



Developing Sustainable Islamic Banking System In Afghanistan: Insights From Malaysia's Success

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Abstract

This paper investigates the potential for developing a sustainable Islamic banking system in Afghanistan, drawing on Malaysia's advanced and successful model which holds approximately 65% of Sharia-compliant banking assets in the region. Islamic banking, grounded in Shari'ah principles such as the prohibition of interest (riba), uncertainty (gharar), and gambling (maysir), has garnered significant global attention due to its ethical foundation and appeal to communities seeking Shari'ah-compliant financial solutions. With over \$2 trillion in assets, Islamic banking has made a profound impact worldwide. Malaysia's dual banking system, inclusive regulatory framework, and innovative Shari'ah supervisory model have positioned it as a global leader in Islamic finance. However, Afghanistan, despite its challenges, has yet to develop a fully functional Islamic banking system. This study proposes that Afghanistan could benefit from adopting Malaysia's model, emphasizing the necessity of a robust legal framework, financial literacy, and an inclusive environment for Islamic financial products. Particularly in terms of regulatory framework, shariah governance and financial inclusion. Utilizing a qualitative research methodology, the paper concludes that with strategic planning, collaboration, and a commitment to financial inclusion, Afghanistan has the potential to build a modern, ethical, and growth-driven Islamic banking system.

Keywords: Development, Islamic Banking, Afghanistan, Malaysian.

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1. Introduction

The essential aim of Islamic banking is to generate profits for both the institution and its depositors through a financial transaction in which giving and receiving interest is strictly prohibited. To achieve this, Islamic banks must have clear and well-defined policies and adhere to certain restrictions governing their business activities. These processes must be carefully designed and implemented for the bank to commence operations. This study delineates the essential Islamic principles required for Islamic banks to operate and examines the guidelines for depositors. It emphasized the importance of adhering to these principles to ensure that the bank maintains a prudent approach in evaluating business opportunities, resisting the allure of potentially high but non-compliant profits. Islamic banking has witnessed significant development in several Islamic countries, with Malaysia standing out as a global leader in this domain. The rapid development of Malaysia's Islamic banking is due to laws, regulations, administrative, and technological frameworks that have made it the leader in the global Islamic industry. On the contrary, Afghanistan's Islamic banking sector remains in its early stages, requiring

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Article history

Received: 31 July 2025

Accepted: 27 August 2025

substantial growth and development. This study aims to draw upon Malaysia's successful and pioneering experience as a model to propose practical strategies for the advancement of Islamic banking in Afghanistan, enabling the country to implement and enhance this sector effectively.

2. Literature Review

2.1 Definition of Islamic Banking

Islamic banks avoid interest payments, generating profits through the actual exchange of goods and services. In parallel, the monetary authorities regulate the money supply, adjusting it to the actual availability of assets in Islamic states (Seyd Othman & Aljunid, 2017). The monetary authority regulates the exchange rate of tangible assets like gold and silver for the national currency, ensuring the economy is based on productive and ethical transactions. Therefore, Islamic banking is a financial institution that operates in accordance with the principles of sharia, raises and invests the funds, aiming to foster societal development, promote justice in wealth distribution, and contribute to economic growth while adhering with Islamic moral and social values. It provides services such as loans, savings, and investments while adhering to ethical financial principles (Dusuki & Abdullah, 2011).

2.2 The Global Count of Islamic Financial Institutions as of 2024

As of 2024, the global Islamic finance industry continues to grow, with over 1,600 institutions managing more than \$3.38 trillion in assets, Islamic banking continues to be the largest segment of the IFSI, constituting 70.21% of the total global IFSI assets in 2023 (IFSB, 2024). This successful sector has experienced annual growth rates of 15% to 25%, with notable expansion in the Gulf Cooperation Council (GCC) countries, Southeast Asia, and increasingly in regions such as Central Asia and the Asia-Pacific (S&P Global, 2024). Notably, countries like Afghanistan and other central Asia show rising demand for Sharia-compliant financial services. Islamic banks have spread to more than 30 non-Muslim countries, including the US, UK, Germany, and Australia. The UK has become a leading location for Sharia-compliant banks such as the Bank of London and the Middle East and Qatar Islamic Bank and is considered a global hub for sukuk issuance. The UK market is expected to grow at a CAGR of 3.12% between 2024 and 2029, reaching assets of \$8.7 billion (IFSB, 2024). In the US, Islamic finance is growing in real estate and healthcare, while in Germany and Australia, real estate and sukuk development are focused. South Africa is also active in Islamic finance, offering Sharia-compliant services and sovereign sukuk (Mordor Intelligence, 2024). This global expansion reflects a growing demand for ethical financial products that align with Islamic principles, attracting both Muslim and non-Muslim investors across diverse financial markets. Modern Islamic banking emerged in the 1960s to comply with sharia law. Key developments include the establishment of the Mit Ghamr Savings Bank in Egypt in 1963, followed by the Islamic Development Bank in 1975, and the establishment of the first full-fledged Islamic bank, the Dubai Islamic Bank. The sector has grown since the emergence of Islamic banking, Islamic equity investments, takaful, and sukuk (Seyd Othman & Aljunid, 2017). Islamic banking in Malaysia began in 1983 with the establishment of Bank Islam Malaysia Berhad (BIMB) under the Islamic Banking Act, initiating a dual banking system. Malaysia has since become a global leader in Islamic finance, with innovations like the Malaysia International Islamic Financial Centre (MIFC) and the development of Sharia-compliant government securities (Seyd Othman & Aljunid, 2017). The Islamic banking sector in Malaysia has expanded significantly, with 41% of funding in 2023 sourced from Islamic finance. Innovations like Aeon Islamic Digital Bank continue to drive growth, solidifying Malaysia's leadership in global Islamic finance. Afghanistan has 12 conventional banks, including three government-owned, seven private, and two foreign bank offices (Centre for Strategic and Regional Studies, 2022). Islamic banking is gradually expanding, with the Islamic Bank of Afghanistan (IBA), the first fully Sharia-compliant bank, transitioning from Bakhtar Bank in 2018. With \$25 million in capital and \$187 million in deposits across 59 branches, the sector still faces challenges, as only 5.7% of the population engages with banking, highlighting significant untapped potential (Disli et al., 2023a). Afghanistan's Islamic banking sector is valued at approximately \$610 million. Some conventional banks have launched Islamic banking windows, including the National Bank of Afghanistan and the United Bank of Afghanistan in 2008, and Maiwand Bank, Ghazanfar Bank, and Kabul Bank in 2009. In 2015, the International Bank of Afghanistan also launched an Islamic banking window (Naseri, 2020). These developments reflect the increasing integration of Shari'ah-compliant services in Afghanistan's banking system. Following the rise of the Islamic Emirate of Afghanistan, all banks were instructed to cease usury-based transactions and align with

Islamic banking principles. The regulation allows a two-year period for converting conventional banks to Islamic ones (Alami et al., 2021). Da Afghanistan Bank (DAB) and the Islamic Emirate of Afghanistan aim to expand Islamic financial services in response to growing public demand. Despite challenges such as limited infrastructure, low public awareness, and regulatory barriers, Islamic banking is viewed to enhance financial inclusion and stimulate economic activity (Centre for Strategic and Regional Studies, 2022). By 2024, more than 1,600 Islamic financial institutions including banks, takafuk companies and investment firms will operate in more than 80 countries, with a total value of more than \$3.38 trillion. Key markets driving this expansion include the GCC, Malaysia, and nations like Indonesia, Iran and Pakistan (IFSB, 2024).

2.3 Requirements To Establish An Islamic Banking

Islamic banking's establishment requires several critical components including a robust legal framework, adequate capital requirements, well- defined governance, comprehensive risk management strategies, a diverse range of Shariah-compliant products, and skilled human resources. Furthermore, the development and operation of Islamic banking institutions must address various challenges and considerations to maintain compliance with Islamic principles while achieving financial stability and growth (Dusuki & Abdullah, 2011).

2.3.1 Legal Framework

The establishment of Islamic banks requires a robust legal and regulatory framework that are in line with Shari'ah principles and conventional banking regulations. In Islamic financial institutions (IFIs), this framework is essential to maintain fair operation integrity and build confidence. These include regulatory development, sharia compliance, and Licensing and auditing (Uddin et al., 2024).

2.3.1.1 Regulatory Developments

Around 20 nations have established formal legal frameworks for Islamic banking, with notable examples including Sudan, Kuwait, Iran, Pakistan, and Saudi Arabia, which implemented Islamic banking laws in 1980, 2003, 1983, 2001, and 2007 respectively (Dusuki & Abdullah, 2011). Other countries, including Afghanistan, Jordan, Qatar, Oman, and Bahrain, have implemented partial Islamic banking laws. Non-Muslim majority nations, like the UK, have also adopted tax neutrality laws (Amuda & Al-Nasser, 2024).

Indonesia's Sharia Banking Law was enacted in 2008, while Malaysia's Islamic Financial Services Act 2013 established a comprehensive legal framework for Islamic banking. The IFSA ensures Shariah compliance, consumer protection, and risk management protocols. Malaysia, a global leader in Islamic finance, distinguishes its operations from conventional banking (Salisu & Saniff, 2023).

Afghanistan lacks a dedicated legal framework for Islamic banking, with a draft law under review awaiting cabinet approval. The legislation's adoption is crucial for establishing a formal structure for Islamic banking development and regulation, ensuring Shariah compliance, and fostering stakeholder confidence (Naseri, 2020).

2.3.1.2 Sharia Compliance

Shariah law, which prohibits practices such as Maysir (gambling), Gharar (excessive uncertainty), and Riba (interest), extortion and frau, serves as a fundamental prerequisite for the operations of Islamic financial institutions (IFIs)(Uddin et al., 2024). Therefore, global IFIs must comply with Shariah rules in terms of products and services, and regulators must clearly maintain good and effective governance structure, and practice to maintain market discipline enforced by supervisory authorities, and foster trust in the Islamic banking system (Dusuki & Abdullah, 2011).

2.3.2 Licensing And Supervision

Islamic banks must meet strict licensing criteria, including implementing a robust corporate governance framework for effective investment monitoring by account holders. In jurisdictions such as Malaysia, mandates Islamic financial institutions (IFIs) to adhere to Shariah governance, risk management, and Central Bank compliance standards at individual and group levels (Salisu & Saniff, 2023). The Central Bank of Bahrain sets eight licensing conditions in Module LR, aligning with international benchmarks like Basel Committee and IFSB (The Islamic Financial Services Board, is an international body based in Malaysia that sets global

prudential standards to ensure the stability and sound regulation of Islamic finance), for initial licenses and operational legitimacy, and ensuring alignment with global regulatory practices (Abozaid & Khateeb, 2024).

2.3.3 Capital Requirements

Islamic banks in some countries like Ethiopia, Kazakhstan, Turkey, the UAE, and the UK must meet identical capital adequacy standards, influenced by the Basel Committee on Banking Supervision framework (BCBS). However, local regulatory preferences can vary, leading to variations in application across these countries (Dusuki & Abdullah, 2011). On the contrary, Bahrain, Jordan, Malaysia, and Sudan modify capital adequacy requirements to align with Islamic banking characteristics, following IFSB rules to better reflect the distinctive tenets of Islamic finance. Islamic banks must maintain a capital adequacy ratio (CAR) between 8% and 12% of their risk-weighted assets (Ismail & Zulkhibri, 2024). Capital adequacy is measured by the "alpha" metric, which varies by location and regional budget, and is influenced by governance systems, making international comparisons challenging. Malaysia requires all sources from investment funds to be converted into risky assets, while Sudan set this ratio at 50%, Bahrain and Jordan set it at 30%. Standardization of Islamic banking capital regulations is essential to improve comparability and financial stability (S&P Global, 2024).

2.3.4 Governance Structure

To preserve operational efficiency and ensure adherence to Shariah principles, Islamic banks' (IBs') governance structure is essential. This structure is characterized by a wide range of obligations and responsibilities, particularly regarding Shariah compliance, which is essential to the validity of financial operations in the context of Islamic banking. An essential part of governance in Islamic banks is the Shariah Supervisory Board (SSB), which is composed of specialists in Islamic commercial jurisprudence (fiqh al-mu'amalat) (Wasim Jan, 2020). The SSB is responsible for business audits, zakah calculation principles, documentation of financial instrument, and processing of non-compliant revenue income. Its fatwas are binding and consist of at least three to six members. The SSB examines banks' operations to ensure compliance with Shariah regulations, with some jurisdictions having their own boards (Tashkandi, 2022). Shariah committees and other business governance systems are part of the governance structure of Islamic banks, aiming to reduce agency issues and ensure transparency. This dual governance, which combines Shariah oversight with traditional processes, is significant for decision-making and strategy development, and requires clear accountability in every workplace (Muhamad Sori et al., 2015).

2.3.5 Operational Infrastructure

This element encompasses both internal control and compliance system, and risk management framework:

2.3.5.1 Internal Controls

To ensure compliance with Sharia law and financial rules, the bank needs to set up strong internal controls and compliance procedures. This includes creating accounting systems that monitor asset-backed transactions, profit and loss sharing, and avoiding interest-based transactions (Algabry et al., 2020).

2.3.5.2 Risk Management

Islamic banks (IBs) face unique risk management challenges due to their Shariah-compliant activities. To maintain stability and compliance, a comprehensive risk governance framework is needed, including policies, procedures, systems, and controls (Ismail & Zulkhibri, 2024). Additionally, Islamic banks must monitor and report Shariah-compliant vehicles, manage operational, credit, liquidity, and market risks, and implement risk management systems in line with the Sharia risk-sharing model, avoiding forbidden actions (Song & Oosthuizen, 2014). Finally, Islamic banks (IBs) require license, documentation, operational infrastructure, sharia governance, branch operations, management control, capital management, and fiduciary responsibilities. These requirements regulate the level playing field for Islamic banks.

2.3.6 Sources Of Funds In Islamic Banking And Its Application

There are different sources of funds in Islamic banking such as Shareholders, Equity based on joint-venture profit sharing, customer's, deposits in current Account based on Wadi'ah Yad Damanah, Customers deposits in saving Accounts based on Wadi'ah Yad Damanah, Customers deposits in general investment Accounts based

on Mudarabah/ trustee profit- sharing, customers deposits in special investment accounts based on Mudarabah/ trustee profit- sharing as well (Khan & Mirakhor, 1986). One of the essential application parts for the bank is statutory reserves that the bank maintains with the central bank based on Wadi, ah Yad Damanah, liquidity requirements based on Qard al-Hasan; it is also the statutory requirement that the bank maintains certain ratios of defined liquid assets to its various types of deposits at all times. This ratio is given by the central bank from time to time. After meeting the reserve requirements and holding the necessary assets, the banks are free to use the remaining customer’s deposits and the shareholders. funds for banking operations like project financing based on Mudarabah, musharakah, Bay, Bithaman Ajil, financing the use of services of asses like Ijarah, syndication services like fees, and security and debt settlement according to Bay, al Dayn (Dusuki & Abdullah, 2011). Each has its own Islamic bank structures and models. The bank provides short-term financing to meet the operating and working capital needs of its customers. These facilities include LC Letters of Credit, LG Letters of Guarantees, and financing operations based on Murabahah, wakalah, musharakah, and Murabahah. The bank uses customers’ deposits and shareholders' funds to invest in musharakah form, while the treasury department manages short-term funds, foreign exchange, and trade money (Al- wadi & Samhan, 2016).

2.3.7 Products And Services Development

Islamic banks promote financial inclusion and avoid interest by offering Shari'a-compliant products and services. They provide advice on transaction amounts, timings, benefits, terms, structure, performance, and features of these instruments, increasing in number daily (Dusuki & Abdullah, 2011). Banking services are divided into assets and liabilities, which are vital for financial stability and the balance sheet of banks. Assets, such as current assets, are economic assets owned by a bank and used to generate income, meet obligations, and invest surplus cash. Liabilities are the obligations of a company, including debts and unpaid services, and are divided into current (short-term) and non-current (long-term). These include deposits, Ruhn, unpaid bills, deferred revenues, wages, and other debts. Islamic banks generally provide a wide range of services and products, including deposits, investments, financing through Mudarabah, joint venture contracts, and other instruments such as Istisna'a, Salm, Muzara'at, Musaqat, Magharist, and Ijarah. It also includes investments in securities such as sukuk, bank guarantees, bank transfers, letters of credit, and credit cards (Al- wadi & Samhan, 2016). The chart below exhibits the features of Islamic Bank’s Balance Sheet.

Table 1: Assets and Liabilities of Islamic Banking

Assets	Liabilities
Inventory Rear asset/ Automobiles Ownership of asset	Demand Deposits Wadiah (safe custody)/ Qard (loan)
Asset backed Transactions Murabahah (cost plus)/ Ijarah (leasing)/ Istisna (manufacture)/ Salam (forward delivery)	Investment account Mudarabah (profit sharing)
Profit Sharing Transactions Mudarabah (profit sharing)/ Musharakah (profit and loss sharing)	Special Investment Account Mudarabah (profit sharing)
Fee Based Services e.g. Ujrah, Wakalah(Agency), Kafalah (Guarantee)., etc.	Profit Equalisation Reserves As prudential tool

(Dusuki & Abdullah, 2011)

2.3.8 Common Finance Models In Islamic Banking

Shariah contracts in trade and commerce can be categorized into trading contracts, participating contracts, and supporting contracts. There are ten shariah contracts commonly used in Islamic banking, including Murabaha, Istisna, Bay, Bithaman Ajil, Ijarah thuma al Bay, Bay, al Salam, Qard Hasan, Bay, al Inah, and Bay, al Dayn (Al- wadi & Samhan, 2016). Trust services are crucial in Islamic finance for trust creation, management, and administration, while developing Shari'a-compliant products requires caution to avoid stifling innovation, especially in markets with lower religiosity (Dusuki & Abdullah, 2011).

2.3.9 Human Resources: Roles, Responsibilities, Qualifications, Experience, And Ethical Considerations

In Islamic banking, the human resources division plays a crucial role in maintaining Shari'ah compliance and regulatory standards. The internal Shari'ah control department, in collaboration with the Shari'ah Supervisory Board (ISB), is responsible for ensuring adherence to Shari'ah regulations, refraining from issuing independent fatwas (Suwandaru et al., 2023). Executives in departments dealing with risk acquisition and control must monitor performance targets while ensuring organizational goals and legal requirements are met. Establishing an Islamic bank requires specialized human resources with qualifications such as a professional certificate in Shari'ah and Islamic banking from organizations like AAOIFI and CIBAFI, as well as a university degree in Islamic Shari'ah or related fields. Some jurisdictions require 10 years of Shari'ah supervision experience, certification programs like CIBP, and ethical recruiting practices, including proficiency in English and Arabic for effective communication within the workforce (Zafar & Jafar, 2024).

2.3.10 Technology And Infrastructure

They are important, particularly in the contemporary era, which includes both IT systems and e-banking services. Therefore, it is crucial to establish modern banking institutions with digital platforms that will manage customer account, banking transactions, and products in accordance with Sharia law. In addition, the IT infrastructure must comply with security and governance requirements. Also, the bank must provide electronic banking services that comply with Islamic finance standards, allowing users to manage funds, conduct transactions and apply for loans online without using products or interest (Riza & Wijayanti, 2024).

2.3.11 Engagement Of The Market And Stakeholders

To support competitive bidding and stakeholder engagement, it is significant to engage with the industry and stakeholders through market research and engagement with local citizens to build trust and ensure that the company's products are shariah compliant. Key regulations that can be introduced for Islamic financial institutions are to ensure that they operate in a shariah-compliant manner and to support the long-term growth, sustainability, and stability of the global financial system (Salahudin et al., 2019).

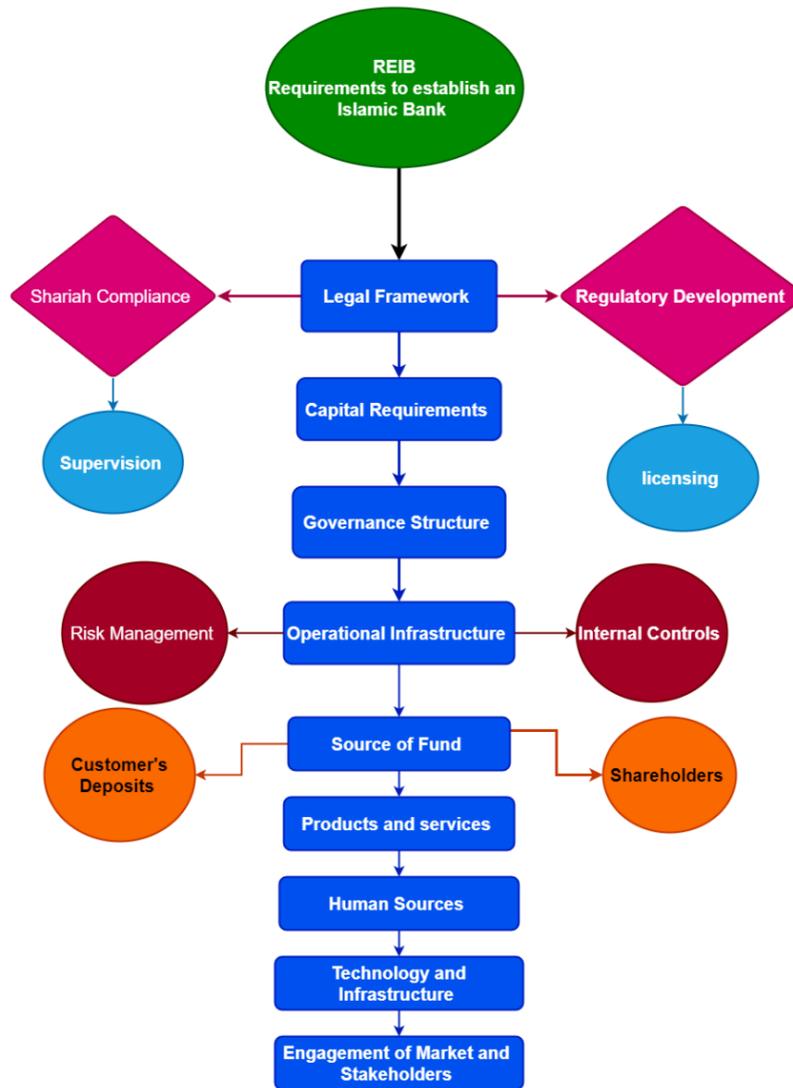


Figure 1: The requirements of establishing an Islamic bank

2.4 Challenges And Considerations (Regulatory Framework, Risk Management, Market Dynamics, Financial Viability And Societal Factors)

Establishing an Islamic bank requires compliance with regulatory requirements that vary by region. While some countries have set comprehensive standards for conventional and Islamic banks, specific requirements for Sharia compliance and governance are often required. These frameworks can vary; some jurisdictions provide broad legal provisions to Islamic banks, while others may offer limited regulatory support, resulting in differences in systems (Salisu & Saniff, 2023). Islamic banks face unique challenges in managing business, operations, and Shari'ah-compliance risks due to capital allocation and liquidity constraints, interest, requirements management, and approval principles. Challenges such as liquidity shortage, insecurity in the secondary market, and lack of public understanding hinder investment attraction and asset management. Islamic banks need to develop business plans that include financial forecasting, capital adequacy, performance monitoring, and risk assessments to ensure financial profitability and build trust, especially in Muslim-majority regions (Abozaid & Khateeb, 2024).

2.5 Malaysia's Pioneer Islamic Banking System

Malaysia's advanced Islamic banking system provides Sharia-compliant financial services, exemplifying a balanced approach to modern banking practices. It operates alongside conventional banking under a dual framework and is supported by a robust regulatory environment. Afghanistan could benefit from Malaysia's governance experience, including finance, digital transformation, risk management, and cross-border investments (Salisu & Saniff, 2023).

2.6 Historical Overview Of The Malaysian Financial System

2.6.1 Malaysia's Economic Development Under Vision 2020

Malaysia's economic development has evolved through successive strategies, each building on the successes and challenges of previous plans. A country's development strategy is determined by long-term, medium-term, and short-term plans for the country's economic development. Vision 2020 is a long-term strategy to make Malaysia a global hub and an industrialized nation for Islamic finance with a high per capita income. Due to socio-political and economic factors, Malaysia's colonial development strategies failed to meet the social needs required to stabilize the economy and further fueled economic concerns. British colonial rule in Malaysia displaced the indigenous Malay populations, resulting in significant wealth and education inequality. The Chinese dominated key industries, and the Malays were marginalized (Mahmoud & Mitkees, 2017). Post-independence in 1957, Malaysia was faced with the challenge of maintaining its ethnic diversity and promoting economic growth. Capitalism prevailed until the 1960s, and by the time the Federation of Malaysia was formed in 1963, agriculture had become the main industry, accounting for 39.3% of GDP and employing more than 60% of the workforce, but the economy was still in decline (Seyd Othman & Aljunid, 2017). Malaysia avoided property confiscation or nationalization due to ethnic tensions, adopting an inclusive approach allowing Chinese, Indians, and Malays to collaborate in economic and political development. Malaysia's first plan (1966- 1970), implemented between 1957-1969, revitalized local economies by integrating and transforming the Malay population into the economy. Despite these efforts, the plan continued to face challenges such as a high poverty rate, lack of entrepreneurship, and unemployment, leading to conflict (Devadas et al., 2020). The 1969 uprising led the government to develop a new strategy. Malaysia's New Economic Policy (NEP) was implemented between 1970 and 1990 with the aim of addressing social inequalities and promoting economic growth. It was divided into five plans: the Second Plan (1971-1975), the Third Plan (1976-1980), the Fourth Plan (1981-1985), and the Fifth Plan (1986-1990). By 1990, the NEP had increased the Malay's share of the country's GDP from 2.4% to 30%, reduced poverty from 49.3% to 16.5%, and achieved an annual GDP growth rate of 7.8% between 1971 and 1990 (Seyd Othman & Aljunid, 2017). In 1991, Mahathir Mohamad launched Vision 2020, a comprehensive development plan that aimed to transform Malaysia into an industrialized country by 2020, focusing on the Malaysian people, the economy, capital, the role of Islam and state. Vision 2020 aims to quadruple Malaysia's per capita income since 1999, establish Malaysia as a global leader in Islamic finance, and address the challenges of globalization. Mahathir has outlined nine major initiatives to promote solidarity, fair trade, social justice and social research, which have been implemented through a series of strategic initiatives over the years (Devadas et al., 2020). The National Development plan (NDP) (phase 1) from 1991 to 2000 aimed to eradicate poverty, reduce social and economic inequality, and further advance the objectives of the New Finance Act. The New Democratic Party implemented two five-year strategies, The Sixth Five -Year Plan (1991-1995), and the Seventh Five-Year Plan (1996-2000), which focused on developing industrial knowledge and establishing the Malaysian Institute for Microelectronics. Our aim is to increase national investment in public investment and private sector growth through the following. This period also coincides with the 1997 Asian Financial Crisis, which had a major impact on Malaysia's economy (Devadas et al., 2020). Unlike its neighbouring countries that sought assistance from the International Monetary Fund (IMF), Malaysia implemented various domestic measures, including capital controls, to ensure that the country quickly recovered, reduced and improved economic growth. Malaysia prioritized the development of Islamic banking from 2001 to 2010 and targeted Islamic banking to account for 20% of total banking by 2010, thereby creating a resilient economy. A society that is wisely governed can meet the challenges of globalization S&P Global, 2024. The New Economic Model (2010-2020) aims to enhance Malaysia's position as a high-income country while promoting the globalization of Islamic finance. The Financial Markets Development Plan (2011-2020) aims to increase the contribution of financial markets to GDP from 4.3 times to 6 times by 2020, with an annual growth target of 8% to 11%. We aim to create a dynamic and competitive financial system by expanding

the range of Islamic finance products and services. Malaysia has implemented various strategies to support its growth path, including the Third National Plan (2006-2020), the Malaysia Education Plan (2013-2025), and the Malaysian Higher Education plan (2015-2020), to foster growth opportunities. Malaysia's National Commodity Policy and National Food Policy aim to strengthen trade and transport, with a target of full development by 2020 (Bunnell, 2022).

2.6.2 The Impact Of Islamic Banking On Malaysia's Economy

Due to the large number of banks and other financial organizations that offer financial services in compliance with shariah law, Malaysia is a top global leader in Islamic banking, with 16 fully Islamic banks, including domestic and overseas banks, providing financial services in compliance with Islamic law (Devadas et al., 2020). Malaysia's Islamic finance sector, including banking and investment, has grown significantly, particularly in Islamic financial instruments; Malaysia controls one of the largest markets in the world. Malaysian Islamic banks are global market leaders in Sharia-compliant financial services, offering interest-free loans and savings through joint ventures such as Murabaha, and Musharaka, where the benefits are shared between the bank and the customers. Islamic finance in Malaysia encompasses property leasing, commercial finance (Istisna), reduced property finance and cash sales (Murabaha). Malaysia's Islamic finance system includes Sukuk, and Takaful, providing an Islamic alternative to conventional bonds and insurance, supporting Sharia-compliant projects (Mahmoud & Mitkees, 2017). On the other hand, Malaysia's Islamic banking services, guided by Bank Negara Malaysia, adhere to Sharia principles, promoting ethical investments in ethically permissible sectors, fostering growth and stability. Islamic finance is expected to account for approximately 41% of total finance in Malaysia by 2024. This reflects the country's success in promoting Islamic finance domestically and globally. Malaysia is also introducing digital innovations in Islamic banking, providing Sharia-compliant electronic and mobile banking services for account management and transactions. Malaysia is a leading player in digital Islamic banking, introducing digital banks like Aion Bank to improve accessibility and expand Sharia-compliant financial services to marginalized communities (S&P Global, 2024). Malaysia's tech-savvy population is driving the growth of online and digital banking, with banks like Maybank2u, CIMB Clicks, and RHB Now offering comprehensive digital services to meet customer needs. To ensure security, these platforms use transaction verification codes and two-factor authentication (2FA) and are regulated by Bank Negara Malaysia to safeguard against cybersecurity threats. Malaysia's digital banks, such as Sea Bank and GXS Bank, were licensed by Bank Negara Malaysia in 2022, to provide accessible financial services to underserved communities, including rural areas and small businesses (Latip, 2024). Malaysia's banks are enhancing efficiency, low-cost services, and innovative financial solutions, integrating Islamic finance principles into digital platforms to uphold Sharia-compliant banking. Malaysia's online banking sector is expected to grow due to rising internet penetration and favourable regulatory conditions, enhancing financial inclusion and solidifying its position as a global Islamic finance leader (IFSB, 2024).

2.6.3 Shariah Legal Framework In Malaysia's Islamic Finance:

Islamic finance in Malaysia operates within a robust regulatory framework that facilitates the coexistence of conventional and Islamic banks. The Malaysian legal system, based on civil law, places most legal matters under civil courts' jurisdiction (Dusuki & Abdullah, 2011). The rapid growth of Islamic finance is supported by sound legal frameworks. Islamic banking and finance in Malaysia is regulated by government legislation, including the Islamic Banking Act 1983 (requires licensing and regulation), the Banking and Finance Act 1989 (allows conventional banks to offer Islamic banking services), the Malaysian Banking Act 2009 and the Central Bank Act, the financial Development Act 2002, the Direct Sale Act 2009, and the Federal Constitution, the supreme law of Malaysia (Salisu & Saniff, 2023). Key elements of the regulatory framework include the Islamic Financial Services Act 2013 (IFSA), which replaced the Islamic Banking Act of 1983 and provides a comprehensive framework for Sharia-compliant banking operations. Malaysia's Central Bank (Bank Negara Malaysia, BNM) is responsible for overseeing Islamic banking to ensure its growth and compliance with Sharia principles (Jalil & Osman, 2020). The regulatory framework for Islamic banks in Malaysia is overseen by BNM and the Securities Commission of Malaysia (SC). BNM sets Sharia regulatory standards for Islamic banks and takaful operators, while the SC provides guidance to Islamic capital markets. The Sharia Advisory Council (SAC), established by BNM, is the highest authority on Sharia matters in Islamic finance. Islamic banks in Malaysia adhere to Maqasid Sharia, focusing on principles such as the prohibition of Riba (interest),

transparency to avoid Gharar (uncertainty), halal in investments, and a risk-sharing model for cooperation between banks and customers (Wasim Jan, 2020). In Malaysia, waqf (Islamic donation) and zakat (almsgiving) regulations ensure that they are operated in accordance with Islamic teachings. While the State Islamic Religious Councils (SIRCs- (Majlis Agama Islam Negeri -Malaysia's statutory body oversees Islamic affairs, including waqf, zakat, mosque management, and religious education, with authority derived from state enactments and the Federal Constitution, chaired by the Sultan.) manage the waqf assets in accordance with state laws, the country also has government federal entities such as JAWHAR. The management of the waqf is regulated by state laws such as the Waqf (Powers of states) Act, and government regulations aimed at promoting sustainable development and investment. The collection and distribution of zakat is overseen by the Selangor Public Services Commission (SIRC) Lembaga Zakat Selangor, in accordance with state laws, supported by institutions such as the Selangor Zakat Department (Lembaga Zakat Selangor) (Salisu & Saniff, 2023). Modern zakat institutions focus on governance, transparency, and digital solutions. Efforts to integrate waqf and zakat resources, such as using waqf assets for zakat projects, are supported by technological innovations development and research centers such as the International Centre for Waqf and Zakat (ICWZ). This principle promotes social and economic cooperation while adhering to Islamic principles (Seyd Othman & Aljunid, 2017).

2.6.4 Shariah Governance In Malaysian Islamic Finance

Malaysia's regulatory framework, specifically the Shariah Governance Policy Document (SGPD), has significantly influenced Islamic finance and capital markets development. Unlike other countries, Malaysia has a centralized system with Shariah Advisory Councils under Bank Negara Malaysia and the Securities Commission, each with its own SAC (Jalil & Osman, 2020). This centralized approach strengthens Malaysia's leadership in Islamic finance and ensures industry uniformity (Aspiranti et al., 2023). The Shari'ah Advisors Council (SAC) is a group of nine experts in Sharia, Islamic finance, economics, law, and finance who will serve for three years to ensure sound governance in Islamic banks. They play a crucial role in adapting classical legal systems to modern finance through ijtihad, reform, and integration. SAC members must have Arabic language proficiency, Islamic commercial law expertise, collaboration knowledge, and research skills. They must also be innovative, collaborative, team-oriented, and maintain high standards of professionalism while demonstrating humility and acceptance of limitations (Muhammad, 2018). The Securities Commission Malaysia (SC) is led by the Securities Advisory Council (SAC), consisting of at least 10 members appointed by the Minister of Finance with expertise in Sharia, finance, economics, and law. The SAC's policy aims to maintain Malaysia's position as a global leader in Islamic finance, facilitating the growth of Islamic capital, equity, debt, commodity, derivatives, and foreign exchange markets (Salisu & Saniff, 2023). The National Shariah Councils (SACs) in Malaysia oversee Shariah committees to ensure compliance and prevent conflicts. The Shariah Governance Policy Document mandates all Islamic financial institutions (IFI) to establish a committee, consisting of five members, including at least three Shariah experts. These committees approve new products and processes, ensure ongoing compliance through review and audit, and serve three-year terms (Jalil & Osman, 2020). The Shariah Committee at the IFI-level in Malaysia ensures compliance with Shariah principles, submitting periodic reports to SACs, and aligning operations with Shariah principles for governance, product standardization, and Islamic finance acceptance. The committee, comprising key stakeholders, meets bi-monthly, requires 75% attendance, and makes decisions by a two-thirds majority. They work together to ensure Islamic financial institutions (IFIs) adhere to Islamic law principles, encompassing governance, compliance, product development, risk management, and auditing. This an overview of the key committees in IFIs in Malaysia, their functions, and typical members.

1. Shariah Committees (SC)

The Shariah Committee, or Shariah Supervisory Board, is the highest authority within an Islamic Financial Institution (IFI) responsible for ensuring Shariah compliance, providing advisory services, issuing fatwa, resolving disputes, and aligning with Shariah principles, typically comprising 5-7 members with expertise in Islamic law, finance, economics, and commercial law (Uddin et al., 2024).

2. Shariah Review Committee (SRC)

The Shariah Review Committee (SRC) ensures Shariah compliance by reviewing contracts, transactions, and practices against SC guidelines and fatwas. It comprises 3-5 members, including

Shariah scholars, auditors, compliance professionals, and legal or financial experts ([Aspiranti et al., 2023](#)).

3. **Shariah Audit Committee (SAC)**
The Shariah Audit Committee, comprising 3 to 5 members, ensures Shariah compliance by monitoring internal processes, transactions, and financial statements, identifying non-compliance, and recommending corrective actions ([Algabry et al., 2020](#)).
4. **Shariah Products Committee (SPC)**
The Shariah Products Committee, comprising 3 to 5 members includes Shariah scholars, product managers, and financial professionals with relevant expertise, reviews and develops Shariah-compliant products and services, ensuring adherence to Shariah law, evaluates financial contracts, investment strategies, and new instruments ([Seyd Othman & Aljunid, 2017](#)).
5. **Shariah Research Committee (SRC)**
The Shariah Research Committee, comprising 3-7 members, is a research group focused on Islamic finance, law, and economics, aiming to develop new theories for Shariah-compliant products and services, identify emerging trends, and contribute expertise to advance the field and ensure Shariah compliance ([Salisu & Saniff, 2023](#)).
6. **Shariah Risk Management Committee**
The Shariah Risk Management Committee, consisting of 3 to 5 members, identifies and manages non-compliant transactions, ensuring risk practices align with Shariah principles, primarily involving Shariah scholars, risk management professionals, and compliance officers ([Wasim Jan, 2020](#)).
7. **Shariah Governance Committee**
The Shariah Governance Committee, consisting of 5-7 members, reviews policies, processes, and performance to ensure alignment with Shariah principles and ensures effective compliance across institutions, including Shariah scholars and senior management ([Dusuki & Abdullah, 2011](#)).
8. **Shariah Compliance Committee**
The Shariah Compliance Committee, comprising 3 to 5 members including scholars, compliance officers, and auditors, ensures consistent alignment with Shariah law in Islamic Financial Institution operations and guides corrective actions when necessary ([Rosli Abdul Aziz, 2019](#)).
9. **Shariah Finance Committee**
The Shariah Finance Committee, comprising Shariah scholars, finance professionals, and investment experts, is responsible for ensuring the financial strategies of Islamic Financial Institutions align with Shariah principles, avoiding prohibited elements like *riba* and *gharar* ([Muhammad, 2018](#)).
10. **Shariah Investment Committee**
The Shariah Investment Committee, consisting of 3 to 5 members, ensures Islamic law compliance in IFI's investment activities by evaluating opportunities, structuring portfolios, and avoiding prohibited sectors, ensuring alignment with Islamic law ([Muhammad, 2018](#)). These committees collectively ensure that IFIs in Malaysia uphold Shariah principles while maintaining robust governance, compliance, and risk management frameworks.

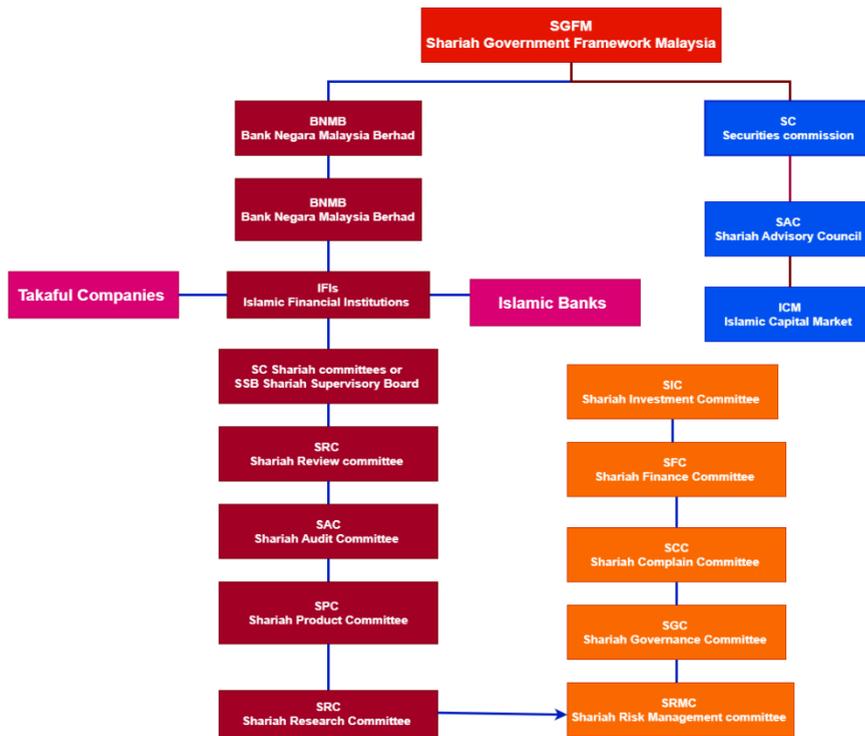


Figure 2: The above figure illustrates the Sharia Governance Framework for Islamic banking in Malaysia

2.6.5 Critical Success Factors For Islamic Banking In Malaysia

Malaysia's success in Islamic banking is attributed to strong government support, Sharia compliance laws, and a well-structured legal framework supported by institutions like Bank Negara Malaysia and the Securities Commission (SC), which ensures adherence to Islamic principles, stability, and transparency in the sector (Wasim Jan, 2020). Islamic banking in Malaysia thrives on offering a diverse range of Sharia-compliant products, including Murabaha, Mudarabah, Musharakah, Ijarah, Musharakah Mutanaqisah, Sukuk, Takaful, and ethical investment options (Muhammad, 2018). Malaysia's Islamic banking sector full-fledge, subsidiaries and DFIs, comprising 40% of its banking assets, is expanding due to digital banking innovation, green Sukuk issuance, and halal financing initiatives, demonstrating its leadership in global Islamic finance. Furthermore, Malaysia's global hub status in Islamic finance is attributed to top institutions like INCEIF, ISRA, IIBF, and INHARA, which provide high-quality education and maintain a steady supply of skilled human capital (Zafar & Jafar, 2024). Malaysia's Islamic finance sector is thriving through government incentives, technological advancements, public awareness, and financial literacy programs. Risk management and resilience are crucial for success, ensuring stability during economic downturns. Among the factors are the ability to access the global market, participation of local and international investors, use of local and foreign currencies, strong interbank money market and a variety of financial instruments (IFSB, 2024). Finally, Islamic banks contribute to community welfare and Malaysia's position in the global Islamic finance market is further enhanced by international partnerships and foreign investments.

3. Research Methodology

This study adopts a qualitative literature review approach, drawing on published academic works, legal documents, industry reports, official records, and relevant websites, and employs comparative and content analysis to examine the systems of Malaysia and Afghanistan.

Adopting the establishment of an Islamic bank in Afghanistan, inspired by the Malaysian experience, is expected to drive significant changes in the Islamic financial system and contribute to the country's economic

development. This paper explores the implementation of an Islamic banking system in Afghanistan, drawing inspiration from the successful Malaysian experience. In Afghanistan, the banking sector plays a crucial role in the country's economic development. Since 99% of the population being Muslim, Islamic banking is expected to gain significant trust, whereas currently only 7.5% of the population uses banking services, mostly concentrated in a few cities like Kabul (Disli et al., 2023a). Afghanistan's banking system, rebuilt post-2001 with international support, now has around 12 banks, including one full-fledged Islamic bank, up from 3 state banks before 2001. This expansion is expected to encourage more people to deposit money and take loans (Centre for Strategic and Regional Studies, 2022).

3.1 Leveraging Malaysia's Islamic Banking Model For Afghanistan's Financial Transformation:

Malaysia's Islamic finance hub serves as a model for Afghanistan, offering Shariah-compliant financial systems. Adopting Malaysia's Islamic banking framework could help Afghanistan establish a stable, inclusive financial sector. Malaysia's Islamic banking promotes financial inclusion through microfinance, aiding poverty reduction. Malaysia integrates Zakat and Waqf into its financial system, funding social welfare initiatives in sectors like healthcare, infrastructure, and education (Seyd Othman & Aljunid, 2017). Malaysia's integration of Islamic banking elements promotes social justice and well-being by developing tailored financial products for diverse groups, including refugees. The country has used Sukuk to fund infrastructure projects, showcasing Islamic finance's potential for large-scale development. The dual-banking system expands service offerings and aligns financial growth with environmental goals through Islamic green financing initiatives (Uddin et al., 2024). Islamic banking in Malaysia has grown significantly through efforts to promote financial inclusion for women and establish a high-quality financial index. The country has also advanced digital banking, enabling rural communities to access services through mobile platforms. Islamic finance initiatives have supported the agricultural sector, mitigated risks for small enterprises, and aided post-conflict economic reconstruction. Regional cooperation and global collaboration have reinforced Malaysia's leadership in international Islamic finance (Latip, 2024). Additionally, Islamic trade finance has expanded export markets, while investments in education and training have created a skilled workforce, ensuring sector growth. Based on the success Malaysia's experience, Afghanistan could benefit from Malaysia's Islamic banking system, focusing on small-scale, Shariah-compliant funding for low-income and rural entrepreneurs. This could improve social development financing and facilitate integration for internally displaced persons, inspired by Malaysia's approach. Furthermore, Afghanistan could fund infrastructure projects with Islamic principles by issuing Sukuk, adopting a dual-banking system like Malaysia, and green Islamic finance products to address environmental issues. Shariah-compliant banking services could empower women, such as microloans and financial support for female entrepreneurs. Also, Afghan Islamic Banking Index, inspired by Malaysia's models, could track sector growth and guide policy decisions. Malaysia's experience suggests that digital and mobile banking solutions can enhance financial inclusion, especially in remote areas. Digitalized payment services include ATMs, CDMs, E-Debit, MEPS, Interbank GIRO, FPX, internet banking, phone and mobile banking, SMS banking, PENTAS, SWIFT, and Islamic interbank (Dusuki & Abdullah, 2011). Additionally, Islamic agricultural financing and Takaful products through Islamic banking can improve risk management and productivity in sectors like agriculture, healthcare, and small businesses, while also aiding Afghanistan's post-conflict reconstruction through Shariah-compliant finance. Islamic trade finance can support Afghan exports in artisanal and agricultural sectors. Developing human capital through specialized training and global collaborations is crucial for driving Islamic finance growth. Regional cooperation with Malaysia can enhance Afghanistan's Islamic banking system through knowledge exchange and joint projects. So, by adopting Malaysia's successful Islamic banking model, Afghanistan can establish a robust, ethical banking system that meets local financial needs, supports national economic stability, and adheres to Islamic principles (Uddin et al., 2024).

3.2 Challenges And Opportunities For Islamic Banks In Afghanistan

The establishment of Islamic banks in Afghanistan presents both significant challenges and opportunities.

3.2.1 Challenges

A major challenge is the lack of infrastructure, Afghanistan's underdeveloped banking sector lacks the physical and digital infrastructure needed for modern banking, including Islamic finance (Disli et al., 2023b). Another

key issue is the absence of a regulatory framework, and without comprehensive laws to support Sharia-compliant banking, it is difficult for Islamic banks to operate effectively. Political instability also poses a significant barrier, as conflict and uncertainty hinder economic development and investor confidence (Naseri, 2020). The shortage of qualified professionals in Islamic finance further complicates the situation, requiring specialized training programs. Additionally, public awareness of Islamic banking is low, which could hinder adoption. Lastly, economic instability, with a large portion of the population living below the poverty line, makes it challenging for many to engage with Islamic banks (Alami et al., 2021).

3.2.2 Opportunities

Despite these challenges, Afghanistan offers several opportunities for Islamic banking. As a predominantly Muslim country, the population is likely to embrace a financial system that aligns with their cultural and religious values. Financial inclusion is a key opportunity, as Islamic banks could provide Sharia-compliant microfinance products to underserved populations, particularly in rural areas (Disli et al., 2023a). Islamic banking can also support social and economic development through Zakat and Waqf, funding projects in healthcare, education, and infrastructure. Additionally, the development of Islamic capital markets, such as Sukuk (Islamic bonds), could provide a means for raising funds for infrastructure projects. Regional collaboration with Islamic financial hubs like Malaysia could offer expertise and investment, while international support from global Islamic finance communities could further strengthen the sector (Naseri, 2020). As a result, while Afghanistan faces challenges like lack of infrastructure, political instability, and limited human capital, there are substantial opportunities for developing a robust Islamic banking system (Zafar & Jafar, 2024). By aligning with cultural values, promoting financial inclusion, and fostering social development, Afghanistan can leverage these opportunities to build a successful and inclusive Islamic banking system (Uddin et al., 2024). On the other hand, Afghanistan can successfully transition from conventional banking to Islamic banking with technical support from international institutions like the World Bank, IDB, IMF, and regional partners like Gulf countries and Malaysia. Key players in this process include the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), which has 45 member countries, and works to harmonize and standardizes Islamic financial and reporting practices globally, and the Islamic Financial Services Board (IFSB) in Malaysia with 57 member countries, which promotes the stability and resilience of the Islamic financial services industry (Abozaid & Khateeb, 2024). Through collaboration with these institutions, Afghanistan can develop a comprehensive legal infrastructure, improve information technology and banking systems, and establish robust supervisory and enforcement frameworks necessary for the successful implementation of Islamic banking.

4. Findings

The study reveals that Malaysia offers valuable insights and ideal model for developing a sustainable Islamic banking system in Afghanistan. Key factors contributing to Malaysia's success include a comprehensive legal and regulatory framework that ensures Shariah compliance and financial stability, coupled with strong governmental support that fosters policy continuity and sector growth. High levels of public awareness and trust in Islamic finance have facilitated widespread adoption of Shariah-compliant products, while the availability of diverse and inclusive financial instruments meets the interests of both individual and corporate clients. Moreover, Malaysia's emphasis on sustainability, risk management, and innovation has fostered resilience and adaptability within its Islamic finance industry. These factors collectively highlight the significance of an integrated strategy that combines regulatory rigor, institutional support, market awareness, and product innovation—in establishing a comprehensive benchmark for developing resilient, competitive, robust and sustainable Islamic banking system in Afghanistan. Additionally, the mechanism of adapting Malaysia's Islamic finance framework to Afghanistan requires establishing a comprehensive legal and regulatory infrastructure for Islamic finance within Afghanistan's existing Sharia court system, strengthening Sharia governance through the establishment a national Sharia Advisory Council (SAC), integrating international standards, and the encouragement of innovation through collaborative efforts with Afghan financial institutions and international bodies. Malaysia's dual financial system and its well-established Shariah governance model provide a practical blueprint for Afghanistan, enabling to enhance financial inclusion,

support SME growth, and advance general financial stability while guaranteeing adherence to the Shariah principles.

5. Conclusion

In conclusion, there are many opportunities and challenges to building a sustainable Islamic banking system in Afghanistan. By drawing insights from Malaysia's successful model, Afghanistan can potentially navigate these obstacles, and overcome these challenges, leveraging Malaysia's expertise in regulatory frameworks, shariah governance, financial innovation, and integration of Islamic principles with modern banking practices. Important takeaways include the significance of establishing a strong legal and regulatory framework, promoting financial literacy, and supporting an enabling environment that is conducive to Islamic financial products. Although Afghanistan's distinct socio-political and economic context requires customized solutions, Malaysia's experience shows that a sustainable Islamic banking system can be established with careful planning, collaboration, and a commitment to financial inclusivity, supporting Afghanistan's financial stability and economic growth.

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