GSC Advanced Research and Reviews
eISSN: 2582-4597 CODEN (USA): GARRC2
Cross Ref DOI: 10.30574/gscarr
Journal homepage: https://gsconlinepress.com/journals/gscarr/

(REVIEW ARTICLE)

Ethical entrepreneurship: Islamic financial principles for Small and Medium Enterprises (SMEs)

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GSC Advanced Research and Reviews, 2024, 18(02), 059–066

Publication history: Received on 20 December 2023; revised on 03 February 2024; accepted on 05 February 2024

Article DOI: https://doi.org/10.30574/gscarr.2024.18.2.0035

Abstract

Islamic ethics prescribe its followers to zealously guard their behavior, words, thoughts, and intentions and observe certain norms and moral codes in their financial transactions; in their social affairs; and in private and public life. The unique feature of the Islamic ethical system is that it permeates all spheres and fields of human life. Islam therefore has its own distinctive value-based ethical system for finance dealings. It prescribes certain specific guidelines governing finance ethics, which are dictated primarily by the notion of *halal* (lawful or permitted) and *haram* (unlawful or prohibited) as per Islamic jurisprudence (*fiqh).* The current global economic meltdown is a clear revelation of the shortcomings of the conventional financial set-up and the weakness of self-designed system devoid of spiritual and divine guidance, hence the yearning and desire for a socially just financial system by conscious individuals and corporate bodies. The assertion that Islamic financial system is only distinguished from other economic systems in its emphasis on interest free and other usurious transactions coupled with the fact that many concepts are springing up contending with the Islamic financial system inform the need to study the system within the context of Islamic ethical principles. This paper is therefore out to articulate the ethical principles of financial institutions as enshrined in the Qur'an and the Sunnah of the Prophet so that Islamic financial system will not lose focus and to avoid being carried away by the flamboyant and excessive profits and surpluses of the conventional financial institutions.

Keywords: Islamic ethical principles; Islamic financial system; Sharia; Halal(lawful); Haram(unlawful); Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

1. Introduction

Islamic banking is also referred to as Islamic finance or Shariah-compliant finance. It refers to finance or banking activities that comply with Islamic law. There are many differences between Islamic and mainstream finance, but two of the most important are the methods of sharing profit and loss, and the prohibition of the collection and payment of interest by lenders and investors. Shariah also prohibits taking interest on loans. Islamic banks make a profit through equity participation, which requires a borrower to give the bank a share in their profits, rather than paying interest (Abdel-Magib, M.F., 1981).

1.1. Ethics in Islamic financial industry

The financial crises have spurred a rethinking not only of the assumed stability and resilience of financial markets, but also of the role of ethics in guiding and, indeed, shaping economic and financial transactions. There is widespread acknowledgement of the loss in trust in the financial sector. There are questions of the financial sector's relevance in an environment of persistent low growth and high unemployment.

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As a remedy to these various ailments, the focus is on restoring integrity and trust in financial institutions and market players. A more inclusive finance is also being sought. This is a profound development, for it represents a transformation of the intellectual lens through which policy makers and analysts have long viewed the relationship between ethics and finance, or ethics and economics (Ariff, Mohamed (2011).

Where does Islamic finance stand in this respect, that is to say, in relation to the role of normative ethics to business and economic transactions? In viewing the moral and ethical underpinnings of Islamic finance it is useful to recall two distinct approaches to normative ethics. First, that ethics is about duties, regardless of their consequences. This is the deontological, duty-bound Kantian view. The second viewpoint, the consequentiality or utilitarian view, stresses the importance of evaluating the consequences of one's actions. These two viewpoints are not mutually exclusive, or need not be.

Thus, Islamic finance comprises a system of ethics in which both duty and concern about consequences feature prominently through their joint presence and interaction. Islamic finance recognizes the material usefulness of finance, whilst simultaneously subjecting it to higher overarching objectives that give intrinsic value to ethical and moral conduct those accords with the goals of the Maqasid Al Sharīʿah (Ariff, Mohamed and Munawar Iqbal (eds) (2011).

Indeed, as the IFSB noted in its Islamic Finance and Global Financial Stability Report in 2010, published jointly with Islamic Development Bank and Islamic Research and Training Institute, "Islamic finance derives its key strengths from its inherent underlying principles." The report, prepared under the leadership of Dr. Zeti Akhtar Aziz, the governor of Bank Negara Malaysia, elaborated the principles, including the prohibitions against unethical or unlawful conduct, and the goals of social justice that are key features of the "embedded governance" that characterize Islamic finance (Billah, MohdMa'sum (2007).

In terms of normative ethics, Islamic finance thus encompasses an approach that is both consequentiality as well as deontological. There is a duty to observe high ethical standards and a corresponding requirement to take into account the wider impact of the transactions financed. This view of ethical conduct, and of wider accountability, as envisioned by Islamic finance thus stands somewhat removed from the notion of a firm that needs only to maximize profits for its shareholders without regard to the social or other consequences of its actions. In this latter example, which has been paradigmatic of much but not all of mainstream economics and finance, the duty that a firm has is only to its shareholders, and firms need concern themselves with nothing else (Zaman, Asad (2015).

The recent issuance of "green" and "social responsibility" Sukūk (Islamic bonds) points to the very real gains from this convergence. Indeed, there are considerable benefits in terms of greater relevance and scope to be achieved by Islamic finance, in augmenting its negative-screening process so that Sharīʿah compliance, and financial scrutiny, sets the stage for use of the social "impact" criteria, something that is a feature of the social investment industry. This is a view that has much merit, as does the point made by the World Bank that Sukūk can serve as a bridge between the worlds of Islamic finance and that of responsible investment (Visser, Hans (2019).

The underlying issue, however, is the critical importance of "norms of ethical conduct" and of adherence to criteria and institutions that will strengthen compliance to these norms. A reputation for compliance with such norms is the key (Zahid, Syeda Nitasha and Imran Khan (2019).

2. Theoretical framework

Islamic finance has emerged as an effective tool for financing development worldwide, including in non-Muslim countries. Major financial markets are discovering solid evidence that Islamic finance has already been mainstreamed within the global financial system – and that it has the potential to help address the challenges of ending extreme poverty and boosting shared prosperity (Yasseri, Ali (2002).

What are the fundamental principles that shape the Islamic financial system?

2.1. Principles of Islamic Finance

Islamic finance strictly complies with Sharia law. Contemporary Islamic finance is based on a number of prohibitions that are not always illegal in the countries where Islamic financial institutions are operating (Ayaz, Mohammad and Mohammad Tahir Mansoori (2017).

Shari'a Law must develop a distinctive corporate culture, the main purpose of which is to create a collective morality and spirituality which, when combined with the production of goods and services sustains the growth and advancement of the Islamic way of life. The impact the divine law has on the practice of finance is evident. Shari'a law has guidelines on the types of activities that are permitted within a financial institution if it is to be considered 'Shari'a compliant.' Shari'a prohibits a financial institution from investing in or supporting businesses that deal in the sale or production of pork or alcohol; nor can the institution be involved with businesses that profit from gambling operations. In addition, there are several key aspects of Islamic financial institutions, which set them apart from their western counterparts (Wagemakers, Joas (2016).

2.2. Baseline of Islamic Finance

(Surah Al-Ma'idahAyat 90) O you who believe! Intoxicants (all kinds of alcoholic drinks), gambling, Al-Ansab, and Al-Azlam (arrows for seeking luck or decision) are an abomination of Shaitan's (Satan) handiwork. So avoid (strictly all) that (abomination) in order that you may be successful.Shaitan (Satan) wants only to excite enmity and hatred between you with intoxicants (alcoholic drinks) and gambling, and hinder you from the remembrance of Allah and from As-Salat (the prayer). So, will you not then abstain?

And obey Allah and the Messenger (Muhammad SAW), and beware (of even coming near to drinking or gambling or Al-Ansab, or Al-Azlam, etc.) and fear Allah. Then if you turn away, you should know that it is Our Messenger's duty to convey (the Message) in the clearest way.

(Surah Al-Imran Ayat 130) O you who have believed, do not eat riba, (i.e., usury; interest and other unlawful gains) doubled (and) redoubled, and be pious to Allah that possibly you would prosper.

(Sura Al-Baqarah from 275 to 281) 275. Those who eat Ribâ(usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitân (Satan) leading him to insanity. That is because they say: « Trading is only like Ribâ(usury) , » whereas Allâh has permitted trading and forbidden Ribâ (usury) . So whosoever receives an admonition from his Lord and stops eating Ribâ (usury) shall not be punished for the past; his case is for Allâh (to judge) ; but whoever returns [to Ribâ (usury)] , such are the dwellers of the Fire - they will abide therein.

276. Allâh will destroy Ribâ (usury) and will give increase for Sadaqât (deeds of charity, alms, etc.) And Allâh likes not the disbelievers, sinners.

277. Truly those who believe, and do deeds of righteousness, and perform As- Salât(Iqâmat- as- Salât) , and give Zakât they will have their reward with their Lord. On them shall be no fear, nor shall they grieve.

278. O you who believe! Be afraid of Allâh and give up what remains (due to you) from Ribâ(usury) (from now onward) , if you are (really) believers.

279. And if you do not do it, then take a notice of war from Allâh and His Messenger but if you repent, you shall have your capital sums. Deal not unjustly (by asking more than your capital sums) , and you shall not be dealt with unjustly (by receiving less than your capital sums)

280. And if the debtor is in a hard time (has no money) , then grant him time till it is easy for him to repay, but if you remit it by way of charity, that is better for you if you did but know.

281. And be afraid of the Day when you shall be brought back to Allâh. Then every person shall be paid what he earned, and they shall not be dealt with unjustly.

3. Literature review

3.1. Distinctive Features of Islamic Finance

The first and most contradistinctive feature of Islamic finance is; there is no concept of the time value of money. A dollar is worth the same today as it is to someone three months from now. This is in stark contrast to the western view of money – a dollar is worth more to me now than it is three months from now. According to modern (western) finance theory, for those three months, I could have that dollar sit in a bank account and earn interest for three months so that once three months have passed; I will have more than a dollar. Therefore, when I am lending money to someone and

not getting it back for a period a time, I am to be compensated by the borrower for the opportunity cost of not receiving interest from that money (Ünal, Murat (2011).

Second, and closely linked to not having a time value of money is the Qur'an's strict prohibition against the collection of interest or riba, which is sometimes translated also as usury or exploitation. The prohibition stems from the belief that money and profits are earned. The charging of interest is considered unlawful gain, as the financial institution is not really providing any service to the borrower, but is profiting from merely existing and being able to lend money. Some adherents to this belief view people that store their money in banks as hoarders, believing that money is not be socked away in banks earning interest, but should be used to support entrepreneurs and the development of Islamic enterprise (Thomson Reuters (2018).

Third, risk taking or gharar is to be avoided as much as possible. In an Islamic contract the price, quantity, and time of payment must be known prior to entering into the contract with the other party. This practice ties in to some of the other characteristics of Islamic finance, but may have something to do with the culture and customs of the people that settled the area. The Middle East is home to people whose ancestors were nomadic, tribal people, who lived off of the land and never took more risk than was necessary. This history of risk avoidance seems to continue to play out in the region's financial sector. However, it is this aspect of Islamic business that we again see the impact that the teachings of Allah. Life insurance, a familiar financial instrument for most in the West, is shunned by Muslims because Allah knows the time and place of each person's passing, their time on this earth being predetermined. Mechanisms have been developed to help ameliorate the consequences of the risk of death from everyday life, with the focus on zakat, social security, and laws of inheritance that allow people to take care of their family members after they pass (Wilson, Rodney (2002).

The fourth feature of Islamic finance that makes it stand apart from conventional, western finance is the understanding that money is not a commodity. When buying and selling products either on the street or through a business contract, money does not change hands until the item being purchased is physically present. In other words, farmers or car producers cannot sell their produce or merchandise until the goods have reached the intended consumer. This requirement is related to risk (the previous feature of Islamic finance). The demand for payment at delivery helps to reduce any unforeseen price fluctuations between the onset of a contract and the final delivery of the product under contract. The immediate exchange of goods for payment also shields the buyer from any problems that may arise for the seller during production that may delay or interrupt the ability for final delivery (Suleiman, Nasser M. (2005).

The last major requirement for a financial institution to be considered '*Shari'a* complaint' is that contracts provided by these institutions share the risks and rewards of the contract evenly between all parties involved. This idea is again in contrast with the western world's idea of contracts and profits in the financial sector. In the west, the finance is a zero sum game: for every person that earns a positive return or profit from their investment, that profit comes from someone else's loss. Often in Islamic contracts, there will be an equal distribution of positive return among all parties, but losses will be reserved for those most heavily invested financially. Those parties contributing technical knowledge or other non-monetary support are not subject to the loss of an investment if there is one (Thomson Reuters (2017).

These ideals present in Islamic finance lead to the development of 'customized' financial products that mimic those used in the western/conventional financial industry, but are considered to be in accord with *Shari'a* Law. There are major types of debt and equity products from which to draw in order to finance debt as well as invest in the development of business throughout the Islamic world (Abdeen, A.M. and Shook, D.N., 1984).

3.2. Product and Finance offered by Islamic Bank

3.2.1. MURABAHA (Purchase of good by the bank and the reality of its possession).

The most widely used financial debt instrument in Islamic finance is a sales contract known as Murabaha, which is a 'cost plus margin' contract. In this contract, the financial institution, most commonly a bank purchases a product for a client and then charges an agreed-upon fee on top of that price. The bank receives repayment for the total amount (fee plus price of product) from the client over a period of time.

3.3. MUDARABA (Speculation)

The other equity product alternative is a partnership known as the Mudaraba, with one party bringing financial capital, while the other party contributes business knowledge capital to the venture. Rewards are shared among all parties involved on an agreed upon basis. However, only those parties that contribute financial capital suffer financial loss. This is an important distinction for the Mudaraba contract – it places equal importance on both financial and knowledge-

based investment. The parties providing the ideas and ongoing training for the business venture are viewed as equally important to the venture. There is also an understanding that these parties cannot provide initial funding and will therefore, not be able to sustain financial hardship (Suharto, Ugi (2018).

3.4. Investment by MUSHARAKA

Equity based products include the Mudaraba and the Musharaka. These are partnerships in which the parties involved bring either monetary or knowledge-based capital to the table for investment. The Musharaka is a partnership in which both parties contribute money and develop a joint venture for investment. Profits are shared on an agreed upon basis and not always in direct proportion to the amount of financial capital invested (Ali). Loss is shared equally among all parties involved to remain in line with one of the main tenets of *Shari'a* finance: the sharing of risks and rewards in financial contracts (Smolo, Edib and M. Kabir Hassan (2011).

3.5. IJARAH Muntahia Bittam leek

The second major type of debt financing, known as an Ijara, is primarily used for the leasing of large equipment or real estate to businesses. The major difference between the murabaha and the ijara is the method of repayment to the financial institution. As the collateral being provided to the business is so large, the bank may choose to either rent the land or equipment or sell the collateral to the borrower and receive a share of the profits generated from its use.

3.6. TAWARRUQ (Personal Finance Murabaha)

The Tawarruq mode of finance which is practiced by some Islamic banks is a Murabaha sale, whereby the bank buys and owns the commodity and then sells it to the customer through a Murabaha sale. The customer then sells the commodity to third party to obtain cash or appoints a third party, other than the bank, to sell the commodity. Therefore, this type of financing is acceptable as long as there are underlying assets, and the guidelines of sale have been met. Access to cash by selling the commodity owned by the client is not prohibited by sharia, as long as each leg of the transaction is being processed independently between the tree parties (State Bank of Pakistan (2018).

3.7. WAKALA Investment by Agency (Wakala Bil Istithmar)

Some Islamic Banks when they apply the Agency contract. It is not permissible to set a fixed profit for Wakalas/investment agencies, just like Mudaraba. However, giving a profit rate is allowed, given that the agent may commit himself not to enter into any investment that may not yield a minimum level of return.

3.8. Investment by SUKUK (Islamic bonds)

The final debt product is referred to as Sukuk, which is an asset-backed, medium-term note made on specific income-producing collateral, similar to a loan for a business. The bank that makes this type of loan contract does not receive interest payments because they are not allowed in Islamic Finance. Instead, the financial institution receives a return from the performance of the collateral for which the loan was made. For example, client borrowing money for his or her business does not pay the loan back with interest, but uses profits generated from operations to repay the loan to the bank (Soliman, Samer (2004).

3.9. The Sharia Supervisory Board

Sharia Supervisory Board are considered the most important element in Islamic financial institutions, and its role is not confined to supervision and audit, either directly or through the sharia audit department, but also to review all financing and operational transaction before approval. Additionally, they review the implementation of the processes and then issue rulings (Fatwas) and answer queries. Moreover, the sharia supervisory board reviews contracts, documents and templates and approve them and provide sharia and awareness courses (Salem, Rania (2012).

4. Methodology of the study

Research methodology, in this case relied on Secondary data that was sourced from publications by different authors who included Islamic banks archives, scholarly journals, among other sources. Qualitative methods of data analysis and content analysis were used to draw conclusions from the study.

5. Results and discussion

Islamic finance is not only applied to those that have the means to operate in the financial sector, but is also being used to bring the poor into the business world. The 'Islamic Financial Model' divides the poor in the Islamic world into two groups, the employable, bankable group and the unemployable, non-bankable group (Zakariyah, Luqman (2012a).

Those considered to be bankable can gain access to the financial products described above, with some oversight by the financial institution providing the financing. Three main debt and equity products are utilized to assist bankable Muslims in beginning their entrepreneurial endeavors. The Murabaha, or sales contract, can be used, which allows for the borrower to be financially and intellectually assisted by the bank. The bank and borrower decide on the type of business to be developed, the products made, and the suppliers used to help support operations. This is a mutually beneficial activity, as the borrower gets real world business exposure and the bank mitigates its risk by ensuring that it has set the borrower up with a solid business plan as well as strong suppliers that the bank trusts (Khan, W.M., l985).

The Mudarabah may be used to support entrepreneurial businessmen who bring solid ideas for a business to the table, but need financial backing to get started. The equity financing model is perfect in this situation. The bank provides the financing and some business knowledge, but the intellectual expertise resides with the businessman. The traditional Mudarabah contract ensures profits and losses are borne equally. Should the aspiring businessman have all the technical and business knowledge necessary to start his or her business, but lacks the start-up capital, the bank can provide an Ijara for this borrower and lease capital equipment to him alleviating large start up costs of running a business.

As a result of this financial and basic business training provided by the banking institutions, strict oversight of these business operations is maintained. The borrowers are monitored, as in western finance, to ensure continuity of repayment on any business loan. However, in contrast to the western financial model, late payments by these borrowers do not incur late payment penalties. One reason for this leniency is the belief that any financially stressed borrower will be further burdened by such penalties. In addition, the idea of charging additional fees when attempting to alleviate these disadvantaged businessmen, can be seen as exploitation.

For those considered non-bankable, businesses and financial institutions alike provide zakat in the form of food and clothing, scholarships, or the establishment of schooling centers to teach the poor valuable trades so they can become productive members of society. As one of the five pillars of Islam, zakat plays a major role in an individual's life, both personally and professionally. In some parts of the Muslim world, this form of almsgiving is required of individuals and businesses alike. If no such requirement exists for individual contributions, companies must take it upon themselves to set up zakat funds on behalf of their employees (Ashraf, Dawood (2013).

In addition to community investment, financial institutions can also make interest free loans to the poor as a way to give back to those in need. This practice is sometimes linked to banks that earn interest on deposits from customers, a practice forbidden by the Qur'an, so this almsgiving is a way to offset the poor view that may be cast upon these institutions for profiting off of others. This focus on the poor in the Islamic faith is a result of the *Shari'a*, which says the divine law should permeate all aspects of an individual's life and work to improve the Islamic way of life. It is not unusual for businesses in the west to ignore the poor, as the gap between the rich and poor gets greater. The almsgiving and interest free loans are two ways for Muslims to try and close the gap between the rich and poor and to stop the cycle of poverty.

6. Conclusion

It is important to examine how the impact of the Islamic financial model on Muslim countries that previously had no exposure to these financial tools. Generally speaking, the movement of Islamic finance through the Muslim world has provided two overarching benefits to individuals and economies.

First, on an individual level devout Muslims now have an investment and savings vehicle in which to deposit or gain access to funds that had previously been unavailable to them prior to the establishment of *Shari'a* compliant financial institutions, the conventional banking method used was unavailable for religious reasons to Muslims who held tightly to the Qur'an's teachings. This situation left people with virtually no system in which to invest and very few options when it came to accessing cash from a bank.

Now that *Shari'a* complaint institutions have made their way into several Middle Eastern, African and Asian countries, the comparison with conventional banking centers with respect to the cost of borrowing is surprising. The Reserve Bank of India reports that Indian Muslims' credit to deposit ratio was 47%, compared to 74% for non-Muslim Indians. Perhaps the financial institution's adherence to the tenets of Islam helps to make borrowing money from these institutions more cost effective than their conventional counterparts. The International Monetary Fund reports the lack of Islamic financial centers has left Islamic nations without adequate project funding and has slowed the development of commerce in these developing nations.

There is a belief among some that the ability for Islamic banks to flourish in these developing nations is due in part to the fact that poorer nations often cling closer to their religion as a foundation of their way of life. Consequently a financial institution associated with the Islamic faith is an attractive alternative to the western banking centers that may exist in these nations.

The second benefit of the spread of Islamic Finance throughout the Middle East and other Muslim countries is the adoption of shared risk/reward financing. The *Shari'a* compliant financial institutions that are infusing capital into the Middle East, Asia, and Africa serve as 'shock absorbers' against the commodity based cash flows prevalent in that region. For example, one of the major commodities found in the Middle East is oil. The world demand for oil causes prices to rise and fall, creating uncertainty in cash flow levels. The partnerships supported by Islamic financial institutions provide a buffer against volatility as they help absorb losses in downtimes and share profits during the good times. This ability to provide some assurance to investors helps strengthen faith in the system and encourages individuals to invest money and develop industry within their own countries.

Studying the spread of Islamic finance throughout the Muslim world, researchers discovered two salient characteristics about the nature of the country into which this financial system is spreading. The first is that the countries in which Islamic finance has thrived most effectively are those that already contain established western or conventional banking centers. It appears as though the Islamic and conventional banking systems seem to complement each other, rather than serve as adversarial systems. As in any religion, there exists a spectrum of 'devout belief' spanning those who strictly follow the teachings of the Qur'an and the Prophet Muhammad, to those that rarely feel the impact of their faith on a daily basis. In countries where there are both conventional and *Shari'a* complaint banks, there are options for every investor, devout or not, Muslim or non Muslim. This system provides access to capital through a system that fits with individual investors' personal beliefs.

Secondly, the success of the Islamic financial institutions within a country is not tied to the stability of the local government. The Islamic faith has an overwhelming influence on the daily lives of devout Muslims that affects the daily activities of financial institutions. Therefore, the driving force behind the development and operation of Islamic financial institutions is not the practices and laws of humans, but is found in a religion that supersedes human law. As Islamic compliant banks are funded by the followers, local governments can exert little influence the operations of banks. In addition, the prohibition of interest collection forces an Islamic bank to find revenue outside the conventional methods making it less susceptible to interest rate changes

Compliance with ethical standards

Disclosure of conflict of interest

No conflict of interest to be disclosed.

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