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An Empirical Investigation of Regulatory Framework for Islamic Banking System in Saudi Arabia

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Undoubtedly, less focus is given to an empirical exploration of standard regulatory framework (SRF) for the Islamic banking system in the Muslim countries in general and Saudi Arabia in particular. The primary objective of this paper is to empirically investigate indicators of regulatory framework for the Islamic banking system in Saudi Arabia. Quantitative research method was used in this paper. The population of the study involved promoters of Islamic banking and the researcher used convenient sampling in distributing 180 survey questionnaires online to the promoters of the Islamic banking system among Saudi Arabian indigenes in order to collect data for this research. Descriptive statistics by using frequencies, percentage, means and standard deviations were used via SPSS version 16.0 for data analysis. Three different dimensions namely: Interpretation of Shar'iah Principle (ISP); Interest-Free Scheme (IFS); and Mobilization of Investment Resources (MIR) of standard regulatory framework (SRF) were specifically identified in this paper. The findings showed that the majority of the respondents strongly agreed that different dimensions identified in this paper were regarded as standard regulatory frameworks in the context of Saudi Arabia. In conclusion, it is reiteratively noted that the triadic components of regulatory framework should serve as a benchmark in propelling and promoting Islamic banking in Saudi Arabia. It is thereby recommended that interpretation of Shari'ah principles by jurists or scholars should be harmonised in order to expand the scope of Interest-Free Scheme (IFS) and Mobilization of Investment Resources (MIR) as being practiced by Islamic banks in Saudi Arabia in particular and Muslim countries in general.

Key words: *Regulatory Framework, Interpretation of Shar'iah Principle (ISP); Interest-Free Scheme (IFS); and Mobilization of Investment Resources (MIR).*

Introduction

A banking system expectedly has a set of guidelines and regulations for its operation. Indeed, the evolvement of Islamic banking system in different parts of the world has allowed its promoters to advocate for standard regulatory framework for its operation (Mahmoud, 2006). Onwards, standardization of regulatory framework for the Islamic banking system has been theoretically explored in the existing literature (Ayub, 2007; Reem, 2007; Mondher Bellah, 2006). Theoretical exploration of regulatory framework is not sufficient as an attempt to solidify the functionality of the Islamic banking system. The motivation for this research is mainly to explore the perceptions of promoters of Islamic banking with regard to indicators of regulatory framework for Islamic banking specifically in Saudi Arabia.

Onwards, it should be reiterated that, some Islamic countries most essentially Gulf Cooperation Council (GCC) have some regulations for the operation of Islamic banking. For instance, there was an amendment in the Law of Central Bank of Kuwait (CBK) in order to accommodate regulatory framework for the Islamic banking system; in the United Arab Emirate (UAE), there was regulation specifically Federal Law No. 6 of 1985 which provided regulation for Islamic banking and finance; in Bahrain, the Central Bank of Bahrain (CBB) provides regulation for Islamic banks and many others. Similarly, in the United Kingdom (UK), the Financial Services Authority (FSA) provides different guidelines for the operation of Islamic banking and finance.

It is not arguable to posit that there are varying degrees of regulations in the operation of Islamic banking in the aforementioned countries. However, Simon and Rifaat (2007) contend that, there are peculiar challenges of regulatory framework in different parts of the Muslim countries. Nonetheless, the regulatory framework is increasingly becoming an area of interest to many scholars and promoters of Islamic banking and finance. An investigation of regulatory framework is essential because there are numerous challenges facing Islamic banking as it continues to expand in scope and operation. It is not arguable to assert that classical juristic legal framework especially al-*Maqasid* which provides ground theory for Islamic banking and finance as literature expounds (Dar, 2011).

Literature asserts that in spite of the fact that the constitution of Saudi Arabia is based on *Sharī'ah*, there are no specific or explicit regulations as measures for operation of Islamic banking and finance. Nonetheless, Saudi Arabian Monetary Agency (SAMA), under the Banking Control Law of 1966, tends to supervise and regulate the activities of Islamic banking alongside the conventional banking system in the country, as literature contends (Alshamrani, 2014). Similarly, a lack of unified interpretation of *Sharī'ah* tenets suggests that within Saudi Arabia, there is no uniformed regulatory framework for the operation of Islamic banking and finance. However, literature posits that there are two major regulatory frameworks in Saudi Arabia, namely: Banking Control Law (BCL) and Capital Market Law (CML).

On one hand, the Banking Control Law (BCL) of 1966, issued under Royal Decree No. M/5, dated 11/6/1966, could be considered as a document meant for regulating banking activities in Saudi Arabia. It is not doubtful to posit that it is the BCL that empower Saudi Arabian Monetary Agency (SAMA) whose primary task among others is to regulate the activities of Saudi Arabian banks (Alshamrani, 2014).

On the other hand, Capital Market Law (CML), issued under Royal Decree No. (M/30) dated 31/07/2003, indicates that Capital Market Authority (CMA) is primarily discharged to the responsibility of carrying out regulatory task of Saudi Arabian Market, specifically by providing transparency and standards for the capital market (Alshamrani, 2014). It can be inferred that, both SAMA and CMA are empowered in coming up with a regulatory framework for the comprehensive operation of Islamic banking and finance in Saudi Arabia. Nevertheless, it is unfortunate to contend that, both SAMA and CMA could provide a particular document stipulating the operation of Islamic banking and finance.

It is in the light of the foregoing that this paper empirically investigates three factors of regulatory framework namely: Interpretation of *Shar'iah* Principle (ISP); Interest-Free Scheme (IFS); and Mobilization of Investment Resources (MIR). Each of this is explained in the subsequent paragraphs.

First, pertaining to Interpretation of *Shar'iah* Principle (ISP), literature identifies *Shar'iah* standard as an essential requirement for regulatory framework in Islamic finance (Dar, 2011). It is not disputable to assert that, jurists and promoters of Islamic banking unanimously agreed that Islamic financial transactions should be *Shar'iah*-compliant; however, the interpretation of *Shar'iah* principles might take into account the peculiarity of each country where *Shar'iah* principles are to be interpreted (Siti Faridah, 2009).

Second, regarding Interest-Free Scheme (IFS), unlike conventional banks, there is an emphasis on interest-free banking schemes by Islamic banks; nonetheless, the essential regulatory framework should be put in place to ensure standards in the activities of Islamic banks (Ayub, 2007). In spite of an of interest-free scheme by Islamic banks, it is argued by the promoters of Islamic banks that risk sharing between provider of capital (investor) and the user of funds (entrepreneur) should be ascertained (Alshamrani, 2014).

Third, pertaining to Mobilization of Investment Resources (MIR), Islamic banks pay greater attention to developing project appraisal and evaluations as a result of the fact that they share profit and loss. Similarly, Islamic banks place greater emphasis on the viability of the projects in order to maximize profits. The status of the Islamic bank in relation to its clients is that of partners, investors, and traders (Obaidullah, 2005; Obaidullah, 2006). The identified factors can bring about transformational change to the financial services being provided by Islamic banks as literature identifies (Obaidullah, 2006; Pearce, 2013). However, an Islamic bank cannot guarantee all its deposits. The triadic components of regulatory framework have been explored. In other words, the three identified variables have been elucidated, therefore, this paper investigates their relevance as indicators of a regulatory framework for the Islamic banking system in the context of Saudi Arabia.

Methodology

The methodology employed in this paper is presented below. Various sub-headings are identified which are: instrument, validity & reliability, population & sample, data collection and data analysis. Each of these is explained in the subsequent paragraphs.

First, regarding the instrument of the study, a survey questionnaire was used. The questionnaire was adapted from the extant literature (Ahmad & Kabir, 2007; Archer & Karim, 2009; Archer, Karim & Sundarajan, 2010). Onwards, a 5-point Likert scale namely: 1=strongly disagree (SD); 2=disagree (D); 3=undecided (UN); 4= agree (A) and 5= strongly agree (SA) were employed. Literature such DeVellis (2003) says that the use of variation of Likert scale allows different variations of responses from the respondents. The survey instrument covers a demographic background of the respondents from Saudi Arabia as well as various indicators of the regulatory framework of Islamic banking and finance namely: Interpretation of *Shar'iah* Principle (ISP); Interest-Free Shceme (IFS); and Mobilization of Investment Resources (MIR). There are five (5) items measuring each factor, which means that the instrument (questionnaire) comprised 15 items measuring the aforementioned dimensions of regulatory framework conceptualized in this paper.

Second, pertaining to validity of the instrument, on one hand, the items were worded to reflect simplicity, flexibility and understandability by the respondents among the promoters of Islamic banking and finance among indigenes of Saudi Arabia. On the other hand, content validity was carried out to address the ambiguities of the items contained in the instrument. In order to ensure that content validity was done accurately, conceptual framework of the study was developed from extant literature (Al-Shamrani, 2014; Asad, Sarfaraz, AbdulQadir & Raja, 2015). Initially, 20 items were developed as the instrument of the study. Thus, the questionnaire was validated by two experts in Islamic banking and finance. Then, five (5) items were considered irrelevant according to the suggestions given by the experts, and consequently deleted. Similarly, some statements were suggested to be rephrased in order to make them clear and flexible to the respondents.

Third, the population of this study comprised all promoters of the Islamic banking system in both public and private sectors in Saudi Arabia. However, convenient and purposeful sampling technique was used to select the total of 180 respondents. The country has certain features such as having a majority Muslim population as well as promoting the Islamic banking system in the Muslim world in general. The targeted sample size is adequate for the use of chosen statistical analysis. The instrument was administered online to the promoters of Islamic banking in Saudi Arabia.

Fourth, the instrument (questionnaire) was distributed among promoters of Islamic banking and finance in the selected Islamic countries. Hence, the respondents were requested to show their agreement or disagreement to various items embodied in the survey questionnaire. Indeed, the researcher strictly monitored the filling of the questionnaire via online. In return, after responding to the questionnaire among the promoters of Islamic banking, out of 180 questionnaires that were targeted by the researcher, all incomplete questionnaires of 11 were discarded; thus 169 questionnaires were used for the final analysis of this research.

Fifth, concerning the analysis of the study, statistical package for social science (SPSS) version 16.0 was employed for the data analysis. Descriptive Statistics with computation of frequencies, percentages, means and standard deviations were used to know the opinions of the promoters of Islamic banking in selected Muslim countries with respect to the predictors of standard regulatory framework of Islamic banking and finance. The subsequent sub-headings present the analysis of the findings of the paper.

Presentation of Data and Findings

Demographic information of the respondents among promoters of Islamic banking and finance, with specific attention of the standard framework for Islamic banking in Saudi Arabia, explored whether they were Islamic banking experts or non-experts. Hence, frequency and percentages were employed to analyse the respondents' demographic information.

Pertaining to the area of specialization of the respondents, the majority of the respondents (124 or 73%) are Islamic banking experts while only 45 (26.6%) were non-Islamic banking experts. Based on the respondents' demographic information, it has been demonstrated that, they were qualified to respond to the instrument (questionnaire) of this study. Table 1: The Respondents' Demographic Information.

Table 1: The Respondents' Demographic Information

Specialization: a. Islamic Banking Expert b. Non-Islamic Banking Expert	 124 45	 73.4%% 26.6%
Total:	**169**	**100%**

The subsequent explanations present the findings on three variables investigated as the standard framework for Islamic banking in Saudi Arabia which are: Interpretation of *Shar'iah* Principle (ISP); Interest-Free Scheme (IFS); and Mobilization of Investment Resources (MIR). Findings on each factor are consequently presented.

Findings on Interpretation of Shari'ah Principle (ISP)

Interpretation of *Shari'ah* Principle (ISP) is an essential underlining indicator of standard regulatory framework for Islamic banking conceptualized in this paper. Thus, the responses obtained from the promoters of Islamic banking and finance in selected countries is presented using descriptive statistics by computing frequencies and percentages, means and standard deviation.

The majority of the respondents (131 or 77.5%) agreed that the functions of Islamic banks are based on the principles of Islamic *Shariah*. Nonetheless, 15 (8.9%) disagreed. However, a few respondents (23 or 13.6%) were neutral (M=4.00; STD=0.96).

In addition, it was asserted by the majority of the respondents (173 or 96.4%) agreed that the operating modes of Islamic banks are in line with the principles of Islamic *Shariah*. (M=4.48; STD=0.70); 3 (1.8%) disagreed and on this statement while 3 (1.8%) maintained neutrality.

More so, pertaining to the respondents' perceptions on the ultimate aim of Islamic *Shariah* is to ensure growth with equity, the majority of the sampled respondents (150 or 88.8%) agreed on this (M=4.42; STD= 0.79). Nevertheless, 7 (4.1%) disagreed on this statement and 12 (7.1%) were natural.

Furthermore, the majority of the respondents (121 or 72.6%) agreed that Islamic bank aims to maximize profit, but subject to *Shariah* restrictions. (M=3.93; STD= 1.03). Nonetheless, 13 or 7.7% disagreed with the statement while 35 (20.7%) were neutral.

Regarding lack of unified interpretation of *Sharī'ah* tenets, the whole sample (155 or 91.1%) agreed with the statement (M=4.28; STD=0.67); however, 3 (1.8%) disagreed with the statement, however, 12 (7.1%) were neutral. Table 2 shows the responses of the respondents pertaining to the Interpretation of *Shari'ah* Principle (ISP) in selected Muslim countries (Bangladesh, Malaysia & Saudi Arabia):

Table 2: Perceptions of the Respondents on Interpretation of *Shari'ah* Principle (ISP)

S/N	Items		A	N	D		M	STD
1.	The functions of Islamic banks are based on the principles of Islamic *Shariah*.		131 (77.5%)	23 (13.6%)	15 (8.9%)		4.00	0.96
2.	The operating modes of Islamic banks are in line with the principles of Islamic *Shariah*.		173 (96.4%)	3 (1.8%)	3 (1.8%)		4.48	0.70
3.	Ultimate aim of Islamic *Shariah* is to ensure growth with equity.		150 (88.8%)	12 (7.1%)	7 (4.1%)		4.42	0.79
4.	Islamic bank aims to maximize profit, but subject to *Shariah* restrictions.		121 (72.6%)	35 (20.7%)	13 (7.7%)		3.93	1.03
5.	There is lack of unified interpretation of *Sharī'ah* tenets.		155 (91.1%)	12 (7.1%)	3 (1.8%)		4.28	0.67

Findings on Interest Free Scheme (IFS)

This section provides the responses on Interest Free Scheme (IFS) in the selected three countries (Bangladesh, Malaysia and Saudi Arabia). Descriptive statistics were used by computing frequencies and percentages, means and standard deviation.

The majority of the respondents (153 or 90.6%) agreed that an interest-free banking scheme should be given license to operate by utilizing existing facilities (M=4.18; STD=0.64); 13 (7.7%) maintained neutrality and just only 3 (1.8%) disagreed with the statement.

In addition, the sampled respondents (130 or 76.9%) agreed that there is an emphasis on interest-free banking scheme by Islamic banks unlike conventional banks. while 20 (11.8) disagreed with the statement (M=3.88; STD= 1.08) and 19 (11.2%) were neutral.

The majority of the respondents (135 or 79.9%) agreed that Islamic bank promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur). Nonetheless, 24 (14.2%) maintained neutrality on this. However, 10 (5.9%) disagreed with the statement (M=3.88; STD=0.93).

Onwards, the sampled respondents (133 or 78.7%) agreed that the concept of *murabaha* under Islamic banking is different from bank loan under conventional banks. (M=5.57; STD=4.08); 19 or 11.2% were neutral with the statement while 17 (10.1) disagreed with this.

In addition, the sampled respondents (136 or 80.5%) agreed that, Interest-free scheme of Islamic banks promotes Islamic banking and finance in Muslim countries. On the other hand, 14 (8.3%) disagreed with the statement while 19 (11.2%) maintained neutrality (M=4.33; STD=0.67). Table 3 shows respondents' perceptions on Interest Free Scheme (IFS).

Table 3: Respondents' Perceptions on Interest Free Scheme (IFS)

S/N	**Items**		**A**	**N**	**D**		**M**	**StD**
1.	An interest-free banking scheme should be given license to operate by utilizing existing facilities.		153 (90.0%)	13 (7.7%)	3 (1.8%)		4.18	0.64
2.	There is an emphasis on interest-free banking scheme by Islamic banks unlike conventional banks.		130 (76.9%)	19 (11.2%)	20 (11.8%)		3.88	1.08
3.	Islamic bank promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).		135 (79.9%)	24 (14.2%)	10 (5.9%)		3.88	0.93
4.	The concept of *murabaha* under Islamic banking is different from bank loan under conventional banks.		133 (78.7%)	19 (11.2%)	17 (10.1%)		5.57	4.08
5.	Interest-free scheme of Islamic banks promotes Islamic banking and finance in Muslim countries.		136 (80.5%)	19 (11.2%)	14 (8.3%)		0.93	7.45

Findings on Mobilization of Investment Resources (MIR)

This section presents the data on Mobilization of Investment Resources (MIR), descriptive statistics by computing frequencies and percentages, means and standard deviation were used.

The majority of the respondents (132 or 78.1%) agreed that for Islamic banks, it is comparatively difficult to borrow money from the money market. Nonetheless, 9 (5.3%) disagreed. However, a few numbers of the respondents (28 or 16.6%) were neutral (M=4.15; STD=0.88).

In addition, it was asserted by the majority of the respondents (138 or 81.6%) agreed that Since it shares profit and loss, Islamic banks pay greater attention to developing project appraisal and evaluations. (M=4.25; STD=0.89); 6 (3.6%) disagreed and on this statement while 25 (14.8%) maintained neutrality.

More so, pertaining to the respondents' perceptions on Islamic banks placing greater emphasis on the viability of the projects, the majority of the sampled respondents (143 or 84.6%) agreed on this (M=4.26; STD= 0.90). Nevertheless, 9 (5.4%) disagreed on this statement and only 17 (10.1%) were natural.

Furthermore, the majority of the respondents (150 or 86.8%) agreed that the status of the Islamic bank in relation to its clients is that of partners, investors, and traders. (M=4.38; STD= 0.68). Nonetheless, while only 19 (11.2%) were neutral with the statement.

The whole sample (152 or 89.9%) agreed that strictly speaking, an Islamic bank cannot guarantee all its deposits (M=4.46; STD=0.83); however, 6 (3.6%) disagreed with the statement, nonetheless, only 11 (6.5%) were neutral. Table 4 shows the responses of the respondents pertaining to the mobilization of investment resource in selected Muslim countries (Bangladesh, Malaysia & Saudi Arabia):

Table 4: Perceptions of the Respondents on the Mobilization of Investment Resources

S/N	Items		A	N	D		M	STD
1.	For Islamic banks, it is comparatively difficult to borrow money from the money market.		134 (79.3%)	23 (13.6%)	12 (7.1%)		4.23	0.93
2.	Since it shares profit and loss, Islamic banks pay greater attention to developing project appraisal and evaluations.		146 (86.4%)	10 (5.9%)	13 (7.7%)		4.25	1.06
3.	Islamic banks, on the other hand, place greater emphasis on the viability of the projects.		141 (83.4%)	19 (11.2%)	9 (5.4%)		5.81	7.39
4.	The status of the Islamic bank in relation to its clients is that of partners, investors, and traders.		156 (92.3%)	10 (5.9%)	3 (1.8%)		4.47	0.69
5.	Strictly speaking, an Islamic bank cannot guarantee all its deposits.		137 (81.3%)	19 (11.2%)	13 (8.7%)		5.31	7.48

Discussion of Findings

This sub-section presents the findings on various identified variables investigated in this paper. The findings of this study obtained that promoters of Islamic banking in Saudi Arabia are in agreement with many other countries, such as Kuwait, Bahrain, United Arab Emirate, and United Kingdom, that provided regulations for operations of the Islamic banking system (Zaidi, 2008). Literature such as Alshamrani (2014) contends that, there are supervisions and regulations manifested from the Saudi Arabian Monetary Agency (SAMA) under the Banking Control Law of 1966. On the Interpretation of *Shar'iah* Principle (ISP), Siti Faridah (2009) posits that it is important to consider the peculiarities of every country, especially Islamic financial transactions should be *Shar'iah*-compliant. Furthermore, Alshamrani (2014) notes that Interest-Free Scheme (IFS) by Islamic banks should be cognizance of risk sharing between investors and entrepreneurs. Indeed, IFS is a distinct feature Islamic banks contrary to the provision of conventional banks. However, Ayuba (2007) asserts that there is need to standardize the activities of Islamic banks in the Muslim countries.

Saudi Arabia has been promoting Islamic financial inclusion as a transformational mechanism and regulatory framework in promoting Islamic banking in the Kingdom (Obaidullah, 1998; Obaidullah, 2005; Pearce, 2013; Reem, 2007). The finding of this study has further buttressed that; the predictors of regulatory framework could further strengthen the activities of Islamic banking and finance. This assertion is in line with the finding of previous studies (Venardo, 2010) that the Islamic banking in the present time has provided resilient and stability. It is noteworthy to assert that, the Islamic option is the best alternative that can address social and economic challenges in different parts of Muslim countries (Younes and Mohd Ismail, 2011).

In this regard, this study is in consonance with many other studies that the role of Shar'iah in Islamic banking is paramount for its success (Dar, 2011b). This is essential in order to achieve a standard regulatory mechanism for Islamic banking in the Muslim countries. Nonetheless, literature posits that the conventional banks operating Islamic banking system or Islamic financial product should be provided with *Shari'ah* compliant audit mechanism for its effectiveness (Dar, 2011b) of which Obaidullah (1998) categorically explicated on Islamic option to financial engineering.

The Organization of Islamic Conference (OIC) can emulate the practical governance by *Shari'ah* advisers to financial institutions which could bring about positive socio-economic development and consequently enhance the well-being of Muslim countries (Zulkifili, 2012). Efficiency and effectiveness of *Shari'ah* compliance in Islamic bank would help to bring its harmonization with regulation and supervision in Islamic finance (Zulkifil, 2012; Zaidi, 2008); Malaysia, according to Zulkifil (2010), has offered the best practice in this regard. It is noteworthy to say that the findings of this study were in keeping with theoretical standard and diversity being provided by the Islamic Development Bank (IDB) alongside with *Shar'iah*-Compliant standards.

Conclusion and Recommendations

This paper has explicated on triadic components-Interpretation of *Shar'iah* Principle (ISP); Interest-Free Scheme (IFS); and Mobilization of Investment Resources (MIR) - of standard regulatory framework for Islamic banking and finance in Saudi Arabia. The findings have demonstrated that promoters of Islamic banking agree that the identified factors better promote the functionality of Islamic banking. It is further noted that, the identified variables (ISP, IFS and MIR) could complement the existing guidelines (i.e. Banking Control Law (BCL) and Capital Market Law (CML) in Saudi Arabia. Therefore, the following are recommendations of the paper:

1. The stakeholders should harmonize the factors investigated in this study with the existing guidelines in Saudi Arabia.
2. The intellectual forum should be organized as a platform for the *Shar'iah* scholars to resolve the differences in interpreting *Shar'iah* principles which will alienate the likely confusion arising from interpretation of *Shar'iah* principles.
3. There is needed for provision of enlightenment with regard to the paramount benefit of interest-free schemes provided by Islamic banking.
4. There is a need for creating awareness on the mobilization of investment resources among the investors and also the risk-sharing formula should be explicitly explained to the participants.

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