Globalization of Islamic Finance: Myth or Reality?

Frederick V. Perry, J.D., Ph.D.
Clinical Professor of Business Law
School of Accounting
College of Business Administration
Florida International University,
Miami, Florida, USA.

Scheherazade S. Rehman, Ph.D.
Director, European Union Research Center,
Professor of International Finance and International Business
The George Washington University
Washington, D.C., USA.

1. INTRODUCTION

This paper investigates the question of whether the phenomenon of Islamic finance or Islamic Banking[1] is truly globalizing, that is, spreading as a universal alternative to conventional finance and banking or whether the proponents of such a view are spreading a myth or are themselves simply deluded by their own enthusiasm. The paper addresses various aspects of the globalization of Islamic finance, among others, the issue of the rise of Islamic banking in the West, Islamic jurisprudence and finance, global standards and integration of Islamic finance, and obstacles facing Islamic finance's integration and growth into the global financial system. One central question asked in this paper is whether the globalization of Islamic finance as a system is even possible, and if so how can it take place?

Rise of Islamic Banking

The beginnings of Modern Islamic Banking

Modern Islamic banking has taken a while to develop. The macroeconomic concept of Qur'anic, that is, of social justice, spawned the so-called interest free Islamic banking at a micro-economic level. In the mid 1940s Malaysia and in the late 1950s Pakistan introduced small-scale interest free banking systems, however they did not survive long. Malaysia then began somewhat of a tradition of Islamic banking institutions commencing in the early 1960's[2]. Probably the first Islamic financial institution created in Malaysia was the Muslim Pilgrims Savings Corporation, founded in l963 to help Muslims to save money so that they would be able to make the once-in-a-life-time pilgrimage to the holy cities of Mecca and Medina in Saudi Arabia, known as *Hajj*. [3]

Another one of the early appearances of modern Islamic banking can be found in Egypt. There in 1963, Ahmad El Najjar opened a savings bank "under cover" so as not to give the perception of being Islamic. This was a bold step for the secular Egyptian government inasmuch as it lived in fear of Islamic fundamentalism.[4] Slowly Islamic banking came out into the open in the form of the Nasir Social Bank (an interest-free commercial bank) in 1971. Even then the Egyptian government made no reference to Islam or Shariah law in the charter of the Nasir Social Bank[5]. In 1973, the Philippine Amanah Bank (PAB) was opened and they too chose to provide no reference to Islam in the bank's charter. Throughout the 1970's, a number of Islamic banks were founded, mostly in the Arab Middle East. Examples are the Dubai Islamic Bank (1975), Faisal Islamic Bank of Sudan (1977), Faisal Islamic Bank of Egypt (1977), Bahrain Islamic Bank (1979), Malaysian Muslim Pilgrims Savings Corporation (1983)[6], among others[7].

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[1] Often throughout this paper, the terms "Islamic finance" and "Islamic Banking" will be used interchangeably.
[2] Ariff, Mohamed. "Islamic Banking", Asian-Pacific Economic Literature, vol. 2, September 1988, pp. 46-62.
[3] Ibid.
[4] Ibid.
[5] Ibid.
[6] This bank was the first Islamic bank in Malaysia.
[7] Ariff, Mohamed. "Islamic Banking", Asian-Pacific Economic Literature, vol. 2, September 1988, pp. 46-62.

The concept seemed to be gaining momentum to such an extent that an intergovernmental Islamic bank called the Islamic Development Bank (IDB) was created in 1974 by the members of the Organization of Islamic Conference (OIC).[8] The Islamic Development Bank (IDB) is a Multilateral Development Bank, established to foster the economic development and social progress of its 57 self-declared Islamic member countries and Muslim communities in non-member countries in accordance with the principles of Shari'ah[9]. The Asia Pacific region found the concept enticing and Malaysia entered the Islamic banking market in a sizeable way in 1983.

Some countries attempted to establish full Islamic banking systems and disconnect themselves from the traditional Western style financial system. Iran, for example, changed over to Islamic banking in August l983, when they commenced a three-year transition period; Pakistan opted for a gradual Islamization process of its financial system beginning in l979.

The popularity of Islamic financial institutions has even been felt in traditional Western countries where they have also established themselves to some degree. In 1978, the first Islamic bank appeared in Luxembourg with the founding of The Islamic Banking System (later renamed the Islamic Finance House)[10]. Shortly thereafter, the Islamic Bank International was created in Copenhagen, Denmark. Then the Islamic Investment Company in Melbourne was created, and more recently, Citi Islamic Investment Bank in Bahrain[11]. Europe issued the first Shari'ah-compliant bond in the German state of Saxony-Anhalt in 2004[12]. So such bonds, or *Sukuk* as they are called in Arabic, are now issued and sold outside the Islamic world, in some instances to non Muslims.[13] In recognition of this, Global Finance magazine has commenced a World's Best Islamic Financial Institutions Award.[14] Islamic retail banks are now proliferating throughout the Muslim world, especially in the Middle East, and there are now Islamic banks and Islamic asset managers in the major financial centers of the United Kingdom and the United States.[15] Connecticut based Shariah Capital was named the best United States based Islamic financial services company by Global Finance.[16]

[8] The Organization of the Islamic Conference (OIC) is an inter-governmental organization grouping fifty-seven States. These 57 States decided to pool their resources together, combine their efforts and speak with one voice to safeguard the interest and ensure the progress and well-being of their peoples and those of other Muslims in the world over. The Organization was established in Rabat, Kingdom of Morocco, on 12 Rajab 1389H (25 September 1969) where the first meeting of the leaders of the Islamic world was held in this city. OIC comprises of the following 57 countries: Afghanistan, Albania, Algeria, Azerbaijan, Bahrain, Bangladesh, Benin, Brunei, Burkina-Faso, Cameroon, Chad, Comoros, Cote d'Ivoire, Djibouti, Egypt, Gabon, Gambia, Guinea, Guinea-Bissau, Guyana, Indonesia, Iran, Iraq, Jordan, Kazakhstan, Kuwait, Kyrgyzstan, Lebanon, Libya, Malaysia, Maldives, Mali, Mauritania, Morocco, Mozambique, Niger, Nigeria, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, Senegal, Sierra Leone, Somalia, Sudan, Suriname, Syria, Tajikistan, Togo, Tunisia, Turkey, Turkmenistan, Uganda, United Arab Emirates, Uzbekistan, and Yemen.

[9] The Islamic Development Bank is "an international financial institution established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in Dhul Q'adah 1393H, corresponding to December 1973. The Inaugural Meeting of the Board of Governors took place in Rajab 1395H, corresponding to July 1975, and the Bank was formally opened on 15 Shawwal 1395H corresponding to 20 October 1975. The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah i.e., Islamic Law. The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms for economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds. The Bank is authorized to accept deposits and to mobilize financial resources through Shari'ah compatible modes. It is also charged with the responsibility of assisting in the promotion of foreign trade especially in capital goods, among member countries; providing technical assistance to member countries; and extending training facilities for personnel engaged in development activities in Muslim countries to conform to the Shari'ah." Source: http://www.isdb.org/.

[10] Ariff, Mohamed. "Islamic Banking", Asian-Pacific Economic Literature, vol. 2, September 1988, pp. 46- 62.

[11] Ibid.

[12] "Government mulls issuing Islamic bonds" , Reuters News U.K., Mon Apr 23, 2007.

[13] Malcolm D. Knight, "The Growing Importance of Islamic Finance in the Global Financial System", speech given at the 2d Islamic Financial Services Board Forum, Frankfurt, December 6, 2007, p.2. Found at www.bis.org/speeches/sp071210.htm

[14] Ibid.

[15] Ibid.

[16] "Islamic Financial Institutions Awards 2008" Annual Survey: Islamic Finance, Global Finance, June 2008, p.38.

In the 1990s there were approximately 10 Islamic mutual funds, in 2005 there are over 120 Islamic Mutual funds.[17]In Malaysia, for example, Islamic securities are approximately 42% of total outstanding private debt securities and 25% of total outstanding bonds.[18] There is little question that there has been rapid growth of Islamic banking; a mere $5 billion market in 1985, $60 billion in 1994, and assets under the management of Islamic banks in excess of $500 billion by 2005,[19]with a current annual projected growth rate of 15%. According to Standard & Poor's, Islamic banking has grown faster than conventional banking in the past ten years.[20] According to Moody's Investor Services, the market for *Sukuk*, the fastest growing segment of the Islamic finance market is growing at about 35% per year and is expected to become a $200 billion market by 2010, while the world-wide market for Islamic finance is now $700 billion.[21] The truth is no one really knows the exact size of the market covered by Islamic banking, since there is no official institution that keeps track of the data.[22] However, in 2006, Khaled Yousaf of the Dubai International Finance Center said that the industry accounted for about $300 billion, and at that time consisted of 282 separate lending institutions, most of them fairly small.[23] Of these the two largest are the Dubai Islamic bank and the Al-Rajhi Bank of Saudi Arabia, each with a capital of in excess of $1 billion.[24]Many claim this is evidence that Islamic finance is finally globalizing and outgrowing and evolving from its long history as a uniquely regional phenomenon. However, upon close inspection one finds that this may not be entirely true.

In spite of all the growth the 10 largest Muslim states have a combined GDP of US$1.2 trillion[25], that is, approximately 2.7% of the world GDP[26]. So even though Islamic banking may become extremely popular in those countries, their total financial impact on the world as a whole is not significant. So if Islamic banking wishes to be an important alternative, it must appeal to people outside those countries, and it must proliferate into non-Muslim countries on a wider scale than it has to date. One finds a lack of tangible evidence that Islamic banking is a global force. For example, if one compares the total value of Islamic banking (arguably $700 billion in 2008) to only one large private international bank, Union Bank of Switzerland (UBS), whose total assets were worth $2,161 billion in 2008[27], Islamic finance does not seem very large (approximately 16% of that of a single private international bank). So even though Islamic financing boasts a 15% to 20% rate of growth currently, the volume of Islamic bank deposits is miniscule compared to the $13 trillion with conventional banks. Further, Islamic banks are not well capitalized compared to conventional banks, since over 80% of them have a market capitalization of under $25 million.[28] The Arab Gulf countries are financially strong and growing and yet conventional financing still represents the greater part of the debt market in the GCC.[29] There are other concerns as to whether the current structure of Islamic banking as a system can be incorporated into the international-western style financial structure. Certainly the lack of uniform practices followed by such banks serves as an obstacle for arriving at a standard on what is to be considered the practice of Islamic banking.[30] Moreover, there are those who claim that the current growth in so-called Islamic banking is not really based on strict Islamic principles, rather the growth phenomenon consists in large part of banks peddling a variety of financial services and products designed to look and feel Islamic in order to fulfill the needs of or to attract a niche customer base.[31]

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[17] Elfakhani, Said and M. Kabir Hassan. "Performance of Islamic Mutual Funds", Economic Research Forum, 12th Annual Conference, Cairo, Egypt, Dec 2005.

[18] El Qorchi, Mohammed . "Islamic Finance Gears Up", Finance and Development, Volume 42, Number 4, International Monetary Fund (IMF), December 2005.

[19] "Islamic Finance Market Turns to Securitization", International Financial Law Review, London, July 2005, p. 1.

[20] Islamic Financial Outlook 2006: Financial Service Ratings, Standard & Poors, September 2007, p. 8.

[21] "Islamic Financial Institutions Awards 2008" Annual Survey: Islamic Finance, Global Finance, June 2008, p.28.

[22] Anita Hawser, "Profits with Principles", Global Finance, July/August 2006, p.23.

[23] Ibid.

[24] Ibid.

[25] World Bank data, (World Development Indicators), Washington D.C., 2006.

[26] Ibid.

[27] First Quarter 2008 Report, 6 May 2008, USB financial Highlights.

[28] Anita Hawser, "Profits with Principles", Global Finance, July/August 2006, p.23.

[29] Ibid.

[30] Luca Errico and Mitra Farabaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision", IMF Working Paper, 1998, International Monetary Fund, March 1998, p.3.

[31] See Scheherazade Rehman, "Globalization of Islamic Finance Law," Wisconsin International Law Journal, Spring 2008. Some parts of this paper are based in part on that article.

Hasan Zubair of the International Islamic University of Malaysia believes, to his dismay that this is happening.[32] He attribute this to the haste to expand the industry and to compete with conventional banking, turning the prohibition against *riba* on its head.[33]

2. ISLAMIC JURISPRUDENCE AND FINANCE

Islamic law is, in a sense, a mixture of the methods of the Civil Law tradition, in that it is based on a "code", in this case the Quran, and of the Common Law tradition, which is based on the opinions of judges who rely on precedents in opinion, interpretation, etc., to decide what is prohibited or what is permissible.

However, the laws in both a Civil Law society and a Common Law society are made by human beings, and are therefore changeable by human beings. So if society, if economics, if the times change, the laws can change, evolve or be created to keep up with such changes. For example, electronic commerce and the internet have given rise to a burning need for a wide variety of new and uniform laws. They are slowly being enacted on a local, national and global scale. Not so in divinely revealed *Shari'ah*, the principles of which have been interpreted to some extent, but not changed.[34] Essentially this is problematic in finance law since one has to bridge the gap of one thousand years of jurisprudence development—which occurred in the Civil and Common Law states, but not in Islamic law--to meet today's modern financial needs. At about AD 1000, the *ulema*, Islamic legal scholars, declared that enough interpretation had taken place, and most schools of Islamic law did not develop their jurisprudence any further, despite radical changes in societies thereafter.[35]

In Islam, the law comes from the religion, so to understand one we will have to understand the other. "The Qur'an is for the Muslim the word of God. For the Muslim, it was revealed to the Prophet Mohammed from God through the angel Gabriel. Mohammed was ordered to recite, and the verses of the Qur'an were the result of that recitation".[36] So the Qur'an is considered to be the word of God. Islamic law or Shari'ah as it is called in Arabic has two primary sources, the Qur'an and the Sunnah, which is the way of life and the sayings of the Prophet Mohammed. The three secondary sources are consensus of the legal scholars, deduction from analogy, and the use of individual reasoning by those scholars.[37] The Islamic scholars, or Ulema, are the ones who provide these foregoing secondary sources, based on their interpretation of the Qur'an and the Sunna, which they apply to the specific question at issue, in the context of the circumstance.[38] In the process of developing financial instruments and services, one is faced with the question of whether to look at "what you are not allowed to do," that is, forbidden practices, or, "what you are allowed to do," that is, things that are neither forbidden nor prescribed.[39] While there is a school of thought that says that charging interest is not forbidden in the Qur'an,[40] that is clearly a minority view.[41] Even so, there are those who believe that charging interest that keeps up with inflation is not only permitted, but a requirement under the theory of unjust enrichment as espoused in the Qur'an,[42] since the lender would actually lose money because of inflation if only the exact principal amount were prepaid, and the longer the time till repayment, the more the lender would lose. Islamic concepts of fairness would seem to prohibit this.

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[32] Hasan Zubair, "Islamic Finance Education at Graduate Level: Current Positions and Challenges", Munich Personal RePEc Archive, Paper No. 8712, May 2008. http//mpra.ub.uni-muenchen.de/8712/

[33] Ibid.

[34] See Frederick V. Perry, "Shari'ah, Islamic Law and Arab Business Ethics", The Connecticut Journal of International Law, Vol. 22 No. 1, Spring 2007.

[35] Joseph Schacht, An Introduction to Islamic Law, Oxford University Press, Oxford, 1982, Chapter 10.

[36] Karen Armstrong, A History of God, Ballantine Books, New York, 1993, pp. 139-140. See also Seyyed Hossein Nasr, Ideals and Realities of Islam, ABC International Group, Inc., Chicago, 2000, Chapter 2. As cited in Frederick V. Perry, "Shari'ah, Islamic Law and Arab Business Ethics", The Connecticut Journal of International Law, Vol. 22 No. 1, Spring 2007.

[37] Ibid. chapter 4. See also Sachiko Murata and William C. Chittick, The Vision of Islam, Paragon House, St. Paul, Minnesota, 1994, Introduction.

[38] Perry, Opcit.

[39] This may be important, since certain things in the Qur'an seem simply to say that one "should not" do a thing, rather than one "must not" do a thing. Some schools of Islamic law have taken the former and considered them to be forbidden. From writer Perry's conversation with Ibrahim Zniber in Meknes, Morocco, December 25, 2008.

[40] See generally Barbara L. Seniawski, "Riba Today: Social Equity, the Economy, and Doing Business Under Islamic Law", Columbia Journal of International Law, Vol. 39, 2001, found at lexis-nexis.com.novacat.nova.edu/universe/document?_m=16f08905210418.

[41] Joseph Schacht, An Introduction to Islamic Law, Oxford University Press, Oxford, 1982, p. 145.

[42] Seniawski, op.cit., p. 8.

When money was invented and came into broad use, in the form of copper coins, the four major Sunni Schools of law[43] believed that the prohibition should be construed strictly, so that it covered only those goods that were originally covered by the prohibition, that is, commodities and gold and silver. So that initially the interest prohibition was not applied to copper coins or other new types of currency.[44] The majority view today however reflects a broad interpretation of the Qur'anic verse: "Those who devour usury will not stand…but Allah… has forbidden usury. Allah will deprive usury of all blessing."[45] That majority believes that interest, or *riba*, as it is known in Arabic, is forbidden in Islamic jurisprudence.[46]

There are a few other Islamic legal prohibitions that apply to financial transactions and transactions with a financial component. One is uncertainty (or *gharar* in Arabic). This concept provides for a prohibition on the sale of items, where their characteristics or existence are not certain or under contract terms that are unclear. This would make an insurance contract or the granting of a purchase option contract unlawful. The Islamic prohibition of gambling (*maisir* in Arabic) disallows dealing in futures and options that are speculative. Prohibited items (*haram*) are disallowed categorically and that includes activities that involve the provision of pork, alcohol and certain illegal activities. There is therefore controversy over whether hotels or aircraft, where such things are served, can be the subject of financing under Islamic rules.[47]

Of course most people are familiar with the Islamic concept of the prohibition of interest charged on loans, but in sum, Islamic banking also sustains 4 other key criteria. Essentially there are five basic principals of Islamic Banking:

1) Any predetermined payment over and above the actual amount of principal is prohibited, that is, no interest.
2) The lender must share in the profits or losses arising out of the enterprise for which the money was lent, so that the borrower is not unjustly enriched at the expense of the financier.
3) Making money from money is not acceptable (this would seem to prohibit securitization of loans or the bundling of securities).
4) Gharar (Uncertainty, Risk or Speculation) is also prohibited
5) Investments for which loans are extended should only support practices or products that are not forbidden (alcohol, the production of pork based products, investment in real estate for a casino, and the like).

The fundamental reason for the prohibition of interest in Islam is that the depositor should not profit unduly from the hard work and risk bearing of others. In traditional Western economic thought, interest rates based on market supply and demand serve an essential function in a market economy. Interest rates affect savings—that is, the higher the rates, the more savings they will attract--and investment. This mechanism efficiently allocates capital from where it is plentiful to where it is scarce. In the traditional Western system of finance and banking, it is believed that in competitive markets this allocation of capital is achieved with efficiency and capital is attracted to where it will earn the highest rate of return.

Although Islam prohibits interest, it encourages profit and return on investment where the investor takes calculated risk. It is for this reason that Islamic financial institutions can offer an investor (depositor) a share of their annual profits (and losses) in proportion to the investor's deposit relative to the total assets of the bank. In the case of depositors, for example, this rate of return to the investor or depositor is different from interest in two important ways: from the outset the amount to be earned is unknown, that is, there are no guarantees of the amount to be paid to the investor, and the investor (or depositor, in the Western sense) has to assume more risk. On the other hand, in a Western system the depositor takes less of a risk because the return is fixed, and the capital of the financial institution's stockholders is first at risk before the capital of the depositor.

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[43] Those schools are the Hanbali, Hanafi, Maliki and Shaf'i. The Shia school is the Jaafari school of jurisprudence.
[44] Seniawski, op.cit.
[45] Qur'an II verses 275-279. Of course the question is whether the word "usury" is the correct translation of *riba*; and the term "usury" in the current English speaking world means an unlawful amount of interest, not simply interest. Some translations of the Arabic word call it "increase". It can be confusing, but most Muslims today agree that the charging of interest is forbidden.
[46] Abdur Rahman I. Doi, Shari'ah: The Islamic Law, Taha Publishers Ltd., London, 1984, pp. 275-278.
[47] "Islamic Finance Market Turns to Securitization", International Financial Law Review, London, July 2005, p. 2.

In this way the depositor's principal and her guaranteed rate of return on the deposit, that is, the interest, is paid before any payments to the stockholders in the event of liquidation or financial difficulty on the part of the bank. There does therefore appear to be an Islamic financial paradigm. But the actual practice of Islamic banking differs substantially from this paradigm in a variety of places, such that practice ends up somewhere in between the "accepted" paradigm and conventional banking. The extent to which practice differs from the paradigm varies by country.[48] It is clear today that one must apply a great deal of caution in applying or even trying fully to understand Islamic financial jurisprudence, since its revival has evolved upon a slippery slope, during a difficult time in history. It is well accepted that Islamic banks have to be *Shari'ah*-compliant and therefore need a *Shari'ah* Supervisory Board of Advisors (of qualified Muslim jurists) which decides (in the form of edicts or *fatwas*) which financial products and services are *Shari'ah*-compliant and which are not.[49] This gives rise to a potential problem since in many countries individual banks self-select their own *Shari'ah* Supervisory Board of Advisors. Moreover, larger banks have an advantage as they can afford to hire well-known Muslim jurists on their *Shari'ah* Supervisory Board of Advisors and, therefore, have their *fatwas* carry more weight regarding the suitability of their financial products and services.[50]

3. THE ISLAMIC FINANCIAL SERVICES INDUSTRY

The Islamic Financial Services Industry is of course part of the broader global financial system, but it is comprised of instruments, infrastructure, institutions and markets that apply Shari'ah rules and principles in their design and operations. The Islamic financial system appears to be able to perform substantially all of the functions associated with typical conventional financial transactions and it therefore has sub-sectors that are similar to the conventional financial system. These sub-sectors consist of, among other things, the Islamic banking industry, the Islamic money market, Islamic capital markets (equity and bond markets), the Takaful (Islamic insurance) industry and the Islamic asset/wealth management industry.

The Islamic financial system has thrived worldwide, in particular in the Gulf Cooperation Council (GCC) region, South-East Asia and South Asia. Currently the following types of Islamic financial system structures are found in the various countries in which Islamic banking is used: (a) Dual system (Malaysia and Indonesia); (b) Dual system with clear separation between the conventional system and the Islamic system (Bahrain and Jordan). In a dual-system environment, it is not uncommon to see big global banks such as HSBC, Citibank, Standard Chartered, Deutsche Bank, BNP Paribas and ABN Amro setting up Islamic window operations or even Islamic banking subsidiaries; and (c) Full Islamization of the financial system: virtual absence of conventional financial institutions, since only full-fledged Islamic financial institutions are licensed to operate in a country (Iran, Pakistan—making its way in this direction-- and until recently, Sudan).

Recent developments in the Islamic financial system represent somewhat of a turning point for the industry as it moves towards greater integration with the broader financial system, domestically, regionally and internationally. Indeed, in order to effectively tap the growing demand worldwide for Shari'ah compliant financial services, several countries are implementing policies aimed at developing their financial centers into international – or at least regional – hubs for Islamic finance. Even though there are around 1.5 billion Muslims worldwide, or about 25% of the world's population, still the assets of the Islamic financial system account for only 1% of global banking assets. There is, therefore, significant growth potential for Islamic finance.

4. GLOBAL STANDARDS FOR ISLAMIC FINANCE LAW

As a practical matter, generally in most countries where Islamic banks operate, they are currently governed by the same regulations that govern conventional banks; such regulations generally follow the guidelines of the Basle Committee on Banking Supervision. But such standards are nor entirely applicable to Islamic financial transactions.[51] The UK's Financial Services Authority has made it clear that Islamic banks that apply for licensure will not be given any discriminatory, that is, lenient, treatment, despite the fact that some of their financial instruments may be different.

[48] Luca Errico and Mitra Farabaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision", IMF Working Paper, 1998, International Monetary Fund, March 1998, p.3.

[49] "Anything But Conventional?" [Islamic Banking], Banker Middle East (CPI Financial), Issue #43, January 2004.

[50] McSheehy, Will and Shanthy Nambiar. "Islamic Bond Fatwas Surge on Million-Dollar Scholars" Bloomberg News Article, May 1, 2007. http://www.bloomberg.com/apps/news?pid=20601109&sid=a.DsH16oTM6U&refer=home.

[51] Luca Errico and Mitra Farabaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision", IMF Working Paper, 1998, International Monetary Fund, March 1998, p.3.

However the British will always require proof of sound management and a sound capital base.[52] Among the British regulatory authorities, given that a depositor's funds are always at risk, some question whether the services they are offering are really those of a bank, rather than a manager of funds.[53] Conventional banks around the world generally govern and manage themselves in a fairly uniform way under the Basel Committee rules. The Basel Committee on Banking Supervision was established by the central-bank Governors of the Group of Ten countries[54] at the end of 1974, and meets regularly four times a year. It has four main working groups which also meet regularly.[55]

Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, initially published in June 2004, is the creation of an international standard for banking regulators to be used for the creation of regulations respecting the amount or ratio of capital that banks should put aside or reserve as a cushion against the types of financial and operational risks which banks confront. Advocates of Basel II believe that these international standards act as a measure of protection for the international financial system against the possibility of a major bank or a series of banks collapsing. To attain this goal, Basel II sets up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk exposure of the particular bank inherent in its lending and investment practices. Accordingly under these rules the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold in reserve to safeguard its solvency and overall economic stability.[56]

Basel II, much like the IFSB (defined below), does not have any formal supranational supervisory authority, nor do its pronouncements, regulation or conclusions have any force of law. Rather Basel II simply formulates broad supervisory standards and guidelines and recommends statements of best practice with the objective that individual authorities in the various countries will take steps to implement the Basel II rules in their own laws or regulations in a manner best suited to their own national systems. It is in this way that Basel II encourages convergence towards common standards, but does not impose detailed standardization or homogenization of member countries' regulatory regimes.[57]

In this way, Basel II helps the world financial markets to run smoothly, through the coordination of global banks, and it is what has been termed "the backbone of the financial system".[58] Basel II has what is called three pillars that it espouses as necessary for an efficient and safe international financial system: Minimum Capital, Supervisor Review, and Market Discipline. Minimum Capital means that banks must keep capital against a percentage of their assets based on an assessment of their risk; Supervisor Review requires that the bank's home country regulatory authority ensures that its banks follow the rules; and Market Discipline is the concept that banks must discloses their risk, in other words, there must be transparency.

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[52] Speech given by Howard Davies, Chairman, Financial services Authority, Seminar on Islamic Finance, Hilton Hotel, Leicester, September 20, 2002, www.**fsa**.gov.uk.

[53] Ibid.

[54] Currently the Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. http://www.bis.org/bcbs/history.htm

[55] "From 1965 to 1981 there were about eight bank failures (or bankruptcies) in the United States. Bank failures were particularly prominent during the '80s, a time which is usually referred to as the "savings and loan crisis". Banks throughout the world were lending extensively, while countries' external indebtedness was growing at an unsustainable rate. (For related reading, see Analyzing A Bank's Financial Statements.)
As a result, the potential for the bankruptcy of the major international banks because grew as a result of low security. In order to prevent this risk, the Basel Committee on Banking Supervision, comprised of central banks and supervisory authorities of 10 countries, met in 1987 in Basel". http://www.investopedia.com/articles/07/BaselCapitalAccord.asp

[56] See http://www.bis.org

[57] Ibid.

[58] David Harper, "Basel II Accord to Guard Against Financial Shocks", Investopedia, http://www.investopedia.com/articles/07/basel2.asp

With the world financial meltdown, Basel III was put in place to provide a new global regulatory standard on bank capital adequacy and liquidity.[59] The Basel accords do not differentiate—nor mention—Islamic banking or finance, and the former head of the UK Financial Services Aauthority, Robert Davies, in a speech in Amman Jordan stated that because of the rise and size of the Islamic finance sector in the world today, the Basel committee will have to coordinate with and take into account this sector.[60] Some view the collateralized debt requirements under Basel II as punitive to Islamic banks, since, as an example a mortgage under the western/Basel approach-where the house is at risk to cover the debt exposure--is not used in similar home purchase instruments in Islamic banking. The house is not put at such risk and the risk for repayment is shared.[61] Some Islamic banks, and even Islamic regions or countries have attempted to implement Basel II. But there are those who saya that Basel III is a reaction to a banking crisis that Islamic banks would not find themselves in and thus should not apply to Islamic banks.[62]

Maybe, but standardization in Islamic banking is till elusive.

Prudent supervision of Islamic banks is as important as is the supervision of conventional banks. Operational risks must be managed, and there must be transparency.[63] In other words, people, institutions and governments must have well confidence in the system. The Islamic financial community is in the process of developing international supervisory standards and practices that reflect the specific needs of *Shari'ah*-compliant financing. This is not only beneficial from a regulatory standpoint as globalization of legal Islamic financial standards would allow the banking community to be able to create a truly global product line. In his 2005 ABANA speech William Rutledge,[64] executive vice president in charge of the Bank Supervision Group at the Federal Reserve Bank of New York and a member of the Bank's Management Committee, commented that:

> To this end, institutions like the Accounting and Auditing Organization for Islamic Financial Institutions and the Islamic Financial Services Board [IFSB] are serving a critical function…the IFSB recently released exposure drafts of capital adequacy and *risk* management standards for Islamic financial institutions. These standards will help regulators both in countries that already have well-developed Islamic financial systems and in Western countries, to understand and supervise Islamic finance … [the IFSB] is also working to strengthen the corporate governance framework for the Islamic financial services industry, and the Federal Reserve Bank of New York … [involvement to date has been its via in the 2007 IFSB-sponsored summit on Islamic finance] … of course, corporate governance issues and compliance have become particularly important … [to Fed over the past few years] … and some of the approaches [the fed] has taken to address this issue already have much in common with the practices of Islamic finance.[65]

According to Malcolm Knight, General Manager of the Bank of International Settlements, there are some "fundamental principals" that are essential for any banking or financial system, among them the need for "strong corporate governance, rigorous risk management and sound capital adequacy requirements".[66] It is important that the industry of Islamic financial services be completely integrated into the global financial markets while maintaining at the same time its distinguishing nature and unique services.

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[59] See Bank for International Settlements Website at bis.org/bcbs/basel3.htm
[60] Anita Hawser, "***The Relevance of Basel III to Islamic Banks***", available at ***http://zulkiflihasan.wordpress.com/2011/02/16/the-relevance-of-basel-iii-to-islamic-banks/***
[61] Ibid.
[62] Ibid.
[63] Luca Errico and Mitra Farabaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision", IMF Working Paper, 1998, International Monetary Fund, March 1998, p.3.
[64] Rutledge, William L. "Regulation and Supervision of Islamic banking in the United States", Remarks at the 2005 Arab Banking Association of North America (ABANA) Conference on Islamic Finance: Players, Products & Innovation in NY City", NY, April 19, 2005.
[65] Rutledge, William L. "Regulation and Supervision of Islamic banking in the United States", Remarks at the 2005 Arab Banking Association of North America (ABANA) Conference on Islamic Finance: Players, Products & Innovation in NY City", NY, April 19, 2005. Mr. Rutledge was a member of the Basel Committee on Banking Supervision from 1999 through 2004, Web site for Federal Reserve Bank of New York, http://www.newyorkfed.org/aboutthefed/orgchart/rutledge.html.
[66] Malcolm D. Knight, "The Growing Importance of Islamic Finance in the Global Financial System", speech given at the 2d Islamic Financial Services Board Forum, Frankfurt, December 6, 2007, p. 3. Found at www.bis.org/speeches/sp071210.htm

The industry should also be subject to the same level of supervisory control as other financial institutions. Any breach of standards, practices or application by Islamic banks will not only be an obstacle to their services and products, but will also serve as a hindrance to the acceptance of their services and products by international financial markets. There is a lot of effort and there are a fair number of proponents working in this direction.[67]

The Islamic Financial Services Board (IFSB) mentioned in William Rutledge's speech has become the main international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry. It is headquartered in Kuala Lumpur[68] and sets the standards for the financial services industry broadly defined to include banking capital markets and insurance.[69] To accomplish this, the work of the IFSB is geared to complement that of the Basel Committee on Banking Supervision (the "Basel Committee"),[70] the International Organization of Securities Commissions[71] and the International Association of Insurance Supervisors[72]. As of 2010, the IFSB had issued seven standards, certain guiding principles and technical notes for the Islamic financial services industry, which deal with Risk Management, Capital Adequacy, Corporate Governance, Supervisory Review Process, Transparency and Market Discipline, Recognition of Ratings on Sharī`ah-Compliant Financial Instruments along with the Development of Islamic Money Markets. The IFSB is also working on five new standards and guidelines on 1) Special Issues in Capital Adequacy; 2) Governance of Investment Funds; 3) Corporate Governance in Takaful (insurance) Operations; 4) Shari'ah Governance and 5) Business Conduct.[73] Of course it is not a regulatory body, and cannot sanction banking institutions for non-compliance with its standards. In December 2010, it published a risk management and capital adequacy guidance note for commodity murabaha (similar to conventional mortgages) transactions and announced it would do more shortly.[74]

The IFSB encourages Islamic financial services industry institutions worldwide to follow its recommendations and to submit to external ratings agencies so as to confirm compliance and provide confidence in the institutions.[75] The Islamic International Rating Agency is one such agency that has credence in the Sector.[76] In 2005 the IFSB issued the Capital Adequacy Standard ("CAS"), which deals with, among other things, the structure and content of Shari'ah compliant products and services not specifically dealt with by the Basel Committee in its document "International Convergence of Capital Measurement and Capital Standards".[77] This document attempts to standardize the way the risks of such products and services are measured.

[67] See generally Malcolm D. Knight, "The Growing Importance of Islamic Finance in the Global Financial System", speech given at the 2d Islamic Financial Services Board Forum, Frankfurt, December 6, 2007.Found at www.bis.org/speeches/sp071210.htm

[68] The Islamic Financial Services Board based in Kuala Lumpur, was officially inaugurated on 3rd November 2002 and started operations on 10th March 2003, and states on its Web site: "The Islamic Financial Services Board (IFSB) is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates initiatives on industry related issues, as well as organizes roundtables, seminars and conferences for regulators and industry stakeholders." www.ifsb.org

[69] Ibid.

[70] The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. http://www.bis.org/bcbs/index.htm

[71] The International Organization of Securities Commissions (IOSCO) is an international organization comprised of the regulatory bodies of the world's securities and futures markets. IOSCO together with its sister organizations, the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors, make up the Joint Forum of international financial regulators. Currently, IOSCO members regulate over 90 percent of the world's securities markets. www.iosco.org

[72] Established in 1994, the International Association of Insurance Supervisors (IAIS) represents insurance regulators and supervisors of some 190 jurisdictions. The IAIS works closely with other **financial sector standard setting bodies and international organisations** to promote financial stability. http://www.iaisweb.org/index.cfm?pageID=28.

[73] http://www.ifsb.org/index.php?ch=2&pg=1&ac=1

[74] Anita Hawser, **"**The Relevance of Basel III to Islamic Banks**"**, available at zulkiflihasan.wordpress.com/2011/02/16/the-relevance-of-basel-iii-to-islamic-banks/

[75] See generally "Guidance Note in connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Thari'ah-Compliant Instruments", Islamic financial Services Board, March 2008.

[76] The aim of the Islamic International Rating Agency is to help the Islamic financial services industry to gain international recognition, attempting to show that they too are strong financial institutions that adhere to ever increasing standards of disclosure and transparency. It communicates its opinions on the ratings to investors and other stakeholders in the process. www.iirating.com

[77] Ibid, p.1.

Thus Islamic financial institutions are provided a common basis for calculation of their risk-weighted capital ratios, since their capital structure and assets may differ from those of financial institutions covered by the Basel Committee or "Basel II" as it is commonly known. The CAS says that the ratings assigned to them by external credit rating agencies is one source of measurement of their status, thereby implying that national authorities should place credence in such external agencies. Basel II allows for a similar approach for conventional financial institutions.[78]

Consolidating a bank's financial data with those of all its subsidiaries and branches is another principle that must be applicable to all banks, and such practice is necessary for ensuring consolidated and comprehensive supervision by the supervisory authorities in the bank's home country. Central banks' governors in Islamic countries, members of the Islamic Development Bank realized the importance of such consolidation 25 years ago when a technical committee was formed, including a number of governors and specialists to consider the needs of Shari'ah compliant banking services.

The most important recommendation was that Islamic banks must be subject to the same supervisory rules and requirements as those that govern conventional banks, with the necessary flexibility, taking into account their specific work methods and products so as not to isolate these banks from global financial markets. Encouraging Islamic banking institutions to integrate into global markets will push them forward to compete with all other financial institutions, stimulating them to innovate in order to meet the needs of corporate and individual customers, expand their scope and base of work, and not to be tied to a specified category of customers or specific markets. This will help them adapt to the requirements of the global financial system, provide them with necessary instruments, help them develop and reinforce their structures, and facilitate their spread. It is fairly clear that globalization is spreading the impact of Islamic financial rules in broad ways around the world, since finance and all other aspects of business are becoming more and more interconnected on a global basis.

Malcolm Knight, of the United States Federal Reserve Bank, considers that the IFSB takes into account the global banking standards of Basel II, and bases its current pronouncements on Pilar 1 of Basel II and two of its recommended drafts currently out for consideration on Pilars 2 and 3.[79] So Muslim standard setters are attempting not only to standardize the Islamic financial industry, but also to bring it in line with global standards.

That is not an easy task. The standardization and global acceptance of Islamic methods of finance as a mainstream method of obtaining financing is faced by at least three serious obstacles: (1) agreement among Muslims and Muslim countries on what the term "Islamic finance" means; (2) standardization of what is and what is not acceptable as being Shari'ah compliant throughout the Muslim financial industry; and (3) acceptance of the Islamic banking industry as a whole and compliance on a case by case basis with Basel II Accord. That represents a difficult agenda.

5. CHALLENGES FACING THE GLOBALIZATION OF ISLAMIC FINANCE

Islamic banks just tend to have weaker liquidity and weak accounting and disclosure framework,[80]but against this backdrop of movement toward standardization, Muslim financiers are continually trying to come up with ways to mimic traditional western financial methods, including derivatives—which are traditionally considered forbidden by Shari'ah.[81] But the fact is there is still considerable dispute over the conventional and fairly simple financing models.[82] In fact some believe that the fact that so many Muslim banks are providing "Shari'ah compliant" financing models is disingenuous, since the instruments are, arguably, little more than interest rate based financial instruments though they are called something else.[83] Accordingly despite the efforts of the IFSB and even Basel II, one of the major stumbling blocks to the development of an internationally accepted Islamic banking industry is a lack of broadly accepted standards.

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[78] Ibid.
[79] Malcolm D. Knight, "The Growing Importance of Islamic Finance in the Global Financial System", speech given at the 2d Islamic Financial Services Board Forum, Frankfurt, December 6, 2007, p. 3. Found at www.bis.org/speeches/sp071210.htm.
[80] Islamic Financial Outlook 2006: Financial Service Ratings, Standard & Poors, September 2007, p. 8.
[81] "International Finance Markets Turn to Securitization," International Financial Law Review, July 2005, p.5.
[82] See generally Mahmoud A. El-Gamal, "Interest and the Paradox of Contemporary Islamic Law and Finance", Fordham International Law Journal, vol. 27, 108, December 2003.
[83] Ibid.

The Shari'ah board of a banking institution in Malaysia may approve a financial product as being Shari'ah compliant, but that same product may not be acceptable or approved in a country within the Gulf Cooperation Counsel.[84] Malaysia, Pakistan, Sudan and Iran have set up Shari'ah boards for approving banking standards at the level of the central bank. In most other countries, the finance industry appoints its own Shari'ah board,[85] which in many cases, is at the institutional level, that is, within each bank or finance house. Further, as noted above, there are four separate schools of thought in Sunni jurisprudence.[86] Khaled Yousaf, head of business development in the Islamic finance sector of the Dubai International Finance Center states that "Egypt and Malaysia have very liberal interpretations of Shari'ah law, while Saudi Arabia and Kuwait are quite strict. Dubai is somewhere in the middle."[87]

Then of course there is the lack of trained Islamic legal scholars with knowledge of the world of finance to set on banks' Shari'ah boards. This puts the industry at a disadvantage.[88] There are not even enough trained business people and economists who understand the Islamic financial industry to man the banks.[89]A further obstacle is the lack of a secondary market for Shari'ah compliant financial instruments. The International Islamic Financial Market is attempting to develop such a secondary market.[90]

6. CONCLUSIONS

At the moment the future of Islamic finance/banking systems in terms of becoming a universally accepted system of finance on a global scale does not look bright, at least in the near term. In order for Islamic banking to grow as a system there must be a real commitment to transform the banking systems in various Muslim countries. This can be difficult even in Muslim-majority countries since most of them have already set up Western style financial structures which already comply with international banking standards. Further since the state is a key in this process, this system appears not to be exportable to Western countries.

The impact that the sub prime mortgage and international banking crisis will have on the Islamic financial services industry is open to question. Sub prime customers are those whose credit worthiness is questionable for some reason. The risk that a lender takes in lending to them is greater, and thus the interest rates and loan covenants given to them are typically higher and more onerous than to top grade credit customer. Sub prime loans are generally used to finance home mortgage loans.[91] The overall shocks have made it more difficult to get mortgage backed financing, which in turn has caused a housing market decline in many markets, especially in the United States and the United Kingdom. Some believe that the crisis will give a boost to Islamic banking,[92] and will open doors for expansion in the industry.[93] While conventional banks had by February of 2008 written down in excess of $80 billion[94] in credit market losses, according to Rasheed al-Maraj, Bahrain's central bank governor, lenders in the Gulf and Malaysia, the global hubs of Islamic finance, have barely reported a loss.[95]

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[84] The Gulf Cooperation Counsel was formed for mutual self defense and consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.
[85] Anita Hawser, "Profits With Principles", Global Finance, July/August, 2006, p.25.
[86] See Laleh Bakhtiar, Encyclopedia of Islamic Law: A Compendium of the Major Schools, ABC International Group, Inc., Chicago, 1996.
[87] Anita Hawser, "Profits With Principles", Global Finance, July/August, 2006, p.25.
[88] Ibid. p.24.
[89] Hasan Zubair, "Islamic Finance Education at Graduate Level: Current Positions and Challenges", Munich Personal RePEc Archive, Paper No. 8712, May 2008. http//mpra.ub.uni-muenchen.de/8712/
[90] Ibid.
[91] Eric Petroff, "How Will the Subprime Mess Impact You?" Investopedia, http://www.investopedia.com/articles/pf/07/subprime-impact.asp.
[92] See "Islamic Banks Give London World Financial Clout", http://www.msnbc.msn.com/id/23505646/; "All Arabs Will Prefer Islamic Banking", The Economic Times, December 3, 2007, ***http://economictimes.indiatimes.com/Interview/All_Arabs_will_prefer_Islamic_banking/articleshow/2590419.cms***; "Islamic Banks Withstand Mortgage Crisis", Konsultasi Muamala, ***http://konsultasimuamalat.wordpress.com/2008/02/08/islamic-banks-withstand-mortgage-crisis/***.
[93] "Islamic Banks Shielded From Subprime", Reuters, February 4, 2008, http://www.reuters.com/article/managerViews/idUSNOA43244920080204.
[94] The Organization for Economic Cooperation and Development (OECD) believes that this could reach up to $300 billion, The New York Times, November 23, 2007, http://www.nytimes.com/2007/11/23/business/23oecd.html?ref=worldbusiness.
[95] Ibid.

One reason, al-Maraj gives is that Islam bans lending on interest and the trading of debt, so complex collateralized debt obligations are not typically found in Islamic finance.[96] Contrasting what Mr. al-Maraj says, Muslim bankers are, as mentioned above, attempting to invent new financing methods to compete with conventional financial institutions.[97] The question is will Islamic finance houses take over the market for sub prime lending? Will they jump into the breach and take over risky loans? Unless they do so, it is difficult to see how the sub prime crisis will open doors or increase Islamic bank market share, as stated by sum Islamic bankers.

The manner in which Islamic banking services are currently provided in both Muslim and Western countries, is primarily in the form of financial services and products. This approach is not likely to transform Islamic banking into a true universal banking system; it is more likely to develop and remain as a specialized form of banking services and products. It appears more likely that the true Islamic or Shari'ah-compliant banking will remain a small segment of the global banking market, supported primarily by Persian Gulf oil money.[98] As stated earlier, industrialized countries will likely treat Islamic banks vying for authority to operate in the same manner that they will treat everyone else.[99] Yet there are those who feel that because the industry is in its infancy and simply does not have the maturity effectively to compete in the broader financial world, it needs protection not competition.[100]Accordingly, at the moment the question of whether the Islamic banking industry is actually becoming a global phenomenon must be answered by first asking the question as to what one means by globalization. It is indeed spreading in the Middle East and throughout the Muslim world and even in parts of the industrialized West, but not in a major way so as to make the system a competitive threat to conventional methods of finance or even a major alternative to such system. It remains a niche market-- and an alternative--for the time being.

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[96] Ibid.
[97] See footnotes 77 & 78.
[98] Rehman, Scheherazade. "Globalization of Islamic Finance Law," Wisconsin International Law Journal, Spring 2008.
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