



Financial inclusion through Islamic financial instruments: A catalyst for small and medium enterprises (SMEs)

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Open Access Research Journal of Multidisciplinary Studies, 2024, 07(01), 134–141

Publication history: Received on 20 December 2023; revised on 06 March 2024; accepted on 09 March 2024

Article DOI: <https://doi.org/10.53022/oarjms.2024.7.1.0008>

Abstract

The term Islamic finance is used to refer to financial activities conforming to Islamic Law (Sharia). One of the main principles of the Islamic finance system is the prohibition of the payment and the receipt of riba (interest) in a financial transaction. The term riba covers all forms of interest and is not limited to usury or excessive interest only. The most critical and significant implication of banning interest is the indirect prohibition of a “pure” debt security. The key point to bear in mind is that Islamic law does not recognize money and money instruments as a commodity but merely as a medium of exchange. Hence any return must be tied to an asset, or participation and risk-taking in a joint enterprise (such as partnerships). A pure debt security is replaced with an “asset-linked” security, direct financing of a real asset, and different forms of partnerships of which equity financing is the most desirable. In addition to prohibition of riba, there are several other important provisions which may affect financial transactions. These include the prohibition of ‘gharar’ (uncertainty or asymmetrical information), ‘maysir’ (gambling, speculation), hoarding, as well as trading in prohibited commodities (for example, pork and alcohol).

Keywords: Interest (riba); Gharar’ (uncertainty or asymmetrical information); Maysir’ (gambling); Shariah-compliant business contracts

1. Introduction

The Quran Verses prescribed foundations of financial transactions to be followed by Muslims, as in Surat Al Baqarah, Verse 275: “Allah hath permitted trade and forbidden usury” and in Surat Al Nisa’, Verse 29: “O ye who believe! Eat not up your property among yourselves in vanities; but let there be amongst you traffic and trade by mutual good will”. On the other hand, the Sunnah applied these foundations practically as in his farewell speech, the Prophet (PBUH) said: “Usury of pre-Islamic ages is let fall including the usury of my uncle Al-Abbas”. From such Quran Verses and Prophet Says, Muslim Jurists deduced the provisions of the financial transactions prevalent in every age. Islamic finance strictly complies with Sharia law and is based on a number of prohibitions that are not always illegal in the countries where Islamic financial institutions are operating (Bley, J., and Kuehn, K. (2004).

Islamic financing is a transformation of Lending into Asset Based Financing, within the ambit of Shariah-compliant business contracts, called Islamic Financial Instruments. The Islamic banking institutions first take ownership of the goods, which are being sold or rented. According to a well-known principle of Islamic jurisprudence, “One cannot earn profit from his capital or asset unless he has have taken a risk, or liability of ownership of that capital or asset”. Contrary to that, conventional banks earn interest by lending money. Islamic bank sign contracts with their customers by using legitimate contracts that are drafted by sharia scholars, legal consultants, and bankers. Hence, all parties involved in such contracts must execute what was stated therein. Moreover, the Islamic bank reflects what is stated in the contract, including transferring and registering ownership of the goods through government agencies and then selling or leasing them through valid contracts. Moreover, sale contracts in Islamic legislation are binding by a mere verbal offer and acceptance hence its legitimacy could not be more affirmative upon signing a written contract at the mutual consent of

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both parties. Moreover, the sharia Supervisory Board oversees the contracts executed by Islamic bank and reviews all documents that are signed by customers (Munawar, I. (2007).

2. Theoretical framework

Islamic Financial systems have become a distinct industry through its philosophy, ideas and systems. They now have institutions that serve them by developing sharia standards, such as 'Accounting and Auditing organization for Islamic Financial Institutions' (AAIOFI) which consist of many Islamic scholars from various Islamic institutions that prepare contracts, amongst other services, along with other supporting institutions. The Islamic banking Industry is being pursued globally by all countries over the world and its reality has become undeniable through the contracts and financing that it offers. Also, the Islamic finance industry operates under the supervision of central banks that regulate, monitor and audit their operations and their economic effects. Evidently, Islamic banks have tangible social effects through the mobilization of local trade within the country (Chapra, M. U. (2011).

2.1. The prohibitions in Islamic Financial Transactions

The basic framework for an Islamic financial system is a set of rules and laws, collectively referred to as shariah, governing economic, social, political, and cultural aspects of Islamic societies. Shariah originates from the rules dictated by the Quran and its practices, and explanations rendered (more commonly known as Sunnah) by the Prophet Muhammad. Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the Quran and Sunnah. The basic principles of an Islamic financial system can be summarized as follows:

2.2. Paying or charging an interest (RIBA)

Prohibition of riba, a term literally meaning "an excess" and interpreted as "any unjustifiable increase of capital whether in loans or sales" is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment) is considered riba and is prohibited. The general consensus among Islamic scholars is that riba covers not only usury but also the charging of "interest" as widely practiced.

This prohibition is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined *ex post*, symbolize successful entrepreneurship and creation of additional wealth whereas interest, determined *ex ante*, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

Islam considers lending with interest payments as an exploitative practice that favors the lender at the expense of the borrower. According to Sharia law, interest is usury (*riba*), which is strictly prohibited (Kassim, S. H., Shabri, M., Majid, A., and Yusof, R. M. (2009).

2.3. Investing in businesses involved in prohibited activities

Some activities, such as producing and selling alcohol or pork, are prohibited in Islam. The activities are considered haram or forbidden. Therefore, investing in such activities is likewise forbidden. Only those business activities that do not violate the rules of shariah qualify for investment. For example, any investment in businesses dealing with alcohol, gambling, and casinos would be prohibited.

3.1.4 Speculation (*maisir*)

Sharia strictly prohibits any form of speculation or gambling, which is called *maisir*. Thus, Islamic financial institutions cannot be involved in contracts where the ownership of goods depends on an uncertain event in the future.

3.1.5 Uncertainty and risk (*gharar*)

The rules of Islamic finance ban participation in contracts with excessive risk and/or uncertainty. The term *gharar* measures the legitimacy of risk or uncertainty in investments. *Gharar* is observed with derivative contracts and short-selling, which are forbidden in Islamic finance. An Islamic financial system strictly discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks.

3.1.6 Risk sharing

Because interest is prohibited, suppliers of funds become investors instead of creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits.

3.1.7 Money as “potential” capital

Money is treated as “potential” capital—that is, it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is “potential” capital.

2.4. Sanctity of contracts

Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.

3.1.8 Material finality of the transaction

Each transaction must be related to a real underlying economic transaction.

Profit/loss sharing

Parties entering into the contracts in Islamic finance share profit/loss and risks associated with the transaction. No one can benefit from the transaction more than the other party.

3.1.9 In addition to the above prohibitions, Islamic finance is based on other crucial principle

- Islam perception of money:

Islam in its primary sources expresses its unique and original perception of money as:

- It belongs to Allah, and human is a trustee.
- It is a tool to evaluate goods and assets.
- It is an intermediate to exchange goods and assets between people.
- Accordingly, money is not a mean to generate profit from itself. The profit can be generated by selling and purchasing goods and assets using money.

3. Literature review

Since Islamic finance is based on several restrictions and principles that do not exist in conventional banking, special types of financing tools/products that is used by small and medium enterprises (SMEs) were developed. The contemporary reality imposes variety of financial needs, and to fulfill these needs Muslim jurists specialized in financial transactions worked hard to develop novel financial products and solutions compatible with Shariah' meeting the requirements of individuals and corporate perfectly as follows (Aggarwal, R. K., and Yousef, T. (2000)).

3.1. Shariah compliant Islamic financial tools/products

3.1.10 Markup-Sale (Murabah)

The word Murabaha is derived from the word 'Ribh', denoting profit or gain. Murabaha is selling a commodity as per the purchasing price with a defined and agreed profit markup. This markup may be a percentage of the selling price or a lump sum. This transaction may be concluded either without a prior promise to buy, an ordinary Murabaha, or with a prior promise to buy, submitted by the person interested in acquiring goods through the institution i.e. Murabaha to purchaser orderer (the customer). This transaction is one of the trust based contracts as the seller explicitly discloses the purchasing price and profit margin to the buyer.

Mechanism of A Murabaha Finance Transaction:

- A customer needs certain goods and promises the Islamic bank to purchase the goods if the Islamic bank buys these goods from the supplier and takes the possession.
- The Islamic bank purchases the goods on the spot payment basis from the supplier and takes the possession (either constructive or physical).

- The Islamic bank sells the goods to the customer after adding its profit markup, generally on deferred payment basis for an agreed period.
- The customer makes the deferred payment to the Islamic bank after or during the agreed period.

Applications of Murabaha Contract in Islamic Finance: Murabaha is one of the most widely used contracts at present in Islamic Banking and the investment sector. The various products where Murabaha is applied are as follows (Ernst & Young (2016):

Home financing, Vehicle financing, Working capital financing, Project financing, Goods financing, Trade financing - LC based on Murabaha, Murabaha based Sukuk, Profit rate swaps, Islamic fund, Credit card

3.1.11 Monetization (Tawarruq)

Tawarruq refers to the process of purchasing a commodity for a deferred price through Musawama (Bargaining) or Murabaha (Mark- up), and selling it to a third party for cash or a price on the spot.

Mechanism of Tawarruq Transactions

- A customer needs cash and requests the Islamic bank to finance.
- Instead of financing in cash, the Islamic bank purchases the commodity from the seller and sells it to the customer through murabaha contract.
- After getting the ownership and taking possession of the purchased commodity from the Islamic bank, the customer sells the commodity to a third party purchaser on spot payment basis.
- The price paid by the third party purchaser on the spot fulfills the need of liquid cash of the customer.
- Later the customer pays the deferred price to the Islamic bank pursuant to the agreed upon terms.

Applications of Tawarruq In Islamic Finance: Working capital financing, Project financing, Credit Card, Personal financing (Zaman, N., and Asutay, M. (2009).

3.1.12 Arbun (Down Payment):

Arbun is a contract where a buyer pays a down payment to reserve the right to purchase an asset at a later date. If the buyer decides not to proceed with the purchase, they forfeit the down payment. Arbun is often used in real estate transactions.

Examples:

- Real Estate: In a real estate transaction, a buyer may pay a down payment to the seller to secure the purchase of a property. If the buyer decides not to proceed with the purchase, the seller keeps the down payment. If the seller fails to transfer the property to the buyer, the buyer is entitled to a refund of the down payment.
- Vehicle Purchase: When buying a car or other vehicle, a buyer may pay a down payment to the seller to secure the purchase. If the buyer decides not to proceed with the purchase, the seller keeps the down payment. If the seller fails to deliver the vehicle, the buyer is entitled to a refund of the down payment.
- Goods Purchase: In a commercial transaction, a buyer may pay a down payment to a seller to secure the purchase of goods. If the buyer decides not to proceed with the purchase, the seller keeps the down payment. If the seller fails to deliver the goods, the buyer is entitled to a refund of the down payment.
- Contracting Services: When contracting for services, such as construction or renovation, a buyer may pay a down payment to the service provider to secure the contract. If the buyer decides not to proceed with the contract, the service provider keeps the down payment. If the service provider fails to fulfil the contract, the buyer is entitled to a refund of the down payment.
- Investment Agreements: In some investment agreements, such as Mudarabah or Musharakah contracts, a party may pay a down payment to secure the investment. If the investment does not proceed as planned, the party may be entitled to a refund of the down payment.

3.1.13 Sale (Bai' Al Salam)

Bai-Al Salam, also known as Bai-salaf or Bai-mafalisa is the purchaser of a commodity for deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the Salam Capital, is paid at the time of contract while the delivery of the item to be sold, known as Al-Muslam Fihi (the subject matter of a Salam Contract), is deferred. The seller and the buyer are known as Al- Muslam Ilaihi and Al-Muslim or Rab al-salam, respectively.

Mechanism of Salam Transaction

- A customer wants financing and approaches the Islamic Bank.
- The customer (as seller) enters into a Salam sale contract with the Islamic Bank (as purchaser).
- The Islamic bank pays the full purchase price in advance to them customer for the specified commodity to be delivered in future.
- On the delivery date which is predefined, the customer delivers the commodity to the Islamic Bank.

Applications of Salam In Islamic Finance

Working capital financing, Financing for agriculture production, Personal Finance (Sardar, Z. (1996)

3.1.14 Manufacturing Finance (*Istisna*)

The word *Istisna* is a derivative from the root word 'Sa na'a, which means to manufacture or to construct something. *Istisna* is a contract of sale of specified items to be manufactured or constructed with an obligation on the part of the seller to deliver them to the purchaser upon completion.

Mechanism of an *Istisna* Transaction

- A customer wants to purchase certain assets to be manufactured or constructed and approaches the Islamic Bank (*san'e*).
- The Islamic Bank as seller (*san'e*) and the customer as purchaser (*mustasne*) execute an *Istisna* contract.
- After completion of the manufacturing process, the Islamic Bank (*san'e*) delivers the assets to the customer (*mustasne*) on agreed upon delivery date.
- The customer (*mustasne*) makes the payment to the seller (*san'e*) pursuant to the terms agreed upon in the *Istisna* contract either in various installments or, as the case may be, at the delivery of the asset.

Applications of *Istisna* in Islamic Finance: Home financing, Project financing

3.1.15 Partnership (*Musharaka*)

The word *Musharaka* in Arabic is a derivative from the root word *Shiraka* or to share. *Musharaka* (*sharikatul al-inan*) is a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that profit is to be distributed among the partners according to the partnership agreement and losses are to be borne by the partners in accordance with the contribution of each partner to the *Musharaka* capital.

Diminishing Musharaka (*Musharaka Mutanaqisa*) is a form of partnership in which one of the partners buys the equity share of the other partner gradually until the title to the equity is completely transferred to the buying partner. This transaction starts with the formation of the partnership, after which buying and selling of the equity take place between the two partners. It is therefore necessary that this buying and selling should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This buying and selling agreement must be independent of the partnership contract. It is not permitted to enter one contract on the condition of concluding another. The contract for purchasing the commodity between the purchaser and the seller on deferred payment basis should be independent of the contract of spot sale between the purchaser and the third party (Haneef, M. A., and Furqani, H. (2009).

Mechanism of a *Musharaka* Transaction

- The customer and the Islamic bank are partners in a *Musharaka* Enterprise or project. Both the parties contribute money capital in a ratio, say, 20:80.
- As per the agreement they decide to share the Net Profit in the ratio, say 40:60. If the *Musharaka* Enterprise realises any profit, then it would be shared between both the parties in the agreed profit sharing ratio i.e 40:60.
- The loss, if any, shall be shared only in the capital contribution ratio, which is 20:80.
- In case of *Diminishing Musharaka*, one of the partners, says the customer, would buy the share of the Islamic bank over a period of time and at a certain period in future would become the complete owner of the Enterprise.

Applications of *Musharaka* in Islamic Finance

A *Musharaka* contract is applied to many Islamic finance products. A few of them are mentioned: Home financing, Project financing, Trade financing - *Musharaka* LC, Shares and equity products

3.1.16 Venture Capital (*Mudaraba*)

The term *Mudaraba* is derived from the phrase *al-darb fil al-ard* found in the Quran, which means to make a journey. It is so called because a worker strives and toils in the course of a business, and in most cases, making journeys is an inevitable and indispensable part of this hard work or toil. *Mudaraba* is a form of partnership in profit whereby one party provides capital (*rab-al-maal*) and another, management skill or labour (*mudarib*) (Munawar, I. (2007).

Mechanism of A *Mudaraba* Transaction

- The customer and the Islamic bank initiate a *Mudaraba* Enterprise. As per the *Mudaraba* contract, the Islamic bank (as *Rab-al-Maal*) contributes 100% capital, whereas the customer (as the *Mudarib*) contributes the management or skills.
- As per the agreement they decide to share the Net Profit in the ratio of 40:60, whereas the loss, if any, shall be borne only by the Islamic bank, the *rab-al-maal*.
- In addition, if there are any direct expenses of *Mudaraba*, then the same shall be charged to the *Mudaraba* Enterprise and not to any of the parties.
- Pursuant to the terms agreed upon in the *Mudarabaha* contract, the *Mudaraba* asset is, either periodically or at the end of *Mudarba*, liquidated to Determine the profit or the loss.
- As agreed earlier, 40% of the realized profit is given to the *rab- al-maal* and 60% is retained by the *Mudarib* while any loss is borne only by the *rab-al-mall*.
- At the expiry of *Mudaraba* the *Mudarabaha* assets are disposed off either by selling them in the market or purchased by the *Mudarib* on their market value.

Applications of *Mudaraba* In Islamic Finance

Similar to the other contracts, the *Mudaraba* contract is also applied to various Islamic deposit and finance products. Few of them are mentioned: Saving account Investment account, Project financing, *Takaful* products, *Mudaraba Sukuk* Islamic funds Haneef, M. A., and Furqani, H. (2009).

3.1.17 Islamic Lease (*Ijarah*):

The term *Ijarah* means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration (Saad, A. M., and Mohammed, A. (1998).

Mechanism of an *Ijarah* Transaction

- A customer who needs certain asset visits the Islamic bank and promises to lease the asset.
- The Islamic bank purchases the asset from the supplier and pays the full amount on the spot as per the quotation.
- Both the parties agree on the terms and conditions of *Ijarah* and execute the lease contract against the predefined periodic lease rent for a specific lease period.
- In a normal lease, after the completion of the lease period, the Lessee would return the asset to the Lessor. In case of '*Ijarah muntahia bittamleek*', the ownership of the leased asset is transferred to the customer at the end of the lease period in which case the rental paid by the customer includes the cost of the asset as well.

Applications Of *Ijarah* Contract In Islamic Finance: Generally, *Ijarah* contract is applied to the kind of products listed below: Home financing, Vehicle financing, Service financing, *Ijarah Sukuk* (Nyazee, I. A. K. (1995).

3.1.18 *Wakala*:

The term *Wakala* literally means preservation. Legally, *Wakala* can be defined as the delegation of one person (the principal) for another (the agent) to take his place in a known and permissible dealing. In this regard, the agent (*wakil*) deals in others' properties and preserves them.

Structure of *Wakala*: Mechanism of a *Wakala* Transaction

- The Islamic bank is appointed as customer's agent (*Wakil*) to carry out certain activities on customer's behalf.
- The Islamic bank as the agent of the customer is paid a Fee, i.e., *Wakala* fee for performing the activities.
- The profits as well as losses solely belong to the customer.
- Muslim jurists are unanimous on the point that proportions of losses borne by partners must be equal to the proportions of their capital contributions.

Applications of Wakala In Islamic Finance: Letter of Credit, Takaful products, Islamic funds, Islamic Syndicated financing Islamic Retail / Corporate products (Diaw, A. (2009).

4 Research methodology

The research based on secondary data on Islamic financial products, explored academic journals, industry reports and database like Islamic finance-focused platforms. Other data were also from government publications and financial institutions reports.

5 Results and discussions

5.1 Statement of contract

Muslim jurists give remarkable importance to the statement of the contract. Few of them opine that it is the only pillar of contract, as all other aspects will automatically follow the statement. A statement of contract constitutes the offer and the acceptance. An 'offer' is a statement of intention expressed by one of the parties inviting the other party to accept a proposal, whereas the 'acceptance' is an expression of approving a proposal by the offeror with regard to the same details as expressed in the offer. Jurists prefer the use of the past tense for verbal expression for forming an offer and an acceptance. For instance, 'I sold you' is written in the statement even before the contract is signed or commodities are sold. It is necessary to confirm the acceptance of an offer. The confirmation has to be explicit. There must be clarity in offer and acceptance. The words and terminologies used must be in conformance with the words and terms that are normally used in the customs of the parties to indicate a particular type of contract. Another important condition for offer and acceptance is that both should be in the same session, i.e., within the agreed time frame between the parties (Ghazanfar, S. M. (2003).

5.2 Contracting Parties

There are at least two parties in a contract. These are the offeror and the offeree. The offeror is the one who makes an offer and the offeree is the one to whom the offer is made. These two parties should have legal capacity to enter into a contract. Legal capacity means that they must attain puberty, maturity and must be San'e. According to jurists, maturity means good and proper dealing with wealth from a worldly viewpoint. An immature person is not allowed to deal with his wealth independently. Anyone who has no legal capacity is not eligible to enter into a contract independently.

5.3 Subject matter of contract

The subject matter of a contract can either be a tangible thing, or a usufruct, or work. It should be in compliance with Shariah. Commodities or goods that are prohibited in Shariah cannot be the subject matter of an Islamic contract. It should also be in the ownership of the seller. If the subject matter is not owned by any of the parties, then it cannot be a subject matter. It should be known to both the parties. The subject matter can be identified through physical viewing or viewing a similar object. It can also be identified by the description of the genus, type and amount in the case where the subject matter is commonly known to people. It should be in the capability of being handed over at the conclusion of contract (Abdul-Razak, A. (2011). Thus, a contract cannot be concluded for subject matters such as stray animals, which the seller cannot hand over to the buyer. It should normally be present at the time of contract if it is a tangible thing. On the other hand, if the subject matter is a utility or work, then its presence is not required. What is rather required is an ascertainment of its occurrence. However, there is an exception to this general rule as in the case of contracts such as Salam and Istisna. Among all the contracts that have evolved into various forms as human civilization progressed, the contract of sale is considered the most fundamental contract. This is clearly remarkable, especially when classical Islamic law is considered. Before the formalization of the Islamic theory of contracts, almost all classical writings of Fiqh began with a sale contract where all the legal pillars and conditions were articulated and discussed in detail (Ahmad (Ed.).

6 Conclusion

Islamic financial institutions, especially Islamic banks offer many products and services to meet the needs of customers, both on the deposit and financing sides. These products and services are important to make Islamic financial institutions competitive with conventional banks in terms of product offering.

To design a successful Islamic financial product there is a need to select an appropriate and relevant contract. Islamic financial institutions offer several categories of products and services to their clients who seek financing. The financing

might be equity based or debt based. Equity based financing is equitable in character in that both parties are willing to put up the capital and work to share the future profit or loss.

When financing involves the purchase or lease of an asset for any defined purpose, it creates a debt over the buyer and lessee and that's why it is referred to as debt financing or asset based financing. Upon entering into debt based financing, a customer is under an obligation to make the payment according to agreed terms and schedules. Although various products are offered by Islamic finance institutions, in this module we will discuss only six Islamic retail products that are commonly offered in the market.

Compliance with ethical standards

Disclosure of conflict of interest

I declare that I have no conflicts of interest, financial or otherwise.

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