CHAPTER I

INTRODUCTION

1.1 Background

Islamic finance has its roots in the ethical and moral principles of Islam, dating back over 1,400 years. These principles promote fairness, transparency, and the sharing of both risks and rewards, while strictly prohibiting interest (riba). Early Muslim traders developed innovative financial tools, such as sukuk (Islamic bonds) and letters of credit, to facilitate trade across long distances in a Sharia-compliant manner (Soage, 2020).

In the 20th century, Islamic finance experienced a resurgence, starting with the establishment of the first modern Islamic bank in Egypt in 1960, followed by a dedicated savings fund in Malaysia to facilitate the Hajj pilgrimage. The 1970s saw significant growth with the establishment of key institutions like the Islamic Development Bank and Dubai Islamic Bank, which helped to formalize and expand the industry's reach. Today, Islamic finance has evolved into a global industry, managing trillions of dollars in assets and offering a wide array of Islamic products.

Riba, or interest, is forbidden in Islamic finance due to its characterization as an unjust and unearned gain derived solely from lending money. Islamic finance employs alternative methods such as profit sharing *(Mudarabah)*, joint ventures *(musharakah)*, and leasing *(ijarah)* to ensure ethical and equitable financial transactions. The broader aim is to create a financial system that promotes ethical investment, social justice, and financial inclusion (Uddin, 2015).

To further illustrate these ethical foundations, both the Quran and the teachings of the Prophet Muhammad (peace be upon him) emphasize the importance of fairness and the prohibition of riba. For example, the Quran states:

وَلَا تَمْنُن تَسْتَكْثِرُ

Meaning: "And do not bestow a favor in the expectation of receiving more in return." (Al-muddaththir:6)

Similarly, the Prophet Muhammad (peace be upon him) warned against destructive sins, including the consumption of riba, as highlighted in the following hadith:

Meaning: The Prophet (□) said, "Avoid the seven great destructive sins." The people enquire, "O Allah's Messenger (□)! What are they? "He said, "To join others in worship along with Allah, to practice sorcery, to kill the life which Allah has forbidden except for a just cause, (according to Islamic law), to eat up Riba (usury), to eat up an orphan's wealth, to give back to the enemy and fleeing from the battlefield at the time of fighting, and to accuse, chaste women, who never even think of anything touching chastity and are good believers. (Hadith Sahih al - Bukhari 2766)

Islamic finance is experiencing rapid growth globally, extending beyond Muslim-majority countries. While discussions often highlight market size and regulatory developments, understanding consumer behaviour remains crucial. Most research focuses on institutional frameworks, overlooking the psychological and socio-economic factors influencing financial decisions (Khamiliyah et al., 2022).

For example, understanding why some Muslim consumers choose conventional products over Islamic finance products, despite the availability of Islamic options, is vital for institutions to refine their offerings. Similarly, understanding the barriers preventing non-Muslim consumers from adopting Islamic finance (eg., lack of awareness, misconceptions) can inform targeted marketing strategies.

Consumer-focused research can also help policymakers. For instance, insights into consumer preferences can guide the development of effective regulatory frameworks that promote both the growth and stability of the Islamic finance sector. By understanding the factors that drive trust and confidence in Islamic financial products, regulators can create policies that foster greater adoption and market penetration (Hatta et al., 2023).

The United Kingdom serves as a compelling case study. Unlike Malaysia and Indonesia, where Islamic finance is deeply embedded, the UK presents a landscape with varying levels of religious adherence, differing awareness, and unique regulatory challenges. Therefore, a comparative analysis can yield valuable insights into the diverse forces influencing adoption (A et al., 2025). These factors collectively shape consumer trust and adoption rates in ways that are not always reflected in market statistics (Chusniah & Samsuri, 2023).

Recognizing this gap, this study explores the drives and barriers to consumer adoption of Islamic finance in the UK, Malaysia, and Indonesia. By examining key socio-economic and psychological factors, as well as the impact of regulatory frameworks, this research aims to provide a comprehensive understanding of consumer behaviour in Islamic finance (Hatta et al., 2023). The comparative approach will highlight the unique characteristics of each market and offer practical recommendations for stakeholders seeking to expand the reach of Islamic finance globally.

Country	Ranking	IFDI 2022 Score	Financial Performance	Governance	Sustainability	Knowledge	Awareness
Malaysia	1	113	98	94	117	147	172
Saudi Arabia	2	74	65	49	89	75	143
Indonesia	3	61	31	65	30	195	56
Bahrain	4	59	35	86	36	49	112
Kuwait	5	59	42	75	20	21	157
UAE	6	52	33	71	28	34	116
Oman	7	48	16	89	45	28	94
Pakistan	8	43	22	75	24	52	58
Qatar	9	38	25	47	21	16	102
Bangladesh	10	36	30	61	18	14	47
Maldives	11	32	16	72	35	12	19
Brunei Darussalam	12	31	14	58	10	32	48
Jordan	13	29	15	40	51	43	17
Sudan	14	27	32	51	3	9	5
Singapore	15	27	4	66	61	4	8
Global Average		9	5	16	7	7	12

Source: (IFDI, 2022)

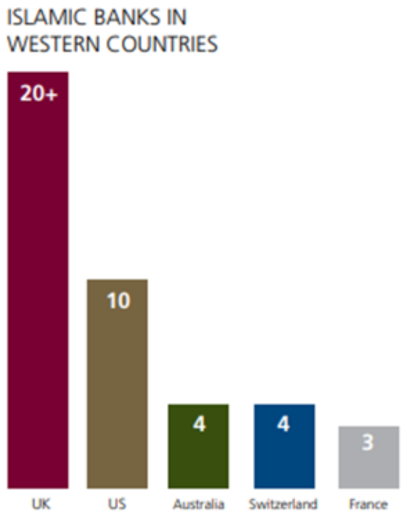
Diagram 1. 1 Top IFDI Countries & Global Everage IFDI Scores for 2022

The global expansion of Islamic finance into non-Muslim countries highlights its increasing appeal beyond traditional markets. Nations like Australia, the UK, and the USA are progressively integrating Islamic finance products, reflecting a broader interest in ethical and values-based financial solutions. This growth is driven by both Muslim and non-Muslim consumers who are drawn to the principles of fairness, transparency, and social responsibility inherent in Islamic finance. The perception of Islamic finance as a trustworthy alternative to conventional banking, particularly after the 2008 financial crisis, has further fuelled its adoption in these regions (JASMINE, 2014).

Recent market data illustrates these trends. The UK's Islamic finance sector is projected to reach significant milestones, driven by increasing consumer demand for ethical products and London's status as a global financial hub. This growth is directly linked to the preferences of consumers who seek investments aligned with their values. For instance, environmentally conscious investors may be drawn to Islamic finance products that avoid investments in harmful industries (IFDI, 2022).

In Malaysia, Islamic banks are now responsible for approximately 42% of all loans in the banking sector, with growth rates surpassing those of conventional banks (Trammell, 2005). Similarly, the rapid expansion of Indonesia's Islamic banking sector, outpacing conventional banking, reflects a growing preference for Islamic finance products. The burgeoning Islamic fintech market in Indonesia further underscores this trend, as consumers embrace innovative digital solutions that align with their values (Islamic finance development report, 2021).

The United Kingdom has become the leading hub for Islamic finance in the Western world, with more than 20 banks offering Islamic finance products far more than any other Western country. For nearly 40 years, UK institutions have been actively involved in Islamic finance, supported by government policies that have established a strong regulatory and fiscal framework to expand the market. This proactive approach has also made the UK a centre for Islamic finance education and training, with many universities now offering specialized courses to meet the growing demand for expertise in this field (Lescher, 2015).



Source: British Embassy Bishkek 2015 (Lescher, 2015)

Diagram 1. 2 Islamic Finance in The United Kingdom

Malaysia and Indonesia are major players in Southeast Asia's Islamic finance market, driving rapid growth through government initiatives and strong regulatory frameworks. Indonesia focuses on converting regional banks to Islamic finance products institutions and strengthening its Islamic capital market, while Malaysia leads globally in Islamic banking and sukuk issuance, attracting international investors. Both countries are pioneering Islamic FinTech innovations to enhance accessibility and financial inclusion, supported by robust regulations promoting sustainable finance (IFDI, 2022).

Consumer adoption of Islamic financial products is motivated not only by religious adherence, such as the prohibition of interest and ethical financial practices, but also by broader ethical concerns and social responsibility. Understanding these drivers is crucial for expanding Islamic finance beyond Muslim-majority countries (Munfariha, 2024).

Regulatory oversight varies: Malaysia's Bank Negara Malaysia (BNM) enforces the Islamic Financial Services Act 2013 (IFSA), Indonesia's National Sharia Board and Financial Services Authority (OJK) ensure Islamic finance products, while the UK's Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) regulate Islamic finance within a competitive, Sharia-compliant framework (Dewar, n.d.).

This study compares the UK, Malaysia, and Indonesia each with distinct market maturity, cultural contexts, and regulatory environments to draw lessons on how culture and regulation influence consumer behaviour and support the global growth of Islamic finance

1.2 Problem Statement

The problem statement that will be discussed in this research is:

1. What are the socio-economic and psychological factors influencing the adoption of Islamic finance in the UK?
2. How do existing studies describe the impact of regulatory frameworks on consumer trust and adoption of Islamic finance in the UK, Malaysia, and Indonesia?
3. To what extent do regulatory frameworks impact consumer trust and adoption rates in Islamic finance in the UK, Malaysia, and Indonesia?
4. What differences in consumer motivation for adopting Islamic finance are identified in existing literature between Muslim-majority (Malaysia, Indonesia) and non-Muslim majority (UK) markets?

1.3 Research Objectives

The purpose of this research is to:

1. To analyze consumer behavior patterns in adopting Islamic finance in the UK through a systematic literature review approach.
2. To identify the impact of regulatory frameworks on consumer trust and adoption of Islamic finance in the UK, Malaysia, and Indonesia.
3. To examine the role of regulatory frameworks in shaping consumer trust and adoption of Islamic finance in the UK, Malaysia, and Indonesia.
4. To formulate recommendations for developing the Islamic finance market in Malaysia and Indonesia based on a comparative analysis of the UK experience.

1.4 Benefits of Research

The benefits of this research are:

- **Theoretical Contribution:** Contributing to the development of consumer behavior theories in Muslim countries (Malaysia and Indonesia) in the context of Islamic finance in non-Muslim (UK).
- **Practical Contribution:** Providing insights for regulators and financial institutions to develop marketing strategies for Islamic finance in Muslim countries based on Islamic finance practice in a non-Muslim country.