

Contributions to Economics

Farhad Taghizadeh-Hesary
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Islamic Financial Markets and Institutions

Challenges, Financial Stability,
and Inclusivity

 Springer

Contributions to Economics

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Introduction

In recent years, Islamic financial institutions have experienced substantial growth, particularly in Asia and the Middle East, with a focus on financial innovation and the advancement of asset securitization. This growth, crucial for the future development of Islamic financial institutions (IFIs), necessitates a robust regulatory framework and effective monetary policies. The book examines IFIs' complexities in maintaining compliance with Islamic law while ensuring financial stability and inclusivity.

Islamic Financial Markets and Institutions: Challenges, Financial Stability, and Inclusivity examines the challenges of limited financial inclusion, poverty, non-Muslim ownership dominance, and the complexities of emerging Islamic financial products. Emphasis is placed on the need for a legal and regulatory structure that ensures transparency, uniformity, and predictability, advocating for the incorporation of standards into supervisory frameworks. The book addresses the challenges of strengthening domestic regulatory structures, ensuring the stability of Islamic finance, and integrating Islamic finance into the global financial system's regulatory framework. Despite significant expansion prospects, the book argues that Islamic finance necessitates a legal and regulatory framework to mitigate the unique risks associated with Islamic financing. The book consists of 15 chapters and is structured into three Parts: *Navigating Challenges in Islamic Financial Markets and Institutions*, *Ensuring Financial Stability Within Islamic Finance Frameworks*, and *Promoting Inclusivity Through Islamic Financial Markets*.

Part I: Navigating Challenges in Islamic Financial Markets and Institutions

Chapter 1: Peykani et al. explore the financial inclusion challenges faced by Iran's fully Islamic banking system, which has operated under Shariah-compliant regulations for over four decades. Unlike countries with dual banking systems, Iran's banking sector lacks conventional alternatives, resulting in unique challenges in distributive justice, profit-loss sharing, moral hazard, and central bank supervision. Through quantitative analysis, the study reveals that while public trust in Islamic banking remains strong, issues such as limited depositor returns and regulatory inefficiencies hinder financial inclusion. The authors propose policy reforms to

enhance accessibility, transparency, and supervisory mechanisms, thereby strengthening the sector's stability and outreach.

Chapter 2: Suhartini et al. examine how economic downturns, inflation, geopolitical instability, and regulatory changes impact Islamic banking performance in Indonesia and Malaysia. Utilizing panel data econometrics, the study finds that GDP and inflation rates have minimal effects, while political instability has a notable influence on financial resilience. Furthermore, regulatory support for digital banking is crucial in stabilizing Islamic financial institutions. The findings underscore the need for stronger governance frameworks, financial literacy programs, and adaptable regulations to mitigate economic uncertainties and foster sustained sectoral growth.

Chapter 3: Kamal et al. employ agent-based modeling (ABM) to compare the efficiency of the Profit and Loss Sharing (PLS) model in Islamic banking against interest-based lending (IBL) in conventional banks. The simulations indicate that borrowers under the Islamic PLS models experience fewer fluctuations in wealth and exhibit greater resilience to economic shocks, such as financial crises. The findings suggest that through its risk-sharing mechanisms, Islamic banking enhances social welfare and financial stability, particularly in dual banking systems. The study advocates for integrating Islamic finance policies into mainstream financial ecosystems to capitalize on their resilience and ethical foundations.

Chapter 4: Nasharudin et al. analyze the risks of Shariah Non-Compliance Income (SNCI) in Tawarruq-based home financing in Malaysia, a structure responsible for 40% of compliance breaches in Islamic banks. The study identifies key risk factors through document analysis and expert interviews, including improper contract sequencing, lack of transparency, and flawed Wakalah agreements. The authors emphasize the importance of strengthening Shariah governance, enforcing stricter audits, and leveraging digital monitoring tools to mitigate SNCI risks. This chapter emphasizes the importance of robust compliance frameworks in enhancing the credibility and financial stability of Islamic banks.

Chapter 5: Asmy et al. propose an Islamic crowdfunding model to support student entrepreneurs in Malaysia, addressing the critical issue of limited access to financing. Despite government backing for youth entrepreneurship, financial constraints remain a significant barrier, mainly due to collateral requirements and risk aversion among financial institutions. The study argues that Shariah-compliant crowdfunding can offer ethical, socially responsible financial solutions that promote financial inclusion and business innovation. The proposed model emphasizes profit-sharing mechanisms, integration with Islamic fintech, and regulatory alignment, demonstrating how Islamic finance can play a transformative role in developing entrepreneurship.

Part II: Ensuring Financial Stability Within Islamic Finance Frameworks

Chapter 6: Muye et al. investigate how capital account openness, trade liberalization, and institutional quality affect the growth of the Islamic insurance (Takaful) sector across 24 markets in the ASEAN and MENA regions. Utilizing dynamic panel GMM estimation, the study finds that capital account openness and institutional quality have a positive influence on Takaful development. In contrast, trade

openness has a negative but significant impact, likely due to ineffective trade policies. The research highlights the significance of high-quality institutions in fostering financial sector development. It supports McKinnon's sequencing theory, which posits that capital liberalization should follow trade liberalization to enhance financial sector development. The findings provide policy recommendations for regulators and Takaful operators to strengthen institutional frameworks and regulatory policies, facilitating the sustainable growth of Islamic insurance.

Chapter 7: Pitchay et al. explore the role of Islamic finance in promoting sustainable aquaculture, using Malaysia's sea cucumber industry as a case study. The authors examine how Shariah-compliant financing instruments, such as *mudarabah* (profit-sharing) and *waqf* (endowment), can promote sustainable marine practices while enhancing community welfare. The study contends that Islamic finance aligns with the Blue Economy concept, integrating economic growth with environmental conservation. It emphasizes the potential of green *sukuk* and other Islamic financial mechanisms to support marine biodiversity, coastal livelihoods, and sustainable aquaculture practices. The findings emphasize the importance of multi-stakeholder collaboration and proactive policy measures in ensuring the success of Islamic finance in addressing environmental sustainability.

Chapter 8: Suleman et al. examine the resilience of Islamic financial institutions during the COVID-19 pandemic, analyzing how risk-sharing mechanisms and ethical finance principles contributed to financial stability. Drawing on Economic Crisis Theory, Systems Theory, and Institutional Theory, the study finds that Islamic banks with strong capital buffers and effective risk management strategies were more resilient than conventional banks. The authors emphasize the crucial role of digital transformation, particularly in the context of FinTech innovations, in enabling Islamic banks to adapt to crisis conditions. Additionally, Islamic financial instruments such as *Qard Hasan* (benevolent loans), *Zakat* (charitable giving), and *Sukuk* (Islamic bonds) played a crucial role in economic recovery and social welfare support. The findings advocate for greater digital innovation, enhanced regulatory frameworks, and the expansion of Islamic social finance tools to improve crisis resilience in the sector.

Chapter 9: As-Salafiyah et al. examine the role of *Maqāsid al-Sharī'ah* (Shari'ah objectives) in promoting financial stability within Islamic finance, particularly through partnership contracts (*Musharakah* and *Mudarabah*). The study examines how these contracts facilitate wealth distribution, promote fairness, and foster sustainable economic development, aligning financial transactions with Islamic ethical principles. By integrating classical jurisprudence with modern Islamic finance practices, the authors highlight how Malaysia has led efforts to align regulatory frameworks with Shariah principles. The findings suggest that Islamic finance institutions should enhance risk-sharing models and expand participatory financing mechanisms to ensure financial stability and ethical economic growth.

Chapter 10: Thaker et al. present a systematic literature review (SLR) and bibliometric analysis of Islamic public finance research from 1972 to 2022. The study identifies key themes, frameworks, and emerging trends influencing the incorporation of Islamic economic principles into public finance policies. It highlights the

roles of Zakat, Waqf, and Sukuk as alternative fiscal instruments that contribute to social welfare, economic stability, and financial sustainability. The research highlights the need for robust regulatory policies and innovative financial mechanisms to align Islamic public finance with contemporary economic challenges. By mapping the evolution of Islamic public finance research, this chapter provides policymakers and researchers with critical insights on how Islamic economic principles can enhance fiscal policies and economic resilience.

Part III: Promoting Inclusivity Through Islamic Financial Markets

Chapter 11: Napitupulu et al. investigate financial inclusion trends in Islamic finance, employing a hybrid review method that combines bibliometric analysis and content analysis. Based on 97 Scopus-indexed documents, the study identifies four critical factors influencing financial inclusion in Islamic financial institutions: the availability of Islamic financial products, the role of fintech, financial literacy, and the effectiveness of Islamic banks. The findings highlight that countries such as Nigeria, Malaysia, and Indonesia play a crucial role in shaping global Islamic financial inclusion. However, regulatory challenges, limited Islamic financial literacy, and gaps in fintech adoption remain significant obstacles. The authors emphasize policy interventions that focus on financial education, regulatory support, and digital transformation to bridge the financial access gaps in the Islamic finance sector.

Chapter 12: Abidin et al. assess the contribution of Islamic financial markets to Indonesia's Sustainable Development Goals (SDGs). Using a systematic literature review (SLR) of 25 Scopus-indexed studies, the authors highlight how Islamic financial instruments such as green sukuk, waqf, and Zakat contribute to poverty alleviation, education, gender equality, and economic growth. Despite their potential, regulatory constraints, limited public awareness, and operational inefficiencies hinder widespread adoption. The chapter proposes regulatory reforms, enhanced stakeholder collaboration, and the integration of digital financial technologies to strengthen the impact of Islamic finance on sustainable development. These insights are particularly relevant as Indonesia seeks to position itself as a global hub for Islamic finance.

Chapter 13: Malahayati & Anggraeni explore the application of “green waqf” for sustainable forest conservation in Indonesia, positioning waqf as a financial mechanism to support reforestation, biodiversity conservation, and sustainable land use. Case studies from Aceh and Bogor Waqf Forests illustrate the potential and challenges of waqf-based conservation initiatives, including complexities in land certification, limited awareness, and underutilization of cash waqf. Policy recommendations include integrating waqf into national environmental strategies, developing waqf-based financial instruments, and launching public awareness campaigns. The study highlights green waqf as an innovative approach to aligning Islamic philanthropy with climate change mitigation efforts, providing an alternative financing model for sustainable development and community resilience.

Chapter 14: Muye et al. examine the global expansion of the Takaful (Islamic insurance) sector and its role in economic growth across 22 Muslim-majority countries. Using the dynamic generalized method of moments (GMM) technique, the study finds that Takaful makes a significant contribution to economic growth,

thereby reinforcing the supply-leading hypothesis in the finance-growth literature. The findings indicate that Takaful enhances financial stability, supports trade, and mobilizes domestic savings, serving as a key economic catalyst in Islamic finance markets. However, regulatory inconsistencies, limited public awareness, and integration challenges with conventional insurance frameworks hinder its full potential. The chapter offers policy recommendations for strengthening Takaful markets, emphasizing its role as an inclusive financial mechanism that supports sustainable economic development.

Chapter 15: Albadaa et al. investigate the impact of Sharia compliance on Initial Public Offerings (IPOs) in Malaysia, where approximately 80% of listed securities are Sharia-compliant. Using a dataset of 453 IPOs from 2000 to 2018, the study employs quantile regression analysis to examine the impact of prestige signals, including board reputation and underwriter credibility, on IPO initial returns. The findings reveal that Sharia compliance alone does not significantly impact IPO initial returns. However, factors such as board and underwriter reputation, offer price, and listing board placement play a decisive role. The study highlights the growing investor confidence in Sharia-compliant firms and offers policy recommendations for enhancing Sharia-compliant initial public offering (IPO) frameworks to attract a broader investor base.

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This book is the result of a collaborative effort by esteemed experts in Islamic banking and finance, all dedicated to deepening our understanding of Islamic financial markets and institutions, particularly in the areas of challenges, financial stability, and inclusivity.

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