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ISLAMIC BANKING: GLOBAL AND INDIAN PERSPECTIVE

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ABSTRACT

Islamic Banking is growing at a rapid speed and has showed unprecedented growth and expansion in last two decades in spite of mismatching of existing financial framework and business practices. The rhythm and the swiftness with which a number of Islamic Banks are coming up across the world have astonished many banking experts. Many international banks like ABN Amro, HSBC, American Express; ANZ Grindlays Bank, Chase Manhattan, Deutsche Bank, Standard Chartered Bank have already opened Islamic Banking divisions across the world especially in Middle East and North African countries (MENA), GCC Countries, Asia, Europe and USA etc. India has the third largest Muslim population in the world, which totals to around 161 million (2011 census), i.e., 13-14 percent of the population. The percentage is much higher in some regions like Kerala and State of Jammu and Kashmir. Islamic Bank is a financial institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic Sharia and to the banning of the receipt and payment of interest on any of its operations. The paper will try to give an insight in to Islamic banking, the various products, present status worldwide and in India.

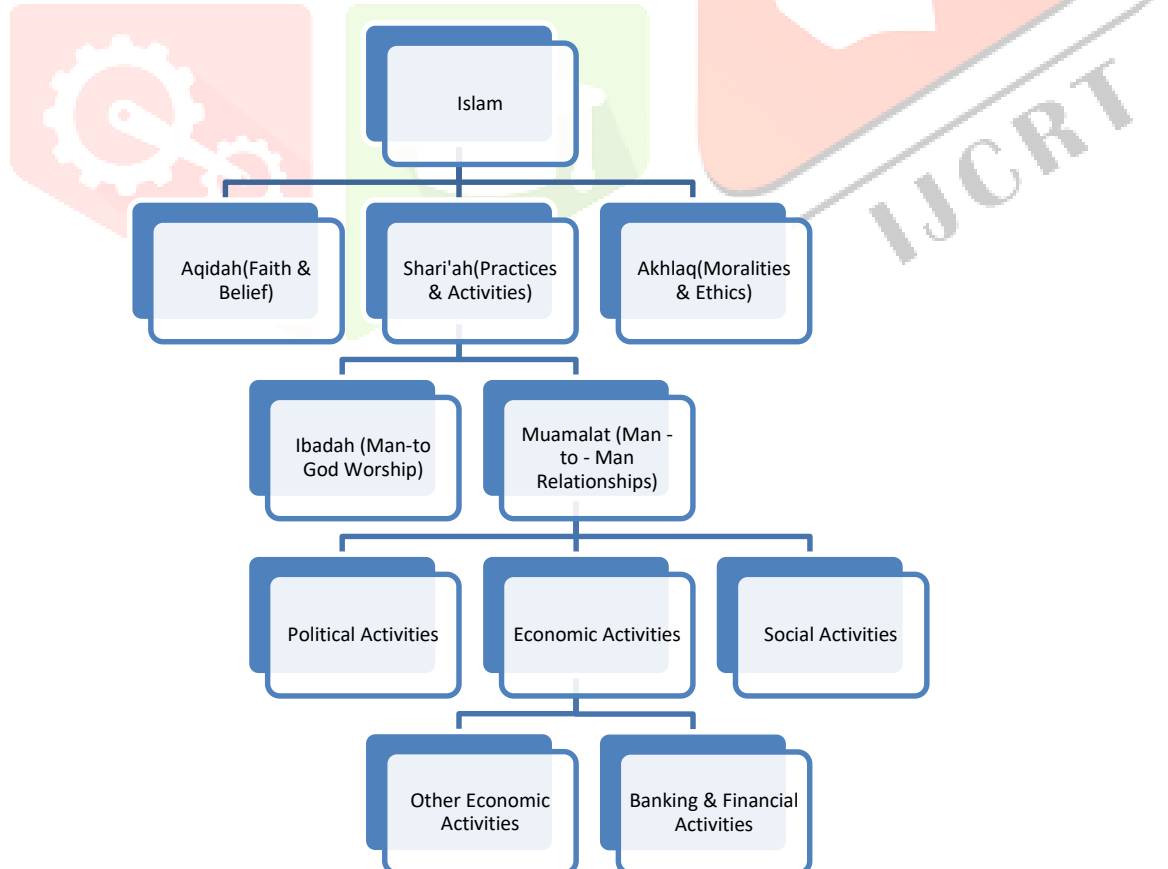
Key words: Islamic Banks, Grindlays Bank, Mudharabha, Musharaka

1 INTRODUCTION

Islamic finance is an integrated, compound and composite field of knowledge that welds together several compartmentalized branches which include Islamic banking, Islamic insurance, Islamic investment, Islamic venture capital and Leasing and Equity funds. Many studies and researches have shown that Islamic finance mechanisms were used in the Muslim world throughout the middle ages in conducting trade and business activities. Islam's body of religious and social laws, sharia, prescribes how a Muslim must run the business. The law forbids (riba) both when lending and borrowing. This is the foremost and the most well known principle of Islamic finance. Investment must be based on shared risk, i.e; making the lender a particular in the business and not a creditor. The crux of Islamic finance is that one must share both risk and reward and investment must be backed by a real good or service.

Turning to the Islamic banking system, one can understand that, Islamic banking financial institutions and products are designed to comply. With the central tenets of sharia and is guided by Islamic economics which is one of the rapidly growing segments of the global financial industry. Islamic banking system is in its developing stage and the concept is being continuously testing and refining. Over the next 20 years, one can see a substantial surge in the Islamic banking globally.

Figure 1 Development of Islamic Finance



Source: www.bankseta.org.za

2 CONCEPT

The core concepts of Islamic finance dates back to the birth of Islam in the 6th century. Islam teaches that Allah is the owner of all wealth in the world, and humans are merely trustees. Therefore, humans used to manage wealth according Allah's command. Muamalat a body of sharia categories the relationship of man with man under three activities.

- (i) Political activities
- (ii) Social activities and
- (iii) Economic activities

The economic activities can be brought under two heads.

- (i) Banking and finance
- (ii) Other economic activities

3 DEFINITIONS

Various organizations and committees have different views on Islamic Banking and Finance. Islamic Banking is defined as banking in consonance with the ethos and value system of Islam and governed, in addition to the conventional good governance and risk management rules, by the principles laid down by Islamic Shariah. **The Organization of Islamic conference (OIC)** defined an Islamic Bank as “ a financial institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic Sharia and to the banning of the receipt and payment of interest on any of its operations.”

According to Islamic Banking Act 1983 of Malaysia, an Islamic Bank is a “company which carries on Islamic Banking business..... Islamic Banking business means banking business whose aims and operations do not involve any element which is not approved by the religion Islam.”To have true financial inclusion in India and meet the goals set out by the government , it is imperative that the Indian Muslim community ...be considered from their actual needs and aspirations perspective...a growing number of Muslims will increasingly exclude themselves from the conventional banking and financial system due to their religious sensibilities and not because of poverty or illiteracy thus further marginalizing their already backward status....Thus it is imperative that Islamic finance be introduced in the country and Muslims be allowed to conduct financial activities as per their preferences...(Saif Ahmed at 29thSkoch Summit on Financial Inclusion , Mumbai 2012).

“Islamic Finance focuses on transparency, cooperative ventures, shared risk, and ethical investing which attracts a wide range of both Muslims and non-Muslims alike. Can you afford to ignore, it is a question for our country not only for Muslims”. “If poverty persists, the poorer, including sections of minorities, could become a national economic liability. Instead of actually participating and contributing to the development process, they will start

acting as a retardation of the development process”. (Wajahat Habibullah, Chairman, National Commission for Minorities (NCM)).

Thus Islamic Banking can be understood as a banking activity that is consistent with the principles of Sharia and its practical application through the development of Islamic economics.

4 HISTORY AND EVOLUTION

The first reference to interest-free finance appeared in 1940s and more serious discussions and debates on fundamentals of Islamic finance took place in 1950s and 1960s. Modern form of Islamic financial institutions has its origin in 1962 when the Malaysian Govt has set up Tabung Haji, a pilgrimage fund board. Despite its impressive growth in other parts of world such as the Middle East, South East Asia (which primarily include Malaysia and Indonesia) and Europe. The search for alternatives to conventional banking in the aftermath of the global financial crisis trained the spotlights on Islamic banking in many parts of the world.

Financial institutions like ABN Amro, HSBC, American Express, ANZ Grindlays Bank, Chase Manhattan, Deutsche Bank, Nomura Securities and Union Bank of Switzerland have in-house Islamic units (Beng, 2004). Now Islamic banking operations exist in about 100 countries. The first bank explicitly based on Sharia principles was established by the Organization of Islamic countries (OIC) in 1974, called Islamic Development Bank (IDB). This bank was primarily engaged in intergovernmental activities for providing funds for development projects running into member countries. Its business model involved fees for financial services and profit sharing financial assistance for projects (Shiyuti, Khairat, Mourtada&Ghani, 2012). The biggest phase of development of Islamic financial institutions occurred in 1980s. In 1985, the High Council of OIC (Organization of Islamic Conference) declared takaful /Islamic insurance as Shariah compliant. The new, wider spectrum of Islamic finance covers not only banking activities but also capital markets, capital formation and other financial instruments and intermediaries.

The biggest change in terms of adaptability came in 1991 when the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established to advice on Islamic finance standards all over the world. Later, the development of uniform standards was supported by other organizations such as Islamic Financial Services Board (IFSB) in Malaysia in 2002. Since then, Islamic finance is spreading all over the world at a tremendous pace from virtual anonymity to becoming a powerful competitive force in the world today (Shiyuti, Khairat, Mourtada&Ghani, 2012)

Figure-3

Progress of Islamic Finance Industry Steady



Source:<http://banksetaconference.org.za>

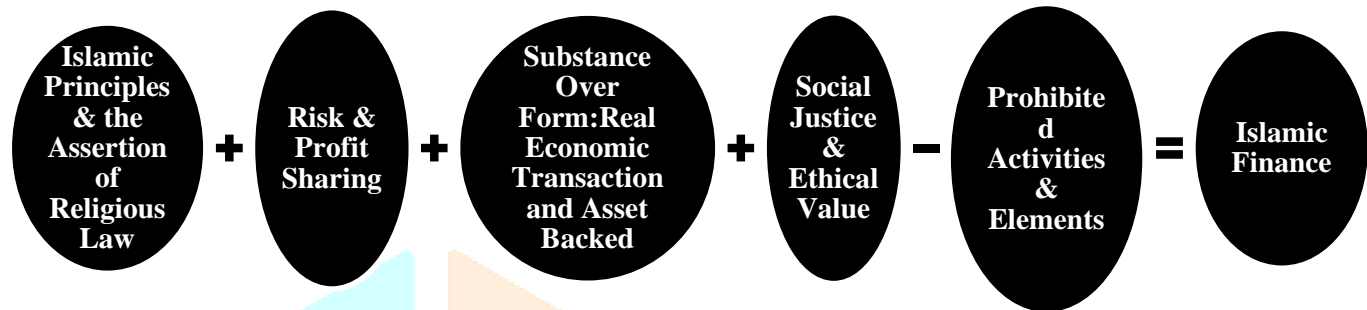
5 THE FIVE PILLARS OF ISLAMIC FINANCE

- Ban on Interest (Riba):** In conventional forms of finance, a distinction is made between acceptable interest and usurious interest (i.e., excessive rates of interest). In contrast, under Islamic law, interest is considered to be usurious and is prohibited. Some question how lenders profit from financial transactions under Islamic law. For instance, in a real estate setting, SCF takes the form of leasing, as opposed to loans. Instead of loaning money to a prospective purchaser, the bank obtains the property and leases it to the sharia-compliant investor, who pays rent instead of interest.
- Ban on Uncertainty:** Uncertainty in contractual terms and conditions is prohibited, unless all of the terms and conditions of the risk are clearly understood by all parties to a financial transaction.
- Risk-sharing and profit-sharing:** Parties involved in a financial transaction must share both the associated risks and profits. Earnings of profits or returns from assets are permitted so long as the business risks are shared by the lender and borrower.
- Ethical investments that enhance society:** Investment in industries that are prohibited by the Qur'an, such as alcohol, pornography, gambling, and pork-based products, is discouraged.

- **Asset-backing:** Each financial transaction must be tied to a “tangible, identifiable underlying asset,” such as real estate or commodities. Under sharia, money is not considered an asset class because it is not tangible and thus, may not earn a return.

Figure 3

Islamic Finance the Basic Equation



Source: www.bankseta.org.za

6 ISLAMIC BANKING PRODUCTS

The Major Islamic banking products are explained below.

Mudharaba:

Customers place funds with the bank which are invested in a variety of assets. Profits are shared between the bank and the customer. Contractually, losses are supposed to be borne by the customer alone although, for commercial reasons, banks are often unwilling to pass the losses along. Superficially, the product resembles a conventional savings or term deposit account. However, because the customer is (in principle if not in practice) exposed to the risk of under-performance in the underlying assets rather than to the bank as counterparty, these arrangements are more like an investment management relationship. In a restricted mudharaba account, the bank creates different pools of assets for its various classes of clients to allow variability in risks, maturities and profitability to match client risk/return appetite. Unrestricted mudharaba accounts freely commingle the bank's own equity with customers' funds and can be invested as the bank sees fit.

Wakala:

As in a mudharaba contract, customers place funds with the bank – but here the relationship is more like a straightforward custody arrangement, in which the bank has the discretion to pay a return but no obligation to do so.

Musharaka:

A private equity transaction, the bank provides finance to a project in return for an equity stake. The bank may or may not play a management role. Losses are shared in strict proportion to the size of the capital contribution, while profits are shared according to a pre-agreed ratio.

Sukuk:

Analogous to an asset-backed securitization, sukuk entitle investors to a share of the profits earned by a pool of underlying transactions which are held in trust by a special-purpose vehicle (SPV). The sukuk originator will transfer exposure to the underlying assets to the SPV by entering into a mudharaba, musharaka or ijarah contract.

Murabaha:

A form of financing often used to finance asset purchases or for consumer loans. The bank buys an item and then sells it to its client at a higher price with deferred repayment terms. The interest that would ordinarily be paid by the client in a conventional loan – and which would constitute the bank's profit – is replaced by the difference between the purchase and the sale price.

Istisna:

A form of financing which works on the same principle as murabaha, with the important exception that the item being purchased does not yet exist. It is typically used for project or construction financing.

Ijarah:

The equivalent of a leasing transaction. In Islamic finance, the owner of the leased asset must retain some of the risks and rewards of ownership. A pure operating lease should normally be acceptable under Shariah. Leases classified as finance leases for accounting purposes may or may not be acceptable under Shariah depending upon their precise terms and the views of the scholars giving the Shariah opinions.

7 GLOBAL OUTLOOK ON ISLAMIC BANKING

Year upon year, the Islamic finance industry posts stellar growth figures. Industry forecast suggest Islamic banking assets with commercial banks globally, will reach \$1.1 trillion in 2012 (2010: \$826bn). The international field of Islamic finance has been growing at an estimated rate of 15% a year. This growth is occurring not only in the Middle East but also in the Western world and in the developing nations of South Asia and Africa. There are now several Islamic financial institutions operating in the UK, Europe, and the USA. Shariah-compliant asset reached about \$400 billion throughout the world in 2009, according to Standard & Poor's Ratings Services, and the potential market is \$4 trillion. Iran, Saudi Arabia and Malaysia has the biggest sharia-compliant assets. Islamic banking is not restricted to Islamic institutions purely. In 1996, Citicorp set up CitiIslamic Investment Bank in Bahrain. Following this precedent, financial institutions ABN Amro, HSBC, American Express, ANZ Grindlays Bank, Chase Manhattan, Deutsche Bank, Nomura Securities and Union Bank of Switzerland now all have in-house Islamic units. Islamic banking operations now exist in about 100 countries, according to Gohar Bilal, a former visiting scholar at the Islamic Legal Studies program of Harvard Law School. In fact, there are currently more than 300 Islamic financial institutions spread over 51 countries, plus well over 250 mutual funds that comply with Islamic principles. Moreover, over the past decade, the Islamic banking industry has experienced growth rates of 10-15 percent per year—a trend that is expected to continue (Solé, 2007). Another source, as per estimates, nearly \$1 trillion is currently being managed by about 400-odd Islamic banks worldwide.

Middle East and North African countries (MENA)

Islamic finance in the Middle East and North African (MENA) countries has now become an important element in their society's development agendas and it is also gaining ground in the financial landscape of the region as well as in the individual countries. It is also a growing business as it caters to the financial needs of the people without conflicting with their social and religious values (Ali, 2011). Several banks are in race to unveil its new customer offerings for MENA customers, in response to growing interest in and customer demand for Islamic finance in the countries and across the regions. In a report from Ernst & Young, Islamic banking assets with commercial banks globally would reach \$1.1 trillion in 2012, a jump of 33 per cent from the 2010 level of \$826 billion. In the Middle East and North Africa, Islamic banking assets increased to \$416 billion in 2010, representing a five year compound annual growth rate of 20 per cent compared to less than nine per cent for conventional banks, Ernst & Young said in a report. "As new geographies open up to Islamic banking, the Mena Islamic banking industry is expected to more than double to \$990 billion by 2015," (John, 2011).

In the backdrop of the fast growing demand for Islamic banking, a group of Islamic financial institutions launched the world's first benchmark for Islamic interbank lending recently as an alternative to LIBOR, or the London Interbank Offered Rate. According to the Dubai Chamber of Commerce and Industry, the collective assets of the eight Islamic banks in the UAE were Dh269 billion at the end of 2010, accounting for around 16.2 per cent of the overall banking assets of Dh1.66 trillion. (John, 2011)

"The market of Islamic finance has reached \$1.3 trillion mark, in which the share of Islamic banking is 77 percent (\$1 trillion), share of Sukuk is 14 percent (\$180 billion), share of Islamic funds 5 percent (\$64 billion) and share of Takaful is 1 percent (\$12 billion) whereas the share of other Islamic financial products like Islamic Leasing, Mudarabah Companies, Islamic Microfinance and Islamic REITs is 3 percent (\$44 billion)." Published in first International Forum of Islamic Banks hosted by Jordan 10/07/2012. (Mughal, 2012)

The growing popularity of Islamic financing and an intensified focus on risk management in the global banking industry are prompting greater awareness of the need for a unified—and appropriate—regulatory regime. In December 2010, the Basel Committee on Banking Supervision (BCBS) issued two documents constituting a reform to the minimum capital requirement for Banks. In fact, this new framework, known as Basel III, is committee's response to the last financial crisis. Islamic Financial Services Board (IFSB), located in Malaysia, has already adapted Basel II framework for Islamic Banks (IBs). In its capital adequacy standard issued in 2005, IFSB has recommended, for the majority of IBs, to adopt the standardized approach in the calculation of eligible capital and risk weighted assets.

Figure-4
Islamic Banking Asset Growth



Source: The World Islamic Banking Competitiveness Report 2011-2012, Ernst and young.

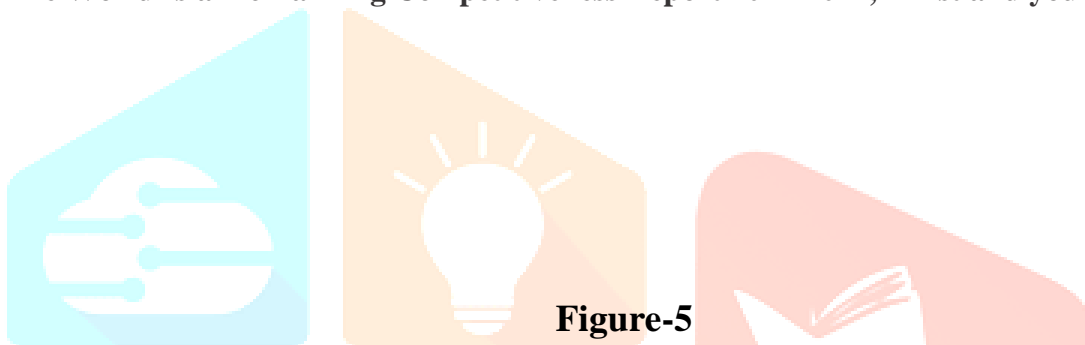
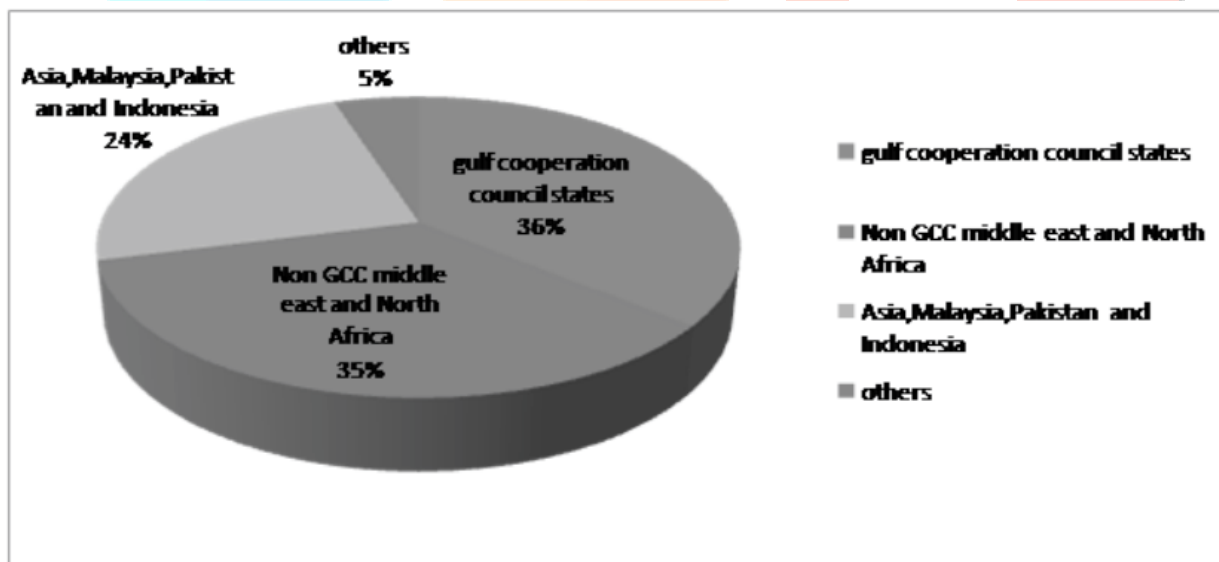


Figure-5

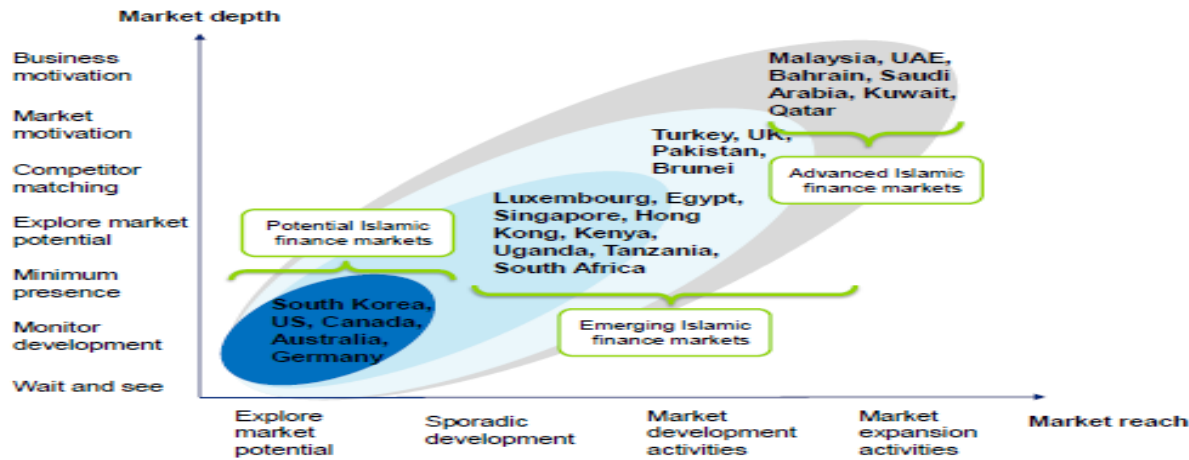


Source: The American Banker

The fast growth economies now form almost half of the global GDP and remain the main contributors to overall global growth. The outlook for Islamic banking in these markets is bright.” Islamic banks are aiming to close the performance gap that currently exists with the overall banking industry. According to Ernst & Young’s report, successful transformation could see the profit pool of Islamic banks rise by an additional 25% by 2015.

Figure-6

Market Potential-Positioned for Growth



Source:<http://banksetaconference.org.za>

7 INDIAN OUTLOOK ON ISLAMIC BANKING

The fact that India has the third largest Muslim population in the world after Indonesia and Pakistan may come as something of a surprise to many people, who wrongly assume that partition in 1947 effectively divided the Muslim and Hindu populations into separate nations – the Muslim-dominated East and West Pakistan (now two states, Pakistan and Bangladesh) and the Hindu-dominated, secular state of India. India has the third largest Muslim population in the world, which totals to around 161 billion (2011 census), 13-14% of the population, although that percentage is much higher in some regions such as in Kerala and the disputed state of Jammu and Kashmir. There are, however, no Islamic banks in India and no conventional banks with Islamic windows. There are statutory and regulatory problems for anyone wishing to set up an Islamic bank in India, but perhaps more problematic is the highly emotional response of those opposing any changes to allow Islamic banking. The emotional issues, which are embedded in India's political history, will be much more difficult to address.

According to M.Y.Khan, former Economic Advisor to Securities and Exchange Board of India (SEBI), Islamic Banks make use of the principle of 'Almudarib-udraib', which means that these banks mobilize funds on the basis of profit sharing and extend the same to the users. Several Indian banks shown inclination to undertake this form of interest free, but profit sharing banking.

With the introduction of Islamic Banking, Indian government will gain diplomatic advantages to make financial dealings with Muslim dominated nations especially to attract trillion dollars of equity finance from gulf countries. The total investment in Infrastructure is expected to be Rs 20, 56,150 crore for the 11th five year plan. Of which Rs. 14, 36,559 crores are supposed to be met from Public Investment and Rs. 6, 19,591 from private investments.

The GCC countries interest in Venture Capitalism and real estate financing can help in infrastructure development in India.

8 RBI AND ISLAMIC BANKING

At present there are no Islamic banks or no conventional banks with Islamic windows operating in India. Although RBI has rejected the concept of Islamic banking, the RaghuramRajan Committee on financial sector reforms in India recommended that interest free banking be initiated for inclusion of economically disadvantaged strata of society who have no access to banking products and services for reasons of faith. The Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.

Except a basic offering like current account, almost no other banking product in India can be modified to meet the conditions of Islamic banking. As a genre of financial services, Islamic banking shuns the very idea of interest rates, and rests on profit-sharing principles. Based on the Shariah law, it abhors the business of making money out of money, upholding the belief that wealth is generated through actual trade and investment. The RBI has not put the report in the public domain. While the final form of the report is not known, from the newspaper reports it can be collected that the members had pointed out how Indian banking laws come in the way of various Islamic banking principles. These are as follows:

Indian banking laws do not explicitly prohibit Islamic banking but there are provisions that make Islamic banking almost an unviable option. The financial institutions in India comprises of Banks and Non Banking Financial Institutions. Banks in India are governed through Banking Regulation Act 1949, Reserve Bank of India Act 1934, Negotiable Instruments Act 1881, and Co-operative Societies Act 1961.

Certain provisions regarding this are mentioned below:

- Section 5 (b) and 5 (c) of the Banking Regulation Act, 1949 prohibit the banks to invest on Profit Loss Sharing basis -the very basis of Islamic banking.
- Section 8 of the Banking Regulations Act (BR Act, 1949) reads, "No banking company shall directly or indirectly deal in buying or selling or bartering of goods..."
- Section 9 of the Banking Regulations Act prohibits bank to use any sort of immovable property apart from private use –this is against Ijarah for home finance.
- Section 21 of the Banking Regulations Act requires payment of Interest which is against Sharia.

As regards to partnership by Islamic banks in a firm, the bank has to make sure that the manager does not avoid his responsibilities or obtain other non-pecuniary benefits at the expense of non-participating partners and ensure the veracity of the profit statements. Monitoring of data about firms in which Islamic bank invests would involve exorbitant cost. However, Islamic banks need to set up monitoring cell to keep them informed of the internal

function of their joint venture. The implication is that banks and entrepreneur have to function very closely. Islamic banking needs to introduce corporate governance with transparent accounting standards. It needs to perform detailed evaluation before embarking Profit Loss Sharing Scheme, which demand a pool of highly trained professionals. The imparting of professional training is costly. Detailed principles are still to be laid down and techniques and procedures evolved to carry them out. It is only after the satisfactory achievement of these that proper training can begin. It is observed that inability to evaluate a projects' profitability has tended to act against investment financing. Some borrowers frustrate the banks appraisal efforts as they are reluctant to provide full disclosures of their business. These exercises are not limited to relatively few large loans but need to be carried out on nearly all the advances made by the bank. Yet, widely acceptable and reliable techniques are yet to be devised. Moreover, the borrowers do not observe business ethics which make it difficult to establish close bank-clientele relationship - a condition for successful Islamic banking.

Adverse selection has been one of the major impediments in the world of Islamic banking. Among the other disincentives from the borrower's point of view is the need to disclose his accounts to the bank if he were to borrow on the Profit Loss Sharing basis. However, many small-time businessmen do not keep any accounts, leave alone proper accounts. And large conglomerates do not like to disclose their real accounts to anybody. The widespread lack of business ethics among certain business community will be another major hurdle in the path of Islamic banking in India. The practices in use by the Islamic banks have evoked questions of morality. Some critics view Sukuk (Islamic Bond) as unIslamic in nature. Others criticize that financing through the purchase of client's property with a buy-back agreement and sale of goods to clients on a mark-up, involved the least risk and are closest to the old interest-based operations. Bai' mu'ajjal (sale with deferred payment) and Murabaha (cost-plus financing) are permitted in the Sharia under certain conditions. What is being done in many countries are fictitious deals which ensure a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This is against the letter and spirit of Sharia.

The BR Act even disallows an Indian bank from floating a subsidiary abroad to launch such products, or offering these through a special window. Thus, the upshot of the findings is that such banking experiment is impossible without a new law or multiple amendments to the BR Act. Another important consideration is the tax procedures. While interest is a passive income, profit is defiantly an earned income which is treated differently. If principles of Islamic banking are incorporated then how does it comply with the tax procedure is the moot question. Further RBI cannot act as the lender to such banks because such accommodation by the monetary authority is also interest based. Islamic banks cannot interact with conventional banks based on principles of interest.

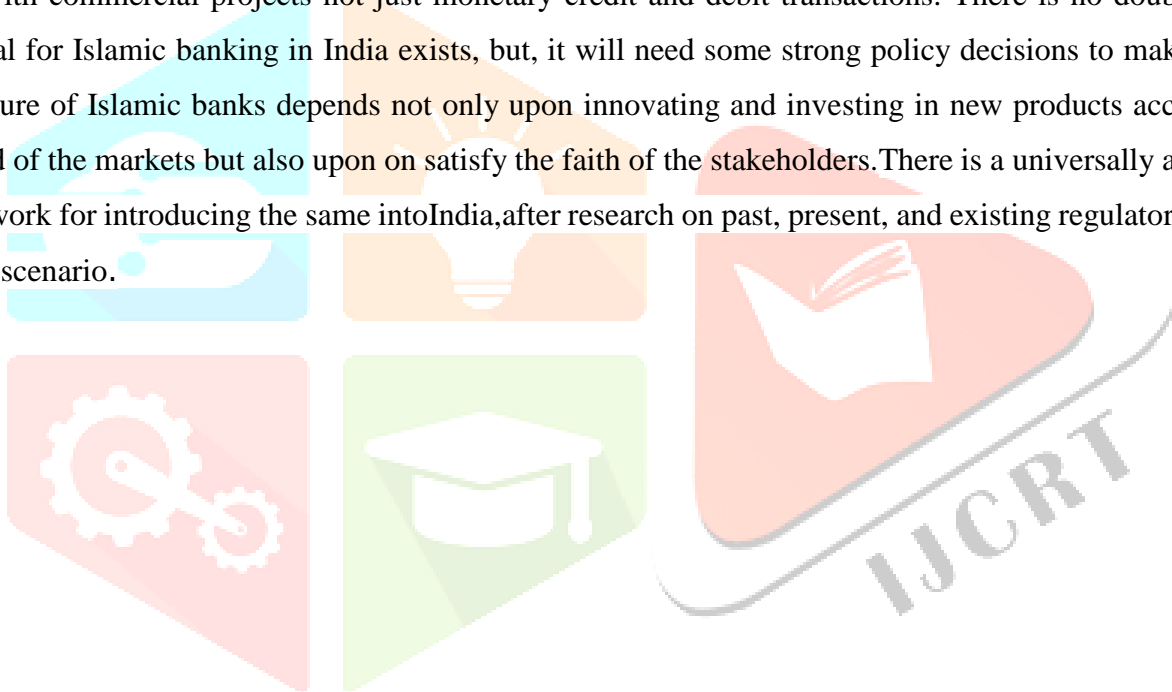
In view of the resilience shown by Islamic banks as compared to conventional banks, government of India should take initiative to amend the laws governing banking sector in India. The position of former governor of RBI Was not encouraging. But the newly appointed governor Dr. Raghuram Rajan has already given green signal to the Islamic banking in India

9 INITIATIVE IN KERALA

RBI has granted permission to start in India Non Banking Financial Company (NBFC) based on Islamic principles. On that basis Kerala State Industrial Development Corporation floated Cheraman Financial Services Limited (CFSL) based in Kochi. CFSL has already received clearances from the RBI, the Securities and Exchanges Board of India (SEBI).

10 CONCLUSION

Growth over the past several years continues to generate optimism for the future of Islamic banking. But as competition ramps up, and early warning signs show growth slowing down, Islamic financial institutions have plenty of work to do. Whether the strategy is to focus on niche positioning, compete with conventional banks head-on or a blend of both sustaining growth will require most Islamic banks to achieve a greater efficiency across the value chain. Islamic banking, however, requires a professional expertise beyond religious belief, because it deals with commercial projects not just monetary credit and debit transactions. There is no doubt that a huge potential for Islamic banking in India exists, but, it will need some strong policy decisions to make it a reality. The future of Islamic banks depends not only upon innovating and investing in new products according to the demand of the markets but also upon satisfying the faith of the stakeholders. There is a universally accepted legal framework for introducing the same into India, after research on past, present, and existing regulatory models and market scenario.



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