

A Comparative Analysis of the Legal System on the Performance of Islamic Banks: A Study in the United Kingdom, Malaysia and Indonesia

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Abstract

This research is motivated by the issue of the influence of the legal system on the performance of Islamic banks in three countries with different legal and social backgrounds, namely the United Kingdom (UK), Malaysia and Indonesia. A qualitative-comparative approach is used by focusing on the substantive and procedural legal system aspects that affect the operation of Islamic banks, as well as on performance indicators such as financial stability, operational efficiency, and the level of public trust. The results show that Malaysia has the most supportive legal system for the development of Islamic banks through its dual banking system framework, formal recognition of sharia principles, and integrated regulatory and supervisory institutions. While Indonesia has made progress in the regulatory aspect, it still faces challenges in harmonization between national law and sharia principles, as well as supervisory effectiveness. On the other hand, the UK, despite having a stable legal system, has not provided a sufficient legal basis to support the full operation of Islamic banks, as its regulatory approach is religion-neutral. This research also emphasizes the importance of legal culture and socio-religious context in supporting the performance of the Islamic finance industry. The practical implications of this research include the need for regulatory harmonization, institutional capacity building, and the establishment of international sharia law standards. Thus, strengthening the legal system that is responsive to sharia principles is a strategic key in strengthening the competitiveness of Islamic banks globally.

Keywords: Legal system; United Kingdom; Indonesia; Malaysia; Islamic Bank.

Abstrak

Penelitian ini dilatarbelakangi oleh isu pengaruh sistem hukum terhadap kinerja bank syariah di tiga negara dengan latar belakang hukum dan sosial yang berbeda, yaitu Inggris (UK), Malaysia, dan Indonesia. Pendekatan kualitatif-komparatif digunakan dengan berfokus pada aspek sistem hukum substantif dan prosedural yang mempengaruhi operasional bank syariah, serta pada indikator kinerja seperti stabilitas keuangan, efisiensi operasional, dan tingkat kepercayaan publik. Hasil penelitian menunjukkan bahwa Malaysia memiliki sistem hukum yang paling mendukung pengembangan bank syariah melalui kerangka sistem perbankan ganda, pengakuan formal prinsip syariah, dan lembaga regulasi dan pengawasan yang terintegrasi. Sementara Indonesia telah membuat kemajuan dalam aspek regulasi, masih menghadapi tantangan dalam harmonisasi antara hukum nasional dan prinsip syariah, serta efektivitas pengawasan. Di sisi lain, Inggris, meskipun memiliki sistem hukum yang stabil, belum memberikan dasar hukum yang cukup untuk mendukung operasi penuh bank syariah, karena pendekatan regulasinya netral terhadap agama. Penelitian ini juga menekankan pentingnya budaya hukum dan konteks sosial-keagamaan dalam mendukung

kinerja industri keuangan Islam. Implikasi praktis dari penelitian ini antara lain perlunya harmonisasi regulasi, peningkatan kapasitas kelembagaan, dan penetapan standar hukum syariah internasional. Dengan demikian, penguatan sistem hukum yang responsif terhadap prinsip-prinsip syariah menjadi kunci strategis dalam memperkuat daya saing bank syariah secara global.

Kata kunci: Sistem hukum; Inggris; Indonesia; Malaysia; Bank Syariah.

Introduction

Islamic banking has grown significantly as a sharia-based financial system promoting fairness, transparency, and the prohibition of interest (Pusvisasari et al., 2023). Its development is closely tied to the legal systems that regulate and legitimize its operations. However, varying legal and regulatory frameworks across countries affect the ability of Islamic banks to achieve their economic and social objectives (Yulianti et al., 2025).

Islamic banking policies in countries like Pakistan, Malaysia, Indonesia, Iran, Sudan, and Saudi Arabia face similar challenges, including the persistence of *riba*-based systems, debt-driven money creation, and misalignment with Islamic macroeconomic principles. The absence of sharia-compliant money market instruments and limited expertise in Islamic economics further hinder progress. As a result, these countries remain in a transitional phase, yet to fully implement an authentic Islamic financial system (Ayub & Khan, 2021).

Research by scholars from Pakistan and the UK found that no Muslim country has fully replaced the interest-based system with one entirely compliant with Islamic principles. Key policy issues include reliance on interest in monetary management, conventional system dominance, lack of effective Islamic instruments, and limited expertise in both sharia and economics. Formal compliance without fulfilling *maqāṣid al-syarī'ah* also hinders reform. The study recommends adopting value-based monetary policies, reforming money creation, and using profit-sharing instruments for a fairer and more sustainable Islamic economic system (Ayub & Khan, 2021).

Meanwhile, policy issues for Islamic banks in Indonesia include the suboptimal effectiveness of the BSI merger and the unequal distribution of services. Customer preference for conventional banks and the focus of financing that is limited to the consumptive sector are also a challenge. Halal industry integration and support for MSMEs are still not maximized. A more inclusive and integrated policy strategy is needed to strengthen the role of Islamic banks in the national economy (R. Yusuf & Haryono, 2022).

Research in Indonesia highlights key issues in Islamic banking policy, particularly the gap between sharia principles and operational practices, which has led to public skepticism and fund withdrawals. Additional problems include a lack of qualified personnel, weak Sharia

Supervisory Board oversight, and marketing misaligned with Islamic values. Financing schemes like *murabaha* resemble interest-based systems, access to financing remains unequal, and support for products like *sukuk* is limited. These findings underscore the need for stronger adherence to sharia principles in practice, oversight, and financial education (Nugroho, 2021).

Policy issues surrounding AI adoption in Islamic banking vary across the UK, Malaysia, and Indonesia. In the UK, strict sharia frameworks and reliance on human authority hinder AI integration. Malaysia faces challenges in aligning AI with its established Islamic banking system, while Indonesia focuses on using AI to enhance financial inclusion and literacy. Across all three, successful implementation requires sharia adjustments and trust-building, though AI presents strong potential to boost efficiency, inclusion, and modernization (Abbas & Hafeez, 2021).

Islamic banking in Malaysia promotes stability and sustainable growth through profit-sharing contracts (PLS), supporting SMEs and enhancing sector resilience (Daoud & Kammoun, 2024). From a *fiqh* perspective, deposits are treated as *qardh*, obliging banks to return funds without fixed returns. To remain competitive while adhering to Islamic principles, banks use the *tawarruq* scheme, avoiding *bay' wa salaf* (Ahmad & Ansary, 2017). Despite the Islamic Financial Services Act 2013 (IFSA) establishing corporate criminal liability (CCL), enforcement faces challenges, necessitating stronger regulations and improved institutional coordination (Yusoff & Hassan, 2022).

Problems with Islamic banking in the world include one of the main issues in its development being the limited range of Islamic financial services, as seen in Kyrgyzstan, where there is only one bank and three micro-credit institutions operating under Islamic principles. Other challenges include the need for special support for new players in the sector, the provision of advisory services for conventional financial institutions seeking to transform to the Islamic system, and the development of educational programs that introduce and deepen the understanding of Islamic finance. This research was conducted in several countries, with a particular focus on Kyrgyzstan and the UK, to assess the real conditions, growth potential, and barriers to the development of Islamic banking in these regions (Kuznetsov et al., 2017).

Similar research shows that there is still a lack of banking alternatives that comply with Islamic principles, especially regarding the prohibition of usury (interest). Many Muslims in Norway feel that the use of conventional interest-based banking is a serious problem in their lives, and the absence of Islamic banking options poses a real challenge to their financial inclusion. This could potentially lead to financial exclusion for Muslims who adhere to these

religious norms. This research was conducted in Norway in 2015 and 2016. Thus the lack of Shariah-compliant financial products hinders the financial inclusion of Muslims in the country (Brekke, 2018).

In addition, issues for Islamic banks include the need to strengthen sources of investment capital and improve returns on investment, especially in the context of global financial market challenges. In addition, the development of appropriate organizational and regulatory infrastructure is also an important challenge in the implementation of Islamic finance. This research was conducted in Kazakhstan, where the development of Islamic banking is still in its early stages with only a few Islamic banks operating and the need to expand services and the role of Islamic finance in supporting the national economy (Oralbaeva et al., 2020).

It also occurred in 16 countries representing three continents, namely Asia, Europe, and Africa, including countries such as Indonesia, Malaysia, Pakistan, Turkey, the UK, Egypt, and the Gulf countries. In this case, a comparison of the liquidity of Islamic and conventional banks during the period of financial stability (2010-2018) is seen. Then there are significant differences in liquidity levels between the two types of banks, as well as complexities in financial performance measurement that often result in contradictory findings. Although the end result shows that Islamic banks tend to be more liquid than conventional banks, the main challenge lies in the limitations of sharia-compliant liquid instruments, different asset structures, and the constraints of non-uniform accounting standards, all of which affect the ability of Islamic banks to manage liquidity efficiently (Haddad et al., 2020).

In Middle Eastern Islamic countries and Muslim communities in Western nations like Spain and Portugal, human milk bank implementation faces religious and cultural barriers. Key concerns include the belief that breastfeeding creates kinship ties, potentially affecting marriage laws, along with traditional practices like discarding colostrum. Limited awareness of sharia-compliant alternatives further complicates acceptance. The core challenge lies in crafting regulations and educational efforts that align Islamic values with global health priorities (Espina-Jerez et al., 2022).

The core issue highlighted in this study is the absence of a fully operational Islamic banking system capable of replacing the conventional interest-based model, despite the widespread application of sharia principles in various forms (Maharani, 2024). While scholarly attention to Islamic banking has grown, most studies isolate financial performance from *shariah* compliance and overlook how differing legal traditions impact its regulatory and operational structure. A comprehensive legal approach that integrates legal systems,

regulatory frameworks, and socio-religious dynamics remains underdeveloped. The novelty of this study lies in its comparative legal analysis of Islamic banking in the UK, Malaysia, and Indonesia, offering insights into structural challenges and regulatory gaps. It aims to identify key barriers and propose strategic policies to foster more inclusive and credible shariah-compliant banking amid growing public skepticism and limited financial inclusion.

Methods

This research uses a comparative qualitative method with the aim of analyzing and comparing the influence of the legal system on the performance of Islamic banks in three countries: UK, Malaysia, and Indonesia. The qualitative approach was chosen because this research focuses on an in-depth understanding of the legal aspects, regulations, and social and cultural factors that affect the operations of Islamic banks, which are difficult to measure quantitatively (Marzuki, 2016). Data Sources Secondary sources are legal documents, Islamic banking regulations, annual reports of Islamic banks, academic literature, as well as official publications from financial authorities and fatwa institutions in each country. In addition, primary data was obtained, regulators (Efendi & Ibrahim, 2018). Data collection is done through literature study, analysis of laws and regulations, literature review, which is comprehensive and relevant from various perspectives. The collected data were analyzed descriptively and comparatively by comparing the legal framework, regulations, and operational practices of Islamic banks in the three countries. The analysis focused on aspects of legal substance, supervisory effectiveness, legal certainty, and the influence of legal culture on the performance of Islamic banks. The results of the analysis are presented in the form of a narrative describing the differences and similarities of the legal system and its implications for the performance of Islamic banks in each country (Ibrahim et al., 2023).

Characteristics of Legal Systems in Each Country

The UK adheres to the common law legal system, which is a legal system based on precedent or previous court decisions. In the context of Islamic finance, this system provides flexibility in customizing sharia contracts as long as they do not conflict with national law (Syamsuri & Lutfiah, 2025). Although not an Islamic country, the UK has shown a high openness to the development of Islamic finance, including the recognition of sharia principles in financial contracts (Harahap et al., 2024). However, since Islamic law is not a formal source of law in the English system, sharia contracts are still subject to common law

principles. This can be a barrier to dispute resolution based on sharia values, as courts are not bound by fatwas or fiqh law (Lewis & Algaoud, 2003).

Malaysia operates a hybrid legal system that combines British colonial common law with the Islamic legal system, particularly in personal and Islamic finance (Hamzani, 2020). The country has a strong legal framework to support Islamic banking, including the existence of the Syariah Court and the Syariah Supervisory Board under Bank Negara Malaysia (BNM) (Agustina, 2021). Fatwas from the National Sharia Council have the force of law that binds Islamic financial institutions. The integration of sharia law and positive law in Malaysia runs relatively harmoniously, allowing the Islamic banking industry to develop rapidly and become a global reference (Hartini, 2020).

Indonesia uses a civil law legal system that is based on the codification of laws and regulations. Although constitutionally not an Islamic state, Indonesia accommodates Islamic law in the financial sector through legislation and fatwas of the National Sharia Council of the Indonesian Ulema Council (DSN-MUI). The fatwa of DSN-MUI is a reference in the formation of Islamic financial products, although it does not directly have binding force in the judicial system (H. Yusuf et al., 2025). The legal institution of Islamic banking is still developing, but it has not been integrated as strongly as Malaysia, so that inconsistencies between positive law and sharia principles often arise in bank operational practices (Bianda, 2024).

Supervisory agencies are vital in ensuring the stability and sharia compliance of Islamic financial systems (Aditya & Lestari, 2025). In the UK, the FCA regulates all financial institutions, including Islamic banks, focusing on consumer protection and market integrity (Aprilia et al., 2025). Malaysia's BNM holds broader authority through its Syariah Supervisory Board, actively overseeing compliance (Habibunnajar, 2020). In Indonesia, the OJK supervises Islamic banking, but coordination with DSN-MUI and the Supreme Court remains a challenge. These differing regulatory models significantly influence the performance and public trust in Islamic banks (Mumtahaen & Romli, 2025).

Regulation and Legal Infrastructure of Islamic Banking

Islamic banking regulations differ across countries in legal sources, legislation, and implementation. In the UK, there is no specific law for Islamic banking, but institutions may operate under general financial regulations, with internal sharia fatwas having no external legal force (Hafizd et al., 2025). Malaysia enforces sharia principles through the Islamic Financial Services Act 2013 (IFSA), making fatwas from the National Sharia Council legally

binding (Adawiyah, 2022). In Indonesia, DSN-MUI fatwas guide sharia product development but require formal adoption by OJK or BI to be binding, highlighting the need for better harmonization between fatwas and formal laws (M. W. Putri et al., 2024).

The Islamic legal infrastructure varies across countries and significantly affects Islamic banks' operational effectiveness. The UK has a modern legal system but lacks specific support for sharia principles, making recognition of contracts like *mudharabah* or *murabahah* dependent on general legal framing (Darmalaksana, 2022). Malaysia offers the most comprehensive infrastructure, with strong integration between sharia and national law, supported by the National Shariah Council and sharia courts (Ghozali et al., 2024). In contrast, Indonesia, though backed by Islamic Banking Law and DSN-MUI fatwas, still faces limitations in infrastructure, human resources, supervision, and regulatory alignment, which constrain sector growth (Ridawati, 2022).

Harmonization between positive law and sharia principles is essential for the stability and legitimacy of Islamic banking. In the UK, this harmonization depends on private contracts, offering flexibility but risking legal uncertainty in sharia-based disputes (N. A. Putri, 2023). Malaysia exemplifies strong integration, with sharia principles formally embedded in national law and serving as legal references in Islamic finance (Triyanta et al., 2024). In contrast, Indonesia still faces overlaps between sharia norms and national laws, highlighting the need for improved regulatory synchronization across legislation, supervision, and enforcement (Aryani, 2021).

Dispute resolution in Islamic banking reflects how well a legal system upholds sharia principles (Al Ghifari & Priyatno, 2024). In the UK, financial disputes are handled in general courts under contract law, limiting the role of sharia interpretation (Gaffar & Al Mamari, 2025). Malaysia offers a more integrated model, with sharia courts having jurisdiction in specific financial cases and fatwas serving as legal references, enhancing legal certainty (Setyowati et al., 2023). In Indonesia, disputes are resolved in Religious Courts under supporting legislation, but jurisdictional ambiguities and limited judicial expertise in Islamic economics remain challenges (Andatu & Arifin, 2024).

Development of Islamic Banks in the UK, Malaysia, and Indonesia

Islamic banks in the UK are still in an early development stage, operating within a secular common law system without formal recognition of sharia law (Permadi, 2023). Despite this, the UK's openness as a global financial hub allows institutions like the Islamic Bank of Britain to offer sharia-compliant products by adapting to conventional regulations.

Growth is fueled by domestic Muslim demand and global market prospects, though challenges remain in the form of limited Islamic instruments and unclear substantive legal frameworks (Karumo, 2025).

Malaysia is a pioneer and center of Islamic banking development in the world, with a legal system that actively accommodates Islamic law in the national structure. The country implements a dual banking system, where Islamic banking officially coexists with conventional banking, with specific regulations governing sharia products, supervision, and enforcement through institutions such as Bank Negara Malaysia and the National Sharia Council (Kitamura, 2020). The existence of a strong legal framework, complete financial infrastructure (including Islamic capital markets and sukuk), and government support has made Islamic banking in Malaysia grow rapidly and become a model for many other countries (Gani & Bahari, 2021).

Indonesia, as a country with the largest Muslim population in the world, has experienced rapid development in the Islamic banking industry, especially since the issuance of the Islamic Banking Law and the establishment of the Financial Services Authority (OJK) (Abdul et al., 2022). The Indonesian legal system is still in the stage of adjustment between national law and sharia principles, with the existence of institutions such as the National Sharia Council of the Indonesian Ulema Council (DSN-MUI) which plays a role in setting fatwas and operational guidelines (Bakhtiar, 2020). However, Islamic banking in Indonesia faces challenges such as overlapping regulations, suboptimal institutional support, and low literacy and market penetration. However, the potential for growth is huge along with increasing public awareness and government support (Firdauzi et al., 2024).

Profitability is one of the main indicators in assessing the financial performance of Islamic banks. Commonly used measures of profitability include Return on Assets (ROA), Return on Equity (ROE), and Net Profit Margin (NPM). ROA reflects the ability of Islamic banks to generate profits from their total assets (Dahruji & Muslich, 2022). ROE measures the level of profit earned on own capital, while NPM shows how much net profit is generated from total revenue. These three indicators provide an overall picture of the efficiency and effectiveness of fund management by Islamic banks (Alam et al., 2023).

A comparison between the UK, Malaysia and Indonesia shows variations in profitability performance that are closely related to the legal and regulatory systems implemented in each country. In the UK, Islamic banks operate under a common law system that provides high flexibility in contract structures, but lacks formal legal support for sharia principles. As a

result, Islamic banks in the UK tend to face challenges in developing innovative Shariah-based products, which impacts their profit margins (Gaffar & Al Mamari, 2025).

Malaysia, with its mixed legal system that integrates sharia principles into the national legal framework, provides high legal certainty for the operations of Islamic banks. Clear regulations and institutional support such as the Shariah Supervisory Board and Bank Negara Malaysia have enabled Islamic banks in Malaysia to demonstrate more stable and competitive profitability performance, especially in ROA and ROE. Standardized Islamic products and investor confidence in the Islamic legal system in Malaysia strengthen the market position and efficiency of Islamic banks (Abdul Rahim et al., 2024).

Meanwhile, in Indonesia, although Islamic banks have shown consistent growth, their profitability still faces structural challenges. This is due to the lack of harmonization between sharia fatwa and formal legislation, as well as limited legal infrastructure support and consistent supervision (Sukardi et al., 2023). In some cases, legal uncertainty or different interpretations between institutions cause obstacles in the development of Islamic products and reduce the competitiveness of banks. In addition, systemic factors such as intense competition with conventional banks and limited Islamic markets also affect the ROA and ROE achievements of Islamic banks in Indonesia (Delvina, 2021).

Thus, differences in legal systems and regulatory frameworks are important factors that affect the level of profitability of Islamic banks. Countries with a supportive legal system that is integrated with sharia principles tend to produce a more stable business climate and allow Islamic banks to develop competitively and sustainably (Andatu & Arifin, 2024).

The Non-Performing Financing (NPF) ratio is a key indicator of Islamic banks' financial health, reflecting their risk exposure and liquidity stability (Kuswahariani et al., 2020). In the UK, strong creditor protections under common law make banks cautious in financing, though sharia-based dispute mechanisms remain limited (Aldahmash, 2025). Malaysia benefits from sharia courts and specific legislation, enabling efficient resolution of financing issues and maintaining low NPF levels. In contrast, Indonesia struggles with overlapping legal authorities and limited capacity of religious courts, hindering effective resolution and potentially raising the NPF ratio (Haque, 2021).

Liquidity is a bank's ability to meet short-term obligations, and is closely related to financial system stability. Effective risk management is a prerequisite for dealing with economic turmoil, including global crises such as the 2008 financial crisis and the COVID-19 pandemic (Halida, 2021). Islamic banks in the UK rely on market-based liquidity mechanisms and are subject to strict FCA prudential regulation. However, limited Islamic financial

instruments and a small market may limit their liquidity flexibility (Mustofa, 2024). Malaysia has a more mature Islamic finance market, including instruments such as sukuk and Islamic money market, which strengthens the liquidity resilience of banks (Al-Barak, 2021).

In Indonesia, although Bank Indonesia provides Islamic liquidity instruments, their utilization is still limited due to the lack of product diversification and low market depth. The global crisis showed that Islamic banks with strong legal and market support (such as in Malaysia) tended to be more stable in the face of external pressures, while countries with immature legal and regulatory infrastructure showed higher vulnerability. Legal certainty plays an important role in building the long-term stability of the Islamic banking sector. This includes legal clarity in sharia contracts, the existence of a competent court system, as well as the consistency of regulations that support sharia principles (Mursid et al., 2023).

In the UK, although legal certainty is high in terms of the rule of law, sharia principles do not have formal standing, so in certain cases Islamic banks experience legal obstacles in executing contracts based on fiqh. Malaysia provides an ideal example of legal certainty, where all aspects of Islamic banking are backed by positive law and have state-recognized sharia court authorities. This creates a sense of security for investors, customers and the financial institutions themselves. In contrast, in Indonesia, while there has been progress in terms of legislation (such as the Islamic Banking Law), inter-institutional disharmony and varying legal interpretations mean that legal certainty remains a major challenge. This can affect public confidence in the system, and have implications for the long-term stability of Islamic banks in Indonesia (Hassan, 2020).

The operational efficiency of Islamic banks can be measured through the ratio of Operating Expenses to Operating Income (BOPO). This ratio shows how much costs the bank incurs to generate income. The lower the BOPO ratio, the more efficient the bank's performance, because it means that operating expenses are smaller than the income earned. In the context of comparison, Islamic banks in the UK face efficiency challenges due to limited market scale and lack of comprehensive Islamic system support, so the BOPO ratio tends to be high (Amalia et al., 2022). Malaysia shows the best efficiency performance because it is supported by an integrated legal and regulatory system, as well as a wider market scale. Indonesia, meanwhile, still faces efficiency issues due to high operating costs, less than optimal utilization of technology, and limited synergy between the legal system and bank operations (Kumar et al., 2021).

Efficiency is also reflected in the bank's ability to manage funds, including the collection of third party funds, distribution of financing, and margin optimization. In countries

with a supportive legal system such as Malaysia, fund management is more effective as defined legal procedures speed up transactions and reduce costs. In addition, efficiency in service quality such as transaction speed, ease of access, and innovation in digital Islamic services contribute to customer confidence and overall efficiency. In the UK, Islamic financial services are still very limited, so service efficiency is not maximized. Indonesia, with rapidly growing technological support, has the potential to improve service efficiency, but still faces challenges such as uneven digital literacy of Islamic customers and regulatory constraints that are not fully adaptive (Usanti & Shomad, 2022).

Regulation has a strategic role in encouraging or hindering innovation and digitalization in the Islamic banking sector. Countries that have a progressive and accommodating legal framework for technological developments, such as Malaysia, have succeeded in creating a conducive Islamic digital ecosystem through regulations that encourage Islamic fintech, e-payment, and digital onboarding (Dasaklis & Malamas, 2023). The UK is also quite advanced in terms of banking technology, but Islamic product innovation is still hampered by the limited legal recognition of fiqh principles in official regulations (Norton, 2025). Indonesia, although starting to develop sharia digitalization regulations, still needs to harmonize between fatwas, supervisory authorities, and positive laws so that technological innovation is not hampered by legal uncertainty. Operational efficiency in the long run depends largely on how adaptive the legal system and regulators are in accommodating digital developments, without neglecting sharia principles (Hasanah et al., 2024).

Islamic banking in Indonesia began to develop since 1992 and experienced significant progress thanks to regulatory support, such as Law Number 10 of 1998 and Law Number 21 of 2008, which expanded the space and opportunities for this industry. The growth was influenced by various factors, including the increasing public understanding of sharia principles, the availability of competent human resources, capital adequacy, and the utilization of information technology. In addition, support from the government and Bank Indonesia, the large Muslim population, and the need for financing in the MSME sector were also key drivers. However, despite the synergy between institutions, the development of Islamic banking is still considered not optimal and tends to stagnate because it has not been able to achieve the target set nationally. Despite having a strong foundation in terms of regulation and market potential, Islamic banks in Indonesia still face challenges in realizing sustainable and maximum growth (Yudhira, 2023).

Islamic banking in the UK began to develop from the late 1970s to the early 1980s, marked by the introduction of Islamic economic concepts such as murabaha and reinforced by

the holding of an international Islamic economic conference in 1976. A significant milestone occurred in 2004 with the establishment of the Islamic Bank of Britain (IBB), the first Islamic bank in Europe. Since then, the Islamic finance sector in the UK has experienced rapid growth thanks to active support from educational institutions, government policies, as well as high investor interest from Islamic countries. Despite not being a Muslim-majority country, the UK managed to become a pioneer and center of Islamic finance in the Western region because the principles of sharia are considered to be in line with national economic values such as social welfare and free markets. The involvement of major banks such as RBS and HBOS in Islamic products shows the sector's widening expansion. With the support of friendly regulations and consistent promotional strategies, the UK has managed to build a strong Islamic banking system and become one of the leading Islamic financial centers in the world (Baihaki & Monica, 2022).

The development of Islamic banking in Malaysia began with the establishment of Bank Islam Malaysia Berhad (BIMB) in 1983, which became an important milestone in the implementation of Islamic financial system in the country. The government showed strong commitment by providing 90% financial support, while the public contribution was only around 10%. Over time, the sector experienced significant growth, reaching a market share of around 29%, which was reinforced by supportive regulations such as the Financial Services Act and the Islamic Financial Services Act enacted in 2013. Currently, there are more than 17 domestic Islamic banks and 5 international Islamic banks operating in Malaysia, making the industry one of the most advanced in the Southeast Asian region. Therefore, Islamic banking in Malaysia is driven by strong government support and comprehensive regulations, which have enabled the sector to grow rapidly and become a regional leader (Afwā & Sulistyowati, 2023).

Relationship between Legal System and Islamic Bank Performance

Regularity and legal certainty play an important role in building investor and customer confidence in Islamic banks. In the financial sector, the clarity of the rule of law creates a sense of security for business actors and service users, as they know their rights and obligations with certainty. In the context of Islamic banking, legal certainty not only concerns the formal legal aspects, but also the certainty that the bank's operations are truly in accordance with sharia principles. Countries such as Malaysia show how clear and consistent regulations, as well as legal recognition of sharia fatwas, have increased public confidence and attracted more investment into the Islamic sector. In contrast, in countries where the legal

system does not fully support the full operation of Islamic banks, such as Indonesia and the UK, legal uncertainty remains a psychological and structural barrier that can affect customers' and investors' decision to choose Islamic services (Mumtahaen & Romli, 2025).

A supportive legal system, such as the dual banking system model in Malaysia, allows Islamic and conventional banks to grow side by side within a clear and separate regulatory framework. This system provides a fair and competitive space for Islamic banks to thrive without having to conform their operations to the norms of conventional banks. Under this system, Malaysia has successfully created a legal environment that is friendly to Islamic product innovation, the development of Islamic capital market instruments, and the strengthening of Islamic financial infrastructure such as sukuk and takaful. This gives Malaysian Islamic banks a significant competitive advantage at the regional and global levels (Harkati et al., 2020). In contrast, in the UK, where there is a single common law-based banking system, Islamic banks have to operate within a common law framework that is not tailored to fiqh principles, limiting their flexibility and competitiveness. Indonesia is still in between these two approaches, with a dualistic system that formally recognizes Islamic banks, but has yet to fully provide strong systemic support in terms of law and regulation (Herijanto, 2019).

In the context of Islamic bank performance, the effectiveness of the legal system can be analyzed from two dimensions: substantive law (the material content of the law, such as sharia principles and regulatory norms) and procedural law (the mechanisms and procedures for applying the law, such as dispute resolution processes and supervision). (Najib, 2020) Strong substantive law means that there are laws and fatwas that are aligned with sharia principles and have been formalized into the national legal system, as is the case in Malaysia with the Islamic Financial Services Act. However, without the support of effective procedural laws-for example, competent courts, independent supervisory bodies, and speedy dispute resolution mechanisms-the implementation of substantive laws can stagnate. In contrast, in the UK, despite the speed and efficiency of legal procedures, the lacuna in sharia substantive law has limited the development of sharia products and contracts (Bhand et al., 2023). In Indonesia, challenges arise on both fronts: substantive regulations are still evolving and often unsynchronized between institutions, while procedural sides such as the jurisdiction of religious courts over Islamic economic cases have not been optimized. This suggests that the balance between legal substance and procedure determines the extent to which the legal system can truly support the growth and stability of Islamic banking.

Comparison of Institutional Policies between Indonesia, UK and Malaysia

Islamic banking regulation in the UK has been progressive, despite the country not having a majority Muslim population. Since the early 2000s, institutions such as the Financial Services Authority (FSA) and the UK government have actively encouraged the growth of the Islamic finance industry. This has been realised through inclusive policies, an equal taxation system, and recognition of the diversity of financial products, making the UK a friendly environment for Islamic banking. However, challenges remain, particularly in adapting sharia principles to the UK's legal and corporate governance systems. Islamic banks must remain compliant with Islamic principles, while also being bound by conventional corporate obligations such as accountability to boards of directors and shareholders. This tension is a major obstacle to the full development of Islamic banks. Thus, while the regulatory support in the UK is strong and opens up great opportunities, the biggest challenge is how to harmonise Islamic law with the modern business system that generally prevails in the country (Baihaki & Monica, 2022).

Differences in Islamic banking regulations in Malaysia have established comprehensive regulations since 1983 through the Islamic Banking Act, which specifically regulates Islamic banking operations. In addition, the supervision of shariah compliance is strengthened by the Shariah Governance Framework which is continuously updated by Bank Negara Malaysia. This approach makes the regulation of Islamic banking in Malaysia more structured and strict compared to Indonesia, which despite its rapid growth, the regulation is still being refined (Pramesti & Nisa, 2024). While the main difference between regulation in the UK and Indonesia in the context of Islamic Banks lies in the approach and implementation. In the UK, regulation is not yet fully supportive as it still uses a conventional legal framework that does not specifically accommodate sharia principles. This has hindered the development of the industry due to the absence of rules tailored to the operational needs of Islamic financial institutions. In contrast, Indonesia already has more stringent and detailed regulations for Islamic insurance, but it still faces challenges in implementation and supervision in order to strictly comply with sharia principles. In addition, in terms of risk management, Islamic insurance companies in the UK still rely on conventional reinsurance that contains non-sharia elements such as *gharar* (uncertainty) and *riba* (interest), due to the limitations of sharia-compliant alternatives. In contrast, Indonesia prohibits the use of conventional reinsurance, so companies have to find shariah-compliant solutions, which is a challenge in itself. This difference shows that although Indonesia is more advanced in sharia regulation, the main

challenge lies in implementation, while the UK faces obstacles in terms of an unsupportive legal framework (Kameliya et al., 2022).

Similar to the results of other studies show that the comparison of Islamic bank policies between the UK and Malaysia where regulations in Malaysia integrate more social norms and Sharia law in harmony, while in the UK regulations are more rigid and less supported by strong social norms, thus having an impact on the behaviour and performance of Islamic banks in each country (Bhatti & Basov, 2022). The implementation of Islamic banking policies in Malaysia and the UK faces different challenges due to different cultural backgrounds and legal systems. In Malaysia, the dominance of the Muslim population favours the acceptance of sharia principles such as the prohibition of usury and halal transactions, although challenges remain in terms of integration with the conventional financial system and strict supervision. In contrast, in the UK, the implementation of Islamic banking policies is more complex due to the Muslim minority and the dominance of the secular legal system, which requires customisation of Islamic financial products, compatibility of local regulations, as well as increasing the literacy and trust of the non-Muslim community towards the concept of Islamic banking (Rana et al., 2025).

The differences in Islamic banking and finance regulations in Malaysia, Indonesia, and the UK reflect the varying levels of readiness and approaches in accommodating sharia principles. Malaysia stands out with a more mature and systematic regulatory framework since the enactment of the Islamic Banking Act in 1983, which was strengthened by the Shariah Governance Framework by Bank Negara Malaysia. This creates a more structured and stable system. Meanwhile, Indonesia already has quite strict and detailed regulations, but still faces challenges in implementation and supervision, so that regulations are still being refined (Seng, 2022). On the other hand, the UK does not yet have specific regulations for Islamic banking and insurance because it still relies on a conventional legal framework, which results in limited support for sharia principles. In terms of risk management, the UK still uses conventional reinsurance which is contrary to sharia principles (Hoque & Liu, 2023), while Indonesia has banned the practice but still faces difficulties in providing appropriate alternatives. Overall, Malaysia excels in regulatory readiness, Indonesia is at the stage of strengthening implementation, and the UK is still in the process of adapting relevant regulations.

Based on the results of the analysis, Malaysia emerged as the country with the most supportive legal system for the development of Islamic banks. This is due to the existence of a legal framework integrated with sharia principles in the national financial system, including

formal recognition of the fatwa of the National Sharia Council, the existence of a sharia court for economic cases, and Special Laws such as the Islamic Financial Services Act (IFSA). This system creates legal certainty, ease of product innovation, and efficiency in supervision, all of which strengthen the sharia banking ecosystem (Alafianta et al., 2021). This is different from the UK and Indonesia, which, although they have sharia banks, have not yet built a legal system that is truly in-depth and substantially integrated with sharia principles (Abdillah & Susilawati, 2020).

The effectiveness of supervision is highly dependent on the independence, technical capacity, and legitimacy of the supervisory institution. Malaysia shows high effectiveness because its financial authority (Bank Negara Malaysia) has a special task force that handles Islamic finance and works synergistically with the National Shariah Council. Supervision is carried out systematically, periodically, and based on sharia principles (Supriyatni, 2020). In Indonesia, although OJK and BI have made efforts to strengthen the supervisory system, coordination between conventional and sharia supervisors still faces challenges. In the UK, there is no specific authority for Islamic finance; supervision is carried out by the FCA which uses a general approach based on market principles, so the sharia approach is not a priority (Al Ben Ali, 2020).

Theoretically, a legal system that supports Islamic banking is a system that accommodates sharia-based material and procedural laws, and provides legitimacy to the principles of *fiqh muamalah*. In practice, only Malaysia approaches this ideal. In Indonesia, although it theoretically supports a dual banking system and has ratified a number of regulations, its implementation is still hampered by disharmony between institutions, inconsistent application of fatwas, and minimal procedural support. In the UK, although the legal system is stable and generally functioning well, the absence of legal recognition of sharia principles creates a large gap between theory and reality, so that Islamic banks are more "sharia by structure" than "sharia by system" (Nurjannah, et al, 2020).

Legal culture and socio-religious context have a significant influence on the acceptance and performance of Islamic banks. In Malaysia and Indonesia, the majority of the population is Muslim and has an awareness of Islamic values, which drives the development of Islamic banks both in terms of demand and regulatory support. In Malaysia, an orderly legal culture integrated with Islamic values accelerates the adoption of the Islamic system in the financial sector. In Indonesia, although religiously supportive, an immature legal culture and complex bureaucracy still hinder the effective implementation of the Islamic system (Reza, 2020). The UK, with its secular society background and lack of general understanding of Islamic law,

faces significant cultural challenges in building an ecosystem that supports Islamic banks as a whole (Shahin, 2023).

Conclusion

Based on the results of a comparative analysis of the legal system and performance of Islamic banks in the UK, Malaysia, and Indonesia, it can be concluded that the existence of a legal system that substantially supports Islamic principles is a key factor in supporting the growth and competitiveness of Islamic banks. Malaysia, with its dual banking legal system that formally integrates Islamic law and strong regulations, is able to create a stable, innovative, and efficient Islamic banking ecosystem. Meanwhile, Indonesia has shown significant development with the support of regulations and institutions that continue to be strengthened, although it still faces challenges in legal harmonization and supervision effectiveness. The UK, with its neutral common law legal system and less specific accommodation of Islamic aspects, provides limited space for the expansion of Islamic banks, so that its performance is still limited compared to the other two countries. In addition to regulatory factors, legal culture and socio-religious contexts also play an important role in shaping trust and adoption of Islamic financial products.

According to conclusion above, harmonization of national laws with Islamic principles, increasing the capacity of supervisory institutions, and international collaboration in standardizing Islamic financial laws are strategic steps that need to be pursued in order to improve the performance and competitiveness of Islamic banks globally. Thus, a legal system that is responsive and adaptive to sharia values not only strengthens the foundation of the sharia banking industry, but also encourages financial inclusion and sustainable economic development.

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