JPPI (Jurnal Penelitian Pendidikan Indonesia)
Volume 11, Number 2 2025

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Publication details, including author guidelines
URL: https://jurnal.iicet.org/index.php/jppi/about/submissions#authorGuidelines
Editor: Tommy Wijaya

Article History
Received: 24 Apr 2025
Revised: 27 May 2025
Accepted: 30 Jun 2025

How to cite this article (APA)
Sudi, D. M. (2025). Enhancing the sustainability and competitiveness of Islamic Banking: a comparative study of fiscal policy and regulatory Frameworks in Indonesia and Malaysia. Jurnal Penelitian Pendidikan Indonesia.11(2), 18-32. https://doi.org/10.29210/020255614

The readers can link to article via https://doi.org/10.29210/020255614

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JPPI (Jurnal Penelitian Pendidikan Indonesia)
ISSN: 2502-8103 (Print) ISSN: 2477-8524 (Electronic)

Vol. 11, No. 2, 2025, pp. 18-32
DOI: https://doi.org/10.29210/020255614

Enhancing the sustainability and competitiveness of Islamic Banking: a comparative study of fiscal policy and regulatory Frameworks in Indonesia and Malaysia

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Article Info

Article history:

Received Apr 24th, 2025
Revised May 27th, 2025
Accepted Jun 30th, 2025

Keywords:

Islamic banking
Fiscal policy
Regulatory framework
Indonesia
Malaysia
Comparative study

ABSTRACT

The rapid global expansion of Islamic banking urgently necessitates robust fiscal policies and regulatory frameworks, particularly in leading Muslim-majority economies like Indonesia and Malaysia, where their long-term sustainability and competitiveness are critically dependent on effective governance. This study addresses a critical gap by providing an in-depth comparative analysis of the fiscal policy and regulatory frameworks in enhancing the sustainability and competitiveness of Islamic banking in these two countries, focusing on underlying issues that justify this comparison. Employing a qualitative, interpretivist comparative case study approach, data were collected through comprehensive literature reviews, in-depth analysis of key policy documents (Indonesia's Law No. 21 of 2008 on Islamic Banking, Malaysia's Islamic Financial Services Act 2013), and secondary data from financial authorities. Thematic content analysis was used to compare their approaches systematically. The findings reveal that both countries have strategically employed tax incentives, liquidity measures, and legal oversight to foster sectoral growth. Indonesia with a multi-agency framework, rooted in Law No. 21 of 2008, demonstrates a strong commitment to Islamic principles but grapples with regulatory overlaps and operational inefficiencies. Malaysia with centralized approach, anchored by the Islamic Financial Services Act 2013 and guided by the Shariah Advisory Council, has contributed to global competitiveness. The findings also highlight key policy challenges, including regulatory fragmentation, *Shariah* compliance in fintech integration, and limited technical capacity, and offer actionable recommendations to strengthen financial inclusion, institutional resilience, and the long-term sustainability of Islamic banking in both jurisdictions.

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Introduction

Over the past few decades, the global Islamic banking sector has witnessed remarkable growth, positioning itself as a vital component of the international financial system, especially in countries with large Muslim populations. Driven by ethical principles and increasing demand for Sharia-compliant financial products, Islamic banking offers a unique value proposition beyond traditional finance, contributing to economic development and broader financial inclusion.

Indonesia and Malaysia have emerged as leading markets for Islamic finance, each implementing distinct fiscal policies and regulatory frameworks to nurture the sector's growth. These measures aim to align with key principles of Islamic finance, such as risk-sharing and the prohibition of interest (*riba*), thereby enhancing financial inclusion and economic resilience. However, establishing robust and effective governance frameworks becomes increasingly crucial as the sector expands. Islamic banks' long-term sustainability and competitiveness in these important markets depend on responsive fiscal policies and comprehensive regulations. Despite their significance, the specific impacts and comparative effectiveness of these policy instruments remain insufficiently explored in certain contexts, highlighting the need for more in-depth academic research.

Islamic banking operates on the principle of transactions that are free from interest, focusing on the sharing of profits and losses. This fundamental difference from traditional banking requires tailored fiscal policies that adhere to Sharia principles (Khalfi & Saâdaoui, 2023). The taxation system within Islamic finance is rooted in historical ideals aimed at fostering justice and welfare. Consequently, contemporary fiscal policies in Islamic banking must modify these age-old principles to align with current conditions (Hakim & Noviyanti, 2024).

The government of Indonesia has introduced various fiscal incentives and regulatory measures aimed at enhancing the accessibility and appeal of Sharia-compliant financial products. The establishment of the National Committee for Islamic Economy and Finance (KNEKS) exemplifies Indonesia's commitment to advancing the Islamic finance sector.

The banking landscape features a dual system where Islamic banks coexist with conventional banks. This arrangement exposes Islamic banks to unique risks, including inconsistencies in fatwas, reputational issues, and inefficiencies within the regulatory framework (Setiawan, 2023). The regulatory landscape in Indonesia is influenced by global financial standards, such as the Basel Accords, yet challenges persist due to the existence of multiple regulatory and supervisory agencies (Setiawan, 2023). It is crucial to ensure compliance with Sharia, and the regulatory framework must ensure that Islamic banking operations conform to these principles (Faruq, 2021).

Similarly, Malaysia has positioned itself as a global hub for Islamic finance through comprehensive policies and a robust regulatory framework overseen by Bank Negara Malaysia (BNM). Malaysia's approach emphasizes governance, transparency, and the development of a supportive legal environment for Islamic banking. Despite these efforts, challenges remain in achieving sustainable market share growth and addressing public awareness regarding Islamic financial products.

Malaysia has established a robust regulatory framework for Islamic banking, which has evolved steadily since the sector's inception in 1983. This comprehensive framework has enabled Malaysia to achieve a significant market presence and continues to support the growth of Islamic banking through ongoing enhancements to its regulatory, legal, and fiscal structures. Moreover, Malaysia's regulatory framework carefully considers the effects of monetary policy on Islamic banks, recognizing that variations in benchmark rates can affect asset-liability management due to Islamic banks' prohibition of interest-based practices. The increasing prevalence of mobile banking in Malaysia further highlights the need for a strong online dispute resolution mechanism to effectively address disputes arising from e-banking transactions.

The success of Malaysia's Islamic banking industry is largely attributed to its robust legal instruments and accommodating regulations, which have been pivotal in driving the industry's growth and performance (Triyanta & Hassan, 2024a). Equally important is the country's Shariah governance framework: the Shariah Governance Framework (SGF) and the Shariah Advisory Council

(SAC) play crucial roles in ensuring compliance with Islamic law. The SAC provides authoritative guidance on Shariah matters and ensures that Islamic financial institutions (IFIs) consistently adhere to Shariah principles (Amsyar Mohd Arif & Markom, 2020).

Islamic banking has undergone considerable growth in both Indonesia and Malaysia, though the paths and factors influencing this expansion differ. In Malaysia, Islamic banking has made a notable contribution to the nation's economic development. Research indicates that Islamic finance positively affects the real economy, especially over the long term, by efficiently directing funds into productive investment activities (Gani & Bahari, 2021; Indrawan & Rahman, 2020). Sectoral analysis reveals that financing from Islamic banking positively influences various sectors, such as agriculture, industry, and services, although the level of impact varies across these sectors (Indrawan & Rahman, 2020). The Malaysian government has been pivotal in advancing Islamic finance through favorable policies and regulatory frameworks, establishing the country as a global center for Islamic finance (Purwanto et al., 2020). The incorporation of *Maqasid Shariah* principles alongside effective governance has improved transparency and accountability, further bolstering the sector (Rahayu et al., 2024a).

Indonesian Islamic banking has also played a role in economic growth, particularly in bolstering the real sector and industrial output. However, its impact is less pronounced than in Malaysia (Trianto & Masrizal, 2021). The pace of growth for Islamic banking in Indonesia has been slower, partly due to a market-driven approach and various structural challenges (Purwanto et al., 2020). The country faces multiple obstacles, including delays in creating a solid legal framework, a lack of skilled human resources, and limited public understanding and awareness of Islamic banking (Purwanto et al., 2020; Sudarsono et al., 2021).

The market share of Islamic banking in Indonesia has struggled to achieve high growth since the establishment of the first Islamic bank in 1992. This slow growth is attributed to various internal and external factors, including operational inefficiencies and the dominance of conventional banks; Influence of Conventional Banks: Many Islamic banks in Indonesia are subsidiaries of conventional banks, which impacts their growth and market share. Profits from Islamic banks often contribute to the parent conventional banks, potentially limiting the independent growth of Islamic banking (Waluyo & Syafrida, 2025).

From comparative insights, Malaysia's growth is fueled by robust government support, regulatory frameworks, and the integration of Islamic principles with good governance (Purwanto et al., 2020; Rahayu et al., 2024a). Indonesia's growth is conversely constrained by structural challenges and a market-driven approach, although there are ongoing efforts to enhance the sector (Purwanto et al., 2020; Sudarsono et al., 2021). Both countries demonstrate that Islamic banking can positively influence economic growth; however, Malaysia's impact is more substantial due to its more developed and supportive environment (Indrawan & Rahman, 2020; Trianto & Masrizal, 2021). In conclusion, while both Indonesia and Malaysia have experienced growth in Islamic banking, Malaysia's state-driven approach and supportive policies have resulted in more significant and sustained growth compared to Indonesia's market-driven approach.

Numerous studies have examined the impact of fiscal policies and regulatory approaches on Islamic banking in Southeast Asia, including Indonesia and Malaysia. Table 1 shows Fiscal policies and regulatory approaches on Islamic banking in this region in brief.

Islamic regulations, including the Islamic regulatory framework and Shari′ah supervisory boards, have been found to negatively impact Islamic bank margins in the Association of Southeast Asia Nations (ASEAN) countries. This suggests that adhering to Shari′ah requirements can help lower the cost of financial intermediation (Taib Khan et al., 2021). Strong corporate governance (CG) practices and Shari′ah supervisory board (SSB) mechanisms positively influence the performance of Islamic banks. These practices enhance transparency, accountability, and stability, which are crucial for the sector's growth (Zain et al., 2023).

Islamic banks in Southeast Asia are statistically more productive than conventional banks. This productivity is influenced by both bank-specific factors and macroeconomic variables (W Jubilee et al., 2022). Factors such as asset quality, liquidity, debt funding, and equity funding significantly determine the financial performance of Islamic banks. External factors like GDP growth rate and interest rates also play a positive role (Al-Shaghdari et al., 2023).

Table 1. Fiscal Policies and Regulatory Approaches on Islamic Banking in Southeast Asia

Aspect	Impact
Regulatory Frameworks	Lowers bank margins, enhances transparency and accountability (Taib Khan et al., 2021)
Productivity	Islamic banks more productive than conventional banks (W Jubilee et al., 2022)
Performance Determinants	Influenced by asset quality, liquidity, debt and equity funding, GDP growth rate (Al-Shaghdari et al., 2023)
Stability Factors	Influenced by financial stability, liquidity risk, GDP, government effectiveness (Iqbal et al., 2024)

Source: Data compiled and analyzed by the author, 2025

The stability of Islamic banks is influenced by past financial stability, liquidity risk, loan risk, inflation, GDP, government effectiveness, rule of law, and control of corruption. However, political stability and regulatory quality did not show a significant association (Iqbal et al., 2024). Effective risk management frameworks and prudent regulatory policies are essential for enhancing the stability of Islamic banks. Promoting good governance practices and instituting effective crisis prevention measures can further bolster the resilience of the sector (Iqbal et al., 2024).

In Southeast Asia, Shari'ah Supervisory Boards (SSBs) have been found to positively influence the performance of Islamic banks, particularly in terms of multi-bank performance indicators and the zakat ratio (zakat on equity), with governance practices in the region generally stronger and SSBs exerting a more pronounced positive impact on bank performance (Mohd Zain et al., 2025). The integration of Information and Communication Technology (ICT) in Islamic banking has significantly transformed the industry by enhancing customer service quality, reducing costs, and improving operational efficiency (Jindal et al., 2024). This technological advancement has enabled Islamic banks to offer sophisticated products and services that align with Sharia principles, thereby attracting a broader customer base (Awamleh et al., 2024). The rapid adoption of mobile banking, in particular, has seen substantial growth, driven by the convenience and accessibility it provides to consumers (Sultan et al., 2023).

While both Indonesia and Malaysia have made significant strides in developing their Islamic banking sectors, differences in their fiscal policies and regulatory frameworks raise questions about the effectiveness of these approaches in promoting market share growth and public engagement. This study seeks to address some questions. How do the fiscal policies and regulatory frameworks for Islamic banking differ between Indonesia and Malaysia? What impact have these policies had on the growth and competitiveness of the Islamic banking sector in each country? What challenges exist in the current policy frameworks, and how might they be addressed to enhance the development of Islamic banking?

The primary objectives of this study are to analyze and compare the fiscal policies and regulatory frameworks governing Islamic banking in Indonesia and Malaysia. Specifically, the study seeks to identify the distinct fiscal policy measures implemented in each country and evaluate the effectiveness of their respective regulatory frameworks in enhancing the sustainability and competitiveness of the Islamic banking sector. Furthermore, the study aims to identify challenges inherent in the current policy frameworks and to propose actionable recommendations for strengthening the sector's contribution to financial inclusion and economic development.

Method

This study adopts a qualitative, interpretivist comparative case study approach to analyze the effectiveness of fiscal policies and regulatory frameworks in enhancing the sustainability and competitiveness of Islamic banking in Indonesia and Malaysia. This research design was chosen for its ability to provide an in-depth, nuanced understanding of complex policy environments and institutional dynamics, which aligns directly with the study's objectives of identifying distinct fiscal measures, evaluating regulatory effectiveness, and proposing actionable recommendations. By focusing on these two key markets for Islamic banking in Southeast Asia and globally, the study is able to explore how fiscal and regulatory frameworks influence the development of the sector in different national contexts.

A comparative case study approach enables a systematic examination of similarities, differences, and unique characteristics between Indonesia and Malaysia, offering valuable insights into how and why certain policy frameworks produce specific outcomes. This method is particularly effective when addressing research questions that require exploring intricate relationships within specific contexts, where purely quantitative or experimental methods may oversimplify complex institutional and social realities or face challenges related to data availability or ethical considerations. Through this qualitative approach, the study aims to generate a comprehensive understanding of the interplay between fiscal policy, regulation, and the performance of Islamic banking.

Data collection involved a comprehensive review of secondary sources, including government reports, policy documents, academic journals, and industry analyses. This approach is commonly used in qualitative research to gather in-depth contextual information on fiscal policies and regulatory structures affecting the Islamic banking sector.

Content analysis and comparative analysis were applied to evaluate policy frameworks established by regulatory bodies such as Bank Indonesia (BI), the Financial Services Authority (OJK), and Bank Negara Malaysia (BNM). Content analysis was used to examine policies like Indonesia's National Payment Gateway, aimed at enhancing economic stability. Additionally, regulations on *zakat maal* (wealth tax) in Malaysia and Indonesia were analyzed to identify similarities and differences in their approaches. The method of content analysis enables the researcher to analyze (large amounts of) textual information and systematically identify its properties, such as the presence of certain words, concepts, characters, themes, or sentences (Krippendorff, 2022).

Comparative analysis was employed to identify commonalities and differences in policy strategies between Indonesia and Malaysia, providing insights into the strengths and weaknesses of each country's regulatory frameworks. For instance, a comparison of public bureaucracies highlighted Malaysia's higher organizational effectiveness due to a more favorable policy environment. Furthermore, an analysis of Indonesia and Malaysia's economic policies revealed their varying responses to global economic shifts, shedding light on the broader implications for Islamic banking regulation and fiscal policy.

Results and Discussions

Fiscal Policy and Regulatory Framework in Indonesia

Indonesia's fiscal policies related to Islamic banking are designed to promote the growth and stability of the sector. The government has implemented a range of measures, including tax incentives and supportive regulatory frameworks, to encourage the development of Islamic financial institutions. For example, the central bank's liquidity policies, such as tailored reserve requirements, aim to stimulate the real sector while recognizing the distinctive role of Islamic banks as financial intermediaries.

The government has introduced temporary stimulus regulations to accelerate Islamic bank financing, particularly during periods of economic crisis. These measures are intended to enable Islamic banks to play a significant role in supporting economic recovery and maintaining financial stability. With appropriate policy support, the Islamic banking sector is expected to achieve sustainable growth. Overall, these fiscal policies demonstrate the government's commitment to fostering a conducive environment for the advancement of Islamic banking, with targeted incentives and regulations positioning Islamic banks as key contributors to meeting community financing needs and driving national economic development.

The regulatory framework for Indonesian Islamic banking is comprehensive and involves multiple authorities. One of the key regulations is Law No. 21 of 2008, which provides the legal foundation for Shariah banking operations, ensuring that these institutions comply with Islamic principles

(Nopriansyah et al., 2022). This law establishes a clear structure for the functioning of Islamic banks, promoting transparency and accountability within the sector.

The Financial Services Authority (OJK) plays a crucial role in overseeing the regulation and supervision of Islamic banks. Since its establishment in 2011, the OJK has been responsible for ensuring that Islamic banks adhere to both financial and Sharia principles (Utama, 2020). This dual oversight is essential for maintaining the integrity of the Islamic banking system and fostering public trust.

The National Sharia Council (DSN-MUI) also contributes significantly to the regulatory landscape by issuing fatwas that guide Islamic banking practices. These fatwas must be converted into binding regulations by either the OJK or Bank Indonesia, ensuring that they are enforced effectively (Syahputra & Armayani, 2021). This collaborative approach among various regulatory bodies helps create a robust framework that supports the growth and of Islamic banking in Indonesia.

The implementation of regulations governing Islamic banking has yielded mixed results. On the positive side, Islamic banking has significantly contributed to financial stability and economic growth by providing Sharia-compliant financing. This approach has been shown to reduce unemployment and foster overall economic development (Budi Cantika Yuli & Rofik, 2023; Rizvi et al., 2020). Additionally, the merger of three major Islamic banks into Bank Syariah Indonesia (BSI) aims to enhance market share and strengthen the institution's reputation within the financial sector (Anwar et al., 2024).

However, the sector also faces challenges despite these regulatory efforts. Issues related to compliance and effectiveness persist, as some Islamic banks have not fully implemented Sharia principles in their operations. This lack of adherence has led to inconsistencies and raised concerns about potential fraud (Husaeni & Jayengsari, 2020; Rasyid, 2021). Addressing these challenges is crucial for ensuring the integrity of Islamic banking and maximizing its positive impact on the Indonesian economy. Several challenges hinder the effective implementation of Islamic banking policies in Indonesia. One major issue is the regulatory overlaps caused by the dual authority of the OJK and DSN, which can lead to inconsistencies and complicate compliance for Islamic banks (Utama, 2020). This situation creates confusion regarding which regulations to prioritize, potentially undermining operational efficiency.

There is a significant gap in awareness and training among staff within Islamic banks, adversely affecting the implementation of Sharia principles (Mehmood et al., 2023; Triasari & Zwart, 2021). Employees may struggle to apply these principles effectively in their daily operations without proper education and understanding.

Islamic banks have also faced criticism for not fully realizing their social functions, often focusing more on business interests than on fulfilling their social commitments (Darmalaksana, 2022). This disconnect can diminish public trust and the perceived value of Islamic banking as a socially responsible alternative. Furthermore, the evolution of Sharia banking regulations is heavily influenced by socio-political factors, which can impact the stability and growth of the sector (Dahlan et al., 2024; Hidayah et al., 2024). Changes in the political climate or economic conditions can lead to shifts in regulatory priorities, complicating the landscape for Islamic banking in Indonesia.

Indonesia's approach to enhancing Islamic banking has been characterized by a blend of fiscal incentives and an evolving regulatory landscape, reflecting its unique context as a populous Muslim-majority nation with a vast, yet still developing, Islamic finance sector. Fiscal policies have primarily focused on creating a more level playing field and stimulating growth. Key measures include specific tax incentives for Islamic financial products, zakat management initiatives linked to Islamic banks, or government sukuk issuance for liquidity management. These policies aim to reduce the cost of Islamic financial transactions, encourage public participation in Islamic finance, or provide Sharia-compliant liquidity instruments for Islamic banks.

Table 2. Fiscal Policy and Regulatory Framework in Indonesia

Aspect	Details
Fiscal Policies	Tax incentives, liquidity policies, temporary stimulus regulations.
Islamic Banking Regulations	Law No. 21 of 2008, OJK oversight, DSN-MUI fatwas.
Implementation and Impact	Positive economic impact, issues with compliance and fraud.

Challenges	Regulatory overlaps, lack of training, social and ethical issues, socio-political influences.

Source: Data compiled and analyzed by the author, 2025

Table 2 shows that the regulatory framework for Islamic banking concurrently has been primarily overseen by the Financial Services Authority (OJK) and guided by the National Sharia Council (DSN-MUI) to ensure Sharia compliance. The foundation of Law No. 21 of 2008 on Islamic Banking] established the legal basis, promoting the establishment of Islamic commercial banks and Islamic business units, and mandating Sharia supervision. While these efforts have significantly contributed to the sector's growth in assets and outreach, our findings indicate several persistent challenges. These include [e.g., regulatory overlaps between OJK and Bank Indonesia in certain areas, inconsistencies in the practical application of Sharia principles across different institutions, and a pervasive lack of public awareness regarding Islamic financial products]. These issues collectively hinder the optimal sustainability and competitiveness of Islamic banking within the Indonesian financial system.

Although Indonesia has made significant strides in developing a robust regulatory framework for Islamic banking, challenges remain in ensuring effective implementation and consistent compliance with Sharia principles. Addressing these challenges will require coordinated efforts from regulators, financial institutions, and other stakeholders to harmonize regulatory responsibilities, standardize the application of Sharia guidelines, and enhance public awareness of Islamic financial services.

Fiscal Policy and Regulatory Framework in Malaysia

Malaysia has positioned itself as a global leader in Islamic finance through a highly centralized and robust approach to its fiscal and regulatory frameworks. Fiscal policy in Malaysia has been instrumental in fostering a conducive environment for Islamic banking, with initiatives designed to promote cross-border Islamic finance.

The regulatory framework in Malaysia is characterized by its comprehensive and proactive nature, primarily governed by the Islamic Financial Services Act 2013 (IFSA) and the Central Bank of Malaysia Act 2009 (CBMA). Bank Negara Malaysia (BNM) plays a central role in regulating the entire Islamic financial industry, with the Shariah Advisory Council (SAC) ensuring stringent Sharia compliance across all operations. This integrated approach has fostered [e.g., greater stability, deeper market penetration, and a stronger emphasis on social responsibility initiatives like waqf and zakat within the banking sector]. Despite its strengths, our analysis reveals challenges such as [e.g., ongoing legal conflicts arising from the dual banking system, where conventional laws can sometimes clash with Sharia rulings in courts, and complexities in integrating rapidly evolving financial technology (fintech) with established Sharia principles, posing challenges for regulatory innovation]. These areas represent critical frontiers for Malaysia's continued leadership in Islamic finance.

In response to the challenges posed by fragmented regulatory structures, recent reforms have introduced the Consumer Credit Act and established the Consumer Credit Oversight Board Taskforce. These initiatives aim to streamline oversight mechanisms and promote a more cohesive regulatory environment for Islamic consumer finance. By enhancing Shariah compliance and safeguarding consumer interests, these measures reflect Malaysia's commitment to strengthening governance within the Islamic financial services sector (Ilias, 2024).

Complementing these legislative efforts, Malaysia has also implemented a comprehensive Shariah Governance Framework for Islamic financial institutions. This framework plays a pivotal role in maintaining ethical standards and reinforcing public confidence in the sector. However, while it has been successfully applied to banks and other financial institutions, the governance structure for Islamic cooperatives is still in its early stages, indicating the need for further development to ensure uniform compliance and accountability across all Islamic financial entities.

Efforts are underway to harmonize accounting and tax principles within Malaysia's Islamic banking sector. These initiatives aim to integrate *Maqasid Shariah* principles with good governance practices to improve transparency and accountability, thereby reinforcing the foundations of the broader Islamic economy (Rahayu et al., 2024b). By aligning fiscal policies with the objectives of Shariah, these harmonization efforts seek to create a more equitable and efficient financial system that supports sustainable growth.

The Malaysian regulatory environment also addresses the specific challenges posed by monetary policy fluctuations, particularly those related to the rate of return risk for Islamic banks. Financial instruments have been developed that enable periodic adjustments of profit rates or lease rentals, ensuring alignment with Shariah principles while allowing Islamic banks to remain responsive to market dynamics. This approach helps mitigate risks inherent in avoiding conventional interest-based benchmarks, thereby safeguarding financial stability.

Research on market concentration and diversification highlights differing effects on the stability of conventional versus Islamic banks. For Islamic banks, market concentration has been shown to enhance stability, suggesting that regulatory frameworks should be tailored to account for these differences (Šeho et al., 2024). Such nuanced regulatory treatments are essential for ensuring that Islamic banks can compete effectively while maintaining their resilience in the face of economic fluctuations.

Technological integration, particularly through the adoption of artificial intelligence (AI), is increasingly vital in the Islamic finance sector. AI-driven solutions enhance regulatory technology (RegTech) and supervisory technology (SupTech), improving compliance and supervision capabilities. However, the absence of a comprehensive legal framework governing the use of AI in Islamic finance presents a significant challenge, underscoring the need for regulatory development to fully leverage the benefits of AI while ensuring adherence to Shariah principles (Arsyad et al., 2025).

Robust legal instruments are fundamental to the continued success of the Islamic banking industry. Policymakers should prioritize the development and enforcement of strong legal frameworks that support the distinct operational needs of Islamic financial institutions. These frameworks must be capable of accommodating Shariah-compliant practices while fostering a stable and transparent legal environment conducive to long-term growth (Triyanta & Hassan, 2024b).

Promoting transparency and accountability is equally vital. Strengthening governance practices and ensuring strict regulatory compliance can significantly enhance public trust and investor confidence. This includes encouraging ethical financial conduct, improving disclosure standards, and enhancing the role of Shariah governance to maintain alignment with Islamic principles. Furthermore, regulatory approaches should be tailored to reflect the unique characteristics of Islamic banking. Unlike conventional banks, Islamic banks operate under different risk-sharing models and profit-generating mechanisms. As such, differentiated regulatory treatment is necessary to account for their distinct stability dynamics and operational models, thereby supporting more sustainable growth trajectories (Šeho et al., 2024).

A key component of this regulatory landscape is the Shariah Advisory Council (SAC) of Bank Negara Malaysia (BNM), which plays an essential role in overseeing compliance with Shariah principles across all Islamic financial institutions. The SAC provides guidance and ensures that operations align with Islamic teachings, thereby enhancing the credibility of Islamic banking in the country.

Additionally, the regulations incorporate mechanisms such as *ta' widh* and *gharamah*, which serve as alternatives to traditional interest (riba) for late payments and defaults (Hassan et al., 2023). These provisions reflect Malaysia's commitment to creating a financial system that is not only compliant with Shariah law but also fair and equitable for all participants in the Islamic banking sector.

Despite a robust regulatory framework, the implementation of Islamic banking policies in Malaysia faces several challenges. One significant issue is legal conflicts arising from the dual banking system, where Islamic and conventional banks operate in parallel. This coexistence can lead to potential legal disputes due to differences in the applicable laws governing each system. The complexity of navigating these legal landscapes poses a challenge for Islamic banks, which must ensure compliance with both sets of regulations. Another challenge is Shariah compliance, which remains a critical concern across all operations. Ensuring adherence to Shariah principles is particularly difficult when integrating new financial technologies (Fintech) into existing frameworks (Razak et al., 2020). As the financial landscape evolves rapidly, Islamic banks must continuously adapt their practices to maintain compliance, which can strain resources and complicate operations.

There is a notable shortage of qualified Shariah experts and insufficient staff training within Islamic banks, which hinders their development and growth (Mehmood et al., 2023). This lack of expertise can lead to inconsistencies in compliance and operational practices, ultimately affecting the performance and credibility of Islamic financial institutions. Without a well-trained workforce, the sector may struggle to innovate and meet the demands of a competitive market.

Table 3. Fiscal Policy and Regulatory Framework in Malaysia

Aspect	Details
Fiscal Policies	Tax regulations for Islamic transactions, enhanced fiscal infrastructure
Islamic Banking Regulations	IFSA 2013, CBMA 2009, *Shariah Advisory Council*, *ta' widh and gharamah*
Implementation and Impact	Economic growth, support for Small and Medium Enterprises (SMEs), financial intermediation, CSR through zakat
Challenges	Legal conflicts, Shariah compliance, shortage of Shariah experts, regulatory harmonization

Source: Data compiled and analyzed by the author, 2025

Fiscal policies and regulatory frameworks of Malaysia have significantly contributed to the growth, sustainability, and competitiveness of its Islamic banking sector. Through comprehensive legal reforms, consumer protection initiatives, tax harmonization efforts, and the strategic integration of advanced technologies, Malaysia has fostered a more resilient and inclusive Islamic financial ecosystem. Nonetheless, persistent challenges in legal harmonization and Shariah compliance remain critical areas requiring further alignment and innovation to ensure long-term integrity and global relevance (see Table 3).

Comparative Analysis of Fiscal Policy and Regulation between Indonesia and Malaysia

A comparative analysis of Indonesia and Malaysia reveals both shared objectives and distinct strategies in leveraging fiscal policy and regulatory frameworks to enhance Islamic banking. Indonesia's approach has been more characterized by [e.g., a focus on domestic market expansion and bringing Islamic finance to the masses through broad tax incentives and institutional oversight focused on foundational growth]. This reflects its larger population and emerging market status, where foundational legal structures and basic incentives are critical. However, its decentralized aspects and challenges with regulatory harmonization across multiple bodies stand in contrast to Malaysia.

Malaysia has established a more advanced and comprehensive regulatory environment for Islamic banking, which actively promotes sustainable finance and green banking practices. This robust regulatory framework has contributed to higher profitability and greater operational efficiency among Malaysian Islamic banks compared to their Indonesian counterparts (Alkindi & Utami, 2025). Furthermore, Malaysia has developed a well-structured regulatory framework specifically for Sharia-compliant financial technology (fintech), encompassing supervision, implementation, and the protection of Sharia principles. This clarity enhances enforceability and provides greater certainty for both fintech service providers and consumers (Fahamsyah et al., 2025).

Indonesia's regulatory framework for Sharia fintech remains underdeveloped, with regulations often intertwined with those for conventional fintech services. This overlap leads to regulatory ambiguity and less effective governance for Sharia fintech activities (Fahamsyah et al., 2025). Additionally, Islamic banks in Indonesia experience greater variability in profitability compared to those in Malaysia, highlighting the need for stronger governance structures and more effective operational strategies to enhance their sustainability and competitiveness (Alkindi & Utami, 2025).

The Government of Malaysia has implemented substantial measures to strengthen both conventional and Islamic finance sectors, which have contributed significantly to the country's economic stability and development. Islamic banks in Malaysia demonstrate superior efficiency and stability, as evidenced by higher scores in key performance indicators such as Technical Efficiency (TE), Pure Technical Efficiency (PTE), and Scale Efficiency (SE) (Ikhwan & Riani, 2023). Additionally, Malaysia's regulatory environment supports the integration of artificial intelligence (AI) into Islamic finance operations, enhancing regulatory compliance, supervision, and overall sector resilience (Arsyad et al., 2025).

Indonesian Islamic banks generally maintain stable efficiency performance, they continue to face persistent challenges related to inefficiencies in managing fixed assets and generating operating revenue (Ikhwan & Riani, 2023). Furthermore, Indonesia's regulatory framework currently lacks comprehensive legal instruments governing the application of AI in Islamic finance. This regulatory gap may hinder the growth of the Islamic banking sector and limit its ability to ensure effective compliance with both financial and Shariah regulations (Arsyad et al., 2025).

Malaysian Islamic banks generally outperform their Indonesian counterparts in terms of green banking practices and profitability, a result attributed to Malaysia's more advanced and supportive regulatory environment (Alkindi & Utami, 2025). The *Maqasid Shariah* Index further highlights Malaysia's leadership, particularly in the posterity dimension, indicating a strong institutional focus on sustainability and intergenerational welfare. These performance indicators reflect the strategic alignment between regulatory design and long-term development goals within Malaysia's Islamic banking sector. In contrast, Indonesian Islamic banks score higher in the religiosity and intellectuality dimensions of the Maqasid Shariah Index, demonstrating a stronger adherence to Islamic principles in their operations (Hakam Naja, 2023). However, the competitive landscape in Indonesia remains monopolistic, with a few dominant players controlling much of the market. This structure may hinder innovation and reduce overall sectoral competitiveness and financial stability in the long term.

Malaysia's Islamic banks benefit from an advanced regulatory framework, challenges remain. Key sources of inefficiency include high financing and labor costs, which may constrain profitability and operational flexibility (Ikhwan, 2023). Moreover, although Malaysia is ahead in integrating artificial intelligence (AI) into Islamic finance, concerns persist regarding Shariah compliance and algorithmic bias, which necessitate ongoing oversight and ethical governance (Arsyad et al., 2025). Indonesian Islamic banks face operational inefficiencies related to fixed asset management and the generation of consistent operating revenue (Ikhwan & Riani, 2023). These inefficiencies, if unaddressed, could undermine institutional sustainability. Additionally, the regulatory framework for Sharia fintech in Indonesia requires urgent reform to eliminate legal ambiguities and improve enforceability, thereby supporting innovation while safeguarding compliance with Islamic financial principles (Fahamsyah et al., 2025).

Indonesia and Malaysia share a strategic objective: fostering sustainable growth through their Islamic banking sectors. However, the challenges they encounter differ in nature and complexity. Indonesia contends with internal regulatory fragmentation and limited public understanding, which impede cohesive sectoral development. In contrast, Malaysia operates within a more mature dual banking system, yet faces integration challenges arising from rapid technological advancement and the imperative of ensuring Sharia compliance in an evolving financial landscape.

Both nations have instituted robust regulatory frameworks. Malaysia has the Islamic Financial Services Act 2013 (IFSA 2013), and Indonesia with Sharia Banking Law No. 21/2008 (UU21/2008). The laws were made to promote financial stability while upholding Sharia principles. The coexistence of Islamic and conventional banking institutions in both countries introduces added regulatory complexity, requiring careful calibration to balance market dynamics and institutional equity. This comparative perspective underscores that while effective regulation is foundational, its success lies in tailoring legal and policy instruments to each country's market maturity, institutional architecture, and socio-economic context (Setiawan, 2023; Widarjono et al., 2023).

The interaction between these frameworks and the dual banking systems fosters a unique environment for Islamic finance in both nations. By maintaining distinct yet complementary regulatory structures, Indonesia and Malaysia aim to enhance the robustness of their financial systems while catering to the growing demand for Sharia-compliant financial products and services. Malaysia adopts a state-driven regulatory approach characterized by robust govern strong governmental role in shaping and enforcing regulations within the Islamic banking sector. In contrast, Indonesia employs a market-driven approach that grants the Indonesian Ulema Council greater independence in matters of Sharia compliance (Maksum, 2020; Purwanto et al., 2020). This distinction reflects differing philosophies in how each country views the role of regulatory authorities in Islamic finance.

When it comes to Sharia compliance supervision, Malaysia integrates Sharia authorities within its state structures, ensuring a cohesive regulatory environment. Conversely, Indonesia's framework combines the independence of the Indonesian Ulema Council with the establishment of Sharia boards, which serve to oversee compliance while allowing for a more decentralized approach (Maksum, 2020). This arrangement highlights the varying degrees of integration and autonomy in the regulatory processes of the two countries.

Overall, these policy differences illustrate the distinct paths taken by Malaysia and Indonesia in regulating Islamic banking. While Malaysia's centralized model aims for uniformity and strong oversight, Indonesia's market-driven strategy fosters a more flexible regulatory landscape, reflecting the unique cultural and economic contexts of each nation.

Malaysia's Islamic banking sector has demonstrated remarkable effectiveness, achieving a significant market share and growth trajectory. By 2023, it reached a 35.5% market share in assets of entire banking system and 41% share of total financing by the Islamic banking system (Bank Negara Malaysia, 2023). This achievement reflects the strength of Malaysia's regulatory framework and its ability to foster a conducive environment for Islamic financial institutions, contributing to their robust performance in both domestic and international markets.

In contrast, Indonesia's Islamic banking sector has faced challenges in achieving comparable growth. The country set a market share target of 7.44% for Islamic banking in 2023 (Otoritas Jasa Keuangan, 2023). This slow growth can be attributed to various factors, including regulatory hurdles and a less supportive operational environment, which have impeded the sector's expansion.

Moreover, the stability and performance of the two countries' Islamic banking sectors further illustrate the effectiveness of their respective fiscal and regulatory policies. Malaysia's regulatory framework has bolstered the stability and competitiveness of its Islamic banks, enhancing their global standing (Kassim, 2016; Triyanta & Hassan, 2024a). Conversely, Indonesia's Islamic banking sector continues to grapple with lower stability compared to conventional banks, compounded by regulatory and operational inefficiencies that hinder its growth potential (Khattak et al., 2021; Setiawan, 2023).

Malaysia with strong legal and regulatory framework, has established the country as a global leader in Islamic finance. Ongoing efforts to enhance this framework have further bolstered its competitiveness on the international stage, allowing Malaysia to attract significant investments and foster innovation within its Islamic banking sector (Kassim, 2016; Triyanta & Hassan, 2024a). This commitment to refining regulations ensures that Malaysia remains at the forefront of the global Islamic finance landscape. Indonesia, despite having the largest Muslim population in the world, has not attained the same level of global competitiveness in its Islamic banking sector as Malaysia. Several challenges have impeded its growth, including regulatory delays that slow down the implementation of necessary reforms, a shortage of skilled human resources, and lower public awareness of Islamic banking products and services (Purwanto et al., 2020; Setiawan, 2023). These factors collectively hinder Indonesia's ability to leverage its demographic advantage in the global Islamic finance market.

Tabel 4. A Comparison of Fiscal Policy and Regulation between Indonesia and Malaysia

Aspect	Malaysia	Indonesia
Regulatory Framework	IFSA 2013	UU 21/2008
Regulatory Approach	State-driven, centralized (BNM)	Market-driven, broader independence (Ulema Council)
Market share	41% by 2023	7,44 % by 2023
Stability	High, globally competitive	Lower stability, slower growth
Global Competitiveness	Strong, leading global position	Hindered by regulatory and operational challenges

Source: Data compiled and analyzed by the author, 2025

Ultimately, the differing impacts of these policies on global competitiveness highlight the importance of a supportive regulatory environment in fostering growth and innovation. While Malaysia's proactive approach has solidified its position as a leader, Indonesia's challenges underscore the need for strategic reforms to enhance its Islamic banking sector's competitiveness on the world stage.

Both Indonesia and Malaysia have developed comprehensive regulatory frameworks for Islamic banking. Malaysia has advanced regulatory environment, state-driven approach, and a focus on sustainable finance to compete globally. Its robust legal infrastructure, fiscal support, and integration of ESG principles have fostered a resilient and growth-oriented Islamic banking sector. Indonesia has strong commitment to Islamic principles, but it faces regulatory fragmentation and operational inefficiencies that hinder the competitiveness and stability of its Islamic financial institutions. To close this gap, Indonesia must strengthen legal coherence and institutional capacity, aligning its frameworks with both domestic aspirations and global best practices (see Table 4).

Conclusions

This study has analyzed and compared the fiscal policies and regulatory frameworks governing Islamic banking in Indonesia and Malaysia. Both countries have deployed targeted fiscal measures, such as tax incentives and liquidity support, to promote the development of Sharia-compliant financial institutions. In Indonesia, these instruments are designed to bolster economic resilience, particularly during financial crises, while in Malaysia, fiscal initiatives are part of a broader strategy to position the country as a global leader in Islamic finance. Regulatory oversight in Indonesia is distributed across multiple institutions, anchored in Law No. 21 of 2008, whereas Malaysia adopts a centralized framework under the Islamic Financial Services Act 2013 and Central Bank of Malaysia Act 2009, with key leadership from the Shariah Advisory Council (SAC) under Bank Negara Malaysia.

Building on this analysis, the study has evaluated the effectiveness of each country′s regulatory framework in promoting sustainability and competitiveness within the Islamic banking sector. Malaysia's centralized and well-coordinated regulatory environment has contributed to robust growth, enhanced Sharia compliance, and global competitiveness. Islamic banking institutions also demonstrate strong contributions to Small and Medium Enterprises (SMEs) financing and social responsibility through zakat initiatives. In contrast, while Indonesia shows strong adherence to Islamic principles and a growing institutional presence through the formation of Bank Syariah Indonesia (BSI), the sector continues to face obstacles such as regulatory overlap, uneven compliance enforcement, and limited human capital capacity–factors that constrain operational efficiency and sustainable expansion.

Based on these findings, the study identifies key policy challenges and proposes actionable recommendations to enhance the sector′s role in advancing financial inclusion and national economic development. Both countries must strengthen regulatory harmonization, improve coordination between oversight bodies, and enhance Shariah literacy across the financial sector. In Indonesia, focused efforts are needed to streamline the multi-agency regulatory landscape and invest in capacity building, while Malaysia must address fintech-related Shariah compliance and legal ambiguities within its dual banking system. Tailored fiscal incentives and public education campaigns can further reinforce resilience, trust, and long-term impact in both jurisdictions.

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