial institutions and funds. Finally, we suggest increased collaboration between Islamic and conventional regulators to strengthen the integration of the financial system, with the aim of benefiting all economic agents regardless of their beliefs. This paper concludes by highlighting the challenge faced by Islamic regulators in adapting to emerging technological trends such as fintech and smart contracts. Concerned about the current lag of IIFS in these areas and the potential competitive disadvantage due to compliance costs, we suggest that future research at the intersection of technology and Islamic finance could offer valuable insights into the evolving relationship between religious beliefs and finance.

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