



UNIVERSITI  
KEBANGSAAN  
MALAYSIA  
*National University of Malaysia*

Research Center for Islamic Economics and Finance  
Universiti Kebangsaan Malaysia  
Bangi 43600, Selangor, Malaysia  
Fax: +603-89215789  
<http://www.ekonis-ukm.my>  
E-mail: [ekonis@ukm.my](mailto:ekonis@ukm.my)

### Working Paper in Islamic Economics and Finance No. 1226

## REGULATORY CHALLENGES AND ISLAMIC BANKING IN THE CROSS BORDER OPERATIONS

*ABUL BASHAR BHUIYAN\*, ABDUL GHAFAR ISMAIL, CHAMHURI SIWAR, & M. KABIR HASSAN*

*\*Corresponding author's: Dr. Abul Bashar Bhuiyan and email: [bashariuk@gmail.com](mailto:bashariuk@gmail.com)*

### Authors' Addresses:

1. **DR. ABUL BASHAR BHUIYAN:** Senior Lecturer at the School of Business Innovation and Technopreneurship, University Malaysia Perlis (UniMAP) and Institute for Environment and Development (LESTARI), Universiti Kebangsaan Malaysia (UKM), Bangi- 43600, Selangor, Malaysia. E-mail: [bashariuk@yahoo.com](mailto:bashariuk@yahoo.com)
2. **DR. ABDUL GHAFAR ISMAIL:** Research Centre for Islamic Economics and Finance, Universiti Kebangsaan Malaysia (UKM), Bangi - 43600, Selangor, Malaysia. Email: [agibab@ukm.my](mailto:agibab@ukm.my); [agibab62@gmail.com](mailto:agibab62@gmail.com)
3. **CHAMHURI SIWAR:** Professor Emeritus & Senior Research Fellow at Institute for Environment and Development (LESTARI), Universiti Kebangsaan Malaysia (UKM), Bangi - 43600, Selangor, Malaysia. E-mail: [csiwar@ukm.my](mailto:csiwar@ukm.my)
4. **M. KABIR HASSAN:** Professor at Department of Economics and Finance, University of New Orleans, New Orleans, LA 70148, USA. E-mail: "kabirhassan63@gmail.com"

### ABSTRACT:

The rapid growth of Islamic Banking activities is crossing global financial hubs to meet the increasing demand of international transactions every day. Due to the issues of Islamic and Conventional banking operations within the same umbrella in the different traditional rules, customs and regulations, Islamic Banks are struggling with Shariah regulations in the cross border countries. Given this circumstance, the aim of this paper is to identify major regulatory challenges faced by Islamic Banks in the cross border activities over the world. It is purely a descriptive presentation on the issues of regulatory challenges in the cross border operations. The study found that Islamic banking is facing challenges to make appropriate rules and regulations to cope up with the present demands for their customers with Conventional counterparts based on the Islamic Shariah principles. There are several Shariah issues that need to be considered especially in the area of lack of appropriate legal framework for maintaining proper

accounting standards, cost and competitiveness of cross-jurisdictions, lack of equal playing field for Islamic and Conventional banking, risk management and diversification, developing the capital market, risk of contracts, documentation and safety net issues especially in the area of financial engineering. Finally, the study recommends that the policy makers should play a vital role to create a common set of regulations with regards to the above issues to ensure the smooth operation of Islamic Banks in the cross border arena.

**Keywords:** *Islamic Banking, Regulations and Cross Border Activities.*

**JEL classification:** *G2I, G24, L26, P5I*

## 1.0 INTRODUCTION

In the era of high-growth Islamic banking, the best-fit alternative and trusted financial institutions is Islamic mode of finance which promises the same benefits based on Shariah . As Islam provides the complete code of life, the religion covers take of human rights as one of the premier agendas (Aziz, 2006). In the increasing demand of Islamic mode of financing from the cross countries customers, the Islamic Bank are offering cross border opportunity of transaction in the global market (Brown & Skully, 2007). The rapid expansion and growth of Islamic banking has attracted the attention of Conventional commercial banks. There are many more conventional banks who are offering to provide the Islamic banking products to their Muslim customers within the national and international perspective. For providing Islamic Banking services they open an Islamic banking window or Islamic banking section (Mohammad Kabir Hassan & Mehmet F. Dicle, 2005).

In such situation cross border banking activities are playing vital rules for meeting up raising demand of global customers. The global economy are interdependence of countries worldwide through the increasing volume and variety of cross border transactions in goods and services and international capital flows and also through the more rapid and widespread diffusion of technology (Ahmad, Khan, & Iqbal, 1998). The changing features of banking transactions in the global market, the Islamic banking are facing often challenges to make appropriate rules and regulations to cope up with present coming demand for their customer with Conventional counter parts base on the Islamic Shariah principles (Gavin, Gibson, McCrum, & Summers, 2010; Mamun, Hassan, & Isik, 2011).

Because, it is merely easy to operate the Islamic Banking activities in the cross border countries within the ubrala of Conventional banking operation in the different tradotional rules, custom and regulation (Amihud, DeLong, & Saunders, 2002; Mohamad, Hassan, & Bader, 2008). Thus, Islamic Banking are facing strong regulatory challenge in the cross boder activities including financial engineering, some sorts of Shariah issues, lack of proper institutional framework, lack of appropriate legal framework, lack of equity institutions, for maintaining proper accounting standards, cost and competitiveness of cross-jurisdictions, lack of equal field for Islamic and Conventional banking, risk management and diversification, to develop of capital market, risk of contract and documentation, risk of contagion and liquidity problem. The aim of this paper is to identify majors regulatory challenges are facing by Islamic Bank over the world in the cross border activities.

## 2.0 REGULATORY SOURCES OF ISLAMIC LAW

As Islam is the complete code of human life. It has complete directions for whole part human life, which should be through the ultimate satisfaction of Allah

(SWT). Allah (SWT) has clearly communicated in the Quran to assist each other in righteous deeds (Al-Quran, Surah Al Maida, Verse no.2), where the agreement should be written having witnesses with faithfulness between parties where any future transaction is involved (Al-Quran, Sura Baqarah, Verse No.282). Shariah is the main sources for Islamic economy and finance. It is come from the Arabic word as meaning of Islamic law which has been given from Allah (SW). Shariah covers not only religious rituals, but many aspects of day-to-day life, politics, economics, banking, business or contract law, and social issues. The main sources of Islamic law are the Quran, the Hadith or directions of the Islamic prophet Muhammad, the unanimity of Muhammad's disciples on a certain issue, and Qiyas (drawing analogy from the essence of divine principles). Qiyas various forms of reasoning, including by analogy are used by the law scholars to deal with situations where the sources provided no concrete rules. The consensus of the community or people, public interest, and others were also accepted as secondary sources where the first four primary sources allow.

#### ❑ *The Holly Quran:*

The Quran is the root based of Islamic. Muslims believe the Quran to be the direct words of Allah, as revealed to and transmitted by the Prophet Muhammad. All sources of Islamic law must be in essential agreement with the Quran , the most fundamental source of Islamic knowledge. When the Quran itself does not speak directly or in detail about a certain subject, Muslims only then turn to alternative sources of Islamic law. Islamic finance may focus on those verses that contain descriptive statements on human nature, epecially on economic phenomena and verses concerning groups or collectivities fall within the ambit of Islamic economics and fianance (Saleem, 2010). The Quran has many verses on human nature. Particularly, (Al-Quran, Sura Al-'Ahzab, Verse no 72) which states that man “has always been prone to be most wicked, most foolish”, verses (Al-Quran, Surat Ash Shuraa, Verse No 27) which links human transgression to affluence and richness, verses (Al-Quran, Sura An Nisa, Verse No.32, Sura Toha,

Verse No.131) that explains the covetous nature of man which desires what others have and thereby his vulnerability to be influenced by external social and economic factors. Moreover, Verses (Al-Quran, Sura An Nisa, Verse No.14-15) describes man's love of wealth and verse (Al-Quran, Sura Al Adiyat, Verse No.8) states that "verily, to the love of wealth is he most ardently devoted". Islam therefore, does not condemn seeking wealth but instead introduced certain guidelines within which wealth can be earned and spent. In the same way, verse 2: 30 where the angels while referring to man's khilafah on earth said that men would "spread corruption thereon (mai ufsidu feeha) and shed blood". On the other hand, verses 43: 32 states: "But is it they who distribute thy Sustainer's grace [Nay, as] it is We who distribute their means of livelihood among them in the life of this world, and raise some of them by degrees above others, to the end that they might avail themselves of one another's help". This verses describes the differences in wealth, talents, physical and mental capacities and other potentials among people. It also explains the reason for the existence of these differences as they enable humans to make use of each other and in the process meet each other's economic needs. The Quran also has descriptive statements on groups or collectivities. These statements are wider in scope and application than the normative statements of the Quran or Sunnah. While the latter are only applicable to Muslim individuals the former are equally applicable to both Muslim and non-Muslim collectivities (Saleem, 2010).

Furthermore, verses 2: 251 and 22: 40 states: "were it not that God repels (dafa) some people by means of others, corruption (fasad) would surely overwhelm the earth". The word dafa used in both verses literally means repelling and convey the meaning of checking and defending.<sup>25</sup> This, it is argued, is a descriptive statement concerning human groups and not its individual members (Saleem, 2010). The Quran in these verses describes that in order to restrain groups of people from doing injustice to each other the law of mutual check and balance applies (Saleem, 2010).

### ❑ *The Sunnah:*

The second source for the knowledge of Islamic economics is the hadith of the Prophet (pbuh). Sunnah is the traditions or known practices of the Prophet Muhammad, many of which have been recorded in the volumes of Hadith literature. The resources include many things that he said, did, or agreed to in the specific issues and he lived his life according to the Quran, putting the Quran into practice in his own life. During his lifetime, the Prophet's family and companions observed him and shared with others exactly what they had seen in his words and behaviors -- i.e. how he performed ablutions, how he prayed, and how he performed many other acts of worship. People also asked the Prophet directly for rulings on various matters, and he would pronounce his judgment. All of these details were passed on and recorded, to be referred to in future legal rulings. Many issues concerning personal conduct, community and family relations, political matters, etc. were addressed during the time of the Prophet, decided by him, and recorded.

### ❑ *Ijma (Consensus):*

In situations when Muslims have not been able to find a specific legal ruling in the Quran or Sunnah, the consensus of the community is sought (or at least the consensus of the legal scholars within the community). The Prophet Muhammad once said that his community (i.e. the Muslim community) would never agree on an error.

### ❑ *Qiyas (Analogy):*

In cases when something needs a legal ruling, but has not been clearly addressed in the other sources, judges may use analogy, reasoning, and legal precedent to decide new case law. This is often the case when a general principle can be applied to new situations.

### ***2.1. Cross Border Issues and Islamic Bank:***

The competitions of Islamic and conventional banks are increasing day by day in the cross border transaction due to globalization (Brown and Skully, 2007). The world markets are rapidly converging into a single market place. Liberalization of foreign exchange markets has further reinforced this trend. Technological innovations are also playing an important part in financial integration and globalization (Amuda, Ariss and Saredidine, 2007). The discovery of easy communication wave through electronic correspondence has reduced the cost of international communication. Customers in many countries can navigate on the Internet banking, unit trusts, mutual funds and even business firms (Ahmad et al., 1998, Iqbal, 2007, Mamun et al., 2011). For the Islamic Banking perspectives, it is a prime challenge to introduce new Shariah-compatible products on the basis of understanding the risk-return characteristics of each building block of the system and offering new products with different risk-return profiles that meet the demand of investors, financial intermediaries, and entrepreneurs for liquidity and safety (Hassan and Dicle, 2005, Iqbal, 2007, Tahir and Bakar, 2009).

Furthermore, in the cross border context global transaction has been increased and as well as increased difficulties lack of integrated capital market. The wide range of instruments with varying structures of maturity and opportunities for portfolio diversification and risk management can be way of solution for transparent integrated capital market in cross countries. In the same way, Islamic Banking have to focus on the development of products that foster market

integration and attract investors and entrepreneurs to the risk-return characteristics of the product rather than to the fact of the product being Islamic or non-Islamic (Iqbal, 2007). In general, Islamic Bank is new field are and they don't have enough and mass funds for investing in research and development of new products in compare with conventional bank. Considering the importance of financial engineering, Islamic financial institutions should seriously consider making joint efforts to develop the basic infrastructure for introducing new products. Conducting basic research and development collectively may save some of the costs required to build this infrastructure individually. A good example of such collective effort would be to sponsor research in the development of analytical models, computer systems, and tools to analyze the risk and return on different instruments (Iqbal, 2007).

### 3.0 REGULATORY CHALLENGES IN THE CROSS BORDER ISLAMIC BANKING

The cross border banking has incresed day by day and its become a part of global life in the recent decays. whlie in the era of high-growth Islamic banking, the best-fit alternative and trusted financial institutions is Islamic mode of finance which promises the same benefits based on Shariah. As Islam provides the complete code of life, the religion covers take of human rights as one of the premier agendas (Aziz, 2006). In the increasing demand of Islamic mode of financing from the cross countries customers, the Islamic Bank are offering cross border opportunity of transaction in the global market. But the services of Islamic Banking are not available in the whole parts global arena where two or more Islamic Bank can do agreement to provide facilities to their customer on the basis of Islamic Shariah.



In such circumstances it is very difficult for Islamic bank to operate and find an alternative way for the cross border transaction. On the other hand, there are many more conventional banks who are offering to provide the Islamic banking products to their Muslim customers within the national and international perspective. For providing Islamic Banking services they open an Islamic banking window or Islamic banking section (Mohammad Kabir Hassan & Mehmet F. Dide, 2005).

Therefore, it is not so easy to operate the Islamic banking activities in the cross border countries within the umbrella of Conventional banking operation in the different traditional rules, custom and regulation. Thus, Islamic banking are facing strong regulatory challenge in the cross border activities including financial engineering, some sorts of Shariah issues, lack of proper institutional framework, lack of appropriate legal framework, lack of equity institutions, for maintaining proper accounting standards, cost and competitiveness of cross-jurisdictions, lack of equal field for Islamic and Conventional banking, risk management and diversification, to develop of capital market, risk of contract and documentation, risk of contagion and liquidity problem.

### ***3.1 Financial Innovations in the Cross Border Context:***

Financial innovations are facing main challenge to cope up with the rising demand from the customers through condition of sharing risk, lowering transaction costs, and reducing asymmetric information and agency costs (Iqbal, 2007). It is the process of making design, development, and implementation of innovative financial instruments and products as well as the formulation of creative solutions. Financial engineering may lead to a new consumer-type financial instrument, or a new security, or a new process or creative solution to corporate finance problems, such as the need to lower funding costs, manage risk better, or increase the return on investments (Ahmad, et al., 1998; Iqbal, 2007).

For the Islamic banking perspectives, it is a prime challenge to introduce new Shariah compatible products on the basis of understanding the risk-return characteristics of each building block of the system and offering new products with different risk-return profiles that meet the demand of investors, financial intermediaries, and entrepreneurs for liquidity and safety (Mohammad Kabir Hassan & Mehmet F. Dicle, 2005; Iqbal, 2007; Tahir & Bakar, 2009).

In the cross border context global transaction has been increased and as well as increased difficulties lack of integrated capital market. The wide range of instruments with varying structures of maturity and opportunities for portfolio diversification and risk management can be way of solution for transparent integrated capital market in cross countries. In the same way, Islamic banking have to focus on the development of products that foster market integration and attract investors and entrepreneurs to the risk-return characteristics of the product rather than to the fact of the product being Islamic or non-Islamic (Iqbal, 2007).

In general, Islamic Bank is new field are and they dont have enough and mass funds for investing in research and development of new products in compare with Conventional bank. Considering the importance of financial engineering, Islamic financial institutions should seriously consider making joint efforts to develop the basic infrastructure for introducing new products. Conducting basic research and development collectively may save some of the costs required to build this infrastructure individually. A good example of such collective effort would be to sponsor research in the development of analytical models, computer systems, and tools to analyze the risk and return on different instruments(Iqbal, 2007).

### *3.2 Unique Shariah Authority:*

The main regulatory council of the Islamic banking is Shariah board who control the whole banking system on the basis of Islamic Shariah and each bank have separate Shariah council to examine and evaluate each new product but there are mere coordinating with other banks within the boundary or cross boundary. Even each board addressed different particular school of thought. (Iqbal, 2007). There are diversity of opinion as to whether particular practices or products are Shariah compliant. This means that some products and services may be approved as being Shariah compliant by some Shariah scholars but not by others. On a global level, the approval of Islamic firms products and services may also depend on the jurisdiction they are to be offered in. This can add another layer of complication for regulators (Ainley, Mashayekhi, Hicks, Rahman, & Ravalia, 2007).

In the competitive Conventional market in the cross border arena, to expand the Islamic banking services within the satisfaction customer, it is an regulatory challenge for Islamic banking activities to solve this issues integrated and unique Shariah decision can be minimize time, effort, and confusion for innovation a new products. In such situations, Islamic scholars agreed to develop common Shariah standards organisations as similar as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). Further more, for example, the IFSB has recently called for a dialogue within the industry to adapt current insurance regulations to meet the specifics of Islamic finance. Greater standardisation could reduce the potential for Shariah 'arbitrage' as well as making it easier for bankers and investors to understand the market (Ainley, et al., 2007).

### *3.3 Harmonization of Shariah Rulings:*

The harmonization of Shariah rulings is essential to make smooth operation of Islamic banking activities in the cross border area but lack of proper standardization of common product for all school of thoughts; it has faced challenges with conventional banking (Abdul Hamid, 2008; Akhtar, 2007). Because of the main regulatory council of the Islamic banking is Shariah board that control the whole banking system on the basis of Islamic Shariah and each bank have separate Shariah council to examine and evaluates each new product but there is mere coordinating with other banks within the boundary or cross boundary.

Even each board addressed different particular school of thought. (Iqbal, 2007). There is diversity of opinion as to whether particular practices or products are Shariah compliant. This means that some products and services may be approved as being Shariah compliant by some Shariah scholars but not by others. On a global level, the approval of Islamic firm's products and services may also depend on the jurisdiction they are to be offered in. This can add another layer of complication for regulators (Ainley, et al., 2007). In the competitive Conventional market in the cross border arena, to expand the Islamic Banking services within the satisfaction customer, it is an regulatory challenges for Islamic Banking activities to solve this issues integrated and unique Shariah decision can be minimize time, effort, and confusion for innovation a new products.

### ***3.4 Lack of Profit and Loss Sharing Financing:***

Islamic mode of finances are operating on the basis of fixed charge on the capital investment and sharing profit from lending money and both of types provide finance through the purchase and sale of real commodities but Conventional financial transactions are based on lending and borrowing of money for a fixed charge (interest). In the context of cross border transaction of Islamic banking are facing conflicts with Conventional parts due to interest based mentality rather

profit and loss sharing financing. In some cases, Islamic bank being used fixed-return mode of financing such as Murabahah and leasing that's are clearly distinguishable from the Conventional mode of finance since the transaction with these mode are always on the basis of real commodities(Ahmad, et al., 1998). For encouraging more and safe cross border activities, the Islamic banks can be encouraged to provide more profit-sharing finance through reducing of operating cost by institutional appropriate arrangements as well as financial engineering consistent with the preferences of fund users.

### ***3.5 Strong Supervisory Authority:***

The legal supervisory entity is an important issue in the competitive global cross border transaction for both of Islamic banking and Conventional one. Because of lack of effective supervisory framework is one of the weaknesses of the prevailing system and deserves serious attention(Ahmad, et al., 1998). The roles of both the Shariah advisory boards and the Central banks need to be streamlined and strengthened(Ahmad, et al., 1998; Iqbal, 2007).

The most of the country central bank has supervised all types of banking activities and Islamic banks are also controlled by the same act of central bank as like as Conventional bank (Mohammad Kabir Hassan & Mehmet F. Dide, 2005; JR.Barth, Caprio, & Levine, 2000; Tahir & Bakar, 2009). Some countries issue special Islamic banking Act to govern the operations of specific Islamic banks and their relationship with the central bank (Tahir & Bakar, 2009) . Thus, it is big difficulties for Islamic bank to adjust within same regulation with traditional interest based convention banking. Even, to protect the public safety most of governments have created elaborate regulatory bodies for smooth operation of traditional banking over the cross countries separately. As a result, banking industry has become one of the most heavily regulated industries all over the world(Ahmad, et al., 1998). Against this background, it is timely requirement to

establish strong supervisory framework as the extension of Shariah council of Islamic banks. It would be provided right observation for all the regulatory obligations with central bank and Islamic bank. Then it will help to find the safe and smooth way of opportunity for Islamic banking activities from the existing rules and regulations of central bank respectively. The following issues can be solved by supervisory authorities.

Such as:

- I. Islamic banks are bound to keep some of their deposits with central banks as like as all other commercial banks doing same. Against those deposits the central banks usually pay interest which is totally prohibited for Islamic banks. An alternative is needed to ensure that Islamic Banks keep some of their deposits with central banks with reasonable return on the basis of Shariah complaints (Ahmad, et al., 1998; Grais, 2008; Iqbal, 2007).
- II. In the cross countries issues where the central bank conducts open market operations, Islamic banks are unable to participate in these operations because of interest-based nature of the securities brought and sold. Thus, Islamic banks are constrained by the fact that financial assets that could be liquidated quickly are not available to them. This introduces some rigidity in the asset structure of Islamic banks operations (Ahmad, et al., 1998; Grais, 2008; Iqbal, 2007).
- III. Sometimes the central bank does not understand clearly regarding the issues Islamic Shariah complaints because of not having proper Islamic Shariah knowledge. As Islamic banks are operating under central bank, all the issues should be clarifying by Islamic bank. This is particularly true of musharakah and mudarabah. In debt financing, granting a loan by a bank is a one-time activity, no matter what is the size of the loan. But musharakah and mudarabah are on-going activities and participation of an Islamic bank in these activities continues as long as the project financed is

in operation. This may have important implications for reporting as well as control and regulation of Islamic banks by the central banks in the cross border transactions (Ahmad, et al., 1998; Grais, 2008; Iqbal, 2007).

### *3.6 Proper Maintains of Accounting Standards:*

The proper accounting practices are more important issues for any financial institutions in the context of cross border activities. In general the Conventional banks are practicing generally accepted international accounting standards that are used as reference and facilitate cross border assessments, and accordingly financial flows and investments (Ilias, 2010). In order to introduce standardization in the accounting practices of Islamic financial institutions, some Islamic banks, under the guidance of the Islamic Development Bank (IDB), have established an organization called Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

The organization are functioning based in Bahrain, is composed of a supervisory committee and a Financial Accounting Standards Board responsible for preparing, issuing and amending the accounting standards of those Islamic banks and financial institutions that have agreed to apply the standards set up by the Board. The AAOIFI is a voluntary organization and has no binding powers to implements its standards but just to observe the accounting practices Islamic bank over the countries (Ahmad, et al., 1998).

In the same way, these have not yet received the general recognition to be references that facilitate cross border information sharing and financial flows. Accordingly, diversity without a set of common references is likely to compound the challenges of cross border comparisons and may put Islamic banking services at a competitive disadvantage (Ahmad, et al., 1998; Amihud, et al., 2002; Ilias, 2010). In such situation to adress the above issues, all the Islamic banks over the

world should maintain common accounting standards which are provided by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The AAOIFI should also work to find out the way of solution for the conflict between the accounting standard Conventional bank and Islamic bank based on the Shariah principles.

### ***3.7 Level Playing Field for Islamic and Conventional Banking:***

The competitions of Islamic and Conventional banks are increasing day by day in the cross border transaction due to globalization. The world markets are rapidly converging into a single market place. Liberalization of foreign exchange markets has further reinforced this trend. Technological innovations are also playing an important part in financial integration and globalization. The discovery of easy communication wave through electronic correspondence has reduced the cost of international communication. Customers in many countries can navigate on the Internet banking, unit trusts, mutual funds and even business firms (Ahmad, et al., 1998; Iqbal, 2007; Mamun, et al., 2011).

In order to operate in cross border markets, Islamic banks have to increase the size of their operations as well as form strategic alliances with other banks through the adopted modern technological inventions carefully. It will also be useful to build bridges between existing Islamic banks and those Conventional banks that are interested to do banking on Islamic Principles. Such strategic alliances will benefit both sides in the same field (Ahmad, et al., 1998; Mohamad, et al., 2008).

### ***3.8 Proper Risk Management:***

In general, while the market is expanding as well as enhancing risk management practices and their related skill and information requirements is another challenge facing Islamic banking in the cross country transactions. The current wave of capital market liberalization and globalization is prompting the need for



enhanced risk management measures, especially for the developing economies and emerging markets. Whereas risk management is practiced widely in Conventional financial markets, it is underdeveloped in Islamic financial markets (Grais, 2008; Iqbal, 2007). The main of risk categories are liquidity risks are substantial because of the inability to manage asset and liability maturity mismatches, due to the absence of Shariah compliant instruments such as treasury bills and lender of last resort facilities.

In such condition, Islamic banks are often unable to facilitate the high-cost management information systems or right the technology to assess and monitor risk in the spare of organisational area (Grais, 2008; Iqbal, 2007). There are weak management and lack of proper risk-monitoring systems, the risk exposure of Islamic banks is high. Furthermore, Islamic banks need to adopt appropriate risk management system not only for their own portfolio but also for that of their clients. Diversification and risk management are closely associated with the degree of market incompleteness (Ahmad, et al., 1998; Iqbal, 2007).

### ***3.8 Development of Islamic Capital Market:***

The Islamic capital market is the one of regulatory challenge for smoothly expanding Islamic banking activities in the cross border boundary. Well formed Islamic capital markets will not only benefit borrowers and institutional investors as well as enhance the stability of Islamic banks, providing them with improved portfolio, liquidity, and risk management tools. But there are certain obstacles must be faced to establish good structure Islamic capital market, especially host country government have to take the responsibility to support in the legal and regulatory issues (Ahmad, et al., 1998; Iqbal, 2007).

Because of Ijarah or leasing is the one of most important mode of Islamic banking activities. Normally the owner of operating assets enters into a leasing

transaction. If the owner of operating assets is often the government itself or related public sector bodies, the relevant laws and regulations in the host country may not allow these bodies to pledge or lease assets needed to structure an ijarah transaction. This is a fundamental point; the host country's policy actions are a key prerequisite for further market development (Ahmad, et al., 1998; Gavin, et al., 2010; Iqbal, 2007).

### ***3.10 Contract and Documentation Risk:***

In the cross border contact between the parties, there are concrete legal and regulatory threats to make a contract and documentation on the basis of Islamic Shariah law and host country traditional rules and regulations (Amihud, et al., 2002). Because, there are no provisions for the choice or application of a non-national system of law, such as Shariah as well as application of Shariah principles are still matter of debate, even in Muslim countries (Ainley, et al., 2007). Thus, it is a regulatory challenge for Islamic banking activities in the cross border boundary and in order to address this risk, contracts have to be written very carefully to minimise potential disputes and state the governing law. If we see the one example in UK, case of Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd et al, in 2004, when the Court of Appeal ruled that it was not possible for the case to be considered based on principles of Shariah law (Ainley, et al., 2007).

### ***3.11 Regulatory Challenges for Deposit Insurers:***

A well structured and effective deposit insurers ensure to build public confidence through well governed and well managed. Because of trust and prudence are cornerstones of public confidence. It must be transparent in their operation to the depositors for increasing awareness of deposit insurance benefits and limitations

to help mitigate bank runs during bad times. The Islamic banking is the amazing sectors in the world economy with facing many folds of challenges with counter parts. Because they have to follow the Shariah guidelines to offer any types new investments (M.K. Hassan & M.F. Dicle, 2005; I.F.S.B, 2005; Van Greuning, Iqbal, & mondiale, 2008).

- *Lack of guidelines and regulatory documents:*

As the deposit insurances increases the confidence in the Islamic banking, thereby reducing potential contagion to healthy banks. Globally, deposit protection has become an integral part of the financial safety net. But there are the absence of guidelines and regulatory documents on Islamic deposit insurance which are approved by Shariah laws. As the new but amazing field economy Islamic bank Shariah council should prepare appropriate rules and regulations to protect their depositors by minimizing risk of any further loss in the crises times (Bashir, 1999; Weigand & Grosh, 2008).

- *Issues of Contracts:*

As the demand of growing customer Islamic banks are introducing rapidly more innovative and complex products were being offered to the public, there were options to either utilize one contract or multiple contracts within a product. In this respect, we need to be able to assess the insurability of these products as well as their priority of payment. This is the another challenges are facing by Islamic bank to ensure risk free investment in the different mode of banking (Bashir, 1999; Weigand & Grosh, 2008).

- *Issues of Disposal Assets:*

It is more important to ensure the effectiveness of the Islamic deposit insurance system. Especially in the issues of the disposal of assets of an insolvent Islamic bank. Given the unique structure of the operations of Islamic banks, the disposal

of assets should take into account the existence of general and specific PSIA that may require separate reimbursement approaches (Muljawan, Dar, & Hall, 2004; Sundararajan & Errico, 2002; Van Greuning, et al., 2008).

▪ *The lack of skilled human capital:*

The lack of skilled human capital is not a new issue within the Islamic financial system. Especially in the Islamic financial industry, Islamic deposit insurance is very new but very important operational issues and challenges are required to solve that need to be researched and addressed. Much still need to be done to build-up Shariah deposit insurance standards. In such circumstances, to build up skilled human capital for the Islamic bank in the specific issues, are one of main challenges (Muljawan, et al., 2004; Sundararajan & Errico, 2002; Van Greuning, et al., 2008).

***3.12 Intervention and Resolution Mechanisms:***

The most of the country central bank has supervised all types of banking activities and Islamic banks are also controlled by the same act of central bank as like as Conventional bank (Mohammad Kabir Hassan & Mehmet F. Dide, 2005; JR.Barth, et al., 2000; Tahir & Bakar, 2009). Some countries issue special Islamic banking Act to govern the operations of specific Islamic banks and their relationship with the central bank (Tahir & Bakar, 2009) . Thus, it is big difficulties for Islamic bank to adjust within same regulation with traditional interest based convention banking. Even, to protect the public safety most of governments have created elaborate regulatory bodies for smooth operation of traditional banking over the cross countries separately. As a result, banking industry has become one of the most heavily regulated industries all over the world (Ahmad, et al., 1998). Against this background, it is timely requirement to establish strong supervisory framework as the extension of Shariah council of Islamic banks. It would be provided right observation for all the regulatory

obligations with central bank and Islamic bank. Then it will help to find the safe and smooth way of opportunity for Islamic banking activities from the existing rules and regulations of central bank respectively.

#### 4.0 CONCLUSION AND RECOMMENDATIONS:

In the expanding trend of Islamic banking activities over the country including increasing volume and variety of cross border transactions in goods and services and of international capital flows and also through the more rapid and widespread diffusion of technology. The Islamic banking are often facing challenges to make appropriate rules and regulations to cope up with present coming demand for their customer with Conventional counter parts base on the Islamic Shariah principles. As the aim of this paper is to identify majors regulatory challenges are facing by Islamic bank over the world in the cross border activities. The study has provided the regulatory boundary that should develop by Islamic bank authorities over the world to face the existing challenges for the smooth future. Especially they have to give the attention in the following issues to solve. Islamic bank have to focus on the development of new products based on Shariah principles that foster market integration and attract investors and entrepreneurs to the risk-return characteristics of the product rather than to the fact of the product being Islamic or non-Islamic. Even considering the importance of financial engineering, Islamic financial institutions should seriously consider making joint efforts to develop the basic infrastructure for introducing new products.

In the same way, it is an regulatory challange for Islamic banking activities to solve this issues integrated and unique Shariah decision can be minimize time, effort, and confusion for innovation a new products. In such situations, Islamic scholars agreed to develop common Shariah standards organisations as similar as

the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

Furthermore, for encouraging more and safe cross border activities, the Islamic banks can be encouraged to provide more profit-sharing finance through reducing of operating cost by institutional appropriate arrangements as well as financial engineering consistent with the preferences of fund users. It is timely requirement to establish strong supervisory framework as the extension of Shariah council of Islamic banks. It would be provided right observation for all the regulatory obligations with central bank and Islamic bank. Then it will help to find the safe and smooth way of opportunity for Islamic banking activities from the existing rules and regulations of central bank respectively. In such situation to adress the above issues, all the Islamic banks over the world should maintain common accounting standards which are provided by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The AAOIFI should also work to find out the way of solution for the conflict between the accounting standard Conventional bank and Islamic bank based on the Shariah principles. Moreover, it will also be useful to build bridges between existing Islamic banks and those Conventional banks that are interested to do banking on Islamic Principles. Such strategic alliances will benefit both sides in the same field. Finally the Islamic banks need to adopt appropriate risk management system not only for their own portfolio but also for that of their clients. Diversification and risk management are closely associated with the degree of market incompleteness. Thus, it is a regulationay challenge for Islamic banking activities in the cross border boundary and in order to address this risk, contracts have to be written very carefully to minimise potential disputes and state the governing law.

## 5.0 REFERENCES

- Abdul Hamid, M. (2008). Harmonization of common law and shari'ah in Malaysia: a practical approach'paper presented at the Abd Al-Razzaq Al-Sanhuri Lecture. *Islamic Legal Studies Program, Harvard Law School*, 6.
- Ahmad, A., Khan, T., & Iqbal, M. (1998). *Challenges Facing Islamic Banking* (Vol. Occational 01). Jeddah: Islamic Research and Training Isntitue, IDB.
- Ainley, M., Mashayekhi, A., Hicks, R., Rahman, A., & Ravalia, A. (2007). *Islamic Finance in the UK: Regulation and Challenges*. London: The Financial Service Authority.
- Akhtar, S. (2007). Building an effective Islamic financial system. *BIS Review*, 38.
- Al-Quran. (Sura Al-'Ahzab, Verse no 72).
- Al-Quran. (Sura Al Adiyat, Verse No.8).
- Al-Quran. (Sura An Nisa, Verse No.14-15).
- Al-Quran. (Sura An Nisa, Verse No.32).
- Al-Quran. (Sura Baqarah, Verse No.282).
- Al-Quran. (Sura Toha, Verse No.131).
- Al-Quran. (Surah Al Maida, Verse no.2).
- Al-Quran. (Surat Ash Shuraa, Verse No 27).
- Amihud, Y., DeLong, G. L., & Saunders, A. (2002). The effects of cross-border bank mergers on bank risk and value. [doi: 10.1016/S0261-5606(02)00026-8]. *Journal of International Money and Finance*, 21(6), 857-877.
- Aziz, Z. A. (2006). *Islamic Banking and Finance Progress and Prospects Collected Speeches: 2000-2006*. Kuala lampur Bank Negara Malaysia.
- Bashir, A. H. M. (1999). Risk and profitability measures in Islamic banks: the case of two Sudanese banks. *Islamic Economic Studies*, 6(2), 1-24.
- Brown, K., & Skully, M. (2007). Islamic Banks from a Global Perspective. *Journal of Islamic Economics Banking and Finance* 3(2).
- Gavin, J., Gibson, N., McCrum, P., & Summers, M. (2010). Annual review of Islamic Banking and Finance, *The Gulf*.
- Grais, W. (2008). Islamic Banking: Policy and Institutional Challenges. *Journal of Islamic Economics Banking and Finance*, Vol: 4(No:1).

- Hassan, M. K., & Dicle, M. F. (2005). Basel II and Regulatory Framework for Islamic Banks. *Journal of Islamic Economics, Banking and Finance Vol: I*(No: 1).
- Hassan, M. K., & Dicle, M. F. (2005). Basel II and regulatory framework for Islamic banks. *Islamic Economics, Banking and Finance: Islami Bank Training and Research Academy (IBTRA), I*(1), 1–16.
- I.F.S.B. (2005). *Capital Adequacy Standard For Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services* Paper presented at the Capital Adequacy Working Group
- Ilias, S. (2010). Islamic Finance: Overview and Policy Concerns: Congressional Research Service, 7-5700, [www.crs.gov](http://www.crs.gov) RS22931.
- Iqbal, Z. (2007). Challenges Facing Islamic Financial Industry. *Journal of Islamic Economics, Banking and Finance, Vol 3*(No: 1), 149-162.
- JR.Barth, Caprio, G. J., & Levine, R. (2000). *Banking systems around the globe: do regulation and ownership affect performance and stability?* World Bank Working
- Mamun, A., Hassan, M. K., & Isik, I. (2011). Cross-border impact of the Financial Services Modernization Act: Evidence from large foreign banks. *Applied Economics Letters, 18*(4), 337-341.
- Mohamad, S., Hassan, T., & Bader, M. K. I. (2008). Efficiency of Conventional versus Islamic Banks: International Evidence using the Stochastic Frontier Approach. *Journal of Islamic Economics Banking and Finance Vol 4*(N 2).
- Muljawan, D., Dar, H. A., & Hall, M. J. B. (2004). A capital adequacy framework for Islamic banks: the need to reconcile depositors' risk aversion with managers' risk taking. *Applied Financial Economics, 14*(6), 429-441.
- Saleem, M. Y. (2010). Methods and Methodologies in Fiqh and Islamic Economics. *Review of Islamic Economics, 14*(1), 103-123.
- Sundararajan, V., & Errico, L. (2002). *Islamic financial institutions and products in the global financial system: Key issues in risk management and challenges ahead*: International Monetary Fund.
- Tahir, I. M., & Bakar, N. M. A. (2009). Islamic Banking Operations: Preparing the Fit for Internationalization. *Journal of Islamic Economics Banking and Finance, 5*(3).
- Van Greuning, H., Iqbal, Z., & mondiale, B. (2008). *Risk analysis for Islamic banks*: World Bank.
- Weigand, C., & Grosh, M. (2008). Levels and patterns of safety net spending in developing and transition countries. *World Bank Social Protection Discussion Paper, 817*.