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**Islamic Economics: New Economic Paradigm, or Political
Agenda?**

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Abstract: The concept of Islamic economics emerged during the decolonization process in Muslim countries. Its creators sought a new economic paradigm reshaped along Islamic principles in an attempt to clearly distance the newly independent countries from their colonial legacy. The whole concept was strongly politically motivated since its very creation and this legacy has never been overcome. This paper outlines the ideological foundations of Islamic economics and its underlying theoretical principles focusing on Islamic banking, undoubtedly the most developed segment of Islamic economics. The empirical analysis of Islamic banking across Muslim countries in the last decade, however, reveals a major general discrepancy between the claims and the reality as well as some interesting regional differences. It turns out Islamic banking does not stand up to its own claims and even more so in those countries where Islamization of economy was imposed by the government. The reasons behind such discrepancy are identified, and influence of political agenda on Islamic finance is suggested as the driver behind the whole concept.

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1 Introduction

The concept of Islamic economics, i.e. economics reshaped along the principles of Islam, emerged during the decolonization process after World War II and has been gradually attracting more attention ever since. Its flagship, Islamic banking, is a very fast growing segment: while in 1970 Islamic banks in Muslim countries (countries with majority a Muslim population) occupied a mere 2% of the banking market; thirty years later it was already 15% (Aggarwal & Yousef 2000: 93). The total assets of Islamic banks today according to different sources may be anywhere between USD 200 and 500 billion,¹ roughly an equivalent of GDP of a medium-sized country like Norway or Poland. Moreover, Islamic banking is no longer confined to Muslim countries, as even the biggest Western banks now offer products compliant with the Islamic law, *Sharia*.

This boom led some authors to claim that Islamic economics constitutes a whole new economic paradigm. This is obviously suggested mainly by Islamic scholars. Choudhury (1997) for instance even claims there is Islamic Political Economy with distinct epistemology. Some Western scholars also share this view, such as Presley & Sessions (1994), Humayon and Presley (2000) or Nienhaus (2000), who writes:

despite the fact that progress is slow and not always continuous, Islamic economics is clearly beginning to establish itself as a science, which will not allow itself to degenerate into an ideology or social revolution or a veneer for conservative dogmatism. (Nienhaus 2000: 98)

Other scholars have not been as enthusiastic. Kuran (esp. 1995, 1996) criticised the economic foundations of Islamic economics, while Aggarwal & Yousef (2000) gathered some empirical evidence to show that Islamic banking falls behind expectations. Proponents of Islamic banking acknowledged some of the critiques, but countered that these are infant diseases that will gradually diminish.

¹ Sources vary, according to Business Week ("Islamic Banks: A Novelty No Longer", August 5, 2005) it was USD 262 bn in 2005, according to Time ("Banking On Faith", December 8, 2002) almost 300 bn already back in 2002. Memri economic blog (<http://memrieconomicblog.org/bin/content.cgi?news=861>, January 24, 2008) even quotes the figure of 450 bn reportedly stated at the Algerian economic forum in 2008.

While the news and the Internet burst with marketing information on how Islamic banking thrives, the academic debate based on empirical research has gone somewhat silent in the last ten years. In this paper, I want to evaluate what progress there has been and whether we are finally entering the new era of two distinct competing economic systems (Islamic and Western) or whether Islamic economics is just an inflated bubble. In the first section I briefly outline the ideological foundations of Islamic economics and its underlying theoretical principles with a focus on Islamic banking, the single most developed segment in Islamic economics. In the second section, the empirical analysis of Islamic banking across Muslim countries in the last decade reveals a major discrepancy between the claims and the reality as well as some interesting regional differences. *Vis-à-vis* the evidence, Islamic banking does not stand up to its own claims and even more so in those countries where Islamization of economy was imposed by the government. In the third section I attempt to explain the reasons behind such discrepancy. Finally, the influence of a political agenda on Islamic banking is suggested as the driver behind the whole concept.

2 Theoretical framework of Islamic economics

2.1 Ideological background

Islamic economics emerged as a part of the Islamic resurgence—an effort to cut off from the political, social, economic and cultural heritage imposed on Muslim countries by Western colonial powers. A leading Pakistani Islamic leader, Sayyid Abu'l-A'la Mawdudi, for instance, openly stated that Islamic economics was a political tool to re-establish Islamic authority over economy (Kuran 1995: 156).

Early Islamic economists, such as Pakistani politician Mawdudi or Iraqi Shi'ite scholar Baqir al-Sadr found inspiration in socialist critique of capitalism.² According to them unfettered market and private ownership lead to injustice and must be contained by Islamic regulation (Watt 1988: 57, Weberová Babulíková 2001, Aziz 2003).

² Pro-capitalist interpretations of Islamic economics are fairly rare. One of the examples could be former Malaysian Prime Minister Mohammad Mahathir, who for instance claimed that Islam is not an egalitarian doctrine and that social stratification is given by God, who also provides tools for its reduction (2002). Mahathir however, does not enjoy the reputation of an Islamic scholar.

As failure of socialism was gradually becoming more evident, Islamic economists moved to the “third way” argument, according to which Islam offers the moderate compromise between the two utopian extremes: capitalism and socialism (see for instance Ishaque 1983, Siddiqi 2002, Taheri 2003, Jafry n. d.)

2.2 Theoretical principles

The central principle of Islamic economics is prohibition of usury (*riba*). Usury is commonly understood as excessive profit on lending out money, and its prohibition is not unique to Islam. In ancient times it used to be a common practice with the inability to pay one’s own debt resulting in slavery. That, however, gradually became socially unacceptable and regulations on interest rates were introduced in most societies.³ Another reason probably was the effort to prevent exploitation by life-sustaining goods (animals and crops) upon which the Muslim barter-trading community was heavily dependent (Mohammed 1988:119).

In most societies harsh restrictions were later gradually lifted, but some degree of regulation remains common to date in most countries (for instance rate-caps on consumer credit is quite common). On the contrary, the proponents of Islamic banking insist that any non-zero rate of interest—even the lowest one—constitutes usury. Interest thus must be not only regulated, but banned entirely.

Apart from prohibition of usury, there are several other Quranic principles that underlie Islam. One of them is the obligation of Muslims to pay religious alms to the poor (*zakat*). While liberal Muslims understand *zakat* as their personal religious duty, many Islamic conservatives and fundamentalists maintain that *zakat* should be institutionalized, its collection centralized and enforced and its revenues redistributed by the government (Qutb 1996, Taheri 2003). Another principle affecting economy is prohibition of gambling and speculation (*gharar*) which under certain interpretations results in a ban on financial derivatives and futures, but it also renders conventional insurance unlawful as an attempt to protect oneself from the will of the God. Islamic alternative to insurance (*takaful*) is based on mutual cooperative risk-sharing.

³ For an overview of historical development of usury and its regulation (in Czech) see Weberová Babulíková (2001)

2.3 Instruments of Islamic banking

Prohibition of interest obviously creates a need for interest-free banking methods. The two main types of transactions used in Islamic banking are profit and loss sharing (henceforth PLS) and mark-up methods.

The two pure methods to conduct business in compliance with *Sharia* are based on profit and loss sharing partnership and are called *mudaraba* and *musharaka*.⁴ Under a *mudaraba* agreement the owner of capital provides it to the entrepreneur, who conducts the business. The profit is then divided between both in a proportion agreed on beforehand. In case of business failure the lender loses his investment and the entrepreneur his time and effort. *Mudaraba* is thus an equivalent to limited partnership. *Musharaka* is a partnership in which all partners contribute capital and all share the profit or loss together accordingly (general partnership).

Where partnership is not applicable, “mark-up” methods are allowed. The major two instruments are *murabaha* (deferred payment) and *ijara* (leasing). Under *murabaha* the bank buys the property for its client, increases (marks up) the price and then sells it to the client at the higher price, which is then paid by the client later, usually in instalments.⁵ *Murabaha* is thus basically equivalent to mortgage or loan. Under *ijara*, the bank owns the asset and rents it to the client for a rental fee. The rental fee should be fixed at the beginning for the whole duration of the contract and entitles the client to the usufruct of the asset—it may or may not result in transfer of ownership.

As globalization proceeds and complexity of financial instruments increases, new methods are introduced, among which the “Islamic bond” (*sukuk*) became prominent. The same dispute about *Sharia* compliance applies, though. The Economist⁶ points out that the prominent Islamic scholar M. T. Usmani⁷ said in November that

⁴ Other transliterations of *mudaraba* and *musharaka* include *modaraba*, *mudharabah*, *mozarebe*, and *musharika*, *musyarakah*, *musharakat* respectively. For simplicity I will use only *mudaraba* and *musharaka*, unless quoting others.

⁵ Usage of terms varies slightly. For instance Malaysian banks use a separate term *Bai' Bithaman Ajil* for a mark-up transaction with one-time deferred payment, while the term *murabaha* is reserved for deferred payment in instalments. The underlying principle is the same, though, and we may safely lump them together for the purpose of this paper.

⁶ The Economist, “Under the microscope”, 10 March, 2008

⁷ Muhammad Taqi Usmani is the deputy chairman of Islamic Fiqh Council of the Organization of Islamic Conference (OIC)

“some 85% of sukuk issues in the Gulf Co-operation Council (GCC) member states failed to comply with sharia principles.”

2.4 Mark-up controversy

Muslim scholars themselves are aware that avoiding the prohibition of interest by relying heavily on mark-up instruments (such as *murabaha* or *ijara*) is a questionable practice for two principal reasons. First, it is prone to be interpreted as interest in disguise, and second, it runs against the declared superiority of economy based on profit and loss sharing. For instance A. A. Kazmi says that “if the Sharia accepts mark-up as valid, it is left with no basis to reject interest (...) Sharia jurists cannot reject interest if they accept ‘mark-up’” (in Ayub 2004). Prominent Islamic economist from Pakistan Muhammad Ayub⁸ adds that *murabaha* is permissible only in a very limited extent: “It goes without saying that the mark-up technique, or for that matter any Islamic modes, should not be used as a back door for allowing interest” (Ayub 2004).

Other thinkers acknowledge that genuine Islamic banking should be based on genuine PLS operations, such as *mudaraba* or *musharaka*, as illustratively summarized by M. T. Usmani (1998):

It should never be overlooked that, originally, *murabahah* is not a mode of financing. It is only a device to escape from ‘interest’ and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where *mudarabah* or *musharakah* are not practicable.

In other words, Islamic economists agree that most of Islamic banking should be conducted on the basis of partnerships. Mark-up methods are permissible under certain circumstances where partnership is not applicable, but they should be more or less exceptional, not form the backbone of the system. For many decades the reality was the opposite, though. For instance Ariff (1988) reviewing some empirical evidence

⁸ Muhammad Ayub is senior joint director in the Islamic banking department of the State Bank of Pakistan.

pointed out: “The most commonly used mode of financing seems to be the ‘mark-up’ device which is termed *murabaha*”. Aggarwal & Yousef (2000:102-103) presented detailed data for several Islamic banks as well as some aggregate findings from the 1980s and early 1990s and demonstrated that the share of PLS financing consistently fell below 10 percent. They also reported that although the fully Islamised Iranian banking system relied on PLS to a greater degree, mark-up principle still outweighed it. This disparity of declarations and reality was countered by Islamic economists as a temporary infancy problem of Islamic banking and it was expected that the share of PLS products in banks’ portfolios will rise in time.

One trick to disguise mark-up is so-called *diminishing musahraka*. Under it, the client and the bank buy a property together as equal partners and the client then pays rental fee, thereby gradually increasing his or her share in the partnership up to 100%, after which the agreement terminates. The defining feature of such a transaction is thus not the initial partnership, but the instalment payments based on mark-up. For instance Dubai Islamic Bank (2008) calculates the rental fee based on interbank interest rate EIBOR, meaning that interest is directly built-in!

2.5 Claimed superiority of interest-free economy

Many proponents of Islamic economics have steadily been trying to justify prohibition of interest on rational as well as moral grounds.⁹

Most claims of interest-free economy superiority are vague, ill-conceived ideologically biased declarations, whose bias is readily apparent. Some hypotheses merit closer examination, though. For instance Khan and Mirakhor (1990: 356-7) suggest that due to non-existence of interest, Islamic economy might be better suited to tackle shocks by absorbing them immediately into the nominal value of shares. This hypothesis, however, lacks any empirical evidence so far. Further hypotheses hold that interest causes unemployment and business cycles. However, Ariff notes that none of them “has really succeeded in establishing a causal link” (1988). It is also often claimed that Islamic system will enable easier financing for small enterprises.

⁹ For a more detailed critical analysis of arguments underlying prohibition of *riba* and equation between *riba* and interest see the Farooq (2005). Claims made by the International Association of Islamic Banks are criticized by Aggarwal & Yousef (2000)

Siddiqi (2002) claims that Islamic finance is not only efficient but also more moral:

(...) superiority [of Islamic finance] over conventional finance (...) lies in its promise to ensure that good returns to investments shall be accompanied by promotion of the good of the society as a whole. A combination of efficiency with morally better end results requires that institutional changes be accompanied by moral regeneration.

For Siddiqi interest is morally unjust because the lender enjoys an unfair advantage of a fixed return, while the whole risk is assumed by the entrepreneur. Secondly, interest allows for “money to be exchanged for more money, making the moneyed richer,” thereby aggravating social injustice. Thirdly, prohibition of interest will result in greater emphasis on profitability, productivity of capital and hence overall efficiency.

The moral argument is bound to eventually end in a clash of value judgments. While I do appreciate such debates, I shall not enter it at this point because my goal is different. Suffice to say that there are some challenging questions that Islamic economists have not yet answered sufficiently. On a philosophical level, for instance, Kuran (1995: 157) raises serious doubts about morality of banning interest based on depriving risk-averse individuals of a safe way to invest money. El-Gamall (2000: 10) also thinks that “any financing conducted through valid trading by mutual consent is permissible [in Islam].” On a practical level, we have a recent example of Grameen Bank in Bangladesh, where interest brings demonstrable benefits especially to the poor.¹⁰

On the other hand, the claim about higher economic efficiency is a clear statement that can be subjected to an empirical test. I shall thus look at the real conduct of Islamic banks to assess this claim in the next section. If the argument about better efficiency of interest-free banking holds, I shall no doubt find plenty of Islamic banks offering genuine PLS-based interest-free products and services.

¹⁰ Although operating in a Muslim country, Grameen is not an Islamic bank. It provides micro-loans based on interest. Grameen is very successful in supplying capital to the poorest people and especially women. In 2006 Grameen and its founder, M. Yunus were awarded Nobel Prize for peace for their effort.

3 Islamic banking: reality check

3.1 Hypotheses

From what proponents of Islamic banking claim and what previous scholars wrote on the topic, I am able to make following three hypotheses:

The larger part of total assets of Islamic banks are instruments of Islamic banking (both mark-up and PLS). This is the first condition if we want to speak meaningfully about Islamic banking.

The larger part of Islamic financing is based on PLS (*mudaraba* or *musharaka*). This is a logical expectation, since proponents of Islamic banking agree PLS instruments are what really distinguished Islamic banking from the conventional one.

In countries with government-imposed Islamic banking (Iran, Pakistan) we will see higher use of Islamic banking than in other Muslim countries (Middle East or Southeast Asia).

3.2 Quantitative evidence

Let us examine the first and second hypotheses in the light of empirical evidence.¹¹ The table below shows the proportion of Islamic financing on total assets and PLS

¹¹ Note on methodology: In order to avoid possible “Western bias,” I gathered all data exclusively from annual reports of the Islamic banks published on their own. A second measure to avoid bias was to focus on those banks that are considered champions of Islamic banking—for this purpose I used IFN Awards, in which Islamic banks choose the best from among themselves every year (IFN Awards 2006, 2007, 2008, available at <http://islamicfinancenews.com/awards.asp>). Such a sample will not only be practically free of Western bias, but in fact it will probably be slightly biased in favour of Islamic banks. In total, I examined 37 Islamic banks in 15 countries. This search yielded close to a hundred annual reports from the past ten years. For the overall quantitative analysis I selected only 18 banks, for which at least three observations were available in the last five years. For each year and bank I extracted three key figures: total assets (in balance sheet), amount of PLS instruments (*mudaraba*, *musharaka*) and amounts of mark-up instruments (*mostly murabaha* and *ijara* but to smaller extent also *istisna*, *salam* and other methods)—these breakdowns are *usually* available in the Notes to the Financial Reports sections. From these the two key unitless ratios were calculated: the proportion of Islamic financing on total assets and the proportion of PLS instruments on total assets. Where data from two consecutive reports differed, the later report (restated) was given priority. Two Iranian banks do not break down their assets sufficiently, so we only know their PLS on total assets share, but not their Islamic financing on total assets.

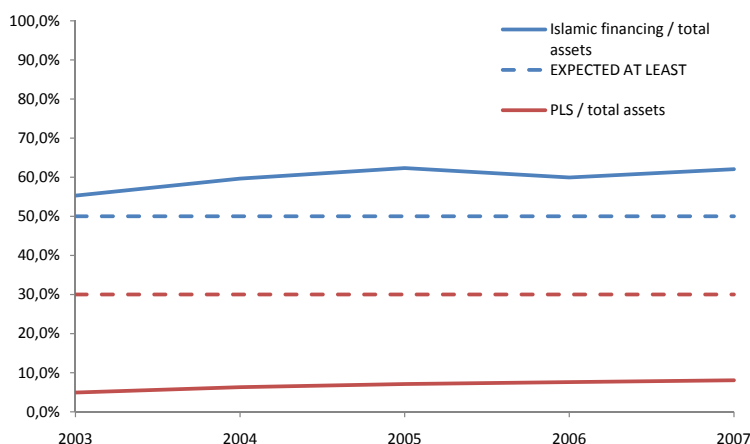
financing on total assets of 18 Islamic banks in the years 2003-2007. The chart shows the average ratio for each year.

bank	Islamic financing / total assets					PLS / total assets				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
Abu Dhabi Islamic Bank (UE)	59,2%	63,5%	64,2%	59,6%	58,5%	0,6%	2,7%	2,5%	4,7%	3,7%
Dubai Islamic Bank (UE)	53,7%	57,1%	65,8%	54,7%	58,4%	9,8%	9,9%	18,7%	9,1%	11,1%
Sharjah Islamic Bank (UE)	86,5%	84,1%	88,9%	82,6%	78,3%	1,5%	3,0%	8,1%	9,0%	5,7%
Al-Tawfeek (SA)	15,9%	11,3%	10,8%	19,0%		1,5%	1,5%	0,9%	0,3%	
Gulf Finance House (BH)	56,4%	62,9%	63,9%	52,4%	36,0%	0,0%	1,2%	3,2%	4,1%	3,7%
Al Baraka Group (BH)	51,5%	51,5%	54,2%	59,5%	66,1%	3,1%	4,5%	3,8%	3,1%	7,0%
Qatar Islamic Bank (QA)			72,3%	56,6%	61,4%			2,3%	2,0%	5,9%
Islamic International Arab Bank (JO)	17,3%	30,5%	44,9%	42,5%	51,4%	1,1%	2,9%	9,9%	9,2%	8,8%
Meezan Bank (PK)	66,6%	62,6%	64,4%	57,5%	51,5%	0,9%	0,5%	0,3%	0,3%	0,1%
Al Baraka Islamic Bank (PK)		58,6%	49,3%	51,4%	57,0%		0,5%	0,1%	3,0%	4,3%
Standard Chartered Modaraba (PK)	95,5%	97,1%	97,3%	96,7%	98,9%	9,8%	13,8%	7,5%	8,3%	0,5%
Refah Bank (IR)						0,4%	0,3%	0,7%	0,7%	0,6%
Sepah Bank (IR)							1,3%	2,2%	2,1%	
Parsian Bank (IR)		63,3%	67,6%	64,0%			7,4%	11,3%	15,2%	
Bank Mandiri (ID)	62,0%	75,8%	69,2%	74,9%	77,6%	9,7%	15,3%	20,2%	27,1%	32,5%
Bank Muamalat (ID)	70,4%	79,1%	80,8%	77,6%	79,7%	25,0%	37,6%	35,7%	37,9%	36,9%
Bank Muamalat (MY)	31,1%	35,8%	40,4%	39,9%	42,5%	0,0%	0,1%	0,1%	0,1%	0,1%
Bank Islam (MY)	52,4%	61,6%	63,4%	70,0%	51,7%	5,8%	4,8%	0,5%	0,5%	0,4%
Mean	55,3%	59,7%	62,3%	59,9%	62,1%	4,9%	6,3%	7,1%	7,6%	8,1%

In the first hypothesis I expected that the proportion of Islamic financing on total assets should be higher than 50%. This hypothesis is confirmed, as in every year the mean was consistently above 50%. On average through all five years it was in fact 60.0%.

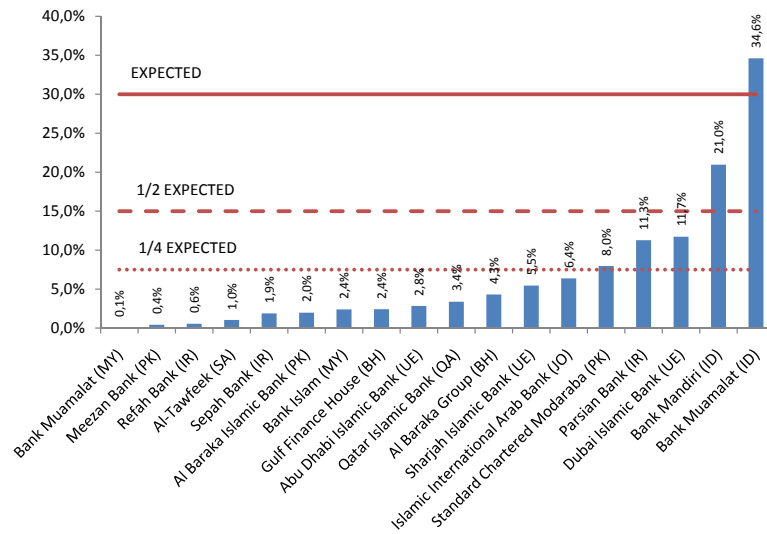
In the second hypothesis, I expected that PLS instruments will take more than half of the Islamic financing. Since the average share of Islamic financing on total assets was 60% and since I expect PLS to be more than half of that, I can reformulate

our second hypothesis: PLS will be on average at least 30% of total assets. It is readily apparent that the real PLS share is consistently and significantly lower than 30%. In all five years the ratio was in fact under 10%, although with a mildly increasing trend. The overall average through the five years was 6.84%. The second hypothesis clearly does not hold.



It is also interesting to look at average ratio of PLS on total assets of each bank over the five years, which is captured in the chart below. It is readily apparent that only a single bank (Indonesian Bank Muamalat) exceeded the expected threshold. Only two banks reached more than half of it, only five banks reached at least one quarter. Conversely, the absolute majority of the banks did not even reach one quarter of the expected PLS share.

The empirical evidence thus clearly shows that in Islamic banking continues the massive use of controversial mark-up instruments at the expense of allegedly superior PLS instruments. In other words, Islamic banking fails *on its own terms*.



3.3 Regional specifics

In order to answer the third hypothesis about the regional specifics, the overall data presented above must be complemented by other qualitative observations. I found it useful to divide Islamic banks into three groups: Middle East, Southeast Asia, and Iran and Pakistan.

3.3.1 Middle East

Most of the eight Middle Eastern Islamic banks in the table above (banks in United Arab Emirates, Saudi Arabia, Bahrain, Qatar and Jordan) kept the share of Islamic financing consistently over one half of total assets. It is noteworthy that Sharjah Islamic Bank that has one of the highest ratios was originally a conventional bank and claims to be the first bank in the world to convert successfully to Islamic banking.

At a first glance in the annual reports it would seem that many Middle Eastern banks are genuinely convinced about superiority of Islamic banking and PLS instruments. Annual reports regularly start with a prayer to Allah and the banks take great care to introduce their Shari'a Supervisory Board members. The Head of Al-Tawfeek, an Islamic investment company operating in Saudi Arabia for instance writes in their

2004 Annual Report: “Al-Tawfeek Company continue (...) its marvellous march and significant role in applying concepts of Islamic banking.” (Al-Tawfeek 2004). Similarly, Faisal Islamic Bank in Egypt praises the benefits of *mudaraba* in its product portfolio:

Mudaraba is an operation of great benefit to economic activity since there are a lot of people who have the efficiency and the ability to operate funds but do not have the money to do so, therefore, the Mudaraba contracts open the door of opportunity to many talented entrepreneurs and increases the volume of trade. (Faisal Islamic Bank 2008)

However, the reality is quite different. All eight Middle-Eastern banks rely heavily on mark-up instruments. The proportion of PLS instruments remained under 10% and it often dropped even under a scant 1%. The only exception was Dubai Islamic Bank, the “world’s first fully-fledged Islamic bank,” whose PLS on total assets share reached almost 19% in 2005 (still below what we expected). However, an unspecified part of PLS financing consisted of so-called *diminishing musharaka*, which, as discussed above, is in fact a mark-up product.

Al-Tawfeek’s “marvellous march” is worth noting, too. Al-Tawfeek’s assets in *mudaraba* in 2003 suddenly soared up more than 20 fold. Upon closer examination, however, it turned out it had been caused by an investment into an affiliated company with guarantees issued on repaying profit. That obviously violates the key risk-sharing principle of *mudaraba*. When this investment was deducted to keep the time series consistent, it turned out that the share of PLS instruments in fact never exceeded 2% of total assets. Faisal’s real fondness in *mudaraba* could not be established, as Faisal consistently reports all Islamic methods in a lump sum and does not break them down into PLS and mark-up (Faisal IB 2003-2006).

Some might expect that due to conservative Islamic government, Saudi Arabia would be among the top-performers. However, Cunningham (2007) has shown that a minority of banks in SA are Shari’a compliant and that the share of PLS in those that are Islamic is minuscule. Also The Economist noticed that Saudi Arabia is a largely interest-based economy.¹²

¹² The Economist, “How to be Islamic in Business”, 7 June, 2007

There are three more groups of Middle-Eastern Islamic banks that could not be included in the quantitative analysis.

The first group are banks that call themselves Islamic, but offer only mark-up instruments (different combinations of *murabaha*, *ijara*, *istisna* and *salam*) while PLS products are completely missing from the offered services. This is the case of ABC Islamic Bank (2008) and UBS Bank (2008) in Bahrain, Kuwait Finance House (2000-2006) or Emirates Islamic Bank (2005-2006).

The second group are banks that do offer PLS products, sometimes even at a very high proportion of their total assets. However, upon closer examination it is revealed that their products are altered by additional conditions that violate the very principles of PLS instruments. For example Al-Amin Bank (2003) in Bahrain reported *mudaraba* at almost two thirds of the bank's total financing. However, the bulk of *mudaraba* financing went to affiliated companies that issued guarantees on repaying the principal plus profit, again violating the fundamental principle of risk sharing. Shamil Bank (2008) in Bahrain, on the other hand, offers *mudaraba* with "profit rates" specified as fixed percentage (i.e. interest).

Third group are banks that either have been established recently and hence do not have data yet (e.g. Syrian Cham Bank established in 2006 or Emirates Global Islamic Bank established in 2007), banks that provide only old annual reports and not the recent ones (e.g. Islamic bank of Yemen for Finance and Investment has last report from 2003),¹³ banks that for whatever reason do not publish Annual Reports online at all (Al Baraka Banks in Lebanon or Sudan), or banks that do publish reports, but do not break down the figures meaningfully for our purpose (Jordan Islamic Bank 2006, Faisal Islamic Bank in Egypt 2003-2006).

While banks in the third group have no bearing for my findings, the cases in the first two groups further reinforce my point that Islamic banks do not use PLS according to their own claims.

¹³ Nevertheless, the share of PLS on total assets of Islamic Bank of Yemen were 5.6% and 3.7% in 2002 and 2003, respectively, which is consistent with our general finding about the very low level of PLS usage.

3.3.2 Southeast Asia

In many studies on various aspects of Islam, the Middle East seems to be somewhat more in focus at the expense of Southeast Asia (at least in Europe), despite the fact that the world's most populous Muslim country is Indonesia. Indonesia and Malaysia are often discounted as not being part of the "core" Islamic world. Southeast Asian Islamic banks are often criticized for overly liberal interpretations of *Sharia* (e.g. El-Gamall 2000: 5, Obaidullah 2005:105). An expectation might thus arise from this stereotype, that the share of PLS instruments will be trailing behind the already low percentages that we have seen in the Middle East. Certainly, our two Malaysian Islamic banks seem to support such hypothesis, as they are among the lowest-performing in terms of PLS usage in the whole sample.

Bank Islam Malaysia, specifically, is one of the older Islamic banks (established in 1983). BIM was until recently specific in that it offered interest-free *Sharia*-based 'benevolent loans' (*qard*) at about 2-4% of total assets, unmatched by other Islamic Banks. As of 2005, though, *qard* is no longer reported. Apart from standard mark-up instruments, BIM offers a special repurchase transaction called *Bai Al-Inah*. In it, the client sells an asset to the bank and the bank immediately sells the asset back to the client at a higher price to be paid later. Obviously, this is nothing else than a regular money loan on a fixed interest, disguised by selling an asset back and forth. The other Malaysian bank CIMB Islamic (2007) started offering a product based on the same principle in 2007. This instrument is widely criticized by Islamic scholars as *Sharia* non-compliant and BIM does not even advertise it on its website (though it does report it in Annual Reports).

If Malaysian banks play into the aforementioned stereotype of laxity in application of *Sharia*, the two Indonesian banks are truly astonishing. Both of them are clearly the top-performers in the whole sample. Bank Muamalat is the only bank in the whole sample that matches our criterion of PLS share on total assets. Our findings are furthermore corroborated by a lengthy study on Islamic banking in Indonesia by the Central Bank (Bank Indonesia 2005). The study shows that the share of Islamic financing in Indonesia grew from roughly a quarter in 2000 to three quarters of assets in 2005 and the share of PLS instruments rose from 10% to 25% in the same period.

The outstanding results of Indonesian Islamic banks are somewhat moderated by the fact that despite being the biggest Muslim country, Indonesia has only three Islamic banks altogether. It appears as though the Islamic banks focus on a specific market segment (pious Muslims), which in turn forces them to uphold high standards of Sharia compliance to preserve that distinction.

3.3.3 Iran and Pakistan

Iran and Pakistan are both special cases, because they share the experience of government-led “Islamisation” of the economy. However, they differ in the pace with which the change has taken place (Khan and Mirakhor 1990). Economic “Islamisation” in Iran was a part of the political agenda of the Islamic Revolution and had a more devastating effect. Pakistan, on the contrary, proceeded gradually in phases and the process is still underway (State Bank of Pakistan 2008).

Let us briefly examine Pakistan first. As Islamic banks are backed by favourable government regulation, we would certainly expect high ratios of PLS-based instruments. Such expectation is wrong, though, as only one bank (SC Modaraba)¹⁴ reached 10% at least once in its history while the other two banks (Meezan and Al Baraka) trail behind with a scant one percent. Meezan furthermore increases its PLS proportion by *diminishing musharaka*, which is not a real PLS, but disguised mark-up instrument.

The situation in Iran seems similar. Despite the enforced “total Islamisation” of Iranian economy, Iranian banks (unlike their Middle Eastern counterparts) do not dedicate many pages to glorifying Islamic financing and explaining its superiority in their annual reports. In fact they barely make any reference to Islam at all. Instead, they typically focus on very secular economic or technocratic issues.

CIA World Factbook is perhaps unsurprisingly critical about the Iranian economy, but what certainly is surprising is that one of the Iranian banks cites CIA’s criticism on its own website: “Iran’s economy is marked by a bloated, inefficient state sector, over reliance on the oil sector, and statist policies that create major distortions throughout. Most economic activity is controlled by the state” (Saderat 2008).

¹⁴ Standard Chartered Modaraba, despite its name, in fact does not offer *mudaraba* at all. The title means that SCM and another company from a big transnational family Standard Chartered are grouped together on a partnership (*mudaraba*) basis (SC Modaraba 2008).

Analysis of PLS and mark-up instruments ratio of Iranian banks was difficult, as they do not even break down their assets according to these criteria. I used the balance sheet item “Investments and Partnerships” that most closely resembles PLS instead. Similar to Pakistan, two out of three banks (Refah, Sepah) barely reach one or two percent share. The third bank, Parsian (2006) reports much higher (but still low) 15 percent of PLS on total assets. Surprisingly though, in its annual report Parsian also openly operates with interest, both received and paid. And a closer look at the description of credit facilities offered in the form of partnerships reveals that Parsian charges interest and requires the applicant to pay for any extra costs and contingency expenses of the project (Parsian, 2008). Such agreement resembles a regular interest-based business loan rather than genuine partnership financing.

Another bank, which openly reports income from interest is Bank Refah (2004) and also London-based Persia International Bank (2007), which is a joint venture of two major Iranian banks Mellat and Tejarat.

In sum, Iranian banks in general do not seem to be very enthusiastic and genuine about the ban on interest like the Middle-Eastern banks. Quite the contrary, they seem to minimize the compliance-costs by just labelling interest as “profit rate” or “rate of return,” loan as a partnership and formally adjusting accounting practices rather than transforming the substance of their products toward real PLS. Iranian banks seem to be playing parts in a gigantic theatre orchestrated by the Iranian Central Bank, which caps the annual “rates of return” of the commercial banks, but itself is excluded from the ban on interest when financing government debt (Ariff, 1988).

3.4 Summary of findings

Although in terms of PLS financing there are outliers in both positive and negative terms, we can say with certainty that Islamic banks still do rely heavily on mark-up instruments. The proportion of PLS-based instruments in most cases remains deep under hypothesised 30% of total assets and I have failed to discover a single bank that used more PLS than mark-up financing.¹⁵ Moreover, in many cases where PLS share exceeded 10 percent it was so due to misleading usage of terms, such as *diminishing*

¹⁵ Even the top-performing Bank Muamalat at its peak reached 41% of PLS (*mudaraba* and *musharaka*) on total assets, but the mark-up instruments (*ijara*) on total assets ratio was 42%.

musharaka. Another common trick is to label as *mudaraba* such a financial operation in which guarantees are issued, violating the very definition principle of risk sharing.

My findings thus perhaps somewhat surprisingly challenge those of Aggarwal & Yousef (2000) who found that Iran outperforms other Islamic countries in terms of PLS financing. According to my own research it appears that forced top-down Islami-sation of the bank sector in Iran was in reality counterproductive: Iranian banks lag behind, and the top-performers are surprisingly Islamic banks in Indonesia, which are often considered too liberal in interpreting Islam. I shall revisit this paradox in the conclusion.

4 Why Islamic banking fails?

At the outset I noticed that Islamic economists claim that Islamic banking based on profit and loss sharing is both more efficient and more moral. I explained that the moral argument lies outside of the scope of this paper and I focused on the efficiency argument. Empirical inquiry provided sufficient grounds to reject this hypothesis—were PLS more efficient, Islamic banks would use it much more, but they do not. Having identified this failure, I would like to look at why that is the case and whether the flaws are of temporary or of structural character. Not too surprisingly, the failure of Islamic banking can be explained with common sense and basic concepts of economic theory.

A. Gafoor (2001), a defender of Islamic banking, maintains:

Broadly speaking, a passive investor has three options: one, deposit in a bank and receive interest; two, buy securities or bonds and receive interest; three, buy shares in a company and receive a dividend. In an Islamic economy, the first two options would be regarded as *riba* (interest) income and therefore prohibited while the last option and the active investment are permissible. On the entrepreneur side, he may finance his project using his own capital, by selling shares in his enterprise, or by borrowing on interest. In an Islamic setting the first two methods are permissible while the last is not.

Presumably not intentionally, Gafoor accurately summarizes the crucial problem of Islamic banking and finance: it reduces individual freedom of choice by forbidding all interest-based methods without providing any functional alternative to them, effectively leaving the individual with only two options: invest on a PLS basis, or not invest at all.

4.1 Inefficiency for individuals

Khan and Mirakhor (1990: 357) suggest that eradication of interest will not necessarily reduce savings. On the contrary, if profit rates will be high enough, savings might actually increase. This argument, however, is flawed. While some market actors may be willing to allocate their capital into a riskier PLS investment, risk-averse individuals are deprived of the possibility of a safe fixed return (interest). Being stripped of incentives, they have no reason to deposit their savings at a bank. In other words, risk-averse actors are as a matter of fact forced to accumulate their wealth in cash. There is thus no reason to think that after abolishing interest, risky PLS instruments would experience a boom. Those who were willing in expectation of higher reward to invest in riskier PLS instruments have already done so. Those who deposited their savings on interest-based saving accounts were presumably risk-averse and only a fraction of them would move their funds to PLS investment. Most would choose not to invest at all. The Islamic system in fact results in precisely the opposite to what it seeks to achieve—capital circulation rather than accumulation.

A study by Presley and Sessions (1994: 587) suggests that “[*mudaraba*] under certain conditions, will act to raise the level of capital investment in the project.” This can of course be true. Similarly Usmani (1998) says that particular problems, such as dishonest clients “should not be taken as a justification, or as an excuse, for rejecting the whole system of *musharakah*.” That reality is a misunderstanding. Criticism of Islamic banking does not imply criticism of PLS methods as such. PLS instruments, such as *mudaraba* may be perfectly suitable under certain conditions (esp. high level of confidence). The real problem lies in eradicating other than PLS instruments thus leaving individuals with no choice under such conditions, where PLS is not applicable.

4.2 Inefficiency for banks

Similar problems arise for the bank as a lender. The bank, deprived of the possibility of lending out money on a fixed interest rate, incurs substantial additional costs on in-depth risk assessment that would not be necessary on an interest-based loan. While for specialized investment banks or private equity funds PLS investment (joint-venture) may indeed be the most efficient form of investment, in most other cases, prohibition of interest-based loan creates inefficiency. Moreover, these additional costs will be relatively higher for small investments, thus harming particularly small businesses. That contradicts another goal of Islamic banking: better accessibility of capital to small businesses.¹⁶

Finally, as Kuran (1995) and others have pointed out, banks operating under a profit and loss sharing mode face higher risk of moral hazard (deceit, information withholding and profit diversion) on the part of the entrepreneurs trying to reduce the bank's share on profit. In most countries Islamic banks compete with conventional banks. Hence, entrepreneurs will tend to choose a conventional bank when they expect high profit (instead of sharing it they will pay lower fixed interest), while to Islamic banks will go those with low expected profit (the bank will bear the loss, or a bank's proportion of the profit will be lower than would be the interest).

Some proponents of Islamic banking are aware of some of the problems following the ban on interest and suggest some counterarguments. Usmani (1998), for instance, claims that the increased risk of PLS investing can be alleviated by better risk assessment and diversification. The problems with dishonesty may be countered by a "well-designed system of auditing" and uncompromising punishments. That is, of course, true, but Usmani misses the point—these measures are exactly the additional costs that render Islamic banking less efficient.¹⁷

¹⁶ Weberová-Babulíková (2001) points out that in order to assess the risk, banks will require accurate information from the investment-seeking businessman. Since common small entrepreneurs in the Muslim world are often illiterate and incapable of comprehensive book-keeping, they will less likely find funding for their projects.

¹⁷ Usmani's argument is like arguing that the risk of driving a less safe car instead of a safer one can be mitigated by fastening the seatbelts. Seatbelts will indeed increase safety, but that applies to both cars, so it will still make more sense to choose the safer car. Islamic banking here is clearly disadvantaged. Another parallel with cars comes to mind here. As Sam Peltzman (2007) showed on Auto Safety Regulation, a newly imposed regulation tends to be partially or even completely offset by its

4.3 Internal inconsistency

Third critical point I would like to raise about Islamic banking and economics as well is its internal inconsistency. Islamic economics rests on vague grounds. For example profit of a businessman is acceptable, as long as it is “not excessive.” Workers are to be paid “fair” wages, and social stratification is acceptable to a “reasonable” degree. Vague definitions may in fact be advantageous, since they allow for flexible adjustment according to the circumstances—after all Western law also operates with similar terms. The problem is that Islamic conservative religious authorities tend to monopolize the interpretation of these principles, preventing the needed flexibility.

Proponents of Islamic economics often refer to the idealized early Islamic community (*umma*).¹⁸ Along with the Qur’an, actions of the prophet Muhammad (recorded in a collection of stories called *Hadith*), also serve as guidelines for Muslims. Liberal Muslim scholars encourage Muslims to re-interpret the meaning of the stories and apply them to contemporary issues with their own individual reasoning (called *ijtihad*). On the contrary, conservative Muslims insist that what is contained in *Qur’an* and *Hadith* is to be obeyed literally in the light of traditional interpretation. Since modernity constantly brings new challenges, their rigid interpretation is bound to produce numerous mutually inconsistent interpretations and in some cases even contradicting authoritative religious rulings (*fatwas*).

An example of such controversy is the debate on private property in Iran captured by Behdad (1995: 203). One interpretation maintains that there exists no scarcity of resources, as God provided infinite amounts of those and their scarcity in the real world is caused by “coercive social relations”, private property being the major one of them. An opposing interpretation holds that the state of infinite resources in the

unintended side-effects. The impact is therefore uncertain and even a very “well-designed system of auditing” is unlikely to lead to the desired outcome.

¹⁸ Labib (1986:80) calls this era *Pax Islamica*: “Islamic trade reached from Gibraltar to the Sea of China. The voyages of Christians, in contrast, were limited to modest coastal journeys...” However, Labib also shows that even in the idealized medieval Islamic community, interest was quite common: “Interest and usury were legally prohibited; however they were customary. Usury and excessive profit played an important role in Islamic capitalism. (...) Even Caliphs, Sultans, and Emirs received loans carrying too high an interest rate.”

Qur'an refers to the era after the return of the Hidden Imam.¹⁹ In the current real world, resources are limited and private ownership is thus legitimate. Another example are two contradictory rulings on indexation as a tool to counter inflation: one fatwa forbids it, whereas another one requires it (Kuran 1995:165, see also El-Gammal 2000:33).

Discord remains at the very heart of Islamic banking. While most Islamic thinkers seem to agree that interest equals usury (*riba*), Rector of Al-Azhar Dr. Tantawi issued a *fatwa* in 2002, which says interest is permissible on account of mutual consent and benefit of eradicating uncertainty and moral hazard. In other words not all interest is necessarily usury—only the evil abusive part of it used on others in need is banned (El Gamal 2003: 9-12). Although, as has been shown, informally practiced in reality, this view still officially remains a controversial taboo and Tantawi's fatwa was hastily rebutted by Islamic Fiqh Institute in Qatar in 2003 (El Gamal 2003: 13).

5 Conclusion

At the outset of this paper I have outlined the concept of Islamic banking based on profit and loss sharing and its claimed superiority. I have then conducted an empirical study and established that in reality Islamic banking does not deliver what it promises, being overwhelmingly dependent on interest-like mark-up instruments. I have suggested that the reason for this underperformance is that contrary to the claims of the Islamic economists, abolition of interest creates inefficiencies. Banks realize that and in practice either use various techniques to disguise interest or claim that prohibition of usury does not cover reasonable mutually agreed interest rates. In the formal public debate, though, interest remains taboo: "To be recognized as an Islamic economist, it is not sufficient to be a learned Muslim who contributes to economic debates. One must be opposed in principle to all interest" (Kuran 1995:157).

Why is that the case? Farooq (2005) suggests that it is because "Islam in general has become a victim of an overly legalistic approach, where form has overtaken the spirit and substance" and I concur. Islamic banking and Islamic economics is in-

¹⁹ Eschatological concept of Shi'a Islam: the Hidden Twelfth Imam will return and lead the humanity to the last apocalyptic battle and salvation.

tended to present a consistent economic paradigm based on Islamic values. But since Islam is a living and internally diverse doctrine, there is no uniform set of values upon which to build. As I have shown, there is not even a clear consensus whether any interest should be prohibited or not. Islamic banking based on prohibition of interest is merely one of possible interpretations of Islam. Individuals and particularly banks do not necessarily see interest as inefficient or immoral, but they are led to believe it is un-Islamic thus propelling a “guilt-ridden Islamic subeconomy” (Kuran 1995). In reality banks offer products more or less obviously based on interest and clients use them, but formally interest is not involved by careful wording of the contracts. This, in turn, it is criticized by Islamic economists as circumventing the key principles of Islamic banking. Islamic economists fail to see or do not want to see that the very principles of the system are ill and therefore their circumvention is inevitable. Forcible imposition of Islamic banking on all Muslims is a purely political act, not very different from imposing a socialist utopia by force and regardless of the number of victims.

The “*qui bono?*” question remains to be answered: Who has the motive to perpetuate such an inefficient and economically flawed system? On one side of the equation are the banks and especially their Shari’a boards. These lucrative posts are often taken by prominent Islamic economists, who at the same time fuel the whole discourse on Islamic economics, and their “dual role” was already criticised by, for instance, El Gamal (2003: 2). The banks veil their questionable practices and resist attempts for independent external auditing (Al Nasser 2008), because that would reveal that the real level of Shari’a compliance is much lower than publicly presented.

But why do the customers participate? There are two reasons. First, because they have to—there is no alternative. The most obvious example is Iran with its top-down imposition of Islamic banking. Second, because they want to—they simply believe Islamic banking is the right way. That is probably the case of many Southeast Asian or Middle-Eastern Muslims. Their belief that God banned interest is a perfectly sufficient reason to participate on Islamic banking. Although the Islamic banks are less efficient and disadvantaged to their conventional competitors, it is a sacrifice the believers are prepared to make, because it is compensated by greater (intangible) benefits.

My research has indicated that the real level of compliance with Shari'a is highest in the most liberal Muslim country (Indonesia). The reason probably is that the clients that seek Islamic banking do so in good faith, therefore requiring genuine Shari'a-compliant products. The Middle East seems to be in the middle, with heavy reliance on mark-up and disguised interest, but with publicly displayed affection about the moral superiority of Islamic banking. This public image may be simply a marketing tool to capture a specific market segment of pious Muslims, who however do not take the pain to inspect the real level of compliance with Shari'a in depth. The lowest adherence to the principles of Islamic banking seems somewhat paradoxically be in the countries where Islamic banking is enforced by the government as a part of its political agenda (Iran). By forcing all banks to become Islamic, the Islamic specificity and genuine motivations were lost.

The differences among these three groups indicate that the more an agenda is imposed and enforced from the top, the more it becomes a caricature of what it ought to be and the less people feel attracted by it. The most conservative Muslim governments that imposed Islamic banking by force have, paradoxically, most contributed to its failure.

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Note: All Internet sources listed in this section have been verified as of 1 November 2009.

